

A Review of the Legal and Regulatory Framework Pertaining to the Corporate Governance of Banks in Lebanon

This report, commissioned by Association of Banks in Lebanon and International Finance Corporation, was prepared by Alem & Associates and Étude Badri & Salim El Meouchi

FOREWORD

The Association of Banks in Lebanon (ABL) and the International Finance Corporation (IFC) joined efforts in launching a survey of corporate governance in the Lebanese banking sector consisting of two components: (i) a survey of corporate governance practices in Lebanese banks, and; (ii) a review of the legal and regulatory framework pertaining to bank corporate governance in Lebanon. Both the survey and review can be read separately, however, are intended to complement one another.

The overall project aimed to (i) analyze the corporate governance framework and practices in Lebanon's banking sector, thus helping banks and the regulator assess their corporate governance policies and practices, respectively framework, vis-à-vis their peers and against international best practices, and; (ii) identify areas for improvement for corporate governance in the Lebanese banking sector for both the regulator and banks themselves.

The review of the legal and regulatory framework —while commissioned, managed and edited by ABL and IFC's technical assistance facility, the Private Enterprise Partnership for the Middle East and North Africa (PEP MENA)—was prepared by Alem & Associates and Étude Badri & Salim El Meouchi. The survey of corporate governance practices in the Lebanese banking sector is published under separate cover. Both publications can be downloaded under www.abl.org.lb or www.ifc.org/mena.

Both the survey and review have been prepared as a guidance documents and are not intended to be exhaustive. Although the information provided therein is believed to be accurate and reliable, ABL and IFC make no representations or warranties, express or implied, as to the accuracy of such information. While the utmost care has been taken in the preparation of both publications, they should not be relied upon as a substitute for legal advice or as a basis for formulating business decisions.

The survey and review are based on information received and collected as of September 2005.

Any views expressed in this survey are those of the authors, Alem & Associates and Étude Badri & Salim El Meouchi, and do not necessarily represent the views of (i) ABL; (ii) the World Bank Group; (iii) IFC and PEP MENA, and; (iv) PEP MENA donor countries.

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About the Association of Banks in Lebanon

ABL is a professional industry organization which was established in 1959. Its key mission is to serve and defend the interests of its Lebanese and non-Lebanese member banks and to promote them on the domestic and international markets.

ABL is a key party when it comes to expressing views and opinions on both debatable macro-economic policy issues and drafts of new financial/banking rules and regulations. In addition, it plays an active role in coordinating banks' efforts on common interest issues such as setting the minimum fees and commissions on banking products and services, negotiating the employees union on employment collective convention, and upgrading the payment and telecommunication systems.

Under the leadership of a bi-annually elected board of directors, ABL fulfills its mandate through a fulltime professional staff, organized under a general secretariat, and through the cooperative efforts of banks' representatives in seven working commissions. Today, the support services provided to member banks have grown to include:

- Advocacy & representation in public policy forums.
- Information dissemination to all interested private and public sector entities, domestic and foreign.
- Research & statistics on financial and economic issues, and
- Training & development of the banking sector's human capital.

About International Finance Corporation

The mission of IFC, the private sector arm of the World Bank Group, is to promote sustainable private sector investment in developing and transition countries, helping to reduce poverty and improve people's lives. IFC finances private sector investments in the developing world, mobilizes capital in the international financial markets, helps clients improve social and environmental sustainability, and provides technical assistance and advice to governments and businesses. From its founding in 1956 through FY05, IFC has committed more than \$49 billion of its own funds and arranged \$24 billion in syndications for 3,319 companies in 140 developing countries. IFC's worldwide committed portfolio as of FY05 was \$19.3 billion for its own account and \$5.3 billion held for participants in loan syndications.

In the MENA region, IFC invested \$315 million in FY05 for its own account in 21 projects across a number of sectors. The focus of IFC's investments in the region was on highly developmental sectors, including housing and the development of smaller enterprises, with about 40 percent of FY05 commitments in these sectors. However, IFC's investment program in MENA remained broad-based and included the financial sector, manufacturing, oil and gas, education, agribusiness, and infrastructure. Efforts in higher-risk countries, including Afghanistan and Iraq, emphasized the financial sector and other basics of private sector development.

PEP MENA, which was launched in FY05, now enables the Corporation to provide a wide range of technical assistance throughout the region, including on corporate governance. IFC is using technical assistance, separately or in combination with long-term capital, to reach its goals and to introduce best practices in the region.

TABLE OF CONTENTS

INTRODUCTION	1
EXECUTIVE SUMMARY.....	5
A REVIEW OF THE LEGAL AND REGULATORY FRAMEWORK PERTAINING TO BANK CORPORATE GOVERNANCE IN LEBANON	13
I. GOOD BOARD PRACTICES	13
I.1 Authority of the board of directors.....	13
I.2 Board composition.....	14
I.3 Board structure	15
I.4 Remuneration of directors and managers.....	16
I.5 Board duties.....	17
I.6 Summary and recommendations	18
II. DISCLOSURE AND TRANSPARENCY.....	20
II.1 Financial performance.....	20
II.2 Risk exposure.....	22
II.3 Corporate governance disclosure.....	23
II.4 Summary and recommendations	25
III. RISK MANAGEMENT, AND CONTROL AND AUDIT MECHANISMS	27
III.1 Risk management.....	27
III.2 Internal control mechanisms.....	32
III.3 Internal audit.....	34
III.4 External audit.....	35
III.5 Summary and recommendations	37
IV. RIGHTS OF SHAREHOLDERS AND OTHER STAKEHOLDERS.....	39
IV.1 General provisions.....	39
IV.2 Ownership registration and disclosure	39
IV.3 Transfer of shares	40
IV.4 Access to information.....	40
IV.5 Shareholder general assembly.....	41
IV.6 Sharing in profits.....	44
IV.7 Disclosure of control-related structures and arrangements.....	44
IV.8 Equitable Treatment of Shareholders.....	45
IV.9 Related party transactions.....	50
IV.10 Role of stakeholders in corporate governance.....	51
IV.11 Summary and recommendations	56

V.	<i>SUPERVISORY FRAMEWORK</i>	60
V.1	Supervisory agencies.....	60
V.2	Permissible activities and appellation.....	62
V.3	Bank establishment.....	63
V.4	Transfer of shares.....	64
V.5	Acquisitions and investments.....	64
V.6	Capital adequacy.....	65
V.7	Evaluation of loan and investment policies, practices and procedures.....	66
V.8	Loan concentration.....	67
V.9	Related party transactions.....	67
V.10	Management of country, transfer, market and other risks.....	68
V.11	Internal control processes.....	68
V.12	Ethical standards and money laundering.....	68
V.13	Examination procedures.....	70
V.14	Financial records and consolidated supervision.....	71
V.15	Corrective measures.....	72
V.16	Summary and recommendations.....	73

ABBREVIATIONS

- **ABL:** Association of Banks in Lebanon
- **assembly:** the general assembly of shareholders
- **BCBS:** the Basel Committee on Banking Supervision
- **BCC:** the Banking Control Commission
- **BDL:** *Banque du Liban*, the Central Bank of Lebanon
- **BSE:** the Beirut Stock Exchange
- **CC:** the Lebanese Code of Commerce
- **central council:** the central council of the BDL
- **CLSS:** the Codes of Labor and Social Security
- **CMC:** the Lebanese Code of Money and Credit
- **governor:** the governor of the BDL
- **HBC:** the Higher Banking Commission
- **NIGD:** the National Institution for the Guarantee of Deposits
- **OECD:** the Organisation for Economic Co-operation and Development
- **SBC:** the Special Banking Court
- **SIC:** the Special Investigation Commission on money laundering

INTRODUCTION

The definition of and overall rationale for corporate governance

1. The OECD defines corporate governance as involving “a set of relationships between the company’s management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently”.
2. From a banking industry perspective, corporate governance involves the manner in which the business and affairs of banks are governed by their boards of directors and senior management, which affects how they:
 - Set corporate objectives;
 - Operate the bank’s business on a day-to-day basis;
 - Meet the obligation of accountability to their shareholders and take into account the interests of other recognized stakeholders¹;
 - Align corporate activities and behavior with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations, and;
 - Protect the interests of depositors.
3. Corporate governance matters to banks and companies as it can improve access to capital, attract premium valuations and lead to financing on improved terms. Corporate governance can further improve corporate performance by producing (i) superior leadership, oversight and strategic direction; (ii) efficient information flows and work processes, and; (iii) better compliance, accountability and less conflict. Corporate governance can make (or break) reputations by creating confidence, establishing goodwill and building or restoring investor trust.
4. Investors too care about corporate governance as well-governed banks and companies will tend to outperform their peers, safeguard and provide for higher returns on investment, protect shareholder rights, and provide assurance that management acts in the best interest of the company and all shareholders.
5. The public sector, finally, cares about corporate governance as it helps develop the public and private capital markets, reduces vulnerability to financial crises and can

1 Supervisors, governments and depositors are among the stakeholders due to the unique role of banks in national and local economies and financial systems, and the associated implicit or explicit deposit guarantees.

improve a country's ability to mobilize, properly allocate and monitor investments, all of which foster economic growth. As noted in the OECD Principles of Corporate Governance (OECD Principles),² "corporate governance is one key element in improving economic efficiency and growth as well as enhancing investor confidence".

Why corporate governance matters for the banking sector in particular

6. Banks play a crucial role in the economic development of any country by providing finance for large businesses and small and medium-sized enterprises (SMEs), basic financial services to a broad segment of the population and access to payment systems. This is particularly true in Lebanon, where the banking system plays the role of a "safety valve" for the Lebanese economy, while being expected to make credit and liquidity available in difficult market conditions.
7. When banks efficiently mobilize and allocate funds, this lowers the cost of capital to firms, boosts capital formation and stimulates productivity growth.³ Thus, weak governance of banks reverberates throughout the economy with negative ramifications for economic development. This is why it is of crucial importance that banks have strong corporate governance.

The purpose of this report

8. From this perspective, this report is submitted to provide a review of corporate governance obligations under the Lebanese legal and regulatory system as applicable to companies in general and to the banking sector in particular, identifying specific strengths and weaknesses, and submitting recommendations for reform.
9. This report is limited to corporate governance obligations imposed on banks incorporated as Lebanese joint stock companies, with the exception of Lebanese branches of foreign international banks.

Internationally recognized principles and best practices

10. Identifying areas for improvement of corporate governance in the Lebanese banking sector goes hand in hand with a clear understanding of internationally recognized corporate governance principles and best practices. In this respect, the main sources of corporate governance regimes on the international level that were taken into account when drafting this report—including legislation, major codes of best practice, and key reports and papers of relevance to corporate governance in the banking sector—are listed in Annex I attached hereto. The main sources that will be relied upon in this report will be the OECD Principles of Corporate Governance and the various papers of the Basel Committee on Banking Supervision (BCBS), including the recently issued 2006 Guidance on Enhancing Corporate Governance for Banking Organizations.

2 OECD Principles of Corporate Governance (2004).

3 Ross Levine, the Corporate Governance of Banks, paper prepared for the Global Corporate Governance Forum (WPS3404).

International experience and Lebanon's specificities

11. Potential reforms need to be considered in the context of both international experience and Lebanese legal and business specificities. Currently, there exists one singular difference between the US and EU experiences on how to approach corporate governance standards: while the US has always favored legislation and regulation including the use of fines and prison sentences as sanctions against companies and directors, the EU and EU countries favored the route of self-administered codes of best practice. Either approach can be valid depending upon national circumstances. It should be noted, however, that there appears to be a trend to shift policies towards more legislative-directed approaches in the EU.
12. In Lebanon, as in other countries, a mixture of self-administered and voluntary corporate governance codes of best practices on the one hand, and, on the other, legislative and/or regulatory interventions will likely predominate. Indeed, and as will be further explained in this report, gaps in legislative and regulatory statutes make some level of legislative intervention desirable.⁴
13. In parallel, the Beirut Stock Exchange (BSE), government authorities, the Lebanese banking regulator, *La Banque du Liban* (BDL) and/or the private sector could adopt a corporate governance code of best practice, based on which banks would be required to develop their own company-specific corporate governance codes and report periodically to the relevant regulatory authority (the BDL and the BSE) on their corporate governance practices and compliance with such codes.

Methodology

14. The research of internationally recognized best practices, analysis of the current legal framework in Lebanon, and conclusions/recommendations will be grouped into the following broad areas:
 - Good Board Practices (section I);
 - Disclosure and Transparency (section II);
 - Risk Management, and Control and Audit Mechanisms (section III), and;
 - Rights of Shareholders and Other Stakeholders (section IV).
15. Section V of this report (Supervisory Framework) restates international principles, and describes the local legal framework as regards the supervisors' task in ensuring the

⁴ The banking sector in Lebanon is governed by (i) the Code of Money and Credit (CMC); (ii) other laws specifically related to the Lebanese banking sector, and; (iii) general laws applicable to Lebanese joint-stock companies, mainly the Lebanese Code of Commerce (CC). Moreover, the Lebanese banking sector is specifically subject to the regulatory, monitoring and supervisory authority of (i) the Central Bank of Lebanon (*La Banque du Liban* (BDL)) created by the CMC, and; (ii) the Banking Control Commission (BCC). As part of their roles and authorities, the BDL and BCC issue decisions and circulars that are binding on Lebanese banks. Banks listed on the Beirut Stock Exchange (BSE) are also subject to the listing rules of the BSE.

sound conduct of banking activities. Banking supervisors are external pressure points for good corporate governance. Hence, a fair understanding of the supervisory framework seems useful in undertaking a review of the legal framework for bank corporate governance.

EXECUTIVE SUMMARY

I. GOOD BOARD PRACTICES

16. The current legal and regulatory framework regarding the authority, composition, structure, remuneration and duties of the board of directors could stand to be improved upon. Indeed, (i) the existing regulation on the board's nomination and election process remains insufficient; (ii) there are no specific qualifications for board members, especially regarding non-executive and independent directors; (iii) the chairman of the board is necessarily (by virtue of law) the bank's general manager; (iv) the legal framework as regards committees is wanting since boards are not required to establish audit, remuneration or nomination committees, and; (v) there is no requirement for the remuneration of board members to be addressed and recommended by a special remuneration committee.
17. Improvements to good board practices could be undertaken through the adoption of a corporate governance code of best practice by the BSE, BDL and/or private sector, directed primarily towards large and listed banks. However, existing legislative statutes have limitations which may make legislative intervention necessary. The following suggestions might be of use when considering reform:
 - Adopting a corporate governance code that recommends the creation of committees, including a:
 - *Audit committee* to oversee the bank's financial reporting, internal control mechanisms, internal and external auditors, non-compliance issues and other problems identified by the auditors in a timely fashion. All members of the audit committee should be independent non-executive directors.
 - *Nomination and corporate governance committee*, making recommendations on all new board appointments and recommending at all times a successor in case of an unexpected vacancy. The majority of the nomination/corporate governance committee members should be independent non-executive directors.
 - *Remuneration committee* for the purpose of making recommendations on remuneration of board members and managers. Remuneration committees should be made up wholly or mainly of independent non-executive directors.
 - Adopting a corporate governance code that recommends that boards include a minimum percentage of non-executive members, with a critical number of independent directors to effectively handle potential conflicts of interests, notably in the areas of overseeing financial reporting, setting executive remuneration and nominating directors. The corporate governance code would moreover have a clear definition of independence, extending to not being a representative of dominant shareholders or having close business or family ties with them.

- Modifying the CC to allow for the separation of the functions of chairman of the board and general manager.
- Modifying article 158 CC to include senior executives and major shareholders of the bank in the enumeration of related parties.

II. INFORMATION DISCLOSURE AND TRANSPARENCY

18. Under the current legal and regulatory framework, banks (as well as all companies) are required to apply the IAS/IFRS, while auditors are required to apply ISA in performing their audit tasks.
19. In general, the current legal framework on the disclosure of information is satisfactory, if not perfect. Listed banks are required to disclose their audited consolidated annual financial statements, quarterly consolidated financial statements, their management discussion of financial results, their external auditor's full report, and other information regarding their current and future situation, such as concentration in their assets, liabilities and off-balance sheet items, details of movement of certain items in the balance sheet and the profit and loss accounts, contingent liabilities and commitments including off-balance sheet items, loan loss, and information regarding the adopted strategies for monitoring and managing risks. Moreover, BCC regulations require listed banks to publicly disclose information on related party transactions.
20. Nevertheless, the current legal and regulatory framework remains laconic regarding public disclosure of the bank's governance structure and objectives.
21. From this perspective, a corporate governance code (to be adopted by the BSE and/or the BDL, jointly with the private sector), or a new BDL circular could recommend that listed banks disclose their corporate governance policies and practices, as well as their company objectives.

III. RISK MANAGEMENT, AND CONTROL AND AUDIT MECHANISMS

Risk management

22. Under the current legal framework, banks are required to (i) distribute their risks into specific categories, mainly credit, market and operational risk; (ii) evaluate their residual risks; (iii) manage credit risk in accordance with the applicable regulations (BCC Circular 238); (iv) manage market risk, operational risk and residual risks in accordance with the norms set by ABL (Generic Risk Management), and in general; (v) give particular attention to risk management.
23. In this respect, BCC Circular 242 provides for a detailed description of the responsibilities of the board, senior management, the bank's risk manager and the internal audit unit in managing and monitoring risks.

24. Credit risk, market risk and electronic banking risk are extensively regulated through binding circulars issued by both the BDL and the BCC. Under the current regulatory framework, banks have to abide, *on a consolidated basis*, by the regulatory limit for credit exposure, by the 12% capital adequacy ratio, and by the provisions of articles 152 and 153 CMC (regulation of related party credit facilities).

Internal control mechanisms

25. Banks are required to establish internal administrative units and implement internal control systems in compliance with the terms of BDL Circular 77, which is based on the Basel Committee's Framework for Evaluation of Internal Control Systems. In this sense, banks are required to establish internal control schemes concerning internal operations and procedures; accounting statements and financial reports; IT applications and safety measures; evaluation of risks; monitoring and mitigating risks; information and archiving, and; evaluation of the quality of assets.
26. Regarding the structure of internal control schemes, BDL Circular 81 requires boards to create one or more specialized committee(s) to approve all decisions concerning the granting of credit facilities, investments of the bank's available cash, real property investments, shareholding participation, and derivative and structured notes operations undertaken for the bank's own account. Pursuant to BCC Circular 242, internal control schemes should provide for a clear definition of the duties of the bank's managers and employees; they should also provide for the segregation of duties amongst the various bank management units. The bank's management is required by BCC Circular 242 to adopt detailed organizational charts establishing communication channels between the various levels of the bank's organizational structure.

Internal auditing

27. As regards internal audit, BDL Circular 77 requires boards to establish independent internal audit units whose duties comprise (i) auditing the bank's operations and financial statements to ensure their accuracy and the efficiency of measures adopted within the bank notably with respect to money laundering; (ii) reviewing the internal control mechanisms and the methods adopted by the bodies in charge of such control so as to ensure its efficiency, and; (iii) ensuring compliance with applicable laws and regulations.
28. In general, the current legal and regulatory framework regarding internal control and risk management is acceptable, since the BDL enjoys enough regulatory powers to address new developments in a timely and efficient manner. It should also be noted that the BDL is in the process of introducing Basel II requirements into the current regulatory framework.

