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Challenges for governance at central banks

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Introduction

In today's world we demand a lot from our governments. This includes respect for the rule of law; openness, transparency and accountability of democratic institutions; fairness and equity in dealing with the public, including mechanisms for consultation and participation; clear, transparent and applicable laws and regulations; consistency and coherence in policy formulation; and high standards of ethical behaviour. We demand all this, combined with effective and efficient delivery of government services.

Central banks are part of the government sector, and face the same challenges, both in terms of governance arrangements and in terms of delivery on their prime tasks. At the same time, they are also asked to exhibit characteristics seen as desirable in the private sector, such as efficient financial performance and transparency in financial accounts.

This paper attempts to highlight the main governance challenges facing the central banking community. These challenges are shaped by the unique position that central banks occupy within the government sector and as an interface between the public and private sectors.

The central banking community intensified its interest in governance developments in the mid-1990s, sometimes leading but more often following similar developments in the private and public sectors. Central banks began to compare their internal governance arrangements amongst themselves, both bi-laterally and within the context of meetings of central bankers such as those that happen regularly at the Bank for International Settlements.¹ This peer reinforcement of the importance of good governance has indeed helped make governance one of their key concerns.

External pressures emanating from other public sector agencies, private sector firms, international institutions such as the IMF and the public at large have all played a part in nudging central banks towards better governance. But, as this paper demonstrates, central banks themselves have become convinced by the merits of improv-

ing governance. Good governance assigns a clear, well-defined, role to the central bank within the government sector, helping central bankers focus on tasks for which they have undoubted responsibility. Good internal governance arrangements make the central bank more transparent to the public, helping the process of justifying the use of public funds and thereby reducing the risk that future resource restrictions undermine the effective discharge of policy functions.

The BIS provides one forum for discussions on the governance of central banks. The BIS is also a host to a range of standard setting bodies, such as the Basel Committee on Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS) and the International Association of Deposit Insurers (IADI). These standard setting bodies have released papers on governance for their constituents. The BCBS (2006), the IAIS (2003) and IADI (draft, 2006)² have all established governance principles/guidelines for their worldwide constituents.³ These initiatives to create standards and guidelines have not gone unnoticed by the central banking community, but beyond general acceptance of the principles embedded in the code of good practices on transparency in monetary and fiscal policy promulgated by the IMF, there is no appetite for a singular standard for the governance of central banks. The reasons are explained in this paper.

I A broad perspective on central bank governance

This paper takes a broad approach to the challenges faced by central banks in the area of governance. The key challenges are placed for expository purposes into two large connected domains: "external" governance, related to factors associated with the political environment in which the central bank operates and over which the central bank has limited control; and "internal" gov-

* The views expressed are those of the author and not necessarily the views of the Bank for International Settlements. The author gratefully acknowledges detailed comments by his colleagues, in particular David Archer and Paul Moser-Boehm.

¹ For the role of the BIS in the international financial system, see www.bis.org.

² At this point in time, the paper on the governance of deposit insurance systems by the IADI is only available in draft form. By relying on key elements of operational independence, accountability, integrity and transparency it leans on the principles of the BCBS. Due to its draft nature and the fact that it is based on BCBS principles, the IADI approach is not discussed further.

³ The OECD (2004) has also released principles of corporate governance for the private business sector (see Section III of the paper).

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ernance, related to how the central bank conducts its business.

The external governance challenge mainly deals with the proper role and function of the central bank within society, and is accordingly located firmly in the political economy domain relevant to each country. The functions assigned to the central bank normally include monetary policy, currency issuance, payment and settlement system oversight and/or delivery, and acting as the lender of last resort. They may also include promotion of financial stability in general and financial supervision in particular. These functions can each have multiple and sometimes conflicting objectives and can overlap and sometimes conflict. Thus, the key issue is to ensure that the external governance parameters are set in such a way that the central bank can achieve its objectives. As it is typically the legislature's or the current government's responsibility to set these parameters, it is accordingly the legislature or the current government that sets the stage for the function of the central bank, its role within the government sector and vis-à-vis the public.

The internal governance challenge concerns how the central bank conducts its business, within the broad parameters set by the external governance arrangements. To a greater or lesser degree, for reasons explained below, central banks are sufficiently independent of direct government control that they can exercise their own judgement on internal governance, management and organisation.

II External governance: challenges of political environment for central banks

How does the central bank sit in terms of the broader political environmental and more formalistic legal structure?

