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والشؤون الدولية

THE FORENSIC REPORT OF THE BANQUE DU LIBAN: A SHORT ANALYSIS



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ANALYSIS

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This Analysis Paper is published by the Issam Fares Institute for Public Policy & International Affairs (IFI) at the American University of Beirut and is available on the following website: <http://www.aub.edu.lb/ifi>.

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The “final preliminary” forensic report of the Banque du Liban (BdL) was issued on August 7, one week after the end of the term of the outgoing governor who headed the BdL for 30 years. The forensic audit is reported to have been a key demand of donor countries that want Lebanon to enact reforms before releasing funds to help address its financial crisis; it was not part of the Staff Level Agreement with the IMF.

Preparation of the report took considerably longer than had been anticipated, which the authors attribute to difficulties in obtaining information from the BdL. The assessment was initially expected to take 12 weeks, but it took almost three years to complete, after the first contract to conduct it was signed with the government. The authors note that repeated delays in the provision of information led to a pause of the review at several intervals. The assessors were not given access to BdL premises, and interaction with BdL staff was restricted to written questions and answers, which limited the possibility for follow-up questions and to explore issues in depth.

The aim of the assessment – as indicated in the first pages of the report – was to “perform a forensic audit and a governance and controls assessment of the Banque du Liban” covering the period 2015-2020. The forensic audit investigated whether financial transactions were used for their intended purpose; whether prices paid by the BdL were unduly inflated; whether payments were made to fictitious companies; and whether there were inappropriate reporting schemes or misuse of funds. It was also tasked to examine changes in the BdL balance sheet and composition of its foreign exchange accounts; examine the “financial engineering” operations and related movements in commercial bank accounts; and look into commercial bank holdings of government debt and their balances with the central bank. The governance and controls assessment reviewed the internal controls at the BdL, including in comparison with other central banks, and made relevant recommendations.

THE REPORT’S MAIN FINDINGS

The report’s findings did not come as a surprise. However, the report is rich in detail, containing interesting and specific information about the central bank and its operations, including a review of the BdL Central Council meeting minutes.

BdL’s Financial Position

The report states that the BdL’s financial position and its foreign exchange holdings declined sharply during 2015-2020, and that this deterioration was obscured by unconventional accounting methods. Concerns about the BdL’s accounting were raised many years prior to 2015; in fact, there were several estimates that the BdL’s capital and net foreign asset positions were negative some time ago. Adjusting the BdL financial statements based on conventional accounting methodologies, the report estimates the net equity position of the BdL to be a negative USD 51 billion at end-2020. Its foreign exchange position is also estimated to have become highly negative, which was accompanied by a shift in commercial bank foreign exchange assets from abroad to the central bank. A large part of this shift was the result of BdL’s financial engineering. The report confirms that these operations were costly to the BdL, a finding that was also previously known, and provides estimates of the cost to the BdL and of the corresponding profit to banks.

Governance and Control Arrangements

The report found that the BdL was run by the governor with little effective oversight or accountability. This was reflected in several aspects of the BdL's operations, including its accounting, financial engineering, and expenses.

An integral part of the BdL's governance framework is the BdL Central Council (CC). It is mandated to approve policy decisions and is the principal venue through which the government supervises the BdL. The CC is composed of the

governor, the four vice governors, and two government representatives, the general directors of the Ministry of Finance (the government commissioner) and of the Ministry of Economy and Trade. According to the Code of Money and Credit (CMC), the government supervises the central bank through the CC and the government commissioner mechanisms. The government commissioner may request the BdL governor to hold a CC meeting and may require the governor to suspend any decision deemed contrary to laws and regulations, referring the matter to Ministry of Finance (MoF). The government commissioner is required by the CMC to periodically inform the MoF of its supervision of BdL operations. Moreover, the governor is required by law to present to the Minister of Finance financial statements and to report on BdL operations annually.

The report notes that the CC has been ineffective in its duties. It offered no challenge to the governor, raising issues related to its competence, mandate, and independence. The impression from the report is that the governor ran the BdL largely as a one-man-show, with the CC providing a legal cover for his actions. The CC gave the governor the mandate to decide on interest rates, the details of the financial engineering operations, and unconventional accounting methods, which effectively hid the financial condition of the central bank, with little or no challenge whatsoever. Moreover, the report states that "the authority concentrated in the governor goes beyond what is reasonably expected in central banks, with insufficient scrutiny over the use of this authority," adding that the governor exercised "largely unscrutinized authority."