External Auditing

29. International policy initiatives have explored audit firm and/or audit partner rotation as a possible means to strengthen their independence. While it may not be necessary to restrict the re-appointment of the same external auditors following expiry of their three-

year mandate, reforms to the legal and regulatory framework and/or development of a code of corporate governance could introduce audit partner rotation.

IV. RIGHTS OF SHAREHOLDERS AND OTHER STAKEHOLDERS

30. The existing legal framework could be strengthened as regards the disclosure of the identity of beneficial owners of bank shares, shareholder access to information, shareholder interaction with the board, and the disclosure of control-related arrangements and structures. In this sense: (i) applicable laws and regulations do not provide for express requirements regarding the disclosure of the identity of beneficial owners; (ii) the CC does not expressly grant shareholders the right of continuous access to information; (iii) form and time requirements for convening and conducting shareholder assemblies are not sufficiently dealt with under the current legal framework; (iv) boards are not legally required to answer shareholder questions (at least not expressly); (v) shareholders do not enjoy the right to place items on the agenda of assemblies (at least not expressly), and; (vi) the current legal and regulatory framework does not provide for specific requirements regarding disclosure of capital structures or arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership, such as pyramid structures or cross shareholdings.
31. A better interaction between the shareholders and the board, coupled with a greater quantity and quality of information are the cornerstones of an effective participation by shareholders in general assemblies. From this perspective, the following suggestions might be of use when considering an update to the current legal and/or regulatory framework:
 - Introducing specific requirements regarding the disclosure of the identities of beneficial owners.
 - Granting each shareholder access to relevant information and documents at the bank's expense as of the date of the call for any assembly. Said information/documents should include at a minimum the detailed meeting's agenda; the draft resolutions; the reasoning behind the draft resolutions, and; a table showing the financial results of the bank for the last five financial years.
 - Granting each shareholder, at all times, access to all information/documents made available to the shareholders for all assemblies held during the last three years.
 - Adding specific legal provisions to the existing general framework pertaining to the form and time requirements for convening assemblies.
 - Granting each shareholder, regardless of his shareholding percentage, the right to submit written questions to the board and be answered on the same, as of the date of the call for the concerned assembly and until the effective holding thereof.

- Granting shareholders representing a pre-defined minimum percentage of the share capital (e.g. 0.5% to 5%, depending on the capital amount) the right to (i) place items on the agenda of assembly meetings and propose resolutions, and; (ii) submit written questions to the board, at least twice a year, concerning anything that might substantially affect the bank's operation.
 - Introducing specific requirements regarding disclosure of capital structures or arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership.
32. Applicable laws and regulations provide for some basic principles and guidelines regarding the equitable treatment and protection of minority shareholders. The legal framework, however, could stand to be improved in certain areas.
 33. Concerning the equal treatment of shareholders, the CC automatically grants a double voting right to shareholders owning registered shares for at least two years. Additionally, the current legal framework does not provide foreign or non-resident shareholders with effective means to vote, since absentee ballots (*vote par correspondance*) are not possible. All shareholders must be present or represented to be able to cast their votes.
 34. On another level, additional measures aiming to protect minority shareholders on an *ex ante* basis need to be introduced. For instance, the lack of cumulative voting makes it difficult for minority shareholders to be represented on the board. As regards remedial mechanisms, the possibility for shareholders to invoke fraud or misuse of authority (*abus de majorité*) as a means to challenge majority voting is rarely successful, while prosecuting directors for fraud, breach of the law, breach of the bank's by-laws or mismanagement before state courts remains a lengthy, open (not confidential) and costly process.
 35. Furthermore, the current legal framework does not expressly provide for a duty of board members and key executives to disclose to the board their material interest in transactions or matters directly affecting the bank.
 36. Accordingly, the following suggestions could be taken into consideration when contemplating a legislative/regulatory reform:
 - Reconsidering article 117 CC. Amending article 117 CC so that the granting of any double voting right becomes subject to the prior approval of the extraordinary assembly could be an option.
 - Pursuant to article 176 CC, the external auditors must convene an assembly whenever required by a group of shareholders representing one-fifth (20%) of the share capital. This threshold may be too high; a lower percentage could be adopted in the context of legislative and/or regulatory reforms.
 - Recognizing cumulative voting in electing board members (a mechanism ensuring proportionate representation of the shareholders at board level) as an acceptable method to protect minority shareholders.

- Regarding listed banks, introducing adjudication procedures (such as administrative hearings or arbitration procedures organized by the BSE) to allow for timely, confidential and cost-efficient processes for resolving disputes between shareholders, directors and managers.
 - Allowing absentee ballots (*vote par correspondance*) for assemblies.
 - Introducing a specific requirement for board members and senior executives to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the bank.
37. The general regulation of related party transactions, as provided under article 158 CC, may also require attention. Article 158 requires that any direct or indirect transaction between the bank, on the one hand, and any of its board members or any other institution or entity, if any of the bank's directors is an owner, partner, manager or director of the same, on the other hand, must be authorized in advance by the assembly. This enumeration of related parties is restrictive; it does not include senior executives and major shareholders of the bank. Moreover, the terminology in article 158 CC with respect to "ordinary contracts involving operations between the company and its clients" could be tightened to avoid circumvention of said rule. Finally, the exception to the requirement for prior approval of related party credit facilities, as provided for under article 152 § 4(e) CMC, should also be tightened.
 38. Under the current legal framework, stakeholders are not granted access to information other than what is publicly available and do not participate in the corporate governance process. For instance, there is no guidance on how a bank could consider employee viewpoints in certain key decisions.
 39. Concerning deposit insurance, the current guarantees provided by the NIGD are nominal. In case of a bank failure, the NIGD pays each depositor a lump sum guarantee capped at an amount equivalent to approximately US\$ 3,335, regardless of the account's balance or the number of accounts opened by the same depositor with the concerned bank. The current deposit insurance framework could be revised with a view towards international best practice in this area.
 40. As regards the current insolvency framework, a legislative effort could be undertaken to modernize and unify the applicable systems. In fact, banks are subject to three sets of laws: (i) the common outdated bankruptcy regulation as set forth under the CC; (ii) Law 2/67 describing the specific measures to be taken in case of a bank's failure, and; (iii) temporary Law 110/91 governing the seizure of banks.
 41. From this perspective, the following suggestions could be taken into consideration when contemplating an update to the current legal framework:
 - Adopting a code of corporate governance that could provide guidance on how to ensure that employees and other stakeholders participate in the bank's corporate governance process, for example for bank employees to form works councils that consider employee viewpoints in certain key decisions.

- Revising the current deposit insurance framework, while maintaining a good balance between the need to prevent bank runs and the need to circumvent tendencies to engage in excessive risk.
 - Updating and unifying the current insolvency systems in one legislative act.
42. On another level, regarding banks' relationships with their customers, in particular depositors, special dispute resolution mechanisms could be adopted in the context of a legislative reform, to look into disputes arising between banks and their customers,⁵ thereby ensuring that customers obtain timely and effective redress for violation of their rights.

V. SUPERVISORY FRAMEWORK

43. The legal and regulatory framework for bank supervision provides for acceptable minimum standards that banks must meet; it allows supervisors (mainly the BDL and BCC) to set prudential rules administratively, where necessary, to achieve objectives, and utilize qualitative judgment.
44. In general, the division of authorities and the interaction between the authorities in charge of banking supervision in Lebanon are sound. The current legal framework for banking supervision is also, in general, suitable. It includes provisions relating to the authorization of banking organizations and their ongoing supervision, powers to address compliance with laws as well as safety and soundness concerns. The BDL, the BCC and the SIC enjoy significant powers to gather and independently verify information. The HBC has the necessary powers to enforce a range of penalties that may be applied when prudential requirements are not being met.
45. Still, two particular concerns may well be raised. First, the existing regulation as regards transfer of significant ownership or controlling interests should be addressed. Pursuant to Law 308, the central council's prior approval is required (i) if as a result of a transfer of, or subscription to, shares, one shareholder becomes directly, or pursuant to Law 520 (i.e., on a fiduciary basis), the owner of more than 5% of a bank's shares or voting rights, and; (ii) for any acquisition, purchase or subscription of shares by a shareholder owning 5% or more of a bank's shares or voting rights.
46. The above restriction would, however, be difficult to implement whenever bank shares are held by other banks or financial institutions on a fiduciary basis, given that Law 520 precludes banks or financial institutions acting as custodians from revealing their beneficiaries' identities.
47. In practice, however, the BDL does not accept that shares of banks be held in custody by banks or financial institutions. Law 308 should be amended to uphold this practice.

⁵ Knowing that disputes between Banks and their "consumer" customers are subject to a specific mediation/arbitration mechanism.

Alternatively, Law 520 could be amended so as to allow disclosure of beneficial ownership in banks to the BDL.

48. Second, independence requirements for banking supervisors could be strengthened further since there is no legal obligation for rotation in the functions of the BDL's governor, the vice-governors, and most importantly the BCC members. Such an obligation, which may possibly include, *inter alia*, a requirement for gradual rotation of the vice governors and the BCC members, could be introduced in the context of a legislative reform.

A REVIEW OF THE LEGAL AND REGULATORY FRAMEWORK PERTAINING TO BANK CORPORATE GOVERNANCE IN LEBANON

I. GOOD BOARD PRACTICES⁶

49. Lebanon's economy depends to a large extent on the drive and efficiency of its banks. Thus, the ability with which a bank's board of directors discharges its responsibilities plays an important role in determining Lebanon's banking sector's competitive position. They must be free to drive their banks forward, but exercise that freedom within a framework of effective accountability. This is the essence of any system of good corporate governance.
50. Together with guiding corporate strategy, the board is chiefly responsible for monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing competing demands on the corporation. In order for boards to effectively fulfill their responsibilities, they must be able to exercise objective and independent judgment. Another important board responsibility is to oversee systems designed to ensure that the bank obeys applicable laws, including tax, competition, labor, environmental, equal opportunity, health and safety laws. The board is not only accountable to the bank and its shareholders but also has a duty to act in their best interests. In addition, boards are expected to take due regard of, and deal fairly with, other stakeholder interests.⁷
51. Board structures are not the same worldwide. Certain countries have adopted two-tier structures where two different bodies are in charge of the supervisory and the management functions. Other countries, including Lebanon, have adopted a unitary structure with a board of directors that brings together both management and supervisory functions, and thus executive and non-executive members.

I.1 Authority of the board of directors

52. *The board of directors should approve and oversee the bank's strategic objectives and corporate values that are communicated throughout the banking organization. The board of directors should set and enforce clear lines of responsibility and accountability throughout the organization. Finally, the board should have a formal schedule of matters specifically reserved to it for decision to ensure that the direction and control of the bank is firmly in its hands.*
53. Pursuant to article 157 CC, the board has the full authority to implement the assembly's decisions and to carry out all activities required for the usual functioning of the bank and which are not categorized as daily activities. In other terms, and as provided under the

6 The following sections will include a brief synthesis of the main internationally recognized principles and guidelines that should govern the authority, composition and appointment, structure, remuneration and performance of the board (highlighted in italics for ease of reference), as well as a review and analysis of the current legal framework in Lebanon as regards the same, and followed by a set of recommendations.

7 From the OECD Principles of Corporate Governance.

same article 157, the board can make any decision regarding the bank's business, except for such matters that are reserved by the law or the bank's by-laws to the assembly.

I.2 Board composition

Election and dismissal of directors

54. *The board should ensure a formal and transparent board nomination and election process. All directors should be submitted for re-election at regular intervals.*
55. Lebanese law does not impose specific requirements regarding the board's nomination and election process. The board (as a whole) is elected by the assembly for a maximum period of three years, while the chairman of the board, necessarily a shareholder and director, is elected by the board itself. The assembly may at any time revoke any of the board members, including the chairman.
56. In this context, the BSE and/or the BDL could adopt a corporate governance code of best practice, recommending the development of selection criteria, as well as the creation of nomination/appointment committees, making recommendations on all new board appointments and recommending at all times a successor in case of unexpected vacancy. The majority of the nomination/appointment committee members should be independent non-executive directors.

Mix-of-skills

57. *Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank.*
58. The board must be composed of three to twelve members, all of whom need to be shareholders of the bank. Moreover, the majority of board members must be Lebanese, which may render acquisitions and equity investments more complex for foreign investors, in particular for investors willing to purchase majority stakes in a bank, and thus negatively affect foreign direct investment into Lebanon. Lebanese law does not impose any other specific requirements or qualifications for board members. Article 127 CMC provides for basic requirements only, prohibiting persons convicted of specific crimes (such as embezzlement, violation of the banking secrecy law and other) or bankrupt persons from founding, incorporating, managing or working with a bank.

Executive vs. non-executive directors

59. *The board should include a balance of executive and non-executive members. A critical number of non-executive directors should be independent.*
60. The existence of independent board members is an important requirement for the board to be able to exercise objective judgment, especially when performing its duties of monitoring managerial performance, preventing conflicts of interest and balancing competing demands on the bank.

61. In defining independent members of the board, some national principles and codes of corporate governance have specified detailed criteria for independence. For instance, the Bouton Report (September 2002) defines an “independent director” as a person who does not have any link whatsoever with the bank (beyond his/her directorship), with any of the bank’s group companies or with the bank’s management and who, as such, is deemed to be acting objectively. In this sense, the independent director may not (i) be (or have been during the past five years) an employee or a manager of the bank or any of the bank’s group companies; (ii) be a manager of a company of which the bank is (or has been during the past five years) a director; (iii) be a significant customer or supplier of the bank; (iv) have family links with a manager; (v) have been an auditor of the bank during the past five years, or; (vi) have been a director of the bank for 12 years.
62. The variety of board structures, ownership patterns and practices in different countries will, however, require different approaches to the issue of director independence. In Lebanon, independence from dominant shareholders should also be emphasized, given that the Lebanese banking sector is dominated by a few families. The considerable powers that a dominant shareholder enjoys in appointing the board and management should be balanced with effective means to guarantee the board’s fiduciary responsibility to the bank and to all shareholders, including minority shareholders.
63. In summary, the BSE, BDL and/or the private sector could adopt a corporate governance code of best practice, based on which banks would be asked to include in their boards a minimum percentage of non-executive members, including a sufficient number of independent directors, with independence extending to not being a representative of dominant shareholders or having close business or family ties with them.

I.3 Board structure

Separation of chairman and general manager

64. *There should be a clearly accepted division of responsibilities at the head of a bank between the running of the board and the executive responsibility for the running of the bank’s business. No one individual should have unfettered powers of decision. In particular, the roles of chairman of the board and chief executive officer should not be exercised by the same individual.*
65. In direct challenge to internationally recognized best practices, the chairman of the board, necessarily a shareholder of the bank and a board member, is also necessarily by virtue of law the bank’s general manager. This individual is, hence, referred to as the chairman-general manager. The chairman is responsible for implementing the board’s decisions and the daily business of the bank.
66. The link between the bank’s chairmanship and general management is one of public order; it is embedded in the text of the CC. Consequently, a legislative intervention is inevitable to make the separation of the two functions possible.

Board committees

67. *The board should establish an audit committee comprised only of independent non-executive directors with written terms of reference defining clearly its authority and duties.*
68. Pursuant to article 153 CC, the chairman may appoint consultative committees composed of board members and/or managers. Such committees enjoy no decision-making authorities; they are only of a consultative nature.
69. Nonetheless, and pursuant to BDL Circular 81,⁸ the board must set one or more specialized committee(s) to address risk issues, and decide on the granting of credit facilities, investments of the bank's available cash, real property investments, shareholding participation, and derivative and structured notes operations undertaken for the bank's own account. ⁹ Also, and according to BDL Circular 83,¹⁰ the board must establish a specialized committee in charge of ensuring effective implementation of anti-money laundering laws and regulations.¹¹
70. Most important, however, is the fact that Lebanese laws and regulations place no obligation on the board to appoint an audit committee. A corporate governance code of best practice (by the BSE and/or the BDL) could fill this gap by highlighting the value-added of board-level and management-level committees, as well as type of committees typically found in banks. More specifically, the code could recommend the appointment of an audit committee that would oversee the bank's internal and external auditors, non-compliance issues and other problems identified by the auditors in a timely fashion. All members of such audit committee should be independent non-executives.

I.4 Remuneration of directors and managers

71. *The board should ensure that remuneration policies and practices are consistent with the bank's corporate culture, long-term objectives and strategy, and control environment. Board member and manager remuneration should be subject to the recommendations of a remuneration committee made up wholly or mainly of independent non-executive directors. The board should align key executive and board remuneration with the longer term interests of the bank and its shareholders.*
72. Remuneration of board members is decided by the ordinary assembly; it is not necessarily subject to recommendation by the board or a board-level remuneration committee, or to the adoption of a specific remuneration policy. In view of that, a code of best practice could recommend best practices with respect to executive and non-executive remuneration policies, as well as the creation of remuneration committees for the purpose of making recommendations on the remuneration of board members and managers. The remuneration committee should be made up wholly or mainly of independent non-executive directors, to avoid having executive directors set their own pay.

8 Basic Decision no. 7776 dated 21 February 2001 (also referred to as Basic Circular 81).

9 BDL Circular 81, however, mentions nothing regarding the composition of this committee(s).

10 Basic Decision no. 7818 dated 18 May 2001 (also referred to as Basic Circular 83), as recently amended by BDL's Interim Decision no. 8488 dated 17 September 2003.

11 See paragraphs 345 and 346.

73. Pursuant to article 145 CC, board members may be remunerated either by an annual lump sum fee, attendance fees, a percentage of the net benefits from the net returns of the exploitation of the bank's object, or a combination of these elements. Returns on portfolios may not be included in such remuneration except by a special decision of the ordinary assembly renewed every year.
74. It should be noted that the remuneration of the chairman and board members holding executive functions¹² may include an equity component. Indeed, pursuant to Law no. 308 dated April 3, 2001 (Law 308),¹³ the bank's extraordinary assembly may authorize the board to grant the above individuals free option rights entitling them to subscribe to the bank's share capital. The board shall decide on the terms and conditions of said option rights.

I.5 Board duties

75. *The board should be effective in exercising control over the bank and monitoring the executive management. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the bank and the shareholders, while taking into account the interests of stakeholders. Board members should be able to commit themselves effectively to their responsibilities.*
76. Under general principles of commercial law, all board members owe a fiduciary duty to the bank to act in its best interest, which is taken to mean a duty to act in the best interest of shareholders as a whole, both present and future. Board members are also required to act with due diligence and care.
77. On the one hand, the above principles require board members to be loyal to the bank and to refrain from using their position to obtain profit for themselves or a third party. This is required by the "Related Party" regulation provided for under the CC and the CMC.¹⁴
78. On the other hand, the duty of care is sanctioned by (i) the assembly's right to revoke any of the board members (including the chairman) at all times, and; (ii) the board members' liability towards the bank and its shareholders for mismanagement, fraud, breach of the law or breach of the bank's by-laws.¹⁵ In this context, each board member must hold a minimum number of shares in guarantee of the good performance of his duties. The minimum number of guarantee shares that a board member must own is determined in the bank's by-laws. Care is warranted in setting the minimum number of guarantee shares to avoid jeopardizing the independence of non-executive directors.
79. Pursuant to article 154 CC, no person may act as chairman for more than four companies/banks. No person may act as a board member in more than six companies/banks, and no person above seventy years of age may act as a board member

12 Also managers and employees.

13 Article 4 (a).

14 See paragraphs 242 to 249.

15 See paragraphs 230 to 234.

for more than two companies/banks. Moreover, pursuant to article 159 CC, board members may not participate in the management of another bank without a prior authorization to be renewed every year.