In terms of broad external public sector governance, Kaufmann et al (2003) claim that traditions and existing institutions determine how authority is exercised in a particular country. This includes, firstly, the process by which governments are selected, held accountable, monitored and replaced; secondly, the capacity to manage resources efficiently and to formulate, implement and enforce sound policies and regulations; and thirdly, the respect of the public and the state for the institutions that govern their economic and social interactions.

There would probably be little disagreement if the starting point of public governance for individual public institutions were indeed as described by Kaufmann et al. At the same time, there would probably also be little disagreement that there are large differences on this score between individual countries.

Nonetheless, it is common across all forms of government that politicians need to operate through public sector agencies in order to implement their wishes. In respect of public services such as tax collection, defence, policing, provision of a social safety net, etc, governments tend to retain close control not only over the selection of objectives but also the manner of their exe-

cution. As regards public services such as the provision of a judiciary, governments typically are constrained from, or refrain from, close involvement in the delivery of the service.

In respect of delivery of monetary and financial policies, practice varies across different countries and through time. But there has been a clear trend over the last two decades in particular to restrict government involvement to the selection of the central bank's objectives. Central banks are thus increasingly seen as one of those agents of government that should be granted a degree of autonomy (or independence⁴) from government for decision-making in pursuit of the specified objective(s). In turn, the central bank is held accountable for its actions, because in an open society a public institution should be ultimately responsible to the public, either directly or as represented by parliaments or legislatures. What lies behind this trend is explained in the next section.

The agency model applied to central banking

The agency model of contracting recognises that in the course of employing someone to execute functions on one's behalf, one needs to be conscious that it will never be possible to fully observe the actions of the agent, and that the agent will have their own interests at heart. The challenge then is to devise an arrangement that makes it most likely that the agent will act in the principal's best interest, without negating the benefits of employing an agent by retaining detailed control of the execution of the function.

In the case of central banking and the execution of the monetary policy function, there are in fact two levels of principal and agent. The population elects an agent to represent its interests, ie the government. The government, in turn, selects an agent to execute its monetary policy, ie the central bank. At both levels, there are problems with conflicting interests and incentives.

Monetary policy has the particular characteristic that the immediate and most observable consequences of monetary policy actions are often different from the lasting but less readily observable results. A tightening of monetary policy, for example, will typically (though not always) lead to a period of economic slack, with slower income growth and elevated unemployment. After some time – perhaps a couple of years – that initial outcome will evolve into a return to normal economic conditions but at a lower rate of inflation. Likewise, a loosening of monetary policy will often produce a temporary burst of growth and drop in unemployment, but with the lasting result being higher inflation.

Because of the variability of the scale and timing of this sequence, it is often difficult for untrained observers to connect today's inflation performance with monetary policy decisions made many months, perhaps years, previously.

⁴ This paper does not elaborate on the different concepts of independence and autonomy.

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These characteristics may tempt governments interested in re-election into actions that are detrimental to the country's long-term interest. A monetary policy easing can boost economic activity prior to an election, with harmful inflationary consequences emerging only subsequently. Unless the electorate is able to understand the likely longer-term outcome, such an exploitation of the dynamics of monetary policy could well go unpunished and in fact be rewarded by electoral success.

Central bankers are not immune from incentive problems associated with these policy dynamics either. Although central bankers do not glean electoral advantage from manipulation of monetary policy, they do often garner public opprobrium when tightening policy to keep inflation low. It is not uncommon for central bankers to be criticised for causing unemployment even though the lift in joblessness will be temporary and more than offset in the longer term by gains from low and stable inflation.⁵ No one likes to be criticised for doing their job appropriately; such criticism inevitably makes it more difficult to do the right thing.

One solution to these incentive problems involves the creation of a governance arrangement for monetary policy whereby the government delegates responsibility for monetary policy decisions to the central bank, which is in turn obliged to explain and justify its actions in relation to the objective of price stability. In many cases governments retain the right to withdraw or override the delegation, or set some other objective. But such an act would alert the public to a renewed potential for manipulation of monetary policy for political ends. Financial market specialists, who for investment return reasons are more attuned to the risk of such manipulation than ordinary citizens, would probably act early and quickly to withdraw investments. The negative economic consequences of a large scale withdrawal of investment funds would undermine any political benefit, hence weakening the temptation to withdraw the delegation.

In this solution, the central bank wields a delegated power to implement monetary policy, but it is clear that there is no direct democratic legitimacy of the central bank and the government retains the legitimate role of determining the functions and objectives of the monetary authority via the legislative process⁶ Since the beginning of the 1990s most governments have in fact been following such a policy of "tying one's own hands" in that they are now basically divorcing the monetary policy function from the political process.⁷

⁵ Amongst the important costs of inflation are a corrosive effect on growth through badly chosen and forgone investment, and the loss of real income within the poorer strata of society where opportunities for protection against inflation are limited.