There was indeed a failure to effectively use the CC. The minutes of CC meetings rarely show any dissent with the governor. There are very few exceptions in six years of monthly meetings (which were suspended during March 2019-June 2020 pending the nomination of new vice governors). Specifically, there were three meetings in 2020 where vice governors raised issues related to monetary policy. The report notes that there was generally no challenge by the vice governors, including through the committees that they head.

Perhaps even more surprising than the general acquiescence of the governor's actions by the vice governors is the ineffective government supervision. The inability of the government to supervise BdL activities was communicated to the Minister of Finance. In July 2019, the government commissioner sent a letter to the Minister of Finance describing how he was unable to perform his duties because of limited access to financial information, recommending that the post be titled as a liaison officer. Another letter, in March 2020, suggested measures that could enable the government commission to perform his duties. There is no mention in the report of the government acting on these letters, suggesting the government could have taken its supervision of the BdL in a more serious manner. Perhaps the government assumed that the BdL was financially sound as the central bank continued to make profit transfers to the MoF of USD 40

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million annually, and thereby saw little need for supervision. There seems to have been no other reporting to the Minister of Finance of the government representative supervision activities, which was in violation of the CMC.

Accounting

The report notes that the BdL used unconventional accounting methods, which hid its losses and negative equity position. A large part of this relates to its accounting for seigniorage (the financial benefit that a central bank derives from issuing a currency) and deferring the cost of its financial engineering operations. While this accounting was nonconventional, it was compliant with BdL accounting rules as approved by the CC and set out in the BdL Accounting Manual. This begs the question as to whether any institution – including a central bank – should set its own accounting rules rather than be subject to international standards. Having the BdL decide on its own accounting rules – especially when they diverge from international best practice – would seem to be a potential for conflict of interest.

Financial Engineering Operations

The report covers two phases of financial engineering operations. One phase offered local banks high returns to attract USD deposits from abroad, and to place these deposits at the BdL. The second phase is aimed at strengthening the financial position of banks, in particular to meet the Basle requirements, partly through offering banks high returns on their treasury bill holdings. The BdL considers that the financial engineering operations were successful in achieving their objectives as evidenced, *inter alia*, by the resultant increase in BdL foreign assets and the strengthening of bank balance sheets. However, these operations were costly to the BdL, given the premiums that were paid to acquire treasury bills and to encourage the placement of deposits in Lebanese lira. The data shows that almost all banks benefited from financial engineering. The largest beneficiaries were Bank Audi and Blom Bank. The report stated that the CC minutes show only a brief description of these operations by the governor without acknowledging their risks, while the CC gave the governor the mandate to determine amounts, coupon rates, and allocations. It suggests that further inquiry be made into the approval of operations with certain institutions and the terms of these operations, presumably because of differences in benefits to banks and rumors that one of the operations was motivated by the BdL wanting to help specific banks. The report also noted that there were irregularities in the way consulting commissions related to the financial engineering operations were developed.

Other Issues

The report questions several payments that were made by the BdL and recommends further investigation. Prime among these payments are the significant commissions, namely USD 111 million that were mostly made to banks in Lebanon where the auditors did not know the beneficiaries; these commissions were besides the USD 333 million to Forry Associates between 2002 and March 2015. Moreover, there were significant consulting fees and sizeable real estate transactions, on which the auditors were

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not able to obtain the needed information. The report also mentions possible overpayments, and in some cases the lack of clarity on the rationale for purchases.

FINAL THOUGHTS

The report's recommendations focus on governance, namely on strengthening institutions and regulations. While there is certainly a need to strengthen institutions, there seems to be a broader issue of a culture of non-accountability, which may go well beyond the BdL and beyond laws and regulations. There are mechanisms already in place for the government to supervise the BdL that it did not use. This lack of accountability may be symptomatic of other state institutions in Lebanon. Possible ongoing examples are progress in dealing with the Beirut port explosion and the electricity sector. It is therefore unclear whether the report will lead to meaningful changes in governance.

The report also outlines several areas for further investigation, including with regards to the financial engineering operations and BdL commissions. These areas could be investigated with better access to information from the BdL, especially given public concerns about the motivation and beneficiaries of some of the BdL's actions.

Lastly, since the report covers the years 2015-2020, an assessment of the BdL during more recent years – particularly related to the Sayrafa foreign exchange platform and the policies that led to the massive decline in foreign exchange reserves – would be highly relevant to addressing concerns related to its handling of the crisis. However, the report was probably expected to be completed in early 2021, which might explain having the year 2020 as the end of the audited period. An assessment of the BdL covering earlier years would also be interesting from a historical perspective, but such an assessment would probably offer little insight into what needs to be done today.



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