I.6 Summary and recommendations

80. The current legal and regulatory framework regarding the authority, composition and appointment, structure, remuneration and duties of the board could be improved upon. Indeed, (i) the existing regulation pertaining to the board's nomination and election process remains insufficient; (ii) there are no specific qualifications for board members, especially regarding non-executive and independent directors; (iii) the chairman is necessarily (by virtue of law) the bank's general manager; (iv) there is no requirement for the remuneration of board members to be addressed by the board and an independent remuneration committee, and; (v) the legal framework as regards committees is wanting since boards are not required to establish audit, remuneration or nomination committees.
81. Improvements could be undertaken through the adoption of a corporate governance code of best practice by the BSE, BDL and/or the private sector, directed in particular towards large and listed banks. However, existing legislative statutes have limitations which may make legislative intervention necessary. The following suggestions might be of use when considering reform:
- Modifying the CC to allow for the separation of the functions of chairman of the board and general manager.
 - Adopting a corporate governance code that recommends:
 - That boards include a minimum percentage of non-executive members, a critical number of which should be independent, independence extending to not being a representative of dominant shareholders or having close business or family ties with them. The corporate governance code would also develop a definition of independence.
 - Banks to differentiate between the remuneration practices for executive and non-executive directors and that advises boards to create remuneration committees for the purpose of making recommendations on remuneration of board members and managers. Remuneration committees should be made up wholly or mainly of independent non-executive directors.
 - That boards create an audit committee to oversee the bank's financial reporting, internal control mechanisms, internal and external auditors, non-compliance issues and other problems identified by the auditors in a timely fashion. All members of the audit committee should be independent non-executive directors.
 - The creation of nomination/appointment committees, making recommendations on all new board appointments and recommending at all times a successor in case of an unexpected vacancy. The majority of the nomination/appointment committee members should be independent non-executive directors.

- Bank's to introduce effective whistle-blowing procedures.
- Loosening the requirement for the majority of board members to be Lebanese nationals, thus facilitating foreign direct investment into Lebanon.

II. DISCLOSURE AND TRANSPARENCY¹⁶

82. *The bank should be governed in a transparent manner.*
83. Bank transparency is a key element of an effectively supervised, and thus safe and sound banking system. Accordingly, the BCBS¹⁷ defines transparency as public disclosure of comprehensive, reliable, material and timely information enabling users (market participants and supervisors) to make an accurate assessment of a bank's financial condition and performance, its business activities and the risks related to those activities, and generally evaluate the safety and soundness of its operations.

II.1 Financial performance

84. *Both market participants and supervisors should be given proper and timely access to sufficient information in connection with the financial performance of the bank. This includes basic quantitative indicators such as breakdowns of income and expenses; management's discussion and analysis of financial performance; significant accounting policies on which financial reporting is based; business and geographical segment diversification; nature and amount of assets, liabilities, commitments, contingent liabilities and shareholders' funds, and; the provisions and allowances for losses. Financial information should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial disclosure.*
85. Article 146 CMC requires banks to provide financial accounts closed on 31 December of each year (noting that the fiscal year must match one full calendar year), including a balance sheet and profit and loss accounts. For this purpose, the concerned bank and all of its branches in Lebanon are considered as one indivisible entity.¹⁸
86. The Lebanese ministry of finance has confirmed, through its decision no. 673/1¹⁹ and circular no. 742/s1,²⁰ the legal requirement for application of both IAS (and thereby IFRS) and ISA.
87. Article 101 CC sets forth a common legal requirement regarding public financial disclosure, applicable to both listed and unlisted banks. Pursuant to article 101, the board must publish every year, two months following the ratification of accounts by the annual assembly, in the official gazette and in an economic and local daily newspaper, the balance sheet of the closed financial year as well as the names of the board members and auditors. It should be mentioned that, pursuant to BDL Circular 34,²¹ the banks' audited annual financial statements (balance sheet and profit and loss accounts) must be published in three formats: (i) consolidated with the accounts of the bank's Lebanese

16 The following sections will include a brief synthesis of the main internationally recognized principles and guidelines pertaining to information disclosure and transparency (highlighted in italics for ease of reference), as well as a review and analysis of the current legal framework in Lebanon as regards the same, and followed by a set of recommendations.

17 See mainly the BCBS paper: Enhancing Bank Transparency (Public disclosure and supervisory information that promotes safety and soundness in banking systems, September 1998).

18 Articles 143 and 144 CMC.

19 Dated 21 June 2001.

20 Dated 15 April 2002.

21 Basic Decision no. 6576 dated 24 April 1997 (also referred to as Basic Circular 34), Article 9.

branches; (ii) consolidated with the accounts of the bank's Lebanese and foreign branches, and; (iii) consolidated with the accounts of all of the bank's affiliates/ related entities, irrespective of if the affiliates are domestic or foreign and irrespective of the nature of their activities (banking or non-banking). For the purpose of BDL Circular 34, an entity will be deemed a related entity if:

- Its financial and operational policies are exclusively controlled by the concerned bank;
- Its financial and operational policies are controlled through a shareholder agreement between the concerned bank and other shareholders, without any of them having exclusive control, or;
- At least 20% of its voting rights are held, directly or indirectly, by the concerned bank.

88. Financial disclosure for banks listed on the BSE is subject to Decree-Law no. 120 dated 16 September 1983²² (D-L 120), the BSE's by-laws and the relevant BDL and BCC circulars.²³ In this respect, listed banks are required to:

- Publish their audited consolidated annual financial statements, along with the annual cash flow statements, in the official bulletin of the BSE, two local newspapers and a specialized economic magazine.²⁴
- Prepare a yearly bulletin in the Arabic language and at least one foreign language. This yearly bulletin, which is a publicly available document, must incorporate the following (BCC Circular 199):
 - The full text of the auditor's Annual Report;²⁵
 - Pre-defined information regarding the bank's affiliates and related parties;
 - Information on the substance and term of the BDL authorization granted to the bank to repurchase its own publicly-traded shares (if any), and;
 - All clarifications as required by IAS, including: management's discussion of assets and liabilities; concentration in assets and liabilities and off-balance sheet items; details of movement of certain items in the balance sheet and the profit and loss accounts; contingent liabilities and commitments including off-balance sheet items; loan losses; information regarding related party transactions, and; strategies for monitoring and managing risks.

22 Regulations of the BSE, as amended by virtue of Decree-law no. 30 dated 23 March 1985 and Law no. 418 dated 15 May 1995.

23 The said BDL and BCC circulars are also applicable to banks listed on foreign regulated markets.

24 BSE's by-laws and BCC Circular no. 199, dated 4 August 1997.

25 As defined under paragraph 165.

- Publish consolidated quarterly financial statements including (i) the status of their assets, liabilities and off-balance sheet items, and; (ii) the profit and loss accounts. The above quarterly statements must be published in the official bulletin of the BSE, two local newspapers and a specialized economic magazine.²⁶
 - Publish their financial results every six months in the official bulletin of the BSE.
 - Notify the BSE and the public of every factor or change affecting their financial situation or activity.
 - Notify the shareholders explicitly, at any moment and under any circumstance, of all information of interest to them and to treat them fairly without discrimination, regardless of their shareholding percentage.
 - Report to the BSE any sale or transfer of assets, when the operation's value exceeds 5% of the bank's market capitalization.
 - Report to the BSE anything that may positively or negatively affect the price of the bank's traded securities.
 - Provide the BSE, for free public access purposes, with five copies of every document addressed to shareholders and any statement published in the newspapers.
89. As far as disclosure to banking supervisors is concerned, article 146 CMC requires banks to submit their annual financial statements to the BDL (and thereby to the BCC), and BDL Circular 76²⁷ requires them to report their monthly situation to the BDL and the BCC (including assets, receivables and off-balance sheet items). Based on articles 146 and 149 CMC, the BCC may request bank managers to submit or to confirm in writing any information, clarification or evidence.²⁸
90. Pursuant to BDL Circular 34,²⁹ the above annual financial statements and monthly situations³⁰ must be submitted to the BDL and the BCC on an individual and consolidated basis, *i.e.* consolidated with the accounts of the concerned related entities; irrespective of if the affiliates are domestic or foreign and irrespective of the nature of their activities (banking or non-banking).

II.2 Risk exposure

91. *Disclosed information must include the limits and periodic review of risk exposures, including strategies for monitoring and managing risk and the effectiveness of those strategies, and of the internal control system.*

26 BCC Circular 195.

27 Basic Decision no. 7723 dated 2 December 2000 (also referred to as Basic Circular 76).

28 BCC Circular no. 136 dated 19 November 1990 describes in detail the information that shall be periodically submitted by banks to the BCC (monthly, quarterly, semi-annually and annually).

29 Article 8.

30 And all other periodical statements.

92. As noted, listed banks are required to publish in a yearly bulletin certain information regarding their risk exposure, including *inter alia*, concentration in their assets and liabilities and off-balance sheet items; details on the movement of certain items in the balance sheet and the profit and loss accounts; contingent liabilities and commitments including off-balance sheet items; loan loss, and; information regarding the adopted strategies for monitoring and managing risks.
93. In addition, and as far as credit risk is concerned, BDL Circular 75³¹ created the *Centrale des Risques Bancaires* (Central Office of Credit Risk). Pursuant to BDL Circular 75, banks must continuously disclose to the Central Office of Credit Risk specific information concerning loans granted to their customers. Its mission is to centralize information relating to debtors. Information available to the Central Office of Credit Risk is confidential and is solely used for informing banks and financial institutions concerning the total loans (total amount of debts) granted to each customer, provided, however, that such customer has granted the interested bank the right to access the information filed with the Central Office of Credit Risk.
94. As far as banking supervision is concerned, and as already explained in this Section, banks are required to submit to the BDL and to the BCC, periodically and on demand, detailed financial information regarding their operations, based on which, the BDL and the BCC will assess the said banks' compliance with the applicable legal and regulatory requirements pertaining to the various risk exposures.³²
95. In particular, and concerning evaluation of credit risk, BDL Circular 58³³ requires banks to provide the BCC with the necessary documentation evidencing their compliance with the evaluation norms adopted by the BCBS. Banks are also required to provide the Directorate of Statistics and Economic Research at the BDL with the status of their loan portfolio's risk evaluation on a quarterly basis.
96. Concerning the effectiveness of internal control systems, BDL Circular 77,³⁴ setting forth the regulatory framework for internal control in banks, grants the BCC access to valuable assessment reports prepared by the concerned bank's internal audit unit and the external auditor.³⁵

II.3 Corporate governance disclosure

97. *Banks should release to market participants and supervisors information on their objectives, basic organizational and governance structure, and their ability to respond to changes in the marketplace. This includes information about: the entity's legal structure; the board structure and its responsibilities; the senior management structure, their reporting duties, their qualifications and experience; the incentive structure including the remuneration policies for executives and*

31 Basic Decision no. 7705 dated 26 October 2000 (also referred to as Basic Circular 75).

32 A description of the current legal framework pertaining to risks and risk management is provided under section III.1.

33 Basic Decision number 7159 dated 10 November 1998 (also referred to as Basic Circular 58).

34 Basic Decision no. 7737 dated 15 December 2000 (also referred to as Basic Circular 77).

35 A description of the legal framework pertaining to internal control is provided under section III.2.

staff, the role of the board in setting compensation; compensation amounts; the transactional structure and the nature and extent of transactions with affiliates, and; related parties.

98. Basic information regarding the bank's legal structure as portrayed in its by-laws, and information regarding the identity of the chairman and board members are generally available to the public through the Commercial Register. In addition, pursuant to article 100 CC, the bank's by-laws must be posted in the bank's offices and any person may obtain a certified copy thereof. Also, it should be noted that the minutes of board and assembly meetings are generally filed with the Commercial Register.
99. Under BCC Circular 199 and the BSE by-laws, listed banks are required to:
- Include in their yearly bulletin³⁶ (i) a detailed list of the names of their major shareholders and board members, and; (ii) a list of the bank's affiliates, their purpose, the names of their board members, and the extent of the bank's shareholding in each of such affiliates.
 - Provide the BSE with all minutes of board and assembly meetings.
 - Provide the BSE with certain information and documentation concerning the bank itself and its affiliates,³⁷ mainly: (i) critical changes in the nature of the operations carried out by the bank; (ii) total or partial changes in the board and general management, and; (iii) appointment of new external auditor(s).
 - Provide the BSE with information regarding any variation in the number of voting rights enjoyed by any of the bank's shareholders, when the bank is aware of the same, and when the variation exceeds: (i) 2% for the general manager, the assistant general manager, or a board member, and; (ii) 10% for each of the other shareholders enjoying directly or indirectly more than 10% of the voting rights in the listed bank.
100. As noted above,³⁸ banks (and all companies in general) are required to apply IAS in the preparation of their financial statements before publishing the same. Consequently, and as required by IAS 24, banks are under a legal obligation to disclose key management personnel compensation, including director compensation. It should be noted, however, that the current legal and regulatory framework does not require public disclosure of the bank's governance structure, charter and objectives. Thus, a corporate governance code (to be adopted by the BSE and/or the BDL, jointly with the private sector), or a new BDL circular could recommend that listed banks disclose their company objectives.
101. As far as banking supervision is concerned, detailed corporate governance information must be submitted to the BDL before granting a license for the establishment of a bank. The application for the license should include (without limitation) the following documents and information:

36 See paragraph 88.

37 As defined by D-L 120.

38 As defined by D-L 120.Section II.1

- Official documents evidencing the identities of the founders, the persons expected to participate in the subscription to and payment of the capital and the persons expected to be in charge of key management duties;
 - Signed CVs, extracts of the judiciary record, and detailed evaluations of assets for each of the above individuals, and;
 - The draft by-laws, the projected management structure, the projected internal audit and control structure, and the projected operational structure.
102. In addition, and pursuant to BCC Circular 214,³⁹ banks are required to submit to the BCC detailed information regarding changes affecting their boards and senior management.
103. Regarding related party transactions, and as noted below,⁴⁰ article 158 CC provides that the board and the external auditor, separately, must submit to the assembly a special report concerning anticipated related party transactions. In the same context, article 152 CMC provides that the board and the external auditor must inform the annual ordinary assembly of the terms and conditions of the granting of credit facilities to related parties and of the status of compliance with said conditions.
104. In addition, and pursuant to article 187 CMC, the external auditor must submit to the annual assembly a special detailed report regarding credit facilities granted directly or indirectly to the bank's board members and senior management.⁴¹ Pursuant to article 188 CMC, bank auditors are also required to communicate a copy of the above reports to the governor and the BCC.
105. As far as public disclosure is concerned, BCC Circular 199 sets a requirement for listed banks to disclose in their yearly bulletin⁴² significant information regarding related party transactions and transactions with their affiliates, including the scope and nature of each transaction, and their strategies in this regard.

II.4 Summary and recommendations

106. The Lebanese ministry of finance has confirmed, through its decision no. 673/1 and circular no. 742/s1, the legal requirement for application of both IAS/IFRS and ISA.
107. In general, the current legal framework on public disclosure of information is satisfactory, however, could be improved upon with respect to non-financial disclosure. Listed banks are required to disclose their audited consolidated annual financial statements, quarterly consolidated financial statements, their management discussion of financial results, their external auditor's full report, and other information regarding their current and future situation, such as concentration in their assets and liabilities and off-balance sheet items, details of movement of certain items in the balance sheet and the

39 Dated 29 June 1999.

40 See paragraphs 242 to 249.

41 See paragraph 168.

42 See paragraph 88.

profit and loss accounts, contingent liabilities and commitments including off-balance sheet items, loan loss, and information regarding the adopted strategies for monitoring and managing risks. Moreover, the BCC regulations require listed banks to publicly disclose information on related party transactions.

108. Nevertheless, the current legal and regulatory framework remains laconic regarding public disclosure of the bank's corporate governance policies and procedures as well as its company objectives. The need for such disclosure is emphasized by internationally recognized best practices.
109. From this perspective, a corporate governance code or a new BDL circular could recommend that listed banks disclose their corporate governance policies and practices, and objectives.

III. RISK MANAGEMENT, AND CONTROL AND AUDIT MECHANISMS⁴³

110. *A bank's board of directors and senior management has an obligation to understand the risk profile of that institution and ensure that capital levels adequately reflect such risk. The board and senior management should further effectively utilize the work conducted by the internal audit function, external auditors and internal control functions.*

III.1 Risk management

111. Risk management is about identifying and evaluating future events and potential risks, assessing the loss that may arise there from, and managing the same with a view to maintaining risks at acceptable levels. Good risk management helps banks achieve sustained profitability through intelligent risk taking with corresponding risk/return features.

General provisions

112. BCC Circular 242⁴⁴ sets the general regulatory framework for risk management. Pursuant to BCC Circular 242, banks are required to (i) distribute their risks into specific categories, mainly credit, market and operational risk; (ii) evaluate their residual risks; (iii) manage credit risk in accordance with BCC Circular 238;⁴⁵ (iv) manage market risk, operational risk and residual risks in accordance with the norms set by ABL (Generic Risk Management), and; (v) give particular attention to risk management.
113. In addition, BCC Circular 242 provides for the responsibilities of the board, the senior management, the risk manager⁴⁶ and the internal audit unit⁴⁷ in managing and monitoring risks. In short, the board is required to (i) set the bank's general business strategies within predefined risk tolerance/appetite margins; (ii) approve and review the bank's general policy for risk management, along with risk limits, and; (iii) appoint the risk manager.
114. Pursuant to BCC Circular 242, the senior management is required to (i) set the bank's risk policy for the board's approval; (ii) set the objectives of risk management procedures; (iii) identify and assess risks; (iv) set the proper risk measurement mechanisms; (v) set the proper risk response norms and mechanisms, and; (vi) ensure the efficiency of the bank's internal controls.
115. The risk manager is entrusted with various responsibilities, including (i) assisting the senior management in setting the bank's risk policy; (ii) preparing detailed and comprehensive procedures for risk management; (iii) assessing the bank's capital

43 The following sections will include a brief synthesis of the main internationally recognized principles and guidelines pertaining to risk management, the internal control and audit process, as well as the external audit function (highlighted in italics for ease of reference), as well as a review and analysis of the current legal framework in Lebanon as regards the same, and followed by a set of recommendations.

44 BCC Circular no. 242 dated 30 June 2004.

45 BCC Circular no. 238 dated 23 October 2002. See paragraph 119.

46 See paragraph 115.

47 See paragraphs 153 to 157.

adequacy in line with the Basel requirements; (iv) assisting the senior management in identifying, measuring and analyzing risks; (v) overseeing all activities on a daily basis to make sure that risk limits and margins are being effectively respected, and; (vi) reporting weaknesses to the board on a quarterly basis.

116. The internal audit unit is required to (i) assist the board and senior management in setting the bank's risk policy; (ii) verifying compliance with the above risk policy; (iii) assessing the efficiency of risk identification, risk measurement and internal control mechanisms; (iv) assessing the risk manager's reports, and; (v) reporting to the board on the efficiency of the bank's risk management and its weaknesses.
117. It should be mentioned that, pursuant to BDL Circular 81, the board must set one or more specialized committee(s) to address risk issues, and decide on the granting of credit facilities, investments of the bank's available cash, real property investments, shareholding participation, and derivative and structured notes operations undertaken for the bank's own account.

