مصرف لبنان
BANQUE DU LIBAN

New Challenges of Global Compliance: A Central Banker's Perspective

Raed H. Charafeddine, First Vice-Governor, Banque du Liban
&
Walid Barakat, Banque du Liban

The Fares Center for Eastern Mediterranean Studies
The Fletcher School, Tufts University
October 8th, 2015 | Medford, MA

Table of Contents

I. Introduction: Transformation towards an Evolving Compliance

The global economic-financial governance is set to exercise economic authority by utilizing mechanisms, processes, and institutions to manage the world's economic-financial interests, legal rights, and regulatory obligations, and mediate the differences among them. From this global, macro, and micro perspectives, along with all their transformational loads, the notion of compliance has emerged.

The first of these transformations is what many analysts consider as the embedded cause of the recent financial crisis, i.e. the nature of globalization itself. As the socio-economic connections between various global actors were vastly globalized, many policies were kept restrained in the national context. As a natural consequence of this paradox, the collapse was brought about by the problematic disparities between the interlinked economies and the lack of a global political process that sustains international solutions.[1]

Another parallel transformation is the revolution of information technology and telecommunications that facilitated enormously the transfer of financial assets, creating a tendency towards marginalizing real economy and launching a virtual one, where currency trading and financial speculations are developed aiming at short-term profits. That led to instability in the chaotic international financial markets. As a consequence, the trend towards financial accumulation dominated over productive goals[2]. Adding to the complexity of the scene, three conditions loaded the dice of trading markets in favor of irrationality: the intangibility of goods traded in the financial markets; the debt as a dynamic factor of financial market bubbles; and the flawed method of valuation that supports irrational exuberance in the financial markets. Hence, this paved the way for unprecedented opportunities for invisible and illicit transactions, posing new economic and political threats, causing many countries to be caught between market fundamentalism and global security concerns.

As a consequence to this unprecedented volume and value of activities and as systematic criminalization tends to push illicit activities further underground, perpetuating exclusion, illicit organizations operating in the area of money laundering and financing of terrorism have been seeking to utilize the latest technology in the means of payment and banking services. Accordingly, it has become crucial for the regulatory authorities, in cooperation with banks and financial institutions, to carry out the transformational process of radically modifying the monitoring techniques used and innovating precautionary focused measures aiming at tracing and combating these operations. Hence, an arms race has risen between systematic criminalization and illicit activities on one hand, and compliance techniques and regulations on the other.

Based on the aforementioned, the world of compliance has undergone extraordinary transformations. It has seized from being an area that is predictable, technical, and largely invisible to outsiders to become an unpredictable, politicized, and highly strategic one. Thus, constant regulatory change and heightened regulatory scrutiny have become an integral characteristic of compliance, posing strategic challenges for financial institutions. Furthermore, compliance platforms have been subject to the globalization of regulatory norms, represented by extraterritoriality, international diffusion, and changes in international law and jurisprudence[3].

As a reflection of such transformations, twenty of the biggest banks in the global banking industry suffered more than $235 billion in fines, settlement fees, and provisions since the financial crash of 2008, according to Reuters. Offenses ranged from Libor rigging and currency market manipulation to breaching sanctions, money laundering, and abusive mortgage practices. On a related note, six global banks were fined by more than $5.6 billion last May alone to settle allegations that they rigged foreign exchange markets.

In the following sections, I will address the topic of compliance through first discussing what I view first as the five essential elements of the compliance ecosystem. Secondly, I will dwell on certain backbone requisites that I consider crucial for restraining compliance challenges on the global, macro, and micro levels. Thirdly, I will highlight the Lebanese banking and financial compliance model.

II. Elements of the Compliance Ecosystem

The transformations in the compliance area have resulted in tailoring a multi-perspective ecosystem that encompasses five elements: Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) process that targets systematic criminalization and illicit activities via underground economy; risk management and effective internal control; improvement of international financial stability approaches; corporate governance practices; and global sanctions measures. The implications of these elements spread over several dimensions: the global dimension, the macro - local regulator - dimension, and the micro – individual banking and financial institutions – dimension. This multi-perspective and multi-dimensional ecosystem is ideally oriented towards securing a pool of social and communal interests. Moreover, the role of the regulator (macro dimension) is enforced by the global stakeholders on one hand (global dimension), and the consumers/end users of the financial system (social interests) on the other. Hence, this comprehensive framework comprises the hierarchy of compliance and enforcement.

1. The AML/CFT Process

With regulatory demands becoming even more stringent, global banking groups are moving to harmonize compliance standards across international borders, striving to work to the highest global standard, even in jurisdictions where it may not currently be required.[4]

Underscoring some of the major Financial Action Task Force (FATF) updated recommendations pertaining to the AML/CFT Process, the following observations can be highlighted:

First, financial institutions must perform customer due diligence (CDD) in order to identify, verify, and monitor their customers and the financial transactions in which they engage.

Second, financial institutions should maintain records of all domestic and cross-border transactions (including occasional transactions) in order to facilitate the reconstruction of individual transactions and provide, if necessary, evidence for the prosecution of criminal activity.

Third, the reporting of suspicious transactions or activity is critical to a country's ability to utilize financial information to combat money laundering, terrorist financing and other financial crimes. All countries should have legal or regulatory requirements that mandate the reporting of suspicious activities.

