مصرف لبنان
BANQUE DU LIBAN

Corporate Governance at Central Banks

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Central Bank Governance: Risk Management and External Audit Oversight
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Excellencies, Distinguished Guests, Ladies and Gentlemen,

I am glad to speak before this prominent audience today and would first like to thank Hawkamah and the International Monetary Fund for organizing this high level forum, and for inviting me to deliver the keynote address. Bringing into the forefront good governance at central banks is highly commendable.

In my talk today, I will mainly cover three areas. I will begin by addressing the **new realities central banks are facing subsequent to the financial crisis**. I then will touch briefly upon the key **milestones that were put in place to date**. And finally, I will share with you **our experience with governance at Banque Du Liban (BdL)** and will end up with my perception of **the challenges ahead.**

Ladies and Gentlemen,

The global financial crisis has utterly changed the landscape of central banking as we all know it. Since then, more questions concerning the role of central banks in the prevention, management and resolution of financial crisis have emerged. In fact, central banks are confronting a new set of challenges from overall strategy, to governance, to risk management.

Central banks are inevitably becoming more powerful, influential and complex.

Since the unfolding of global financial crisis in 2007 and the resulting large-scale increase in government debt in the US, Europe and Japan, central bankers became the focal point of public attention and scrutiny. Many central banks have admitted their partial responsibilities for the financial turmoil, as Ben Bernanke, Chairman of the Board of Governors of Federal Reserve Board told the US Congress in 2009, *"There were mistakes made all around … We should have done more [in banking supervision]. We should have required more capital, more liquidity. We should have required tougher risk management controls"*[i].

Clarity about the new responsibilities of central banks related to financial stability is needed in order to reduce the mismatch risk between public expectations and what the central bank can deliver. Financial stability is interlinked with central banks' core responsibilities whether price stability, liquidity management, or banking supervision. However, the central bank is not alone; proper coordination with other authorities involved in financial stability policy including the Ministry of Finance, deposit insurance agency, capital market authority is very important for effective decision-making and accountability. More importantly, with the new complex environment comes the necessity of **good governance arrangements at the central bank.**

Incidents of weak corporate governance in several companies in the 1990's – such as Enron, WorldCom and Parmalat, among others – and the ensuing losses to shareholders and the economy at large, prompted the issuance of a range of standard setting bodies to develop good governance principles for their constituents, among which the OECD's *Principles of Corporate Governance* (2004) for corporations in general; the BCBS[ii] *Principles for Enhancing Corporate Governance* (1999; 2006; 2010) for Banking Institutions, followed by similar guidelines for insurance and deposit insurers IAIS[iii] (2003, 2011, 2012), IADI[iv] (2009), and as well as the OECD's *Guidelines on Corporate Governance of State-Owned Enterprises* (2005). There is a general consensus among those bodies that **corporate governance** is a framework comprising **"clear objectives, transparency and accountability"**[v].

The central banks were not far from the abovementioned debates even before the global financial crisis. It was clear they should lead by example. Central banks cannot emphasize the need of banks and financial institutions to set in place good board practices, effective control environment and processes, transparency and disclosure, stakeholders' (including shareholders') rights and a commitment to good corporate governance and risk management plan without adopting similar standards of their own.

In fact, in response to the growing interest in good governance of central banks and building on work carried out since the mid-1990s, the Bank of International Settlement (BIS) formally established a **Central Bank**

Governance Forum in May 2005 to foster good governance of central banks as public policy institutions. It serves as a venue for the exchange of views among governors on matters relating to the design and operation of their institutions. It also compiles analyses and disseminates a wide variety of information on governance and organizational arrangements amongst central banks. Two flagship publications have been produced till date, one regarding *the Governance of Central Banks* issued in 2009 and another regarding the *Central Bank Governance and Financial Stability* issued in 2011.

Prior to that, in 1999, the International Monetary Fund had also developed a *Code of Good practices on Transparency in Monetary and Fiscal Policies*, which identifies desirable transparency practices for central banks in their conduct of monetary policy and other financial agencies in their conduct of financial policies. It was followed in the year 2000 by the introduction of the IMF *Safeguard Assessment* for central banks of the countries borrowing from the Fund. This diagnostic review entails key attributes[vi] of good governance at central bank, namely: **discipline, transparency, autonomy, accountability and responsibility.** The assessment covers five key areas of control and governance namely (i) **the External audit mechanism**; (ii) **the Legal structure and independence**; (iii) **the financial Reportingframework;** (iv) **the Internal audit mechanism**; and (v) **the internal Controls system**. They are summarized by the acronym ELRIC.

Yet to date, **no formal code of good governance at central banks** has been developed; and it is still being debated whether such a code is needed or even practically implementable.