Credit risk

118. *The BCBS advocates that banks must operate within sound, well-defined credit-granting criteria that include a clear indication of the bank's target market and an understanding of the borrower or counterparty, the purpose and structure of the credit, its source of repayment, the overall credit limits at the level of individual borrowers and counterparties, both in the banking and trading book and on and off- the balance sheet. Banks should establish a clear process for approving new credits as well as the amendment, renewal and refinancing of existing credits; such credits must be made on an arm's length basis. In particular, credits to related companies and individuals must be authorized on an exceptional basis and monitored with particular care. Banks must ensure that the credit-granting function is being properly managed and that credit exposures are within levels consistent with prudential standards and internal limits.*
119. Pursuant to BCC Circular 238, banks are required to establish full comprehensive files incorporating detailed information regarding customers which are granted credit facilities. This requirement aims to reduce the bank's credit risk by setting the ground for a greater understanding of the borrowers' financial, legal and organizational situation.
120. In summary, the required information will include (i) a detailed description of the requested facilities, their purpose, sources of repayment and proposed guarantees; (ii) information regarding the concerned customer's financial reputation and history, and his outstanding financial liabilities towards other banks (through the Central Office of Credit Risk);⁴⁸ (iii) a description of the concerned customer's real estate properties; (iv) detailed financial information, including, for legal entities, individual and consolidated financial statements for the last three years prepared in accordance with IAS; (v) geographical concentration of customer activity and market share (for large customers); (vi) relevant information regarding the legal, organizational and administrative structure of the customer, together with the bank's assessment of the customer's

48 See paragraph 93.

management structure compared with concepts of institutional performance, and; (vii) an assessment of the concerned customer's risks.

121. Pursuant to BDL Circular 81, the granting of credit facilities shall be subject to the prior approval of one (or more) specialized committee(s), to be established and to operate pursuant to regulations set forth by the board.⁴⁹ Said regulations must aim to avoid exposure of the bank to excessive risk.
122. BDL Circular 48⁵⁰ is the main regulatory document that provides limits to credit exposure. BDL Circular 48, entitled "maximum limits for banking facilities risks", provides for the following restrictions:
 - A bank may not grant facilities to one natural person or legal entity or to a group of correlated debtors, in excess of 20% of the bank's private funds,⁵¹ and;
 - The aggregate of facilities, exceeding 15% of the bank's private funds each, should not exceed eight times the total private funds.
123. As far as related party lending is concerned, article 152 CMC combined with BDL Circular 81 prohibit banks from granting loans to board members, managers or major shareholders (or any of their family members) if the bank does not comply with the liquidity and solvency ratios set forth by BDL regulations or if the bank fails to constitute the required provisions. Moreover, the value of such loans must not exceed the following two ratios:
 - 50% of the borrower's stake in the transaction that he intends to invest in, and;
 - 40% of the net financial assets of the borrower and his guarantors.
124. Under all circumstances, the above lending should be made on an arm's length basis, and the total credit extended to the above individuals or entities must not exceed 5% of the bank's private funds, as of 31 December 2005 (article 152 CMC).
125. Pursuant to BDL Circular 51,⁵² banks are forbidden from granting their customers credit earmarked for the formation of a portfolio of securities, unless the portfolio is pledged and the securities in question are marketable in Lebanese financial markets. The credit granted should not exceed 50% of the value of the securities forming the portfolio as determined by the closing rates in the financial markets on the date the credit was extended. If the decrease in the portfolio's market value reaches 25% of its initial value, the customer must cover the decrease immediately; otherwise the bank must liquidate

49 This committee must also approve investments of the bank's available cash, real property investments, shareholding participation, and derivative and structured notes operations undertaken for the bank's own account.

50 Basic Decision no. 7055 dated 13 August 1988 (also referred to as Basic Circular 48).

51 Pursuant to BDL's Intermediary Decision no. 8649 dated 24 February 2004 (Intermediary Circular 47), the limit becomes 5% for non-resident individuals or foreign entities, provided further that the aggregate of facilities granted to non-residents does not exceed 25% of the bank's private funds.

52 Basic Decision no. 7135 dated 22 October 1998 (also referred to as Basic Circular 51).

the part of the portfolio necessary for maintaining the balance of credit within the 50% limit of the portfolio's value.

126. Concerning guarantees for granted facilities, a bank may not purchase its own shares or accept a pledge of the same in guarantee of any such debt.
127. BDL Circular 58 requires banks to classify and evaluate the facilities granted to their customers according to the risk factor classification adopted by the BCBS. The different classes of debt are the following: standard, follow-up and collection, sub-standard, doubtful and bad debt.
128. The above classification serves as the basis for the legal and accounting treatment of the bank's loan portfolio. For instance, interest accrued on substandard, doubtful and bad accounts must be credited to unrealized interest (balance sheet account). As far as provisioning is concerned, BDL Circular 58 mandates partial provisioning for doubtful loans and full provisioning for bad loans. In this respect, a detailed regulatory framework for the provisioning of bank loan portfolios is provided under BDL Circular 73.⁵³

Market risk

129. *The BCBS advocates that banks should have market risk measurement, monitoring, and control functions with clearly defined duties that are sufficiently independent from market risk position-taking functions. Since interest rate risk is very specific to banks, and senior management should provide detailed quantitative information about the nature and extent of interest rate-sensitive assets and liabilities and off-balance sheet exposures. Major hedging or risk management initiatives should be approved in advance by the board or its appropriate delegated committee.*
130. Pursuant to BDL Circular 81, all decisions of the bank relating to lending, investments of the bank's available cash, real property investments, shareholding participation, derivative and structured notes operations undertaken for the bank's own account, must be subject to the prior approval of one (or more) specialized committee established and operating pursuant to regulations set forth by the board.
131. BDL Circular 57⁵⁴ provides that a bank may not invest more than 25% of its private funds in foreign sister or affiliated banks and companies. Pursuant to article 2 of BDL Circular 57, the acquisition by banks of any interest in the banking or financial sector abroad (foreign bank, financial institution, fund and so forth) is subject to the prior approval of the BDL.
132. Concerning foreign exchange risk, and as per BDL Circular 32⁵⁵ and its amendments, banks can maintain a net foreign exchange trading position, in assets or liabilities, that does not exceed, at any time, a ratio of 1% of the total components of their tier one capital, provided that the total foreign exchange position does not, at the same time,

53 Basic Decision no. 7694 dated 18 October 2000 (also referred to as Basic Circular 73), as amended.

54 Basic Decision no. 7156 dated 28 October 1998 (also referred to as Basic Circular 57).

55 Basic Decision no. 6568 dated 24 April 1997 (also referred to as Basic Circular 32).

exceed 40% of total tier one capital. In addition, banks can maintain foreign exchange fixed positions whose equivalent value in Lebanese Pounds does not exceed 60% of their tier one capital after obtaining a prior approval from the BDL with the specification of the quantity and type of currency to be acquired.

133. Pursuant to BCC Circular 197,⁵⁶ banks are required to set up a provision equivalent to 5% of the net open exchange position for adverse foreign currency exchange fluctuation.
134. As far as interest rate risk is concerned, article 156 CMC provides a general principle under which banks must combine the term of their placements with the nature of their incomes.

Operational risk

135. *The BCBS advocates that the board should be aware of the major aspects of the bank's operational risk and should promote an operational risk management framework to be implemented by senior management throughout the whole banking organization. Senior management should also have responsibility for developing policies, processes and procedures for managing operational risk in all of the bank's material products, activities, processes and systems and should put in place contingency and business continuity plans to ensure their ability to operate on an ongoing basis and limit losses in the event of severe business disruption.*
136. Apart from the general guidelines provided for under BCC Circular 242,⁵⁷ the current applicable laws and regulations do not provide for specific provisions regarding operational risk.

Electronic banking risk

137. *The BCBS advocates that the board and senior management should establish effective management oversight over the risks associated with e-banking activities, including the establishment of specific accountability, policies and controls to manage these risks. A security control infrastructure should be established to safeguard e-banking systems and data from both internal and external threats. Additionally, the board and senior management should create an ongoing due diligence and oversight process for managing the bank's outsourcing relationships and other third-party dependencies supporting e-banking as well as authentication of e-banking customers and protection of their identities.*
138. According to BDL Circular 69⁵⁸, banks that undertake electronic financial and banking transactions should follow principles of honesty, integrity and transparency; adopt adequate procedures for ensuring maximum security, and; take all necessary measures to define and restrict various responsibilities. Banks should not disclose any information about customer accounts without their prior and unequivocal written permission, and banks should accept digital signatures only when they meet specific conditions. In this

56 Dated 5 May 1997.

57 See paragraph 112.

58 Basic Decision no. 7548 dated 30 March 2000 (also referred to as Basic Circular 69).

respect, banks continue to be governed by BDL regulations concerning ceilings on their credit facilities.

139. Banks should: facilitate control operations on their activities by the BDL or the BCC, including technical control; inform the BDL about their operations system and its technical basis and about any modification in this respect, and; request their external auditor to prepare semi-annual reports on their electronic banking operations and on their technical and organizational status, with copies to be sent each year to the BDL and the BCC.

Unidentified risks

140. *The board should set and periodically review the strategies and policies related to risk management to address any new or previously uncontrolled risks, setting acceptable levels for banking risks.*
141. BDL Circular 50⁵⁹ requires banks to constitute yearly from their net benefit after tax, an “unidentified banking risks reserve” equal to 0.2% of the solvency denominator. Unidentified risks are defined as risks arising from banking activity, whose nature and value may not be determined in advance, even in an approximate manner.

Consolidated assessment

142. *Risk management should include separate evaluations as required on a consolidated basis and, as appropriate, at the level of individual affiliates.*
143. Pursuant to BDL Circular 34, banks have to abide, on a consolidated basis, by: the limit for credit exposure;⁶⁰ by the 12% capital adequacy ratio,⁶¹ and; the provisions of articles 152 and 153 CMC (regulation of related party facilities). All remaining banking ratios are to be computed on a bank-only (individual) basis.⁶²

III.2 Internal control mechanisms

144. Internal control is a process performed at all levels within a bank, and has as its objectives to promote the efficiency of the bank’s operations; the reliability and completeness of financial and management information, and; the compliance with applicable laws and regulations, supervisory requirements, and internal policies and procedures.

General provisions

145. *Regarding internal control, the BCBS recommends that banks should establish and enforce an effective system of internal controls that is consistent with the nature, complexity, and risk of their on and off-balance-sheet activities. This will ensure that exceptions to strategies, policies,*

59 Basic Decision no. 7129 dated 15 October 1998 (also referred to as Basic Circular 50).

60 As per BDL Circular 48.

61 As per BDL Basic Decision no. 6939 dated 25 March 1998 (also referred to as Basic Circular 44), amended by BDL Basic Decision no. 7644 dated 26 August 2000, and BCC Circular dated 8 July 2002.

62 See paragraphs 366 and 367.

procedures and limits approved by the board and imposed by banking supervisors are reported in a timely manner from the personnel to the appropriate level of management for early remedial action.

146. BDL Circular 77 sets forth the “internal control” requirements for banks. In this context, all banks are required to establish internal administrative units and implement internal control systems in compliance with BDL Circular 77 which, in turn, are based on the Basel Committee’s Framework for Evaluation of Internal Control Systems.

Structure of internal controls

147. *The BCBS recommends that senior management must set up an appropriate control structure ensuring effective internal controls, defining the control activities at every business level. These shall include: top level reviews; appropriate activity controls for different departments or divisions; physical controls; periodic checking for compliance with exposure limits; system of approvals and authorizations, and; a system of verification and reconciliation.*
148. BDL Circular 77 provides no specific guidelines regarding the structure of internal control schemes. However, pursuant to BDL Circular 81, one or more specialized committee(s) must be established by the board to approve all decisions concerning the granting of credit facilities, investments of the bank’s available cash, real property investments, shareholding participation, and derivative and structured notes operations undertaken for the bank’s own account.
149. It is worth mentioning that, pursuant to BCC Circular 242, internal control schemes should provide for a clear definition of the duties of bank managers and employees; they should also provide for the segregation of duties amongst the various bank management units. Moreover, the bank’s management is required by BCC Circular 242 to adopt detailed organizational charts defining communication channels between the various levels of the bank’s organizational structure.

Scope of internal controls

150. *The BCBS recommends that the control structure should promote adequate segregation of duties to identify and minimize areas of potential conflicts of interest. Further, the BCBS recommends that the internal control process should not aim only to reduce instances of fraud, misappropriation and errors, it should be more embracing, addressing different risks faced by banking organizations.*
151. BDL Circular 77 requires banks to establish internal control schemes concerning the following.⁶³
- Internal operations and procedures;
 - Accounting, statements and financial reports;

63 They should also review such schemes continuously so as to ensure their efficiency.

- IT applications and safety measures;
 - Evaluation of risks;
 - Monitoring and mitigating risks;
 - Information and archiving, and;
 - Evaluation of the quality of assets.
152. According to BDL Circular 77, the internal control system must take into consideration the methods for determining and evaluating risks, including lending; market; interest rate; liquidity; operational; payment; legal; reputation, and; country risks.

III.3 Internal audit

153. *The BCBS recommends that there should be an effective internal audit of the internal control system carried out by appropriately trained and competent staff reporting directly to the board or its audit committee, and to senior management.*
154. Pursuant to BDL Circular 77, the board must establish an internal audit unit that: (i) is completely independent from the bank's management, and; (ii) has no executive responsibilities.⁶⁴ The bank may appoint an external specialized institution to undertake the functions of the internal audit unit, provided that the BCC is informed accordingly and that the said institution is (i) completely independent from the bank's auditors, and; (ii) is bound by banking secrecy laws.
155. The internal audit unit's mission includes:
- Auditing the bank's operations and financial statements to ensure their accuracy and the efficiency of measures adopted within the bank notably with respect to money laundering;
 - Ensuring compliance with applicable laws and regulations, and;
 - Preparing periodic reports at least semi-annually on its audit activities, and submitting the same to the board, noting that the BCC as part of its monitoring activity, has the right to access such reports and meet with the head of the internal audit unit as necessary, and noting further that the internal audit unit may directly address its reports to the relevant authority (e.g. to the BCC) if need be.
156. The mission of the internal audit unit's head includes:
- Reviewing the internal control mechanisms and the methods adopted by the bodies in charge of such control so as to ensure its efficiency;

⁶⁴ BCC Circular no. 129 dated 12 September 1989 and BCC Circular no. 143 dated 12 March 1991 already require banks to establish internal audit units.

- Following up on issues raised by the reports and documents remitted by the internal audit unit, the auditors and the BCC, and;
 - Preparing periodic reports at least semi-annually and submitting the same to the board, noting that the BCC has the right to access such reports. The said reports must include a synthesis of the internal audit unit's activities as well as suggestions. It is also worth mentioning that the internal audit unit's head may directly address its reports to the relevant authority (e.g. to the BCC) if need be.
157. The internal audit unit's report and all documents communicated to the board shall be the subject of discussion and in-depth analysis by the board in a special meeting held for said purpose at least twice a year in the presence of the internal audit unit's head.
158. The bank's auditors must prepare periodic reports at least twice a year concerning the implementation of BDL Circular 77 by the bank. These reports must include an evaluation of the adopted internal control procedures from a practical perspective and include recommendations for the improvement of the efficiency of such procedures. These reports must be submitted to the board and the BCC.

III.4 External audit

159. *The OECD Principles require that an annual audit be conducted by an independent, competent and qualified, auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the bank in all material respects.*
160. Pursuant to articles 172 and 174 CC, banks must appoint at least one external auditor to exercise continuous monitoring over the bank's activities. The auditor's mandate is three years and is renewable. International policy initiatives have explored audit firm and/or audit partner rotation as a possible means to strengthen their independence. This issue could be addressed in the context of a legislative reform.
161. Besides the relevant provisions of the CC and the CMC, a bank's external auditor is subject to Decree no. 1983 dated 25 September 1971 regulating the profession of bank auditors (Decree 1983). Pursuant to Decree 1983 and article 186 CMC, a bank auditor (the representative of the auditing firm, if a legal entity) must fulfill all prerequisites and qualifications for an individual to be accepted as an accounting expert before Lebanese courts. He must also be sworn. In addition, the auditor must have a minimum of ten years of experience in the banking, auditing or accounting sector, or a minimum of three years of experience if the auditor holds a university degree in accounting or commerce, or has a level of professional seniority acceptable to the BDL. It should be mentioned that pursuant to article 185 CMC, combined with article 127 of the same code, persons convicted of specific crimes or bankrupt persons may not be appointed as bank auditors.
162. Decree 1983 provides for certain "independence" requirements, based on which the following individuals/entities may not be appointed as the external auditor for a bank:

- The concerned bank's board members, chairman, assistant general manager and any other person related to any of the aforementioned individuals up to the third degree;
 - Any partner or employee of the above individuals/entities;
 - Previous employees of the concerned bank, of any related company or any of the above individuals/entities, during the two years following the end of their service, and;
 - Any person indebted to the bank or to any company related to the bank whether directly or indirectly.
163. In the same line of thinking, article 152 CMC prohibits banks from granting credit facilities to their external auditors or to any member of the latter's families, while article 9 of Decree 1983 provides that said entities/individuals may not, for two years following the end of their mandate as auditors, act as a board member or employee of the concerned bank or any company related to it.
164. Most importantly, article 9 of Decree 1983 prohibits the external auditor from providing any separate non-audit services (*e.g.* tax consultancy, business advise, etc.) to the concerned banks.
165. Pursuant to article 175 CC, the external auditor is required to submit the annual report to the annual assembly concerning the situation of the bank, its balance sheet, the financial statements submitted by the board members and the suggestions for dividend distributions (the Annual Report). Absence of this Annual Report renders the deliberation of the annual assembly null and void.
166. According to article 12 of Decree 1983, the auditor's Annual Report must include (i) a general overview of the bank's accounts; (ii) a description of violations and discrepancies with respect to applicable laws and regulations, if any, and; (iii) the auditor's confirmation at their own responsibility that they have verified the validity of all accounts and measures taken by the bank in connection with its balance sheet, all based on available documentation. Verified accounts/measures are mainly:
- The inventory of securities and immovable properties;
 - The accounts of debtor customers and the provisions that must be taken for doubtful debts;
 - Amortizations;
 - Financial information concerning affiliated companies, and;
 - The suggested distribution of dividends.
167. It should be noted that applicable laws and regulations require auditors to apply the ISA. It is also worth mentioning that, pursuant to article 178 CC, auditors are liable jointly and

severally, even towards third parties, for faults committed in performing their audit duties.

168. In addition to their Annual Report, auditors are required by article 158 CC to submit to the annual assembly a special report regarding anticipated related party transactions (the Special Related Party Transactions Report).⁶⁵ Article 187 CMC also requires the external auditor to submit to the annual assembly a special detailed report regarding credit facilities granted directly or indirectly to the bank's board members and senior management (the Special Related Party Facilities Report).
169. Moreover, and pursuant to article 187 CMC, a bank's external auditor must, throughout the year, inform the concerned bank's management of any discrepancies or violations as discovered by them and request that management redress the situation promptly. The external auditor must also submit to the bank's management a detailed yearly report incorporating a description of their audit activities and findings (the Detailed Report).
170. It should be noted that, pursuant to article 188 CMC, bank auditors are required to communicate copies of their Annual Report, Special Related Party Transactions Report, Special Related Party Facilities Report and Detailed Report immediately to the governor and to the head of the BCC. It should be also noted that a bank's external auditor is bound by banking secrecy laws.