Fourth, the use of non-bank agents to distribute financial services and carry out AML/CFT functions is part of an increasingly popular model for financial inclusion in many countries. Such countries have developed some forms of agent banking options, some of which are referred to as branchless banking, or banking beyond branches.[5]**Error! Reference source not found.** These practices encompass person-to-government (P2G), business-to-government (B2G), and government-to-person (G2P) digitized payments. They can be spotted in countries like Kenya, in which a Kenyan government bond that will only be traded on mobile phone platforms has been initiated, and mobile financial services for channeling remittance transactions are widely used. Pakistan, is another example, whereby regulators, governments, and mobile financial service providers trace mobile money accounts for security purposes through being linked to sim cards and personal biometric data.[6]

Some of the latest FATF publications highlighted money laundering and terrorist financing risks and vulnerabilities associated with gold as a substance that possesses features that make it attractive to criminals to use as a vehicle for money laundering. The highly lucrative gold market presents proceed-generating opportunities for criminals at each stage, from mining to retailing; thus, regulators implement stronger anti-money laundering and counter terrorist financing measures to protect the formal financial sector from abuse. Moreover, FATF published Best Practices Paper on Combating the Abuse of Non-Profit Organizations (NPOs) in an attempt to prevent misuse of NPOs for the financing of terrorism while, at the same time, respecting legitimate activities of NPOs. Furthermore, FATF provided guidance on a risk-based approach in relation to the transfer services of funds or values and its access to banking services, in addition to virtual currencies.[7]

2. Risk Management and Effective Internal Control

The risk-based approach (RBA) is central in implementing FATF requirements, highlighting the need to understand, identify, and assess risks and to apply mitigation and management measures that are risk-sensitive. The general principle of RBA is a contingent one, stating that countries must require financial institutions to take enhanced measures to manage and mitigate high risks; however, correspondingly where the risks are lower (with no suspicion of money laundering or terrorist financing) simplified measures may be permitted. This implies that countries can and should tailor their AML/CFT regime to their specific national risk context. Accordingly, this will address the consequential risks of financial exclusion. Normally, the application of the RBA entails as a starting point that regulators and supervisors take appropriate steps to understand, identify, and assess the national ML/TF risks. Equally, financial institutions are required to understand, identify, and assess the ML/TF risks relevant to their activities.[8]

In addition to the adoption of the Mutual Evaluation process for determining the extent of the compliance of member states to the AML/CFT measures, the FATF recommended the usage of the Strategic Implementation Planning (SIP) Framework as post-mutual evaluation implementation assistance. This framework aims to use the Mutual Evaluation Report (MER) findings to develop a National Implementation Plan (NIP), concentrating on key areas found to be less than fully compliant.[9]

As regulatory expectations for the financial services industry escalate, many boards are engaging more intensively in risk governance by implementing a risk appetite framework, which is a structured approach to governance, management, measurement, monitoring, and control of risk. An effective risk appetite framework is supposed to include three key principles and success factors: first, alignment to strategy and provision of a forward-looking view of an organization's desired risk profile; second, active involvement of board and senior management, with strong accountability structures and clear incentives and constraints; third, operationalization of risk appetite statements through effective use of information, fostering internal relationships, and establishing risk limits.[10]

To illustrate, an effective enterprise risk management can be established through the implementation of the "three lines of defense" model, which was outlined in the Revised Supervisory Guidance by Basel Committee in 2012 and can be used to implement the risk appetite framework. The first line of defense in this model is carried out by the business unit, which takes and manages risk. The second line of defense is arranged by the risk management authority, which sets risk policy and monitors. The third line of defense is set by the internal audit, which validates the quality and effectiveness of the risk management program.

From the perspective of internal control, as punishment and fines for control violations are substantially intensified, banks should look to strengthen controls, whereby the emphasis on compliance needs to shift toward preventing breaches from occurring. Specifically, banks should be taking steps to assure that they are treating customers fairly; observe proper standards of market conduct; protect the integrity of its operational systems; prevent criminals and terrorists from using the bank and from gaining access to the financial system; implement official sanctions against specific entities and/or jurisdictions; and improve data quality.

The Basel Committee's guiding principles for internal audit functions have introduced key changes in 2012, emphasizing the independence and direct supervisory role of the internal audit function, compliance with The Institute of Internal Auditors (IIA) international standards, and the relationship between the supervisory authority and the internal audit function. Moreover, the new guidelines outlined the "three lines of defense" model.[11]

As for FATF Recommendations concerning internal control, financial institutions are required to develop AML/CFT programs that include: first, the development of internal policies, including appropriate compliance management arrangements, and adequate screening procedures to ensure high standards when hiring employees; second, the establishment of an ongoing employee training program; and third, the formation of an audit function to test the system. Financial institutions must therefore develop an effective internal control structure, which monitors and reports suspicious activity, in order to create a culture of compliance. Thus, this control structure will ensure that staff adheres to the financial institution's policies, procedures, and processes designed to limit and control risks. In addition to complying with the AML/CFT requirements of their home country, financial institutions should also ensure that their foreign branches and subsidiaries comply with the requirements of the countries in which they are operating.[12]

A proposed control system aiming at attaining organizational regulatory compliance in banking and finance is the duality-based segregation-of-duties type system. Two factors are required for the effectiveness of this system: social relations characterized by relative autonomy through third-party dependence, and work task interdependence. The main idea in the principle of duality is that control, and thus regulatory compliance, is integrated into and becomes a natural function of the performance of ordinary work tasks. Consequently, it can be experienced as a form of social support and incentive for workers, avoiding the negative feeling of distrust and coercion. One of the prominent advantages of duality-based control is that it involves employees in the company's security arrangement and control routines, permitting the participation of employees in the self-organization of the control activity.[13]

3. *Improvement of International Financial Stability Approaches*

As the revolution of information and telecommunications has greatly facilitated the transfer of financial assets, a tendency towards developing a new virtual economy emerged, in which currency trading and financial speculations thrived, thus leading to instability in the international financial markets.

In the aftermath of the 2008 financial crisis, the Basel committee proposed measures and updates seeking to improve international financial stability, having both a macro-prudential dimension aiming at the risks existing at the level of the whole banking system, and a micro-prudential dimension, aiming at strengthening the resilience of each bank. These two dimensions enclose reform measures that imply the following: first, redefining capital so as to raise the quality, consistency, and transparency of the capital base, enabling banks to better absorb losses; second, allowing better risk capture, especially concerning the capital markets activities; third, introducing a leverage ratio for the purpose of containing the buildup of excessive leverage in the banking system; fourth, introducing measures meant to build up capital buffers in prosperous times to be a refuge in times of stress; fifth, introducing a global minimum liquidity standard for internationally active banks.