FOUNDATIONS FOR SOUND GOVERNANCE PRACTICES IN CENTRAL BANKS

Today, central banks are key public institutions whose roles are not solely limited to monetary stability, but have also included fostering **financial stability**. In addition to providing core components of **payment systems**, they also **manage a country's gold and foreign exchange reserves, and oversee the development of financial systems** to better handle their new roles, missions and objectives.

As the financial crisis has altered the balance sheets of central banks and increased the types of risks they need to mitigate, some have been keen on moving towards a new governance structure where "**objectives, tasks, and functions delegated to the central bank are achieved effectively and efficiently. It is now generally accepted that central banks should have clearly defined and prioritized objectives; be given sufficient authority and autonomy to achieve their objectives, tasks, and functions; and be held accountable to ensure checks and balances**"[vii].

THE GOVERNING PRACTICES AND POLICIES AT BANQUE DU LIBAN

BdL governance practices have been internally assessed and reviewed on a continuous basis vis- à-vis the existing best governance guidelines and principles. In April 2007 and in November 2008, the Lebanese government reverted to the IMF Emergency Post-Conflict Assistance (EPCA) facility valued at USD 76.8 Million and as such, Banque Du Liban had participated in a Fund assessment of its governance structure based on the ELRIC. A full safeguards assessment was conducted in 2008 and an updated one took place in 2009. Based on these assessments, BdL had taken on the assessment recommendations and focused on **reserve management, financial reporting transparency, and audit and control procedures**.

Current BdL governance and practices can be regrouped around five main areas: The legal mandate and governance; the role of the board; The strategic planning and budgeting; The staff policies and remuneration; and specific management issues relating to foreign reserves risk management, financial reporting transparency, and audit and control procedures.

On the legal mandate and governance

BdL operates under the Code of Money and Credit, a specific law which stipulates its duties and responsibilities. By law, BdL's mission is to "*Safeguard the national currency in order to ensure the basis for sustained social and economic growth.*"

As such, BdL is responsible for
1) Safeguarding monetary and economic stability;
2) Ensuring the soundness of the banking sector;
3) Developing money and capital markets; and since 1999 a new task was added **to regulate and develop the payment, clearing and settlement systems as well as electronic financial operations**.

Currently, we are focusing our efforts on preserving monetary and economic stability given the challenging political, economic and security environment that we operate within.

On the role of the Board

BdL board members have a clear understanding of their role in corporate governance. They oversee the bank's strategic objectives and corporate values that are communicated throughout the organization.

In addition to the Governor and the four Vice-Governors, BdL board includes two independent members, the Director General of the Ministry of Finance and the Director General of the Ministry of Economy and Trade. They sit on the Board in their ex-officio capacities and not as Government proxies.
Moreover, there is a clear distinction between policymaking and managerial boards.

On the strategic planning and budgeting

BdL has clearly defined objective for each function performed. These goals have been specified within a comprehensive strategic plan which was approved by the governing board. To date, we are still working on linking our budgeting process to this strategic plan.

On the staff policies and remuneration

The existing employee code is being reviewed to incorporate the best conduct practices in the industry. Additionally, a new structure, grading system and performance management system are currently being developed.

On Risk Management

On the foreign reserves risk management front, BdL established in January 2009 an *Investment Committee* and prepared formal guidelines for foreign reserve management[viii] as they constitute a vital asset in a central bank. Moreover, we should always keep in mind that risks are not avoidable but can be mitigated. We followed the IMF guidelines which state that the objectives
of foreign exchange reserve management are, ensuring that " (i) adequate foreign exchange reserves are available for meeting a defined range of objectives; (ii) liquidity, market, and credit risks are controlled in a prudent manner; and (iii) reasonable earnings are generated over the medium to long term on the funds invested [subject to liquidity and other risk constraints]"[ix].

When formulating its investment choices, the *Investment Committee* takes into consideration a wide range of exposure risks, namely market, credit, counterparty, liquidity and operational risks. Another important development was the adoption of a "framework" for the investment decisions to effectively manage risk. The framework establishes the acceptable parameters (limits and controls) and asset allocation (benchmark portfolio).

On the operational risk management front, a formal system to identify, assess and mitigate the risks at the nine BdL branches has been put in place earlier this year.

On External Auditors

Almost two decades ago, specifically in 1994, Banque Du Liban was one of the first central banks in the region to appoint an external auditor (Deloitte and Touche - one of the Big Four). Since 2004, Earnest and Young was appointed as a second external auditor. Lately, since 2009, we have adopted a formal policy for the selection, appointment and rotation of BdL's external auditors.