III.5 Summary and recommendations

171. Under the current legal and regulatory framework, banks are required to (i) distribute their risks into specific categories, mainly credit, market and operational risk; (ii) evaluate their residual risks; (iii) manage credit risk in accordance with the applicable regulations (BCC Circular 238); (iv) manage market risk, operational risk and residual risks in accordance with the norms set by ABL (generic risk management), and in general; (v) give particular attention to risk management.
172. In this respect, BCC Circular 242 provides for a detailed description of the responsibilities of the board, senior management, the bank's risk manager and the internal audit unit in managing and monitoring risks.
173. Credit risk, market risk and electronic banking risk are extensively regulated through binding circulars issued by both the BDL and the BCC. Under the current regulatory framework, banks have to abide, on a consolidated basis, by the regulatory limit for credit exposure, by the 12% capital adequacy ratio, and by the provisions of articles 152 and 153 CMC (regulation of related party credit facilities).
174. Banks are required to establish internal administrative units and implement internal control systems in compliance with the terms of BDL Circular 77, which is based on the Basel Committee's Framework for Evaluation of Internal Control Systems. In this sense, banks are required to establish internal control schemes concerning internal operations and procedures, accounting, statements and financial reports, IT applications and safety

65 See paragraph 245.

measures, evaluation of risks, monitoring and mitigating risks, information and archiving, and evaluation of the quality of assets.

175. Regarding the structure of internal control schemes, BDL Circular 81 requires boards to create one or more specialized committee(s) to approve all decisions concerning the granting of credit facilities, investments of the bank's available cash, real property investments, shareholding participation, and derivative and structured notes operations undertaken for the bank's own account. Pursuant to BCC Circular 242, internal control schemes should provide for a clear definition of the duties of the bank's managers and employees; they should also provide for the segregation of duties amongst the various bank management units. The bank's management is required by BCC Circular 242 to adopt detailed organizational charts establishing communication channels between the various levels of the bank's organizational structure.
176. As regards internal audit, BDL Circular 77 requires boards to establish independent internal audit units whose duties comprise (i) auditing the bank's operations and financial statements to ensure their accuracy and the efficiency of measures adopted within the bank notably with respect to money laundering; (ii) reviewing the internal control mechanisms and the methods adopted by the bodies in charge of such control so as to ensure its efficiency, and; (iii) ensuring compliance with applicable laws and regulations.
177. In general, the current legal and regulatory framework regarding internal control and risk management is acceptable, since the BDL enjoys enough regulatory powers to address new developments in a timely and efficient manner. It should also be noted that the BDL is in the process of introducing Basel II requirements into the current regulatory framework.
178. International policy initiatives have explored audit firm and/or audit partner rotation as a possible means to strengthen their independence. The current legal framework does not restrict the re-appointment of the same external auditors following expiry of their three-year mandate. While the law- or rule-makers may not wish to limit the mandate of external auditors to a three year non-renewable mandate, compulsory audit partner rotation could be introduced via regulations or a code of best practice.

IV. RIGHTS OF SHAREHOLDERS AND OTHER STAKEHOLDERS⁶⁶

179. Because not all shareholders wish to be involved in the overall direction and management of the bank, shareholders delegate many of their responsibilities as owners to directors who act as their stewards. Shareholders do however retain basic rights to influence the corporation, in particular its governance, which center on such fundamental issues as electing board members, or other means of influencing the composition of the board, amending the company's organic documents, approving extraordinary transactions, electing the external auditor and other basic issues as specified in company law and internal corporate statutes.⁶⁷
180. Investors' confidence that the capital they provide will be protected from misuse or misappropriation by managers, board members or controlling shareholders is an important factor in capital market development. Directors, managers and controlling shareholders may have the opportunity to engage in activities that advance their own interests at the expense of non-controlling shareholders. This explains the need for regulation ensuring equal treatment and protection of shareholder rights, and providing for appropriate preemptive rights and effective remedies once such shareholder rights are violated.

IV.1 General provisions

181. Pursuant to article 105 CC, participation in the share capital of Lebanese joint-stock companies, including banks, confers unto the shareholder the following general basic rights (i) the right to dividends; (ii) a preferential right to subscribe to any capital increase; (iii) the right to reimbursement of the shares' nominal value and to a distribution of the bank's equity and assets; (iv) the right to assign and transfer shares, and; (v) the right to vote at assemblies.

IV.2 Ownership registration and disclosure

182. *The legal framework should provide adequate protection for, and facilitate the exercise of, shareholder rights, including the right to secure methods of ownership registration. Where information about beneficial owners is not known to the bank or may not be publicly disclosed, at a minimum such information should be obtainable by regulatory and enforcement agencies and/or through the judicial process.*
183. All shares are required to be registered with Midclear S.a.l. (the Lebanese central depository) in the name of their respective owners. The books of Midclear evidence and establish the ownership of the shares. Any sale, encumbrance or other right related thereto must be registered with Midclear.

66 The following sections will include a brief synthesis of the main internationally recognized principles and guidelines pertaining to the rights of shareholders and other stakeholders (highlighted in italics for ease of reference), as well as a review and analysis of the current legal framework in Lebanon as regards the same, and followed by a set of recommendations. .

67 From the OECD Principles of Corporate Governance.

184. The current legal framework provides for no express requirement regarding the disclosure of the beneficial ownership of bank shares. Moreover, Law no. 520 dated 6 June 1996 on the “Development of the Financial Market and Fiduciary Contracts” (Law 520), combined with Law 308, make it possible for banks and financial institutions to hold and manage bank shares in custody for investors, without revealing the investors’ identities.
185. In practice, however, the BDL does not accept that shares of banks be held in custody by banks or financial institutions.⁶⁸ Law 308 should be amended to uphold this practice; alternatively, Law 520 could be amended so as to allow disclosure of beneficial ownership in banks to the BDL. In short, the lack of an express requirement for disclosure of beneficial ownership does not seem to be an intended policy. Accordingly, nothing should prevent introducing such a requirement into the current legal/regulatory framework.

IV.3 Transfer of shares

186. *The OECD Principles call for the legal framework to provide adequate protection for, and facilitate the exercise of, shareholder rights, including the right to convey or transfer shares.*
187. Issuance and trading of bank shares is governed by the CC, and in particular by Law 308. In principle, the transfer of bank shares is free and is not subject to restrictions. However, pursuant to articles 89 and 147 CC, guarantee shares owned by board members and shares representing in-kind contributions upon the bank’s incorporation are subject to specific transfer conditions as prescribed in the above articles. Pursuant to article 118 CC, the by-laws may provide for a pre-emption right in favor of the shareholders, some of the shareholders or the bank itself.⁶⁹ However, this preemption right may not be abusive or result in an important prejudice to the concerned shareholder.
188. Moreover, some share transfers resulting in ownership of a specific percentage of shares are subject to the BDL’s prior approval as shall be further described under Section V.4.

IV.4 Access to information

189. *A country’s legal framework should provide adequate protection for, and facilitate the exercise of, shareholder rights, including the right to obtain relevant and material information on the corporation on a timely and regular basis.*
190. The CC does not expressly grant shareholders the right of continuous access to information.⁷⁰ Legally speaking, shareholders are entitled to access only specific information before the annual assembly. Indeed, pursuant to article 197 CC, any shareholder (or debenture holder) may, within 15 days preceding the annual assembly, obtain at the headquarters of the bank, communication of the inventory, the balance

68 As confirmed by the BDL’s legal department.

69 Provided the concerned bank is not listed on the financial markets; pursuant to Law 308, *all* shares of listed banks must be freely negotiable.

70 Listed banks, however, are required to provide their shareholders, on a regular basis, with “all information of interest to them”. See paragraph 88.

sheet, the profit and loss account, the list of shareholders, the report of the board, the auditor's report and the consolidated profit and loss account and balance sheet if applicable. The interested shareholders may, at their own expense, obtain copies of such documents, to the exception of the inventory, noting that the expense charged by the bank for the delivery of the copies may not exceed the fee set by the Minister of the Economy. Failure to comply with the aforementioned information requirements exposes the assembly meeting to being declared null and void.

191. Nonetheless, shareholders justifying a serious and legitimate interest may request the summary judge to compel communication of documents, other than those enumerated under article 197 CC and/or outside the delays set forth therein, subject to the banking secrecy laws. Precedents in this sense exist. On several occasions, the summary judge has accepted to determine the scope of the information in light of the interests of the shareholder and those of the bank, the shareholder's interests being appreciated on a case-by-case basis.⁷¹
192. Strengthening shareholder rights by enhanced and smoother access to information prior to assemblies remains a key element of good corporate governance. Shareholders need to be well informed before making decisions that affect the future of their bank. In this respect, article 197 CC could be amended to grant shareholders access to information free of charge starting the date of the call for any assembly. Accessible information should include, at a minimum the meeting agenda, draft resolutions, the reasoning behind said draft resolutions and a table showing the financial results of the bank for the last five financial years.
193. Additionally, shareholders need to have constant access to information regarding their bank, irrespective of the call for a specific assembly. The CC could be modified to allow shareholders access at all times to all information/documents made available to shareholders for all assemblies held during the last three years.

IV.5 Shareholder general assembly

General provisions

194. *The OECD Principles call for the legal framework to provide adequate protection for, and facilitate the exercise of, shareholder rights, including the right to participate and vote in general shareholder meetings.*
195. Under the principles of the Lebanese commercial law, the shareholders' general assembly is the highest governing body in the sense that it is said to be the source of all powers. The ordinary assembly elects the board's members, sets their remuneration (noting that compensation schemes involving an equity component, namely share option rights, are resolved under more stringent quorum and majority requirements, *i.e.* by the extraordinary assembly) and has the right to terminate their membership at any time.⁷² It

71 See for example, Summary Judge of Beirut, Decision no. 109, dated 26 February 1972 (*Saab vs. Continental Bank for Development*), *Hatem Review*, Vol. 143, page 34.

72 Article 151 CC.

also appoints the bank's external auditor, approves the annual accounts, and decides on dividend distribution and on non-convertible bond issuance. In general, the ordinary assembly is the competent authority to resolve all issues that are not specifically reserved by law to the board or to the extraordinary assembly. The extraordinary assembly, held under stricter quorum and decision-making requirements, is the competent authority to resolve any amendment to the by-laws, increase and decrease of capital, issuance of convertible bonds, amendment to the bank's object or legal form, the bank's liquidation, the listing of the bank's shares as well as mergers and acquisitions. However, the extraordinary assembly may not change the bank's nationality, increase the obligations of shareholders, or jeopardize the rights of third parties.

196. The annual ordinary assembly is held each year after the end of the financial exercise to approve the accounts, decide on the distribution of dividends, appoint a new external auditor and elect board members (upon expiry of their predecessors' mandate). A quorum of shareholders representing one third of the share capital must be present at the first meeting of the ordinary assembly, failing which a second meeting shall be convened with no minimum quorum requirements. Resolutions of the ordinary assembly are passed by the absolute majority (50% plus one share) of shareholders present and represented at the meeting. In addition to the annual ordinary assembly, an ordinary assembly may be held at any time during the year to resolve other issues as necessary.
197. The extraordinary assembly is held whenever convened to deliberate and resolve on issues of its competence.⁷³ A strict minimum quorum of shareholders representing three quarters of the share capital is required for extraordinary assemblies to amend the purpose of the bank or its legal status. For all other purposes, a minimum quorum of two thirds of the share capital is required for the first meeting of the extraordinary assembly. If such quorum is not secured, a second meeting is convened by two notices published in the Official Gazette, an economic newspaper and a local newspaper at the interval of one week. The notice must include the agenda and the results of the preceding meeting. A minimum quorum of 50% of the share capital must be present for the said second meeting, failing which a third meeting is convened where the minimum quorum will be one third of the share capital. Resolutions of all extraordinary assemblies are passed by the affirmative vote of two thirds of shareholders present and represented at the meeting.

Rules governing shareholder assemblies

198. *Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures that govern general shareholder meetings.*
199. The rules governing assemblies are provided for in the bank's by-laws filed with the Commercial Register and accessible to the public. In addition, pursuant to article 100 CC, the bank's by-laws must be posted in its offices and any person may obtain a certified copy thereof.

73 See paragraph 195.

The convening of shareholder assemblies and meeting agenda

200. *Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting.*
201. According to articles 164 and 180 CC, the board is, in principle, in charge of convening the assembly. Applicable laws and regulations do not provide for specific form or time requirements for such a call.⁷⁴ These issues are generally governed by the bank's by-laws. Nonetheless, under general principles of commercial law, assemblies must be convened in a timely manner using appropriate communications channels to reach all shareholders effectively and on a timely basis. The legal framework could be enhanced by introducing specific provisions to the CC, regarding the form and time requirements for convening assemblies.
202. The assembly's agenda must be communicated to shareholders concurrently with the call for the concerned assembly. Pursuant to article 184 CC, the assembly may not discuss, deliberate or vote on any matter not listed on the said agenda.
203. Furthermore, pursuant to article 190 CC, if shareholders representing at least one quarter of the assembly's members attending a meeting deem that they are not sufficiently informed on the issues deliberated at the said meeting, the assembly shall be postponed to another date within eight days.

Shareholder question time

204. *Shareholders should have the opportunity to ask questions to the board, including questions relating to the annual external audit, to place items on the agenda of general meetings, and to propose resolutions, subject to reasonable limitations.*
205. Nothing in the CC gives shareholders the right to ask questions to the board and be answered on the same, or to place items on the agenda of general meetings (at least not expressly). However, article 176 CC provides that the external auditor is bound to convene an assembly meeting when the same is requested by a group of shareholders representing one fifth of the bank's share capital. Accordingly, it can be implied that, *a fortiori*, such a group of shareholders must be able to place items on the agenda and propose resolutions.
206. Still, a legislative intervention could be helpful. In this respect, it is advisable that any shareholder, regardless of his shareholding percentage, be expressly granted the right to

74 It is, however, widely believed that the notice for convening the annual Assembly must be served at least 15 days prior to the meeting date. This belief is based on an interpretation of article 197 CC, which provides that any shareholder may, within fifteen days preceding the annual Assembly, obtain at the headquarters of the bank, certain documents, failing which the Assembly meeting will be declared null and void (see paragraph 190). It should be also noted that, as mentioned under paragraph 197, if the quorum for the first extraordinary assembly meeting is not secured, a second meeting is convened by two notices published in the Official Gazette, an economic newspaper and a local newspaper at the interval of one week. Moreover, listed banks' assembly meetings are convened through notices published by the BSE in the Official Gazette.

submit written questions to the board and be answered on the same, starting on the date of the call for the concerned assembly and until the effective holding thereof. Additionally, shareholders representing a pre-defined minimum percentage of the share capital (e.g. 0.5% to 5%, depending on the capital amount) should be expressly allowed to (i) place items on the agenda of assembly meetings and propose resolutions, and; (ii) submit written questions to the board, at least twice a year, concerning anything that might substantially affect the bank's operation.

Voting in absentia

207. *Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.*
208. According to article 181 CC, any shareholder who is unable to attend an assembly may be represented, provided such representative is himself a shareholder.⁷⁵

IV.6 Sharing in profits

209. *The OECD Principles call for the legal framework to provide adequate protection for, and facilitate the exercise of, shareholder rights, including the right to share in the profits of the corporation.*
210. According to article 105 CC, shareholders are entitled to share in the bank's distributable profits. Each shareholder is entitled to a portion of the dividends corresponding to his ownership ratio in the bank's share capital.

IV.7 Disclosure of control-related structures and arrangements

211. *The OECD Principles state that capital structures and arrangements which enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.*
212. The current legal and regulatory framework does not provide for specific requirements regarding disclosure of capital structures or arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership, such as pyramid structures or cross shareholdings. This issue needs to be addressed on the legal and/or regulatory level, in order to provide investors with a clear understanding of the existing control schemes in the bank.
213. It should be noted, however, that shareholder agreements granting certain shareholders a degree of control disproportionate to their shareholding ratio are considered as null and void, being contrary to public order.⁷⁶ Still, article 117 CC provides that all registered shares that have been registered in the name of the same shareholder for at least two years shall automatically have the right to two votes each.⁷⁷

75 This requirement is not of public order; specific provisions to the contrary may be added to the by-laws of the bank.

76 See paragraphs 216 and 217.

77 See paragraph 218.

IV.8 Equitable Treatment of Shareholders

214. *The OECD Principles call for the corporate governance framework to ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.*

Equal treatment of shareholders

215. *The OECD Principles call for all shareholders of the same series of a class to be treated equally. Within any series of a class, all shares should carry the same rights. All investors should be able to obtain information about the rights attached to all series and classes of shares before they purchase. Any changes in voting rights should be subject to approval by those classes of shares which are negatively affected.*
216. Article 110 CC sets the general principle according to which all shareholders within the same class must enjoy the same rights and benefits. In this context, article 186 CC provides that, in principle,⁷⁸ all shareholders shall have one voting right for each share (the principle of one share, one vote) without limitation unless such limitation is expressly provided for in the by-laws and applies in the same way to all shareholders.
217. Concerning banks in particular, Law 308 protects all shareholders' rights including foreign and minority shareholders in that it provides that the share capital of a bank consists of "one category of shares that are all subject to the same legal regime concerning their issuance and transfer".
218. Nonetheless, an important exception to the above general principles subsists. In this sense, article 186 CC provides that shareholders who own registered shares for at least two years are entitled to a double voting right. Article 117 CC confirms the same, providing that all registered shares that are paid in full and that have been registered in the name of the same shareholder for at least two years prior to the date of the call for an assembly, shall have the right to two votes each. For the purpose of this article, shares are deemed to have been registered in the name of the same shareholder if transferred by donation or by inheritance.
219. Policy-makers may wish to reconsider article 117 CC. Article 117 CC could be amended so that the granting of any double voting right becomes subject to the prior approval of the extraordinary assembly.
220. The above equal treatment principles do not prevent banks from issuing preferred non-voting shares. Indeed, according to article 2 of Law 308, the extraordinary assembly may, subject to BDL approval, resolve for the issuance of non-voting preferred registered shares with specific privileges, priorities and rights as the extraordinary assembly may decide. Preferred shares do not bestow the right to participate in deliberations or vote at assemblies, with the exception of assemblies considering (i) changing the bank's object or legal form; (ii) increasing the bank's capital by means of in-kind contributions, and; (iii) the bank's premature liquidation, or merger and acquisition transactions involving

78 See paragraph 218.

the bank. In any event, the bank's management must provide the owners of preferred shares with all information and documents provided to the bank's ordinary shareholders. If the bank fails to provide holders of preferred shares with the rights and privileges they are entitled to (including the distribution of a minimum percentage of dividends, where applicable), the holders will have the right to participate in, and vote at the bank's assemblies to the same extent as the bank's ordinary shareholders for as long as they are deprived of their aforementioned rights (and such until they receive full payment of dividends due to them). Preferred shareholders do not have the right to act as board members. All board members (including the chairman) and general managers as well as their spouses and minor descendants, may not hold preferred shares, whether directly or indirectly or via any intermediary.

221. Pursuant to article 111 CC, should the assembly pass a resolution that is likely to affect, in one way or another, the rights of the preferred non-voting shareholders, then such resolution would be enforceable only when ratified by a special assembly of such preferred non-voting shareholders.