4. Corporate Governance Practices for Operational Effectiveness

The Basel committee has lately conducted a comprehensive revision over the corporate governance principles for banks. The primary objectives of this revision are: first, to reinforce the collective oversight and risk governance responsibilities of the board; second, to emphasize key components of risk governance such as risk culture, risk appetite, and their relationship to a bank's risk capacity; third, to outline the specific roles of the board, board risk committees, senior management, and the control functions; fourth, to strengthen the banks' overall checks and balances.

Many financial services industry (FSI) companies have been stressing more on the operational perspective of the structures they have adopted. In addition, the expectations of regulators, investors, and other stakeholders regarding governance have shifted towards enhancing operational accountability over the past few years. Hence, boards have been viewed recently as more accountable for the effectiveness of their overall governance process. This shift implies an expectation of greater board involvement in the means by which governance is affected, and for more active oversight by the board and its committees.

A Deloitte study found that while FSI companies are reinforcing governance and oversight, only 33% of those surveyed have management risk committees, 41% disclose whether risk management/oversight is aligned with strategy, and 19% note the board's oversight with regard to corporate culture. The trend toward increasing disclosure regarding governance and risk oversight cannot be actualized without utilizing reliable methods of operationalizing governance. In this sense, a governance operating model may assist the board and management in fulfilling their governance roles through organizing the governance structure and the mechanisms by which governance is implemented.

Practically, a governance operating model should: first, organize operational, financial, risk management, and reporting processes; second, bridge the gap between the governance framework and operational realities through highlighting roles, responsibilities, reporting lines and communications; third, sustain governance by providing a feedback loop through which the board and management can identify and respond to new business, operational, competitive and regulatory needs.

5. Politicized Measures Aiming at Enforcing Sanctions

In 2012 Standard Chartered agreed to pay a $340 million fine to the New York State Department of Financial Services (DFS). It was accused of scheming with Iran to hide billions of pounds' worth of transactions from the authorities.

Moreover, France's biggest bank, BNP Paribas, reached a $8.97 billion settlement with the US authorities in July 2014 for violating sanctions against Iran, Cuba and Sudan.[14]

These two examples illustrate how judicial practices have changed for international finance. Accordingly, with the ability of the US structural power to determine the structures of the global political economy, the US law has been enforced to transactions that conform to US and European rules, laws, and regulations, as well as the rules laid down by the UN and other national jurisdictions.[15]

In this context, the US surveillance of capital flows became global, thus enhancing the powers of the Office of Foreign Assets Control (OFAC), the Treasury Department agency responsible for compliance with sanctions. As the US regulators have most major international financial institutions in their sights, litigation resolution remains arbitrary, having many participants involved in an ever-changing context. American government agencies are motivated by a variety of legal, ideological, financial, and political considerations. For federal agencies, foreign policy is significant, while state-level authorities are guided by electoral and domestic factors.[16]

III. Prerequisites for Overcoming Compliance Challenges

1. The Ethical, Educational, and Social Backbones of Compliance

Tackling the challenges inflicted by the compliance ecosystem requires setting certain backbone requisites that provide ethical, educational, and social backbones for compliance, thus setting a humanitarian infrastructure that assists in meeting those challenges.

It has become obvious that the late financial crisis is one of the manifestations of the awkward relationship between economics and ethics, whereby the absence of the ethical dimension played a critical role in causing and fostering it. From this perspective, the exaggerated liberal course led to the elimination of many essential monitory and control measures that comprise basic elements for the principles of transparency and accountability. This boundless environment permitted the collusion of the political system with the financing scheme, sacrificing the interests of depositors and national economies on the medium and long ranges for the sake of instant immense profits, which in turn led to the creation of the real-estate bubble and the banking liquidity crisis. The "Madoff" scandal (2008) is one of the landmarks for this ethical dilemma, which represents the greatest embezzlement act in history, reaching up to $50 billion!

Hence, meeting heightened regulatory expectations for compliance will require management to extend its focus from improving specific processes to incorporating a code of ethics into the rationale of compliance measures by fully integrating risk management, compliance, good governance, and ethics into the bank's culture. Impacting culture requires several actions: first, banks should reinforce a strong managerial tone by flowing explicit messages through each function and business line. Second, boards should effectively scrutinize senior management's risk assumptions and business plans. Third, risk officers should enact collaboration with business lines, giving compliance and risk management an enterprise-wide focus. Last, risk management and compliance responsibilities should be manifested in performance management programs and reinforced in employee training.[17]

Moreover, banking compliance is said to be undermined by the dependence corruption phenomenon that is endorsed by inevitable career interpersonal attachments, which strongly influence the appropriate dependencies and the ability to adhere to them. This corruption can be curbed by emphasizing the ethical practice of honoring commitment to appropriate dependencies and values of good governance, all the way to promoting whistleblowing actions and protecting whistleblowers.[18]

From the socio-educational perspective, compliance is interlinked with the issue of financial innovation and consumer protection. Hence, one of the fundamental advocates of compliance is securing access and suitability. This is true because ensuring consumer access to financial services and guaranteeing suitability to consumers through improving financial education serve the same ultimate objectives of compliance requirements in enhancing financial inclusion, promoting good governance, protecting end users' interests, improving disclosure to address high search costs, and countering illicit transactions. In this respect, the ideal arrangement to attain these common objectives is to establish a set of principles to ensure that the incentives of financial intermediaries are consistent with the objective of safeguarding the interests of the consumers that hold their obligations. But such measures will still need to be supplemented by micro-prudential regulation and supervision to address safety and soundness and macro-prudential regulation to limit systemic upheavals.[19]

Shifting to more social structural factors that constitute the backbone of compliance, one cannot ignore the malignant effects that the inequity of incomes and wealth inflict on the success of the compliance process. This is due to the major role that such inequity plays in unleashing the greed of those who search for high-return/high-risk investments and engage in illicit transactions and imprudent governance practices on the expense of national and public interests, as pointed out by prominent economic scholars such as James Galbraith (2012), Joseph Stiglitz (2012), and Jean Paul Fitoussi (2009). In this context, Inge Kaul (2012) suggests that it is most urgent to begin developing theories and global public economics with a clear focus on global and/or regional public goods to promote social protection.[20] Similarly, Nobel prize-winning economist Robert Solow speaks of sustainable social investments, as superior to private investments.[21]