On Internal Audit

Since its inception in 1993, the role of the *Internal Audit Department* (IAD) at BdL has evolved over time to meet the challenges imposed on the changing role of the audit function from a "traditional" to a more "progressive/best practices" one. The scope of the audit is based on the evaluation of risks and focused on the bank's processes. BdL's IAD is currently divided into three sections: audit methodology, IT and security audit, and financial audit. It conducts reviews of the bank records and operations and reports the results of these reviews directly to the Governor on regular basis. These reviews are conducted according to the Standards for the Professional Practices of Internal Auditing and best practices.

In addition, being a Francophone country, Lebanon is actively involved with the internal auditors of central banks in francophone countries. In 2010, the third meeting was hosted by Lebanon, where BdL suggested the adoption of a "framework of good conduct for internal auditors at central bank of francophone countries". That proposal was ratified unanimously.

Financial Reporting

Since 1994, our financial statements are prepared in accordance with International Financial Reporting Standards – adapted for the special activity of a central bank and taking into consideration the applicable Lebanese laws and regulations. Our accounting software was updated twice in 1997 and in 2008. The software we are currently using (Oracle) has helped upgrade the quality, accuracy and the speed of producing financial reports. This system not only helped us in improving the accounting and financial reporting but also helped in better timely decision making and costs rationalizing.

The summary (interim) Balance Sheet of the Central Bank is published every two weeks and we are part of the IMF General Data Dissemination System (GDDS).

CORPORATE GOVERNANCE AT THE BANKING SECTOR

As early as the year 2000, BdL issued several circulars to activate the control mechanisms as well as the principles of good governance in banks operating in Lebanon. Among other priorities, that included their boards' compositions and adherence to the principles of the International Basle Committee for enhancing Corporate Governance in banking institutions. Additionally, they were requested to prepare their own corporate governance guide.

In 2009, we established a unit dedicated to the issue of *Corporate Governance*. Its mission is to raise awareness about the **corporate governance culture** and to **enhance and advance its concept in the financial and banking sectors through promoting transparency and the development of**

effective monitoring and controls. This unit advocates international best practices and proposes regulations, policies and systems aiming at developing corporate governance frameworks at banks and financial institutions, and follows their sound implementation in these sectors.

In January this year, banks were directed to establish a Compliance Department responsible for wider risk management and financial stability that monitors and assesses their capital adequacy ratios, administration, profitability, liquidity, asset quality and ascertains the level of compliance with the circulars and standards set by BdL and the Banking Control Commission.

CHALLENGES AHEAD

Good corporate governance is a culture; our work on the subject will never be over. It is an every-evolutionary dynamic process.

On the global level, some fundamental questions need to be addressed:

- Are the current central banks' **institutional frameworks** in line with their new strategic mission of financial stability? Or do we need to amend our legislative mandates?

- How **independent** can central banks remain given their new and extended role?

- With the expansions of central banks' balance sheets, are the right skills and processes set in place, to measure, access and manage the **increased risk**?

As for us, at Banque Du Liban, we deal with an additional set of challenges. I will highlight a couple of major ones: how to weather the turbulent political and uncertain environment we are operating within? How to strengthen our balance sheet, and that of our banking system to ensure financial stability given the fiscal deficit? The most imminent one, however, remains internal - on the governance front – and that is to base every decision within the organization on the set of values that we have assented for ourselves – those of Sense of Urgency, Professionalism, Ethics beyond Doubt and Leadership-by-Example. After all, we consider that our most valuable asset is our reputation.

Thank you

References

[i] Senate hearing, December 2009

[ii] Basel Committee on Banking Supervision

[iii] International Association of Insurance Supervisors

[iv] International Association of Deposit Insurers

[v] Basel Institute on Governance, 2007, p6.

[vi] Key attributes of Good Governance: (IMF Safeguard assessment 2012)
Key attributes of good governance reflected in the safeguards assessments cover:
- Discipline, represented by senior management's commitment to observe and promote good governance;
- Transparency, which facilitates effective communication to, and meaningful analysis and decision-making by, external parties;
- Autonomy, which enables the top decision-making body such as the Board to operate without risks of undue influence or conflicts of interest, and is achieved through the application of objective criteria for the composition of, appointments to, and removal from such bodies;
- Accountability, whereby decision-makers such as the Board, its committees, and top management have effective mechanisms in place to report to, and as necessary discuss their actions with, the Parliament; and
- Responsibility, which entails giving a high priority to observance of ethical standards and permit corrective action, including for mismanagement where appropriate

[vii] Lybek & Morris, 2004, p37.

[viii] IMF article IV country report, 2009

[ix] IMF Guidelines for Foreign Exchange Reserve Management, September 2001