Protection of minority shareholders

222. *Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress.*⁷⁹

223. In general, legal measures for the protection of minority shareholders are classified under two categories: preventive *ex-ante* measures aiming to avoid disputes, and remedial *ex-post* mechanisms seeking to redress minority shareholder rights when violated.

224. Applicable laws and regulations provide for some specific forms of preventive measures. Following is a brief overview of the same:

- Preventive measures include qualified quorum and majority requirements for decisions involving amendment to the by-laws, increase of capital or issuance of convertible bonds, decrease of capital, amendment to the bank's object or legal form, the bank's liquidation, as well as mergers and acquisitions.⁸⁰
- Pursuant to article 112 CC, all shareholders have equal rights to subscribe to any capital increase prorated to their percentage shareholding at the time of such increase, thus avoiding the dilution of their share. However, the extraordinary assembly may, pursuant to article 113 CC, decide otherwise by resolving that (i) subscription to a specific capital increase shall not be reserved to existing shareholders in full or in part, or that (ii) the right of existing shareholders to subscribe to such capital increase shall not be prorated to their respective percentage shareholdings at the time of the said capital increase. In such case, and subject to

79 Common measures to protect minority shareholders include pre-emptive rights in relation to share issues, qualified majorities for certain shareholder decisions and the possibility to use cumulative voting in electing members of the board.

80 See paragraph 197.

declaring the said capital increase null and void, any allocation of newly issued shares to one category of shareholders or to non-shareholders, shall be subject to the verification mechanism applicable to in-kind contributions. This verification mechanism involves appointment by the court of an expert to verify the value of the issuance premium, followed by approval of the report of such court-appointed expert by the extraordinary assembly.

- Pursuant to article 176 CC, the auditors must convene an assembly whenever required by a group of shareholders representing one fifth of the share capital. This threshold is, arguably, too high. A lower percentage could be adopted in the context of a legislative reform, to make article 176 CC effective.
- According to article 186 CMC, and without prejudice to the banking secrecy law, any shareholder or group of shareholders owning at least 10% of the bank's share capital may file a request with the court for the appointment of an expert to verify specific matters or issues concerning the bank's activities. The report of the appointed expert must necessarily be submitted to the court, the applicant, and the bank's board, and must be discussed at the first assembly following its submission.
- Article 186 CMC provides that if the assembly fails to appoint an external auditor for the bank, any shareholder may request such appointment from the competent court. The court shall issue a decision appointing an auditor for a period ending upon the appointment by the assembly of another auditor.
- In addition, article 186 CMC provides that any shareholder or group of shareholders owning at least 10% of the bank's share capital may oppose the nomination of the bank's external auditor and request the competent court to appoint another auditor. The external auditor appointed by court order may not be replaced or revoked except by a court decision.
- Another form of preventive measure consists also in the regulation of related party transactions.⁸¹

225. The above preventive measures ought to be complemented since alternative voting mechanisms for electing board members are not recognized under the CC, thus contributing to keeping minority shareholder representatives off of the board.

226. For instance, cumulative voting rights are not recognized under Lebanese law.⁸² Cumulative voting is designed to provide minority shareholders with the opportunity to elect directors to the board. Potential legislative reforms could permit cumulative voting as a means to protect minority shareholders.

81 See paragraphs 242 to 249.

82 Cumulative voting is a system of shareholder voting which multiplies one's voting shares by the number of candidates and allows the shareholder to vote them all for one candidate to the board. For example, if there are five directors to be elected and 10,000 shares issued, a shareholder with 2,000 shares could vote 10,000 for his candidate rather than being limited to 2,000 for each of five candidates.

227. In addition to preventive measures, applicable laws and regulations provide for remedial mechanisms aiming to redress minority shareholder rights when violated. In this sense, Article 192 CC sets a general principle according to which decisions of the assembly are binding on all shareholders provided they do not constitute fraud or misuse of authority. The CC provides no indication as to the exact meaning of the said terms; this task has been left to the Lebanese courts to resolve while being inspired by the French legal system.
228. In short, fraud has been traditionally interpreted as referring to situations where an assembly decision is made with the intent to harm minority shareholders. The concept of misuse of authority is broader; it refers to situations where the majority shareholders adopt decisions that are (i) in contradiction with the bank's interests, and; (ii) made deliberately to favor the majority's interests to the detriment of the minority shareholders. In case of fraud and/or misuse of authority, the concerned decision of the assembly will be null and void.
229. It is to be noted that declaring a decision of the assembly as null and void on the basis of fraud or misuse of authority is an issue to be decided by the Lebanese courts upon request of a shareholder. Such a procedure is, normally, lengthy and a positive result is the exception rather than the rule.
230. Another remedial mechanism consists of a shareholder's right⁸³ to prosecute directors for fraud, breach of the law or breach of the bank's by-laws. The shareholders are also (though subsidiarily) granted the right to prosecute directors for mismanagement.
231. Indeed, article 166 CC provides that directors are liable for fraud, breach of the law or breach of the by-laws. Article 166 adds that lawsuits against the said directors may be filed individually by each shareholder (irrespective of his shareholding ratio); the said lawsuits may not be prevented by a vote of the assembly discharging the directors.
232. In case of mismanagement, the lawsuit will be filed by the bank itself against the concerned directors. However, should the bank's management remain unresponsive, then every shareholder may substitute the bank in exercising the lawsuit within the limits of the said shareholder's interest therein (article 168 CC).
233. It should be mentioned that the Lebanese legal system sets a general standard of reference for determining the directors' duty of care in running the bank's business, which is the behavior that a reasonably prudent person would exercise in similar circumstances. The duty of care does not extend to errors of business judgment so long as directors are not grossly negligent and their decisions are made with due diligence.
234. However, prosecuting directors for fraud, breach of the law, breach of the bank's by-laws or mismanagement before state courts remains a lengthy, open (not confidential) and costly process. Regarding listed banks, specific adjudication procedures (such as administrative hearings or arbitration procedures organized by the BSE) could be

83 As well as third parties.

contemplated by the competent authorities, allowing for timely, confidential and cost-efficient processes for resolving disputes between shareholders and directors.

Custodians and nominees

235. *Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares.*
236. As noted,⁸⁴ Law 520 combined with Law 308 make it possible for banks and financial institutions to hold and manage bank shares in custody for investors without revealing the beneficiaries' identity.
237. Article 14 § 2 of Law 520 provides that fiduciary contracts (the instrument through which a bank or financial institution is appointed as custodian) shall define the custodian's powers. Article 13 of the same Law provides that fiduciary contracts are subject to agency laws. Consequently, custodians are required under Lebanese law to (i) abide by the beneficiaries' instructions, especially with respect to casting votes, and, failing which; (ii) act and vote shares they hold as nominees in the best interest of the beneficiaries. Pursuant to BDL Circular 29,⁸⁵ custodians must provide the beneficiaries with periodical statements regarding their management activities.

Equal opportunity to vote

238. *The OECD Principles call for impediments to cross border voting to be eliminated. Processes and procedures for general shareholder meetings should allow for the equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.*
239. As mentioned earlier, general principles of commercial law provide that assemblies must be convened in a timely manner using appropriate communication channels to reach all shareholders effectively and on a timely basis.⁸⁶ Moreover, the possibility for shareholders to vote *in absentia* (through proxy voting) makes it easier for non-resident shareholders to cast their votes. However, absentee ballots (*vote par correspondance*) are not possible under current applicable laws, thus suggesting a legislative response.

Abusive self-dealing and disclosure of interest

240. *The OECD Principles call for insider trading and abusive self-dealing to be prohibited.*
241. Article 158 CC and article 152 CMC provide the legal framework as regards related party transactions. Details of the legal framework are provided hereafter.⁸⁷ It is noted that neither article 158 CC, nor article 152 CMC expressly mention the board members' and senior executives' duty to disclose to the board their material interest in any transaction

84 See paragraph 184.

85 Basic Decision no. 6349, dated 24 October 1996 (also referred to as Basic Circular 29).

86 See paragraph 201.

87 See paragraphs 242 to 249.

or matter directly affecting the bank. Hence, a legal and/or regulatory response could be considered.

IV.9 Related party transactions

242. *The board should be in charge of monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of the bank's assets and abuse in related party transactions.*
243. Article 158 CC provides the general legal framework governing related party transactions, applicable to all joint-stock companies including banks. Pursuant to article 158, any direct or indirect transaction between the bank, on the one hand, and any of its board members or any other institution or entity, if any of the bank's directors is an owner, partner, manager or director of the same, on the other hand, must be authorized in advance by the assembly. Clearly, interested parties may not participate in the deliberations of the said assembly.
244. The enumeration of related parties, as provided under article 158 CC, is limitative; it does not include senior executives or major shareholders of the bank. This issue needs to be considered in the context of a future legislative reform.
245. The board has an important role to play in the authorization process. Indeed, both of the board and the external auditor, separately, must submit to the assembly a special report concerning the anticipated transactions, based on which the assembly's decision will be made. The assembly's authorization must be renewed yearly if the transaction includes long-term obligations. However, board members often avoid the prior approval requirement by taking advantage of an exception set out in article 158 CC for "ordinary contracts involving operations between the company and its clients", a notion which may be too vague to provide legal certainty and be consistently enforced by judges.
246. Credit facilities to related parties are subject to a distinct regulation. In this sense, article 152 CMC provides a detailed regulation, applicable only to credit facilities granted by banks to related parties. Indeed, article 152 CMC prohibits banks from granting facilities directly or indirectly to their board members, senior executives or major shareholders, as well as any of the formers' family members (as such term is defined in the CMC),⁸⁸ unless the following conditions are cumulatively complied with:
 - The principle of granting such facilities must have been authorized in advance by the assembly, whose authorization must necessarily set the maximum ceiling for the facilities that may be granted to each individual person. It is worth mentioning that interested shareholders may not (whether in their own name or in their capacity as a proxy) participate to the assembly's vote (article 187 CC);

88 It should be mentioned that the definition of related parties under article 152 CMC is more comprehensive than the one adopted by article 158 CC.

- The board and the external auditor must inform the annual ordinary assembly of the terms and conditions of the granting of such facilities and of the status of compliance therewith;
 - The assembly's authorization must be renewed yearly if applicable;
 - Each of the said facilities is granted by an express decision of the board setting forth the value and the conditions thereof. It should be noted that, pursuant to BDL Circular 81, loans to related parties should be granted on an arm's length basis; i.e. they must be subject to the same administrative and financial conditions as applicable to similar credit granted to the bank's customers;⁸⁹
 - The facilities must be secured by real estate guarantees, bank guarantees or a guarantee from a financial institution registered in Lebanon and approved by the BCC, and;
 - The total amount of such facilities must not exceed 5% (as of 31 December 2005) of the bank's private funds (article 152 § 4(d) CMC, as amended).
247. As an exception to the generality of the above regulation, article 152 § 4(e) CMC⁹⁰ authorizes banks to grant facilities to the above individuals without complying with the above requirements, provided that the total amount of such facilities does not exceed 2% of the bank's private funds.
248. It should be noted that the BCC has the authority to monitor and control compliance by banks with the requirements pertaining to related party credit facilities. It is also worth mentioning that facilities granted to a lending company owned by the bank are excluded from the above requirements if the company is registered with the BDL.
249. As a final note, BDL Circular 57 provides that a bank may not invest more than 25% of its private funds in a foreign sister or affiliated banks and companies.

IV.10 Role of stakeholders in corporate governance

250. A stakeholder in a bank is defined as any person, entity or party who has an interest in the operations and reaching the targets of the bank. Stakeholders may be persons/groups who have a binding contractual agreement with the bank. Stakeholders can be shareholders as well as employees, creditors, customers, suppliers, trade unions, various non-governmental organizations, governmental organizations and potential investors. In bank corporate governance, supervisors, governments and depositors are among the key stakeholders due to the unique role of banks in national and local economies and financial systems, and the associated implicit or explicit deposit guarantees.

89 Article 2 of BDL Circular 81.

90 As amended by BDL Intermediary Decision no. 9040, dated 1 June 2005 (also referred to as Intermediary Circular 95).

251. The OECD Principles state that the corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements, and encourage active co-operation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises. Indeed, corporate governance is not only concerned with ensuring the flow of external capital to companies both in the form of equity and credit, but also with finding ways to encourage the various stakeholders in the firm to undertake economically optimal levels of investment in firm-specific human and physical capital. The competitiveness and ultimate success of a corporation is the result of a teamwork that embodies contributions from a range of different resource providers including investors, employees, creditors, and suppliers. Corporations should recognize that the contributions of stakeholders constitute a valuable resource for building competitive and profitable companies. It is, therefore, in the long term interest of corporations to foster wealth-creating cooperation among stakeholders. The governance framework should recognize that the interests of the corporation are served by recognizing the interests of stakeholders and their contribution to the long term success of the corporation.

Rights of stakeholders and effective redress for violation of rights

252. *The OECD Principles state that the rights of stakeholders that are established by law or through mutual agreements are to be respected. Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.*

253. Pursuant to article 166 CC, board members have a general duty to undertake their mission without fraud and in compliance with applicable laws and the bank's own by-laws—even towards third parties.⁹¹ Breach of applicable laws includes, for example, misappropriation of funds, dissimulation of benefits, distribution of fictitious dividends and so forth. In case of breach, any customer, depositor, creditor, bondholder and any other prejudiced individual or entity may file a claim for damages against directors.

254. Applicable laws also provide for some specific forms of protection for stakeholders, including the following:

- Pursuant to article 107 CC, board members are liable in case fictitious dividends are distributed to shareholders. In this vein, the external auditor is liable for the same if he commits a surveillance fault. Any individual or entity prejudiced by such distribution may sue the board members and the external auditor. It should be noted that shareholders, having cashed fictitious dividends, would not be bound to return the same unless their bad faith or gross negligence is proven.
- The increase of capital through in-kind contributions is subject to a specific verification mechanism. The said mechanism involves appointment by the court of an expert to verify the in-kind contribution's value and the number of shares granted in consideration thereof. The court-appointed expert's report is then submitted to the bank's extraordinary assembly for approval, noting that pursuant to article 194 CC,

91 I.e., parties other than the Bank itself and its shareholders.

shareholders providing the in-kind contributions shall not count for purposes of computing the quorum of such assembly.

255. As far as customers (including depositors) are concerned, article 156 CMC provides for the general principle according to which banks must use deposits in a manner that preserves the depositors' interests.
256. In addition, applicable laws and regulations provide for specific protection mechanisms for customers and depositors. Said mechanisms are, mainly, the following:
- Under general principles of law, banks should provide their customers with reasonable information and advice regarding the products and services they offer. In particular, BDL Circular 66⁹² provides that banks must adopt full transparency with their customers while issuing or marketing financial indexes, derivatives or products. BDL Circular 66 provides a general description of information that must be communicated to interested customers concerning the above investments and related risks. Moreover, and pursuant to the consumer protection law⁹³ (the CP Law), banks must provide their "consumer" customers⁹⁴ with accurate and clear information on the products and services they offer, notably the risks affecting such products.
 - Article 26 of the CP Law provides for the general principle according to which abusive contractual clauses in consumer contracts are null and void. For the purposes of the CP Law, abusive clauses are stipulations that aim at or may lead to an imbalance between the rights and obligations of the customer and the bank (e.g. clauses waiving any of the customer's legal rights or granting the bank the unilateral right to amend its customer's contract). Moreover, the CP Law sets forth a two-stage mediation/arbitration mechanism in case of dispute between the bank and any of its consumer customers. In the context of a legislative reform, similar dispute resolution mechanisms could be adopted to look into disputes between banks and their non-consumer customers.
 - Pursuant to the Law on banking secrecy,⁹⁵ all banks, bank managers, employees and any other individual having access to the bank's books, transactions and correspondence, are bound by absolute secrecy in favor of the bank's customers and the latter's heirs.
 - Regarding deposit insurance schemes, in case of a bank's failure, the National Institution for the Guarantee of Deposits (NIGD) pays to each of the depositors a total lump sum guarantee capped at an amount equivalent to approximately US\$ 3,335, regardless of the account's balance or the number of accounts opened by the same depositor with the said bank. The current deposit insurance framework could be revised with a view towards international best practice.

92 Decision no. 7493 dated 24 December 1999 (also referred to as Basic Circular 66).

93 Law no. 659 dated 4 February 2005 entering into force and effect as of 10 May 2005. It should be mentioned that this Law applies to contractual relationships between all *professionals*, including Banks, and *consumers* (as such terms are defined in the Law itself).

94 *I.e.* individuals or entities benefiting from the Bank's services for purposes other than their professional activity.

95 Law dated 3 September 1956.

257. The rights of employees are provided for under the Codes of Labor and Social Security (CLSS) and the collective labor accord signed between the ABL and the Syndicate of banks' Employees in Lebanon (the Accord).
258. The Accord enumerates the employees' benefits, subsidies, allowances, holidays, maternity leaves, working hours, employment termination rights, workplace and safety standards and other employment terms and conditions. Moreover, the Accord provides for a specific conciliation/arbitration mechanism in case of dispute over the interpretation of the Accord's terms.

Performance-enhancing mechanisms

259. *Performance-enhancing mechanisms for employee participation should be permitted to develop.*
260. Pursuant to Law 308, the bank's extraordinary assembly may authorize the board to grant the bank's employees⁹⁶ free option rights, entitling them to subscribe to the bank's share capital. The board shall decide on the terms and conditions of said option rights. Moreover, the Accord provides for the possibility to reward and promote employees who distinguish themselves by their performance, devotion and discipline as evidenced by a report drafted by their superiors. The Accord further provides for minimum automatic annual salary increases.
261. In the context of corporate governance, performance enhancing mechanisms for participation may benefit banks directly as well as indirectly through the readiness by employees to invest in firm specific skills. Examples of mechanisms for employee participation that could be considered within the context of legal and regulatory reforms include employee representation on boards, and; governance processes such as works councils that consider employee viewpoints in certain key decisions.

Stakeholder participation in the corporate governance process and the right to access information

262. *Where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on a timely and regular basis.*
263. Under the current legal framework, stakeholders do not participate in the corporate governance process and have no access to information other than publicly available information. This issue could be considered in the context of a legislative reform.