2. Lesson-Based Challenges of Compliance Requirements

After underlining the backbones, the following compliance challenges that financial institutions face can be highlighted by classifying them into global, macro, and micro levels:

a. At the global level.

i. *Single Supervisory Mechanism*. One of the important challenges post-financial crisis is the necessity of developing a financial integration process that should inevitably lead to the creation of a single regulator for the entire financial system under a Single Supervisory Mechanism. The promoting of the single regulator is determined by minimizing the differences between services offered by various financial institutions, increasing the number of financial conglomerates, and achieving economies of scale in the regulation. Moreover, the parameter of the comprehensive financial regulation should be extended to all the financial institutions, especially the shadow banking system which has been lightly regulated.[22] What intensifies this challenge is the fact that some of the effective parties in the financial industry use their money and lobbying influence to obtain lax regulations, thus reflecting the corruption of a political process in which organized interests outweigh the public interest.[23]

ii. *Macro-prudential supervision*. Ensuring the resilience of individual financial institutions, and particularly large global institutions, through more equity capital funding is the most important way to protect them and the whole system from inevitable shocks. But there is another equally important challenge, that of ensuring the resilience of the system as a whole. That is the task of a newly discovered regulatory activity: macro-prudential supervision, which regulates the stability of the financial system as a whole through a two, mirror-image functions: to protect the financial system from the economy and the economy from the financial system. This implies protecting the financial system from destabilizing developments encouraged by price-stability practices of the monetary policy on one hand, and protecting the economy from the excesses of the financial system on the other.[24]

iii. *Integrity and competency of rating agencies*: stressing on the integrity and competency of rating agencies, which, after the sub-prime lending crisis, revealed many irregularities in their activity, thus severely affecting their reputation and credibility.[25]

b. At the macro level.

i. *Balancing AML/CFT requirements and financial inclusion*. Promoting formal financial systems and services by an AML/CFT regime through applying an overly cautious approach to AML/CFT safeguards can have the unintended consequence of excluding legitimate businesses and consumers from the formal financial system. Hence, this challenge should be targeted by implementing the risk-based approach (RBA) introduced by FATF, through which the AML/CFT measures are flexibly tailored to meet the national goal of financial inclusion, without compromising the measures that exist for the purpose of combating crime, thereby decreasing overall ML/TF risk.[26]

ii. *Reinforcing capital markets*. Regulators and supervisors are aiming at overcoming the challenge of financing growth and development through reinforcing capital markets as a source of financing, while assuring that capital markets enhance or, at least, do not threaten financial stability. This assurance could be based on precautionary measures such as making the derivatives market more robust, controlling securities funding to prevent spillovers of any investment failures, and creating capital markets unions.[27]

iii. *Actualizing coordination among competent authorities and between public authorities and the private sector*. The challenge of building up an appropriate and balanced AML/CFT regime based on domestic circumstances requires extensive coordination among competent authorities and between public authorities and the private sector. In this context, effective information exchange between the public and private sectors will form an integral part of a country's strategy for combating money laundering and terrorist financing.[28]

iv. *Rallying a broadly based financial literacy program*. The challenge of enhancing consumer empowerment through rallying a broadly based financial literacy program, developed to increase the financial literacy of the population, involves a range of organizations, including those of the government, state agencies, and non-government organizations.[29]

v. *De-risking*. On the economic security level, the phenomenon of de-risking has received considerable attention lately as an outcome of the global fight against money laundering and terrorist financing. Its negative dimension appears when applied generally and without scrutinizing individual cases in order to avoid the high cost of compliance. For example, despite the adoption of international best practices in the field of compliance, some Arab Banks are facing difficulties in their relations with the US correspondent banks, thus witnessing a gradual decline in their banking operations.

vi. *The SoLoMo synergy*. The dynamic nature of mobile technologies, interlinked with the wide social media penetration and the innovative localization of services, created the so called SoLoMo (Social-Local-Mobile) framework, which posed risks and challenges along with opportunities for mobile financial services. These risks can be mitigated through introducing innovative security high-tech measures that prevents illicit and fraud activities. Moreover, capitalizing on such a revolutionary opportunity requires synergy and integrative approaches between the telecommunication and banking industries.

vii. *Oversight of agents*. Agent monitoring is a very important and challenging element in an effective AML/CFT program. The oversight of agents is mainly performed by the principal financial institution. It is nevertheless also essential that the regulatory supervisor reviews financial institutions' oversight functions, by examining the policies, procedures, training, and monitoring of agents put in place by the principal financial institutions.[30]

viii. *Mitigating the Costs of Compliance*. Having been created for stabilizing the financial sector in order to actualize mutual benefits among financial service providers and consumers, compliance requirements nonetheless have witnessed surging costs due to the increasing complexity of global finance. As a consequence, the challenge of mitigating the costs of compliance can be approached through finding ways to set the incentives of financial intermediaries in consistency with the objectives of safeguarding the interests of the consumers and abiding with compliance requirements.

c. On the micro level.

i. *Regulatory challenges for banks*. These challenges imply shaping strategy to satisfy both supervisory standards and investor demands, requiring banks to rethink and reshape strategy. First, banks need to concentrate on customer and market segments where they have critical mass in order to avoid businesses that are losing money and/or absorbing disproportionate amounts of capital and liquidity. Second, banks need to improve asset efficiency by assuring that assets promote the bank's ability to create efficient investments with clients, thus economizing on the use of capital and enhancing return on equity. Third, banks need to streamline costs through strengthening governance and controls in order to reduce the frequency and severity of costly compliance breaches- something that will please investors as well as supervisors. Fourth, enhancing data quality may also represent an opportunity for banks to tackle long-standing shortcomings in management and technology, reducing the cost of managing both data and risk. Finally, boards ought to make compensation regimes more investor-friendly by linking compensation to the ability of equity to earn its cost of capital.[31]

ii. *Simplifying and Automating Know Your Customer (KYC) requirements*. Just as KYC requirements are crucial for due diligence, so is the task of simplifying and automating KYC process, especially when medium sized corporations and SMEs are concerned. From this perspective, international banks have developed the tendency to shift from pure identification in a traditional sense to examining customer transactions and automating exchange of information through a centralized system.[32]

iii. *Linking corporate governance to compensation policies*. Financial institutions are challenged by the lack of correlation between short-term generous bonuses to employees and medium and long-term risks they imposed on their financial intermediaries. This challenge should be met through prudent corporate governance practices and compensation policies.[33]

IV. The Lebanese Banking and Financial Compliance Model

1. A Challenging Backdrop

The Lebanese economy has been witnessing structural malfunctions for the past two-and-a-half decades. These malfunctions have escalated in light of the upheavals in the Arab region, especially in neighboring Syria, and the late global instability on the political and economic levels. Problematic signs encompass the burden of public debt, budget deficit, unemployment, administrative corruption, imbalance in institutional work, informal employment, insufficient financial inclusion, and lack of security and political stability. To illustrate, public debt has surpassed $66 billion, amounting to more than 140 percent of GDP, though Lebanon has proved to absorb the public debt pressure due to the substantial size of its money supply. Moreover, official unemployment rate record 11 percent, of which 18 percent among woman and 34 percent among youth. As for corruption, Lebanon has scored -1.06 out of a score range of -2.5 to +2.5 in 2014.[34] Furthermore, the World Bank has announced that confessional governance in Lebanon cuts GDP to half its potential.

Amid this traumatic scene, the vital role of the Lebanese monetary authority's, embodied by Banque Du Liban (BDL), became center piece in maintaining and mobilizing socio-economic security. This role has marked the most significant contribution in establishing the Lebanese financial sector as a haven of stability despite the surrounding myriad of instability. This sector is best known for its resilience, financial soundness, profitability, and robust capitalization due to the prudent regulation and supervision of BDL. It has been able to weather various internal and external storms, most notably the recent global financial crisis that has shaken many banking systems in the world.

This confidence can be observed through these select indicators: out of a total of 70 commercial banks operating in Lebanon 13 are foreign-owned. The Lebanese banking system transacts efficiently with approximately 200 foreign correspondent banks located in 88 cities around the globe, including the US and Europe. There are currently 33 Lebanese banks in 33 countries, operating as many as 376 financial and banking units in these countries.[35] Despite the current challenging operating environment, the Lebanese banking sector is still reporting a healthy growth in total banking activity, encompassing total assets of more than $181 billion in August 2015, marking an increase from $142 billion in December 2008. Furthermore, bank deposits, accounting for 86 percent of total banking activity, reached an unprecedented level of $156 billion in August 2015, with a dollarization rate of deposits dropping to 65 percent after peaking at 77 percent in early 2008, reflecting confidence in the Lebanese currency. In parallel, lending activity registered around five percent growth during the first half of 2015, with total credit to the private sector surpassing that to the public sector. This total credit to the private sector has reached a historical level, exceeding $53 billion versus $38 billion to the public sector in August 2015, as compared to $25 billion versus $27 billion to the public sector in 2008; thus, it reflects a positive fundamental transformation in the banks' relation with the market, which is significantly affected by BDL's incentive programs since 2009. The loan dollarization ratio continued its downward trend to reach 74.8 percent at end-2014, its lowest recorded level in more than two decades. The Lebanese banking sector's high levels of liquidity enable commercial banks to finance the government and private sector needs while maintaining a stable interest rate structure.

Did compliance parameters play a role in synthesizing this level of confidence? In fact, early lessons drawn from the Lebanese model are similar to many of the post-crisis reforms suggested later by international financial regulators, including US regulators. Most important of these measures are: decreasing leverage, regulating derivatives and structured products, strengthening banks' capital and liquidity requirements, enhancing the corporate governance and transparency of financial institutions, enabling the central bank to oversee all players in the financial market, drawing a clear demarcation in the scope and activities of commercial banks and investment banks, prohibiting any defaulting of banks that threatens the systemic stability, and regulating the establishment and management of collective investment schemes by banks.

2. Lebanese Commitment to Compliance

Looking more specifically into the compliance measures implemented by BDL, it can be noted that they are consistent with those elements presented earlier on the global perspective:

a. The AML/CFT process.

BDL and Lebanese banks do comply with international standards and AML/CFT norms. BDL regularly reviews and amends its AML/CFT regulations, keeping up with the latest international legal and technical developments and setting the foundations of a financial sector in line with global financial practices.

As a historic outlook, despite the fact that Lebanon has acceded in 1996 to the UN 1988 Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, in addition to launching the initiative of "Due Diligence Agreement" in the same year, it wasn't before June 2002 that Lebanon was removed from FATF's Non-Cooperative Countries and Territories list and from its monitoring list in October 2003. This was preceded by issuing Law No. 318 enacted in April 2001 on "Fighting Money Laundering", gave birth to the Special Investigation Commission (SIC), which acts as an independent Financial Intelligence Unit affiliated with BDL, whose mission is to investigate suspected money laundering operations and scrutinize compliance with the rules specified by AML law. In order to carry out its mandate fully, the SIC has the exclusive powers to lift banking secrecy and freeze suspicious transactions and accounts.[36]

After FATF declared Lebanon as a member in the fight against money laundering in July 2002, the Financial Crime Enforcement Network (FINCEN) of the US Department of Treasury noted that BDL had enacted significant reforms to the AML system and had established a regime that meets international standards. This was followed by the State Department's acknowledgement of the SIC's support to international case referrals. In parallel, in July 2003, Lebanon joined the Egmont group of FIUs, and in 2004, it contributed to establishing the MENA-FATF and became its president in its first year of operation. (Shahin) In 2007, the "National Committee on Suppressing Terrorism Financing" was established, following BDL's proposal, as a framework that addresses challenges and fosters coordination among Lebanese agencies involved in the fight against money laundering.

In 2012, BDL required banks to be fully informed of the laws and regulations governing their correspondents abroad, and deal with the latter in conformity with the laws, regulations, procedures, sanctions and restrictions adopted by international legal organizations or by the sovereign authorities in the correspondents' home countries in order not to jeopardize their sound reputation, or their relationships with any of their correspondent banks.