Free communication of concerns to the board

264. *Stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and their rights should not be compromised for doing this.*

96 In addition to the Chairman of the Board, Board members holding executive functions and other executives.

265. The Accord requires every employee who witnesses a default or negligence by another employee, to report the same to his direct superior and to the branch management. This requirement, however, provides few guarantees for the reporting employee, especially when the superior or the management itself is involved. Since current applicable laws and regulations do not require banks to establish audit committees, an alternative would be for employees to report illegal/unethical acts to the bank's internal audit unit, the latter being independent of the management.⁹⁷ It should be noted that when money laundering activities are suspected, employees should report them to the branch operation controller.⁹⁸

Insolvency framework

266. *The corporate governance framework should be complemented by an effective and efficient insolvency framework, and by effective enforcement of creditor rights.*
267. Banks are all subject to the common bankruptcy regulation as set forth under the CC. Said regulation proved, however, to be outdated, failing to provide effective solutions for businesses in difficulty. Accordingly, complementary special regimes were set forth addressing specifically banks in financial difficulty. As a result, banks are currently subject to three sets of laws: (i) the common outdated bankruptcy regulation as set forth under the CC; (ii) Law no. 2/67 dated 16 January 1967 (Law 2/67) describing the specific measures to be taken in case of a bank's failure, and; (iii) temporary Law no. 110/91 dated 7 November 1991 (Law 110/91) governing seizure of banks. A legislative effort to unify the applicable regimes in one act would be desirable.
268. Law 2/67 describes the specific measures to be taken in case of a bank's failure. Pursuant to Law 2/67, whenever a bank (i) declares its own failure to pay its dues; (ii) fails to pay any debt due to the BDL upon maturity; (iii) draws a cheque on the BDL without sufficient provision, or; (iv) fails to provide sufficient provision to cover a debtor balance resulting from clearinghouse operations, the governor must necessarily request the competent court to confirm/declare the failure of the concerned bank.
269. Declaring a bank failure entails the appointment by the competent court of a management committee representing the government, the BDL, the creditors and the shareholders of the bank, the said committee to be in charge of re-floating the concerned bank and managing it in the best interest of its creditors, depositors, employees and shareholders. Pursuant to Law 2/67, the management committee may exercise all powers otherwise enjoyed by the bank's board and ordinary assembly, however, subject to judicial control.
270. The management committee should complete its task within a maximum six-month period. If, within the said period, the management committee deems that the bank will not be able to continue its operations, then the competent court will decide the bank's liquidation and will appoint a liquidation committee⁹⁹ for such purpose. Alternatively,

97 Regarding internal audit, see paragraphs 153 to 157.

98 See section on money laundering, paragraphs 342 to 352.

99 To include representatives of the Bank's creditors and shareholders.

the Lebanese Council of Ministers may resolve the appointment of a special committee with extended prerogatives, assuming basically the management committee's mission for an additional two-month period. The special committee is in charge of finding one or more buyers for the bank, failing which it will be replaced by the liquidation committee.

271. The liquidation committee may, with court approval, create one or more companies to replace the bank, the shares of which are to be split into two classes: (i) class 1 including all depositors and creditors of the bank, each being granted shares prorated to the value of its debt, and; (ii) class 2 including all shareholders of the bank who shall be remitted amortized "use" shares. Dividends realized through the operation and liquidation process will be transferred to the class 1 shareholders until full repayment of their debts.
272. Another specific (though temporary) regulation for banks in difficulty is set forth under Law 110/91. In summary, the governor may request the Special banking Court (SBC)¹⁰⁰ to decide the seizure of a bank in difficulty, in which case the BDL acquires full title to all assets and rights of the concerned bank. The BDL pays the value of the assets to the NIGD, and the latter settles the debts of the bank on a prorated basis.¹⁰¹

IV.11 Summary and recommendations

273. The existing legal and regulatory framework could be improved upon as regards disclosure of the identity of beneficial owners of bank shares, shareholders' access to information, shareholders' interaction with the board and, disclosure of control-related arrangements and structures. In this sense (i) applicable laws and regulations do not provide for express requirements regarding disclosure of the identity of beneficial owners; (ii) the CC does not expressly grant shareholders the right of continuous access to information; (iii) form and time requirements for convening and conducting assemblies are not sufficiently dealt with under the current legal framework; (iv) boards are not legally required to answer shareholder questions (at least not expressly); (v) shareholders do not enjoy the right to place items on the agenda of general meetings (at least not expressly), and; (iv) the current legal and regulatory framework does not provide for specific requirements regarding disclosure of capital structures or arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership, such as pyramid structures and cross shareholding.
274. A better interaction between the shareholders and the board, coupled with greater quantity and quality of accessible information, are cornerstones in ensuring an effective participation by shareholders in assembly meetings. From this perspective, the following suggestions might be of use when considering an update to the current legal and/or regulatory framework:
 - Introducing specific requirements regarding disclosure of the identities of beneficial owners.

100 Created by virtue of Law 110/91.

101 Following specific orders of priority as detailed under Law 110/91.

- Granting each shareholder, starting the date of the call for any assembly, access to relevant information and documents at the bank's own expense. Said information/documents should include at a minimum the detailed meeting's agenda, the draft resolutions, the reasoning behind said draft resolutions and a table showing the financial results of the bank for the last five financial years.
 - Granting each shareholder, at all times, access to all information/documents made available to the shareholders for all assemblies held during the last three years.
 - Adding specific provisions to the existing general framework pertaining to the form and time requirements for convening assemblies.
 - Granting each shareholder, regardless of his shareholding percentage, the right to submit written questions to the board and be answered on the same, starting the date of the call for the concerned assembly and until the effective holding thereof.
 - Granting shareholders representing a pre-defined minimum percentage of the share capital (e.g. 0.5% to 5%, depending on the capital amount) the right to (i) place items on the agenda of assembly meetings and propose resolutions, and; (ii) submit written questions to the board, at least twice a year, concerning anything that might substantially affect the bank's operation.
 - Introducing specific requirements regarding disclosure of capital structures or arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership.
275. Applicable laws and regulations provide for some basic principles and guidelines regarding equal treatment and protection of minority shareholders, however, the legal framework could be improved upon.
276. Concerning the equal treatment of shareholders, the CC automatically grants a double voting right to shareholders owning registered shares for at least two years. Additionally, the current legal framework does not provide foreign or non-resident shareholders with effective means to vote, since absentee ballots are not possible. All shareholders must be present or represented to be able to cast their votes.
277. On another level, additional preventive measures aiming to protect minority shareholders could be introduced. For instance, the lack of alternative mechanisms for electing board members (e.g. cumulative voting) makes it difficult for minority shareholders to be represented on the board. As regards remedial mechanisms, the possibility for shareholders to invoke fraud or misuse of authority (*abus de majorité*) as a means to challenge majority voting is rarely successful, while prosecuting directors for fraud, breach of the law, breach of the bank's by-laws or mismanagement before state courts remains a lengthy, open (not confidential) and costly process.
278. Furthermore, the current legal framework does not expressly provide for a duty of board members and senior executives to disclose to the board their material interest in transactions or matters directly affecting the bank.

279. Accordingly, the following suggestions could be taken into consideration when contemplating a legislative and/or regulatory reform:
- Reconsidering article 117 CC. Amending article 117 CC so that the granting of any double voting right becomes subject to the prior approval of the extraordinary assembly could be an option.
 - Pursuant to article 176 CC, the external auditor must convene an assembly whenever required by a group of shareholders representing one-fifth (20%) of the share capital. This threshold is too high; a lower percentage could be adopted in the context of a legislative reform.
 - Recognizing cumulative voting in electing board members as an acceptable mechanism to protect minority shareholders.
 - Regarding listed banks, introducing adjudication procedures (such as administrative hearings or arbitration procedures organized by the BSE) to allow for timely, confidential and cost-efficient processes for resolving disputes between shareholders, directors and managers.
 - Allowing absentee ballots (*vote par correspondance*) for assemblies.
 - Introducing a specific requirement for board members and senior executives to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the bank.
280. The general regulation of related party transactions, as provided under article 158 CC, may also require attention. Article 158 requires that any direct or indirect transaction between the bank, on one hand, and any of its board members or any other institution or entity, if any of the bank's directors is an owner, partner, manager or director of the same, on the other hand, must be authorized in advance by the assembly. Obviously, this enumeration of related parties is restrictive; it does not include senior executives and major shareholders of the bank. It is thus recommended to modify article 158 CC to include senior executives and major shareholders of the bank in the enumeration of related parties and tighten the terminology in article 158 CC with respect to "ordinary contracts involving operations between the company and its clients". The exception to the requirement for prior approval of related party credit facilities, as provided for under article 152 § 4(e) CMC, should also be tightened.
281. Regarding stakeholder rights, the following suggestions could be taken into consideration when contemplating an update to the current legal framework:
- Adopting a code of corporate governance that could provide guidance on how to ensure that employees and other stakeholders participate in the bank's corporate governance process, for example for bank employees to form works councils that consider employee viewpoints in certain key decisions.

- Revising the current deposit insurance framework, while maintaining a good balance between the need to prevent bank runs and the need to circumvent tendencies to engage in excessive risk.
 - Updating and unifying the current insolvency systems in one legislative act.
282. On another level, regarding banks' relationships with their customers, in particular depositors, special dispute resolution mechanisms could be adopted in the context of a legislative reform, to look into disputes arising between banks and their customers,¹⁰² thereby ensuring that customers obtain timely and effective redress for violation of their rights.

102 Knowing that disputes between Banks and their "consumer" customers are subject to a specific mediation/arbitration mechanism.

V. SUPERVISORY FRAMEWORK¹⁰³

283. Weaknesses in the banking system of a country, whether developing or developed, can threaten financial stability both within that country and internationally. Several official bodies, including the BCBS, the Bank for International Settlements, the IMF and the World Bank have been examining financial stability throughout the world. The BCBS has been working in this field for many years and, as part of its efforts, released a comprehensive set of core principles for effective banking supervision in 1997.
284. The relevance of the supervisory framework to good bank corporate governance should be obvious. In fact, the way by which banks undertake their activities is largely dependent on the legal and regulatory framework pertaining to banking supervision. As part of their role, supervisors set minimum standards and requirements touching all aspects of a bank's life, including its management organization, disclosure activities, as well as internal control and risk management policies.
285. In short, and as already noted, banking supervisors are external pressure points for good corporate governance. This explains the interest that is given in this report to the Lebanese banking supervisory framework.

V.1 Supervisory agencies

286. *The Core Principles for Effective Banking Supervision as developed by the BCBS call for clear responsibilities and objectives for each agency involved in the supervision of banking organizations to be set. Each of such agencies should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking organizations and their ongoing supervision, powers to address compliance with laws as well as safety and soundness concerns, and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.*
287. In Lebanon, banking supervision is performed by four bodies: the Central Bank of Lebanon (BDL), the Banking Control Commission (BCC), the Higher Banking Commission (HBC) and the Special Investigation Commission on money laundering (SIC).
288. *The BDL was established by the CMC. The BDL is a public legal entity enjoying financial and decision-making autonomy. However, it is not subject to the administrative and management rules and controls applicable to the public sector. Its administration is accomplished through a governor, four vice-governors and a central council.*
289. Pursuant to article 70 CMC, the BDL's general mission is to safeguard the national currency, thereby ensuring the basis for permanent economic and social development. In particular, the BDL should protect the national currency's solidity, the economic stability,

103 The following sections will include a brief synthesis of the BCBS Core Principles for Effective Banking Supervision (highlighted in italics for ease of reference), as well as a review and analysis of the current legal framework in Lebanon as regards the same, and followed by a set of recommendations.

and the safety and soundness of the banking sector. The BDL should also work on developing the monetary and financial markets.

290. The BDL is endowed with substantial authorities, aimed to ensure the fulfillment of its mission. The authorities of the BDL are exercised through the central council. The central council's authorities, enumerated (without limitation) under article 33 CMC, include the following:
- Defining the monetary and credit policy of the BDL;
 - Issuing regulations for the implementation of the CMC, said regulations being binding on all banks;
 - Determining and adjusting, based on current economic circumstances, discount rates and interest rates for credit granted by the BDL to the banks, and;
 - Deliberating on all issues concerning banks.
291. In particular, the BDL controls entry into the banking industry as well as shareholding concentration.
292. Article 20 CMC provides that the governor and vice-governors, being members of the central council, must dedicate all their time and effort to the BDL; they may not exercise any other activity, whether remunerated or not. Moreover, neither the governor nor the vice-governors may receive or maintain any interest or participation in any private entity. Most important is that the governor and vice-governors may not, for two years following the expiry of their mandate, be employed by, share in or be appointed as board members in, any bank or financial institution or any entity controlled by the same. Also, pursuant to article 152 CMC, no member of the central council or employee of the BDL may receive credit facilities from banks.
293. It should be noted, however, that the governor has a six-year renewable mandate, while the vice-governors have a five-year renewable mandate. In order to ensure greater independence for the BDL, a legal obligation for rotation in the functions of the BDL's governor and vice-governors could be introduced in the context of a legislative reform.
294. *The Banking Control Commission* (BCC) was created by Law no. 28/67 dated 9 May 1967 (Law 28/67) as a special administrative body forming part of the BDL. As such it has no separate legal existence and enjoys no financial autonomy *vis-à-vis* the BDL. Nonetheless, Law 28/67 provides that the BCC is independent as its activities are not subject to the BDL's control.
295. Law 28/67 provides that BCC members may not exercise any other activity during their mandate, whether remunerated or not. Moreover, they may not receive or maintain any interest or participation in any private entity.

296. It should be noted, however, that the BCC has a five-year renewable mandate. In order to ensure greater independence for the BCC, a legal obligation for rotation in the functions of BCC member could be introduced in the context of a legislative reform.
297. The BCC is in charge of verifying, periodically and continuously, compliance by all banks with applicable laws and regulations as well as the sound conduct of banking activities. It may ask any bank to produce all information, documents, clarifications or justifications as it deems fit. The BCC may exercise its control activities without prior notice. Furthermore, it enjoys all control authorities granted by the CMC to the BDL and its governor. As such, it may request from the BDL communication of all information it deems useful. The BCC may even intervene in the monetary and financial policies of any bank, including by submitting it to a determined program aimed to enhance its financial performance.
298. The BCC must continuously inform the governor of the bank's situation, both individually and globally. Similarly, the central council may obtain from the BCC all additional information regarding its activities.
299. *The Higher Banking Commission (HBC)* was created by Law 28/67 as a special administrative body forming part of the BDL and having a judicial character. Similarly to the BCC, the HBC has no separate legal existence and enjoys no financial autonomy *vis-à-vis* the BDL.
300. The HBC is in charge of imposing administrative penalties on banks that violate their own by-laws, the provisions of the CMC or the measures imposed by the BDL, and on banks who submit incomplete or false reports and information. The above administrative penalties range from warnings to the revocation of the operating license.
301. *The Special Investigation Commission on money laundering (SIC)* was created by Law no. 318 dated 20 April 2001 (Law 318) as an independent legal entity having a judiciary nature, to be in charge of (i) investigating money laundering operations, and; (ii) ensuring bank compliance with the legal and regulatory requirements pertaining to money laundering.

V.2 Permissible activities and appellation

302. *The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in names should be controlled as far as possible.*
303. Article 121 CMC defines banks as "institutions whose main object is to use—for their own account—the funds they receive from the public in credit operations".
304. The above definition may be considered unclear and incomplete. Indeed, it implies that banks may undertake activities other than those mentioned. This is contradicted by the clear terms of article 152 CMC that provides that banks may not be involved in any activity that does not fall under the banking profession. The definition is also incomplete; it considers only credit operations, while failing to mention the provision and management of payment systems, which are an integral part of banking activities.

305. Pursuant to article 136 CMC, the BDL shall issue a list of all registered banks. According to article 137 CMC, no entity may include the terms “bank”, “banker” or any other similar term in its title, object or commercials, or use the term in a manner that confuses the public, unless the entity is registered on the above-mentioned list of banks.

V.3 Bank establishment

306. *The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organization’s ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base. Where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.*
307. Banks are established by obtaining a specific license from the central council.¹⁰⁴ The license is granted upon request addressed by the founders to the central council represented by its chairman, the governor. The application for the license should include the following documents and information:
- Official documents evidencing the identities of the founders, the persons expected to participate in the subscription to and payment of the capital, and the persons expected to be in charge of key management duties;
 - Signed CVs, extracts of the judiciary record, and detailed evaluations of assets for each of the above individuals;
 - The shareholding class and percentage for each of the expected subscribers;
 - A feasibility study for the first three years of operation, showing clearly the bank’s sources of finance and prospects for investment;
 - A description of all direct and indirect connections between the bank and any economic group(s), whether Lebanese or foreign;
 - A description of the bank’s or the founders’ interests in other similar institutions, and;
 - The draft by-laws, the projected management structure, the projected internal audit and control structure and the projected operational structure.
308. In addition, and pursuant to article 1 of Law no. 99/91 dated 6 November 1991, the BDL shall set the minimum capital requirements for establishing a commercial bank in Lebanon. According to BDL Circular 79,¹⁰⁵ the minimum capital is ten billion Lebanese pounds (approximately 6.7 million US dollars).

104 Article 128 CMC.

105 Basic Decision no. 7739 dated 21 December 2000 (also referred to as Basic Circular 79).

309. The central council enjoys discretionary power to accept or refuse the granting of the license, taking into consideration the public interest. The central council's decision will be based on an assessment of the ownership, financial, management and organizational structure of the bank.

V.4 Transfer of shares

310. *Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.*
311. In principle, the transfer of shares in banks is free and is not subject to any restriction, except for guarantee shares owned by board members and shares representing in-kind contributions upon the bank's incorporation.
312. However, and pursuant to Law 308, the transfer of significant ownership or controlling interests remains subject to the central council's prior approval. In this context, the central council's prior approval is required (i) if as a result of the transfer of, or subscription to, shares, one shareholder becomes directly, or pursuant to Law 520 (i.e., on a fiduciary basis), the owner of more than 5% of the bank's shares or voting rights, and; (ii) for any acquisition, purchase or subscription of shares by a shareholder owning 5% or more of the bank's shares or voting rights.
313. The above restriction would, however, be difficult to implement whenever bank shares are held by other banks or financial institutions on a fiduciary basis, given that Law 520 precludes banks or financial institutions acting as custodians from revealing their beneficiaries' identities.
314. In practice, however, the BDL does not accept that shares of banks be held in custody by banks or financial institutions. Law 308 should be amended to uphold this practice. Alternatively, Law 520 could be amended so as to allow disclosure of beneficial ownership in banks to the BDL.
315. Any transfer for which the central council's prior approval has not been obtained shall be deemed without any effect and the governor may instruct Midclear to block the same and sell the concerned shares for the account of the transferee in a public auction or on the stock market.
316. Under all circumstances, the BDL may oppose any transfer if, as a result of such transfer, any shareholder or business group shall lose, directly or indirectly, in part or in full, actual control over the management of the bank or the rights to vote.

V.5 Acquisitions and investments

317. *Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.*

318. Under article 153 CMC, a bank may hold interests in other entities provided its aggregate assets (including any participation interests in any entity whatsoever) and credit granted to related parties, do not exceed in total the bank's aggregate private funds. It is understood, however, that banks may acquire participation interests (or real estate properties) whose value exceeds the above threshold, provided the same is made in settlement of doubtful or bad debts. In such case, the bank must liquidate the acquired assets within two years maximum.¹⁰⁶
319. Using its regulatory authority, the BDL issued Circular 57, which establishes additional complementary restrictions pertaining to investment abroad. According to BDL Circular 57, a bank may not invest more than 25% of its private funds in foreign sister or affiliated banks and companies. Moreover, and pursuant to article 2 of BDL Circular 57, the acquisition by banks of any interest in the banking or financial sector abroad (foreign bank, financial institution, fund and so forth) is subject to the prior approval of the BDL.