Also in 2012, BDL proposed amendments to the Lebanese AML/CFT law to incriminate terrorist financing acts. The suggested amendment also calls upon lawyers, public notaries, and accountants, when carrying on their mission, to notify the SIC immediately of any operation they suspect is linked to money laundering or terrorism, and introduces financial sanctions for non-compliance with the AML laws and regulations. It also proposed a draft law on the cross-border transportation of funds and the exchange of tax information law. All were approved in 2012 by the Council of Ministers and were consequently forwarded to Parliament.

In order to prevent money dealers from being used as a safe haven for money laundering, BDL has regulated the electronic transfer of funds, especially the non-official channels to transfer cash, forbidding small money changers from performing cash transfers using these unofficial channels. It also tightened its regulations regarding the activities of exchange institutions, by demanding the increase in their capital, prohibiting them from carrying out any of the banking transactions, placing constraints on transporting cross-border cash and precious metals, and requesting the appointment of a Compliance Officer in order to control the institution's conformity with the AML/CFT law. This Compliance Officer must attend, on a continuous basis, AML/CFT training sessions or obtain specialized certificates, as instructed by Circular 3 to exchange institutions. Moreover, Circular 103 noted that trained officers should take examinations, as part of the general examination scheme organized by BDL in order to attest the scientific, technical, and ethical qualifications required for performing certain functions in the banking and financial sectors.

In 2012, BDL requested Lebanese banks to abide by the FATCA, the US law that concerns all US taxpayers worldwide, in the context of preserving the sound and good reputation of the Lebanese banking sector, in addition to maintain its relationship with correspondent banks that comply with FATCA.

b. Risk Management and Effective Internal Control.

In 2001, BDL issued circulars that regulate the means by which banks and financial institutions control their operations with their customers in order to avoid any involvement in operations related to money laundering or terrorist financing.

In the scope of risk management, BDL has been implementing the notion of the risk based approach since 2010. Accordingly, it requires banks to adopt a risk-based approach in classifying customers and operations according to the risk levels (low, medium or high risks), taking into account the country risks, customer risks and services risks. It also demanded the establishment of risk-based control measures and procedures, according to Circular 83, dated 2001.

The stage was further set for internal control through establishing risk policies and monitoring. In 2011, each bank operating in Lebanon was requested by BDL to establish compliance and risk management units and to appoint independent members in their Board of Directors. These units include an AML/CFT Special Committee, an AML/CFT Compliance Unit (in charge of verifying compliance with AML/CFT procedures, laws, and regulations in force), and an AML/CFT Officer in each of the bank's branches in charge of controlling the operations.

Additionally, BDL requires banks and financial institutions operating in Lebanon to strictly implement the Regulations for the Control of Financial and Banking Operations for Fighting Money Laundering and Terrorist Financing, particularly with customers who request the conduct of cross-border operations by way of correspondent banks and financial institutions. It stipulated that banks and financial institutions should follow a risk based approach by verifying the identity of individuals or companies involved in the transaction and those that have economic ownership, as well as by developing procedures to continuously monitor the related operations and accounts. Within this scope, banks and financial institutions must adopt the utmost accuracy and due diligence to vet the identity of the economic right owner in the operations conducted. Banks are requested to update their database related to AML/CFT information and to notify the SIC about suspicious transactions.

In order to further intensify the legal aspect of compliance and risk management, BDL have requested in 2013 banks and financial institutions operating in Lebanon to establish a Legal Compliance Unit that is in charge of identifying and preventing legal risks, taking the required measures to mitigate these risks.

c. Improving Financial Stability.

BDL has equipped the banking sector with the appropriate regulatory and supervisory framework that is in line with international standards for the sake of reinforcing prudent precautionary regulatory measures. Such regulations aim at deepening the resilience of the banking sector against risks in general, without contradicting with free market rules. Hence, banks were required to: maintain high levels of liquidity; exceed international standards on capitalization requirements; comply with investment and balance-sheet regulations; and avoid excessive leveraging along with building adequate provisions.

In this context, BDL has always assured high levels of liquidity in the Lebanese banking sector, thus enabling commercial banks to finance the government and private sector needs and aiming at thrusting growth and development, while maintaining a stable interest rate structure. BDL's prudent efforts in managing this liquidity are also of an utmost importance for curbing inflationary pressures within the objective of four percent. In terms of capitalization, Lebanese banks are exceeding the required ratio of 10 percent, as required by Basel III, and have even exceeded the rate of 12 percent, which is the objective to be attained by the end of 2015. Exposures of Lebanese banks operating abroad are regularly monitored and assessed by BDL through MOUs with the regulatory and supervisory authorities in those countries.

BDL has historically regulated banks' dealings with derivatives and structured products by forbidding banks from making subprime investments both domestically and internationally. BDL has also regulated the on-and-off-balance sheet operations and ensured that the off-balance sheet assets were related to the actual solvency of the banks. Moreover, BDL has issued circulars regulating consumer loans and requiring the formation of provisions, intended as preventive steps to avoid any future crises. Accordingly, BDL has set out lending regulations that place a ceiling of 50 percent on the value of an equity portfolio and a requirement of a 20 percent down-payment on foreign exchange operations. In order to prevent a real estate bubble, banks are not allowed to lend more than 60 percent of a project's value. In addition, BDL has set maximum acceptable levels for consumer lending, so as not to exceed 45 percent of the household income with a maximum limit of 35 percent for housing loans.

BDL has strived for a well-organized financial market through regulating the establishment and management of all financial market participants, including financial institutions, brokerage firms, collective investment schemes, and money dealers. All these institutions are under the supervision of the Central Bank and the Banking Control Commission. BDL has also set a clear distinction between the role of commercial banks and investment banks, which has protected both banks' and customers' interests.

Moreover, BDL plays a key role in the development of domestic payment systems. It has regulated e-banking to provide a secure platform for e-services in the Lebanese financial sector, stressing compliance with international norms and standards in order to promote safety and improve efficiency of the multi-currency payment system in Lebanon (US Dollars, Euro, and L.L.). In order to enhance economic efficiency, BDL has adopted real time online connections with the financial sector through implementing the Real Time Gross Settlement (RTGS) system for domestic settlement, offering the banking and financial sectors a secure, reliable and real time method of payment that adheres to international standards. Furthermore, BDL has set in place the automated Retail Payment and Clearing System (BDL-CLEAR), a low value - high volume bulk payments system, for clearing retail payments, including cheques, direct debits, and card transactions.

BDL has strived to preserve the reputation of the banking sector by reinforcing anti-money laundering measures while maintaining banking secrecy; encouraging small banks to merge with bigger ones in order to avoid bankruptcies or losses to depositors; solving the problem of non-performing loans by allowing creditors to reschedule their loans over a 10-year period; imposing academic, technical, and ethical requirements for staff in key banking and financial positions; and promoting the export of banking services by supporting the regional expansion of leading Lebanese banks. BDL has further established the Financial Stability Unit whose mission is to monitor the financial sector in Lebanon in order to avoid any likely crisis, and the Consumer Protection Unit to ensure that banks deal equitably and fairly with all their customers in a transparent manner.

d. Corporate Governance Practices.

Being aware of the importance of corporate governance in optimizing the performance of the financial sector and protecting the interests of its stakeholders, BDL emphasizes on the compliance with the principles of good governance at all banking and financial managerial levels, including boards of directors and senior management, whereby training programs have been set by BDL for this purpose. This is done in parallel with the creation of appropriate awareness in financial institutions, in which compliance units were established to protect the banks. This approach aims at increasing transparency and enhancing prudent management as main objectives of BDL policy, which has established for this purpose the Corporate Governance Unit.

e. Adopting Global Sanctions Measures.

The global scene is witnessing more than ever the interconnection of a diversity of systems to form complex ecosystems that inflict intense compliance requirements, which are undeniably subject to international fluctuating political-economic balances of power. In this sense, BDL is keen to guard the vital interests of the Lebanese banking sector, as a strategic national sector, through abiding by the international sanctions. This compliance serves the Lebanese banks in maintaining good and clear relations with correspondent banks by avoiding any operations that might expose correspondent banks and jeopardize the relationship with them by involving them in situations contravening the regulations enforced in their respective countries.

f. Ethical, Educational, and Social Levels.

The nature of the central banks' practices has changed towards enhancing its role in the economies of the world. They are increasingly encompassing socio-ethical and developmental dimensions. Accordingly, central banks no longer rely solely on traditional instruments in the implementation of monetary policy, but they resort to other financial engineering tools that benefit the economy and society. These tools serve to support governments in creating the necessary conditions for sustainable growth, providing the potentials to revitalize the labor market, reinforcing social and environmental security, and promoting human development.

From this perspective, BDL has launched several initiatives that serve to endorse the ethical, educational, and social backbone of compliance. To begin with, BDL has promoted the notion of corporate governance within the banking sector, stressing the benefits of transparency and accountability for securing the wellbeing of both the banks and end users.

Moreover, BDL has enacted strict regulations for prohibiting imprudent investments in subprime mortgage loans that may result in sacrificing the interests of depositors and the national economy on the medium and long ranges for the sake of short-term profits.

As for consumer protection, BDL has required that banks establish consumer protection units to ensure that they deal fairly with all their customers in a transparent manner, and it enhanced financial education to enable customers protect their rights through conducting training programs for student internship and public teaching, and disseminating information through pamphlets, workshops, awareness campaigns, conferences, speeches, and interviews.

Concerning financial inclusion, it reaches around 47 percent in Lebanon according to the World Bank, scoring more than double the average rate in the Arab region. BDL is continuing its efforts to broaden financial inclusion, so as to restrain shadow banking practices and instill compliance. Hence BDL encourages bank penetration and promotes new electronic payment methods.

Sustainable growth and development have been considered as a priority to BDL's initiatives. Accordingly, several initiatives were launched by BDL to ensure that the incentives of financial intermediaries are consistent with the objective of safeguarding the interests of the consumers and community as a whole. The most prominent aspect of such practices has been embodied in stimulus packages that take the form of exemptions in the required reserve ratio and soft loans extended to Lebanese banks in order to boost lending activity, aiming at fostering growth in productive sectors and satisfying vital socio-economic needs. These packages, extending from 2013 through 2015 and amounting to a total of $5 billion, proved to be successful by contributing around 50 percent of real GDP growth. They included incentives to support housing, education, renewable energy projects, innovative projects, research and development ventures, entrepreneurship, and other productive sectors of the economy. Moreover, BDL announced a fourth stimulus package amounting to $1 billion for the year 2016. Other initiatives launched by BDL for the sake of sustainable growth and development are: targeting SME through micro credits; thrusting entrepreneur projects as part of its vision in inducing knowledge economy; encouraging commercial banks to offer low-interest-rate loans for youth educational needs and environmental projects; launching boot-camps for students having innovative ideas; and vitalizing capital markets for providing communal equity financing options for productive sectors and SMEs.

All these initiatives and measures don't deny the presence of challenges in the Lebanese compliance ecosystem, many of which are linked to the traumatic Lebanese fiscal and political environment. In short, these challenges are related to enhancing financial inclusion, curbing corruption, empowering capital markets, increasing coordination between public and private sectors, de-risking, building a modernized legislative-regulatory infrastructure, mitigating costs of compliance, and restraining the disruption of the political system.

V. Conclusion

Banking organizations should strive to refine compliance through implementing an effective qualitative assessment performance indicator in order to consistently and effectively structure socially sustainable incentive-based compensation. Additionally, organizations should adopt a stand-alone reporting structure for compliance that presents it as a critical issue on senior-levels, targeting compliance risks within the organization. Implementing such a vision should enable the organization to develop a superior compliance program that is not only concerned with the current regulatory environment but also navigates through future regulatory changes, providing compliance with a sustainable ethical prospect.[37]

The Lebanese compliance model represents a benchmark for regional and global practices, relative to strenuous socio-economic-political environment in Lebanon and the Arab region; however, there lies ahead significant loads of challenges that ought to be confronted to shift compliance from being a tedious burden to becoming an ingrained culture.

Thank you.