V.6 Capital adequacy

320. *Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks.*
321. Article 174 CMC confirms the BDL's authority to issue recommendations and to take all measures aiming to ensure the safety and soundness of banking activity. In particular, the BDL sets and modifies rules of management to be implemented by banks in order to maintain their liquidity and solvability. In this context, article 175 CMC grants the BDL the authority to set periodically the proportions that must exist between assets and liabilities or between certain elements of assets and the various liabilities.
322. BDL Circular 44¹⁰⁷ and BCC Circular 237¹⁰⁸ set the capital adequacy ratio at a minimum of 12%.¹⁰⁹ BDL Circular 44 defines capital adequacy by comparing the bank's eligible capital with its balance sheet assets, off-balance sheet commitments and market and other risk positions at weighted amounts to reflect their relative risk. For that purpose, assets are weighted according to broad categories of notional risk, being assigned a risk weighting according to the amount of capital deemed to be necessary to support them. Five categories of risk weights are applied (0%, 20%, 30%, 50% and 100%).¹¹⁰ For example, cash and placements with BDL have zero risk weighting which means that no capital is required to support the holding of these assets. Clean overdrafts carry a 100% risk weighting, meaning that it must be supported by capital equal to 12% of the carrying amount.
323. As per BDL Circular 84,¹¹¹ banks are required to maintain with the BDL a compulsory cash reserve on customer deposits in Lebanese pounds, which must be in the form of a

106 Article 154 CMC.

107 Basic Decision no. 6939 dated 25 March 1998 (also referred to as Basic Circular 44), as amended by Basic Decision no. 7644 dated 26 August 2000.

108 BCC Circular no. 237 dated 8 July 2002.

109 Compared to a minimum 8% ratio required by the Bank of International Settlements.

110 BDL Circular 48.

111 Basic Decision no. 7835 dated 30 May 2001 (also referred to as Basic Circular 84).

non-interest earning deposit calculated on the basis of 25% of the weekly average demand deposits and 15% of the weekly average term deposits.

324. Pursuant to BDL Circulars 86 and 87,¹¹² banks are required to maintain with the BDL a compulsory cash reserve on customer deposits in foreign currencies, which must be in the form of an interest earning deposit calculated on the basis of 15% of the weekly average foreign currency deposits.
325. Also, it should be noted that pursuant to article 134 CMC, all banks must make sure that their assets' value exceeds the value of their total liabilities by at least the value of their capital. Article 132 CMC adds that 10% of the annual net profits must be transferred to a legal reserve.

V.7 Evaluation of loan and investment policies, practices and procedures

326. *Banking supervisors must evaluate and be satisfied with bank policies, practices and procedures related to (i) granting of loans and making of investments and the ongoing management of the loan and investment portfolios, and; (ii) evaluating the quality of assets, and the adequacy of loan loss provisions and loan loss reserves.*
327. As previously explained,¹¹³ the general responsibility for verifying compliance with applicable laws and regulations as well as the sound conduct of banking activities, lies with the BCC. The BCC's authorities include intervention with the monetary and financial policies of any bank to enhance its financial performance.
328. Legally speaking, the BCC must identify and address problems affecting each bank's policies, practices or procedures related to the granting of loans and making of investments, the ongoing management of the loan and investment portfolios, the evaluation of the quality of assets, and the adequacy of loan loss provisions and loan loss reserves.
329. In this context, the BCC has recently issued Circular 238, providing for a detailed description of information that needs to be gathered by banks before granting credit facilities to their customers.¹¹⁴ In the same vein, BDL Circular 81 requires the granting of credit facilities to be approved by one (or more) specialized committee(s), to be established and to operate pursuant to regulations set forth by the board.
330. It is also worth mentioning that, concerning evaluation of credit risk, BDL Circular 58 provides that banks should make sure that the BCC is provided with the necessary documentation evidencing their compliance with the evaluation norms as adopted by the BCBS. Banks are also required to provide the Directorate of Statistics and Economic Research at the BDL with the status of their loan portfolio's risk evaluation on a quarterly basis.

112 Basic Decision no. 7926 dated 20 September 2001 and Basic Decision no. 7935 dated 27 September 2001 (respectively, Basic Circulars 86 and 87).

113 See paragraph 297.

114 See paragraph 120.

V.8 Loan concentration

331. *Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.*
332. As noted above, pursuant to BDL Circular 75, banks must continuously disclose to the *Centrale des Risques Bancaires* (Central Office of Credit Risk), information concerning loans granted to their customers. Information made available to the Central Office of Credit Risk is used to inform banks and financial institutions concerning the total loans (total amount of debts) granted to each customer.
333. BDL Circular 48 regulates bank exposure to single borrowers or groups of borrowers. It provides for the following restrictions:
- A bank may not grant facilities to one natural person or legal entity or to a group of correlated debtors, in excess of 20% of the bank's private funds,¹¹⁵ and;
 - The aggregate of facilities, exceeding 15% of the bank's private funds each, should not exceed eight times total private funds.
334. For the purposes of BDL Circular 48, a group of correlated debtors is defined as (i) a group of institutions, the financial and operational policies of which are controlled by one individual or company; or (ii) a group of two or more companies, each of which has at least 20% interest stake in the other's share capital. BDL Circular 48 provides, however, that the BCC may for prevention purposes deem that a number of debtors form a group in the sense of BDL Circular 48—even if none of the above conditions is met—should the concerned bank fail to prove the absence of correlation between the risks of said debtors.

V.9 Related party transactions

335. *Banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.*
336. The legal framework governing related party transactions has already been described in this report.¹¹⁶ It shall be noted that, pursuant to BDL Circular 81, loans to related parties should be granted on an arm's length basis, *i.e.* they must be subject to the same administrative and financial conditions applicable to similar credits granted to the bank's customers.¹¹⁷

115 Pursuant to BDL's Intermediary Decision no. 8649 dated 24 February 2004 (Intermediary Circular 47), the limit becomes 5% for non-resident individuals or foreign entities, provided further that the aggregate of facilities granted to non-residents do not exceed 25% of the Bank's private funds.

116 See paragraphs 242 to 249.

117 Article 2 of BDL Circular 81.

V.10 Management of country, transfer, market and other risks

337. *Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, measuring, monitoring and controlling (i) country and transfer risks, and; (ii) market risks, where supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.*
338. BCC's duty to control bank policies and procedures for identifying, measuring, monitoring and controlling country, transfer, market and other risks stems from its general responsibility to verify their compliance with applicable laws and regulations as well as the sound conduct of banking activities.¹¹⁸
339. As far as credit risk, market risk and electronic banking risk are concerned, certain regulations exist as already described in this report.¹¹⁹ Concerning unidentified risks, BDL Circular 50 requires banks to constitute yearly from their net benefit after tax an "unidentified banking risks reserve" equal to 0.2% of the solvency denominator.¹²⁰

V.11 Internal control processes

340. *Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks. Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business.*
341. All banks are required to establish internal administrative units and implement internal control systems in compliance with BDL Circular 77 which, in turn, is based on the Basel Committee's Framework for Evaluation of Internal Control Systems. Details of the internal control legal requirements are provided under Section III.2 above.

V.12 Ethical standards and money laundering

342. *Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know your customer" rules that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, by criminal elements.*
343. Law 318 provides the general legal framework regarding money laundering. Law 318 defines money laundering and places a general obligation on banks to monitor operations with their customers to make sure that they are not involved in money laundering activities.
344. Pursuant to article 5 of Law 318, banks must, at a minimum (i) verify the real identities of their permanent customers and determine the identities of economic beneficiaries; (ii)

118 See paragraph 297.

119 See section III.1.

120 See paragraph 141.

apply the same verification procedures for non-permanent customers should the concerned operation's value exceed a predefined limit; (iii) maintain copies of all documents and official identity papers related to customer operations for at least five years; (iv) define indicators suggesting the existence of money laundering operations and put in place prudential policies to reveal suspected operations, and; (v) provide accurate information to administrative and judiciary authorities. Moreover, the external auditor must verify the bank's compliance with applicable regulatory requirements regarding money laundering, and must report any breach to the governor, in his quality as head of the Special Investigation Commission on money laundering (SIC).¹²¹

345. A detailed description of bank duties in connection with money laundering is provided under BDL Circular 83. As far as control structures are concerned, BDL Circular 83 requires each bank to establish a specialized committee and a compliance unit, and to appoint an operation controller in each of the bank's branches.
346. The specialized committee must: (i) create a manual of procedures for implementing Law 318 and BDL Circular 83 (the manual); (ii) create a "know your customer" or KYC form including information required from the bank's customers; (iii) monitor the implementation and effectiveness of the adopted anti-money laundering procedures; (iv) review and update the above procedures periodically; (v) implement a program for training the bank's employees on control techniques as adopted in the manual and as required by applicable laws and regulations, and; (vi) review and comment on reports submitted by the compliance unit and the internal audit unit¹²² with respect to suspected operations and high risk accounts.
347. The compliance unit is in charge of: (i) verifying employee compliance with the terms of the manual; (ii) conducting periodic reviews of the effectiveness of anti-money laundering procedures and submitting suggestions to the specialized committee for subsequent action by management; (iii) reviewing daily and weekly reports from the concerned branches with respect to financial operations; (iv) reviewing customer accounts and operations on a consolidated basis, on and off-balance sheet, at the headquarters and at all other branches whether in Lebanon or abroad, and; (v) investigating suspected operations and submitting corresponding monthly reports to the specialized committee.
348. The internal audit unit has similar duties as regards monitoring compliance with anti-money laundering procedures and auditing of operations. It must report breaches to the auditors and the compliance unit. The same also applies to the operation controller and other managers of the bank.
349. It should be noted that, pursuant to BDL Circular 83, a bank's external auditors must review the internal control procedures to verify compliance with anti-money laundering laws and regulations. They should submit an annual report to the governor and the BCC, including their findings, recommendations and certain related information.

121 See paragraph 350.

122 See paragraph 155.

350. The main public authority in charge of ensuring compliance with anti-money laundering laws and regulations is the SIC. As noted above, Law 318 created the SIC as an independent legal entity having a judiciary nature, to be in charge of (i) investigating money laundering operations and (ii) ensuring bank compliance with the legal and regulatory requirements pertaining to money laundering.
351. Pursuant to Law 318, the SIC is assisted by a special body of “auditors” in charge of monitoring bank compliance with anti-money laundering laws and regulations. Moreover, the BCC examiners, the banks and their auditors are required under Law 318 and BDL Circular 83 to report immediately any suspect operations to the SIC.
352. The SIC investigates reported suspicious transactions, with a proactive approach in applying the provisions of Law 318. Cases considered by the SIC as money laundering are deferred to judicial authorities and to the HBC as specified in Law 318.

V.13 Examination procedures

353. *Banking supervisors must exercise both on-site and off-site supervision. Banking supervisors must have regular contact with bank management and a thorough understanding of the institution’s operations.*
354. Pursuant to article 149 CMC, combined with Law 28/67, the BDL exercises its supervisory duties through the BCC by verifying statements, documents, information, clarifications and evidence that must be submitted by banks in accordance with the CMC (off-site supervision). In this context, article 146 CMC requires banks to submit their annual financial statements to the BDL. BDL Circular 76 requires them to report their monthly situation to the BDL and the BCC (including assets, receivables and off-balance sheet). Based on articles 146 and 149 CMC, the BCC may request bank managers to submit or to confirm in writing any information, clarification or evidence.¹²³
355. The BCC may also decide to conduct on-site examinations through its own examiners if deemed necessary, in which case the concerned bank managers must give such examiners access to all relevant documents and information. It should be noted that all BCC members and examiners are bound by banking secrecy laws.
356. In addition, the BCC enjoys effective access to independent validation of its own supervisory information. Indeed, and pursuant to article 188 CMC, bank auditors are required to communicate copies of their Annual Report, Special Related Party Transactions Report, Special Related Party Facilities Report and Detailed Report to the governor and the BCC.¹²⁴ Moreover, said auditors must answer promptly any request for information or clarification by the governor or the BCC. Similarly, the auditors are bound by banking secrecy laws.¹²⁵

123 BCC Circular 136 dated 19 November 1990 describes in detail the information that shall be periodically submitted by banks to the BCC.

124 See paragraph 170.

125 Article 190 CMC.

357. In practice, the BCC carries out on-site and off-site examinations, in order to ensure that the bank's problems are correctly identified and addressed. The BCC sets the supervisory strategy and the guidelines to be implemented by its examiners, and the guidelines are reassessed and revised on a regular basis. Meetings organized periodically by the BCC with the managers of the concerned bank serve as a complement to these procedures.
358. On average, a full-scope on-site examination is conducted on each bank once a year. Limited-scope on-site examinations are conducted more often to tackle specific problems identified by off-site examinations. BCC's on-site examiners are requested to evaluate the soundness and transparency of the bank's financial condition, its compliance with monetary and supervisory regulations, the reliability of its reporting, the asset risk factors, the ability to collect assets, and an estimation of provisioning requirements.
359. As a complement to field visits, off-site examination is conducted by three BCC units: the follow-up unit; the electronic data processing (EDP) unit, and; the research and development unit.
360. The follow-up unit is responsible for identifying early warning signals, monitoring the implementation by banks of the decisions and recommendations made by the BCC, controlling the provisioning process imposed by the BCC, reviewing the documents submitted by banks for building such provisions, and analyzing submitted financial statements and statistical reports.
361. The EDP Unit is responsible of processing the financial statements and periodic reports submitted to the BDL and to the BCC.
362. The research and development unit is in charge of—in addition to elaborating circulars to be addressed to banks about new regulatory measures taken by the BCC and setting guidelines on the implementation of the BDL's circulars—reviewing the external auditors' reports and submitting them in short form to the BCC, evaluating the feasibility studies on opening new banking branches and monitoring the compliance of banks with regulations that govern foreign exchange operations and exposures.

V.14 Financial records and consolidated supervision

363. *Banking supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on an individual and consolidated basis. They must further have a means of independent validation of supervisory information either through on-site examinations or the use of external auditors. Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business. Banking supervisors must oversee banking groups on a consolidated basis. Banking supervisors must practice global consolidated supervision over banking organizations that are active internationally. And finally, banking supervisors must establish contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.*

364. As noted under section II, the Lebanese ministry of finance has confirmed the legal requirement for application of both IAS/IFRS and ISA.
365. As far as consolidation requirements are concerned, and as noted above, banks are required by article 143 CMC to keep separate accounts for the entirety of their transactions in Lebanon. All branches of the same bank in Lebanon constitute one entity for the purpose of the CMC.¹²⁶
366. The BDL goes even further in defining consolidation obligations. As per BDL Circular 34, banks must keep and submit periodically to the BDL and to the BCC, consolidated financial statements with their banking and non-banking affiliates/related entities, irrespective of if the affiliates are domestic or foreign.
367. By requiring consolidation of financial statements for banks and their Related Entities (banking and non-banking, foreign and domestic), the BDL confirms its intention to exercise its supervisory authorities on a consolidated basis. In this sense, and as per BDL Circular 34,¹²⁷ banks have to abide by: the capital adequacy ratio;¹²⁸ the limit for credit exposure,¹²⁹ and; the provisions of articles 152 and 153 CMC (regulation of related party facilities) on a consolidated basis. All remaining banking ratios are to be computed on an individual basis.

V.15 Corrective measures

368. *Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.*
369. As previously noted,¹³⁰ the HBC is in charge of imposing administrative penalties on banks that violate their own by-laws, the provisions of the CMC or the measures imposed by the BDL, and on banks that submit incomplete or false reports and information. The above penalties range from warning to disbarment, all as follows:
- Warning;
 - Reducing or suspending credit facilities granted to the concerned bank;
 - Prohibiting certain activities and imposing other restrictions in the conduct of banking activities;
 - Appointment of a controller or an interim manager, and;

126 Article 144 CMC.

127 Article 7.

128 As per BDL Circular 44.

129 As per BDL Circular 48.

130 See paragraph 300.

- Removal from the list of banks.

370. All of the above administrative sanctions are without prejudice to applicable criminal penalties.

V.16 Summary and recommendations

371. The legal and regulatory supervisory framework provides for acceptable minimum standards that banks must meet; it allows supervisors (mainly the BDL and BCC) to set prudential rules administratively, where necessary, to achieve objectives, and utilize qualitative judgment.

372. In general, the division of authorities and the interaction between the authorities in charge of banking supervision in Lebanon are sound. The current legal framework for banking supervision is also, in general, suitable. It includes provisions relating to the authorization of banking organizations and their ongoing supervision, powers to address compliance with laws as well as safety and soundness concerns. The BDL, the BCC and the SIC enjoy significant powers to gather and independently verify information. The HBC has the necessary powers to enforce a range of penalties that may be applied when prudential requirements are not being met.

373. Still, two particular concerns may well be raised. First, the existing regulation as regards transfer of significant ownership or controlling interests should be addressed. Pursuant to Law 308, the central council's prior approval is required (i) if as a result of a transfer of, or subscription to, shares, one shareholder becomes directly, or pursuant to Law 520 (i.e., on a fiduciary basis), owner of more than 5% of a bank's shares or voting rights, and; (ii) for any acquisition, purchase or subscription of shares by a shareholder owning 5% or more of a bank's shares or voting rights.

374. The above restriction would, however, be difficult to implement whenever bank shares are held by other banks or financial institutions on a fiduciary basis, given that Law 520 precludes banks or financial institutions acting as custodians from revealing their beneficiaries' identities.

375. In practice, however, the BDL does not accept that shares of banks be held in custody by banks or financial institutions. Law 308 should be amended to uphold this practice. Alternatively, Law 520 could be amended so as to allow disclosure of beneficial ownership in banks to the BDL.

376. Second, independence requirements for banking supervisors could be strengthened further since there is no legal obligation for rotation in the functions of the BDL's governor, the vice-governors, and most importantly the BCC members. Such an obligation, which may possibly include, *inter alia*, a requirement for gradual rotation of the vice-governors and the BCC members, could be introduced in the context of a legislative reform.

ANNEX I. SOURCES OF CORPORATE GOVERNANCE REGIMES

Main legislation

- US: The Sarbanes-Oxley Act enacted on July 30, 2002.
- France: Law 2001-420 on “New Economic Regulations” (*Loi NRE*).

International codes of best Practice

- Organization for Economic Co-operation and Development (OECD) Principles of Corporate Governance (2004).
- International Corporate Governance Network (ICGN) statement on global corporate governance principles (July 1999).
- The European Association of Securities Dealers (EASD), Corporate Governance: Principles and Recommendations (May 2000).

Principal EU member states codes and reports

- UK: The Combined Code on Corporate Governance (July 2003).
- France: Vienot I (July 1995); Vienot II, Report of the Committee on Corporate Governance (July 1999); the Bouton Report (September 2002).
- Germany: German Code of Corporate Governance (the “Cromme Code”, March 2002, updated in July 2003).

Turkey

- The Capital Market board of Turkey: Corporate Governance Principles (July 2004).

Jordan

- The Central Bank of Jordan: Bank Directors’ Handbook of Corporate Governance, 2004.

Bahrain

- Bahrain Monetary Agency: Regulations and Supervisions, Rulebooks, High Level Controls Module.

Basel Committee on Banking Supervision (BCBS) key papers

- Basel I and Basel II.

- Core Principles for Effective Banking Supervision (September 1997).
- Framework for the Evaluation of International Control Systems (January 1998).
- Enhancing Bank Transparency (Public disclosure and supervisory information that promotes safety and soundness in banking systems, September 1998).
- Enhancing Corporate Governance for Banking Organizations (February 2006).
- Principles for the Management of Credit Risk (September 2000).
- Sound Practices for the Management and Supervision of Operational Risk (February 2003).
- Risk Management Principles for Electronic Banking (July 2003).
- Principles for the Management and Supervision of Interest Rate Risk (July 2004).

World Bank papers

- The Corporate Governance of Banks: Practical Measures to Strengthen boards of Directors (May 2004).
- The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence (Ross Levine, September 2004).
- Corporate Governance and Family Control, Special Issues Relating to Corporate Governance and Family Control.

International Monetary Fund

- IMF Code of Good Practices on Transparency in Monetary and Financial Policies: Declaration of Principles (September 1999).