References

[1] Lashhab, B., 2010. The Global Financial Crisis – An Attempt for Understanding and Overriding. Arab Economic Journal, Fall 2010.
[2] Lashhab, B., 2010. The Global Financial Crisis – An Attempt for Understanding and Overriding. Arab Economic Journal, Fall 2010.
[3] Warde, I. Compliance Briefings: The Future of Compliance.
[4] Compliance Services, 2015. Banks Seek Harmonized Approach to Address Global Compliance Challenges. Compliance Services. [online] Available at: <https://complianceservices.swift.com/news/banks-seek-harmonised-approach-address-global-compliance-challenges> [Accessed 23 September 2015]
[5] Financial Action Task Force, 2013. FATF Guidance: Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion. FATF, 2013.
[6] Banking Beyond Branches: NextGen Finance for the Inclusive Economy, 2015. [online] Available at: http://bankingbeyondbranches.com/ [Accessed 1 November 2015]
[7] Financial Action Task Force. [online] Available at: <http://www.fatf-gafi.org/publications> [Accessed 23 September 2015]
[8] Financial Action Task Force, 2013. FATF Guidance: Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion. FATF, 2013.
[9] Financial Action Task Force, 2013. FATF Guidance: Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion. FATF, 2013.
[10] Deloitte, 2015. The Benefits of Implementing a Risk Appetite Framework. The Wall Street Journal. [online] Available at: <http://deloitte.wsj.com/riskandcompliance/2015/01/05/the-benefits-of-implementing-a-risk-appetite-framework/> [Accessed 23 September 2015]
[11] Protiviti, 2012. Financial Services Flash report: Basel Committee Issues Revised Supervisory Guidance on Assessing the Effectiveness of Internal Audit Functions. Protiviti, 2012.
[12] Financial Action Task Force, 2013. FATF Guidance: Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion. FATF, 2013.
[13] Engdahl, O., 2013. Ensuring Regulatory Compliance in Banking and Finance: the Principle of Duality in the Segregation of Duties. Regulation & Governance, volume 8, issue 3, September 2014.
[14] Department of Financial Services. [online] Available at: <http://www.dfs.ny.gov/about/press> [Accessed 23 September 2015]
[15] Warde, I., 2014. US Financial Regulation Is Back — But It's Aggressively Pursuing Crimes, And Criminals, Not Relevant To The Near-Destruction Of The World Economic System In 2008. Le Monde Diplomatique, July 2014.
[16] Warde, I., 2014. US Financial Regulation Is Back — But It's Aggressively Pursuing Crimes, And Criminals, Not Relevant To The Near-Destruction Of The World Economic System In 2008. Le Monde Diplomatique, July 2014.
[17] Deloitte, 2015. Banking Outlook: Boosting Profitability Amid New Challenges. The Wall Street Journal. [online] Available at: <http://deloitte.wsj.com/riskandcompliance/2015/04/20/banking-outlook-boosting-profitability-amid-new-challenges/> [Accessed 23 September 2015]
[18] Kenny, K., 2014. Banking Compliance and Dependence Corruption: Towards an Attachment Perspective. Harvard University, 2014.
[19] Lumpkin, S., 2010. Consumer Protection and Financial Innovation: A Few Basic Propositions. OECD Journal: Financial Market Trends, volume 2010, issue 1. OECD, 2010.
[20] Young, B., 2014. Financial Crisis: Causes, Policy Responses, Future Challenges. European Commission, 2014.
[21] Read, C., 2009. Global Financial Meltdown: How We Can Avoid the Next Economic Crisis. Palgrave Macmillan, New York, 2009.
[22] Gabriela, C., 2014. Basel III – A New Approach To Improve International Financial Stability. Spiru Haret University, 2014.
[23] Wolf, M., 2014. The Shifts and the Shocks: What We've Learned-and Have Still to Learn-from the Financial Crisis. Penguin Press, New York, 2014.

[24] Wolf, M., 2014. The Shifts and the Shocks: What We've Learned-and Have Still to Learn-from the Financial Crisis. Penguin Press, New York, 2014.
[25] Gabriela, C., 2014. Basel III – A New Approach To Improve International Financial Stability. Spiru Haret University, 2014.
[26] Financial Action Task Force, 2013. FATF Guidance: Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion. FATF, 2013.
[27] Ray, J., 2015. A 2015 Regulatory Challenge for Banks: Shaping Strategy to Satisfy Supervisory Standards and Investor Demands. Ernst and Young, 2015.
[28] Financial Action Task Force, 2013. FATF Guidance: Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion. FATF, 2013.
[29] The World Bank, 2012. Good Practices for Financial Consumer Protection. International Bank for Reconstruction and Development / The World Bank, Washington, 2012.
[30] Financial Action Task Force, 2013. FATF Guidance: Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion. FATF, 2013.
[31] Ray, J., 2015. A 2015 Regulatory Challenge for Banks: Shaping Strategy to Satisfy Supervisory Standards and Investor Demands. Ernst and Young, 2015.
[32] Compliance Services, 2015. Banks Seek Harmonized Approach to Address Global Compliance Challenges. Compliance Services. [online] Available at: <https://complianceservices.swift.com/news/banks-seek-harmonised-approach-address-global-compliance-challenges> [Accessed 23 September 2015]
[33] Gabriela, C., 2014. Basel III – A New Approach To Improve International Financial Stability. Spiru Haret University, 2014.
[34] The World Bank. Worldwide Governance Indicators. [online] Available at: <http://data.worldbank.org/data-catalog/worldwide-governance-indicators> [Accessed 30 September 2015]
[35] Association of Banks in Lebanon. [online] Available at: <http://www.abl.org.lb/subPage.aspx?pageid=7337> [Accessed 30 September 2015]
[36] Shahin, W., 2013. Compliance with International Regulation on AML/CFT: the Case of Banks in Lebanon. *Journal of Money Laundering Control*, Vol. 16 Iss: 2, pp.109-118.
[37] Melwani, V., 2015. Refining Compliance within Large Banking Organizations in a Post SR 08-8 World. Brooklyn Journal of Corporate, Financial and Commercial Law. Volume 9, issue 2, article 6, 2015.