⁶ In this paper the terms central bank and monetary authority are used interchangeably.

⁷ Boylan (2004) calls it "tying successor hands". She also notes that "those who favour low inflation should welcome autonomy with open arms, while those who prefer more political control over the economy have incentives to oppose it." (p.9)

This paradigm shift towards more operational autonomy, and the accountability that is coupled with it, makes it more likely that policies are pursued which contribute to macroeconomic stability. Empirical research tends to support this proposition, as more autonomy has been shown to foster lower inflation.⁸

The more credible the commitment to the objective of price stability and the independence of policy decisions and implementation, the fewer options exist for the government to change the basic tenets of monetary policy. Successive generations of politicians may have different value sets in terms of the dangers of manipulating monetary policy. But a successful policy of "tying the hands" of governments may effectively reduce this temptation. Operational autonomy of the central bank is thus a means to achieve a favourable macroeconomic outcome and not an end in itself.

Good legal underpinning

This new view of the external governance arrangements appropriate for monetary policy is now reflected in the legal framework for many central banks.

Amongst other issues, the higher in the domestic legal order that central bank operational autonomy is anchored, the more serious the "tying of the hands" of the government. For example, central bank independence enshrined in constitutional law is inherently more credible, as constitutional law is more difficult to change than common law. A recent study by Gutiérrez (2003) claims that for countries in Latin America and the Caribbean "the constitution is likely to be better enforced than ordinary statutes owing to its higher legal rank. Our empirical analysis finds that... those countries that entrench the independence of the central bank in the constitution have a better inflation performance."⁹

Moreover, central bank law does not stand in isolation from the rest of the legal code. With respect to the regulatory functions of central banks, Mullineux (2006) makes the point that "... the independence and effectiveness of financial regulators and supervisors is dependent on the quality of the wider governance system, including the judiciary. A supportive (independent and trusted) legal system is thus a requirement for good governance". There are parallels elsewhere. IADI (2006) notes that "governance generally refers to the processes, structures and information used for directing and overseeing the management of an organisation. Importantly, governance also refers to the relationship between the deposit insurance system and the authority from which it receives its

⁸ See Cukierman et al (2002). This proposition is not undisputed (Ismihan and Ozkan (2004)). More generally, countries with a credible policy commitment where the feasibility of policy change is limited may be better off eg in terms of vital infrastructure investments (see Henisz, 2002)

⁹ This is not a dead issue, as the discussions on the envisaged new central bank law for South Africa demonstrates

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mandate or other authority to which it is ultimately held accountable”.

The alignment of legal arrangements and the overall external governance structure of the central bank will always be main external challenges for central banks. In some countries this means placing the central bank law high in the hierarchy of laws. But legal arrangements are not always the dominating consideration. General attitudes towards central bank autonomy by the government and the public at large will continue to be crucial for central banks. To some extent, central banks themselves can influence general attitudes through the quality of their own performance, and indeed, this is a crucial aspect of the accountability mechanism at work.

It is key to our understanding that operational autonomy is not an end in itself but that it has become a mainstay for central banks for the benefit of the public. The key challenges for central banks on the external governance front are thus:

- (1) continued emphasis on the virtues of operational autonomy so that it remains a solid pillar in the mindset of politicians and is reflected in the central bank law;
- (2) continuous justification of the virtue of these arrangements by solid monetary and financial policy performance; and
- (3) transparency and accountability as the integral counterpart of operational autonomy.¹⁰

III Challenges of internal governance at central banks

Operational autonomy for central banks to pursue agreed monetary policy objectives has profound implications for the internal governance of monetary institutions. More independence implies more accountability towards the public and the government, and accountability requires more transparency about how decisions are being made and resources deployed. Accountability and transparency are fast becoming a standard part of central banking. The IMF's Code of Good Practices on Transparency in Monetary and Fiscal Policies (2000) (see Annex 1) is an example of the new found orthodoxy.¹¹ For example, the code requires transparency in monetary policy decision-making and reporting of underlying data and specifies the quality of transparency.

Alan Blinder, a keen observer of monetary policy and central banks, has called the general process towards

better governance in monetary policy by central banks “the quiet revolution” (See box).

¹⁰ The World Bank (2006) notes, “Transparency is the foundation of good governance, because access to information reduces the incidence of corruption, and transparent institutions earn the public's trust” (p 6).

¹¹ IMF (2000): “...transparency for central banks and financial agencies refers to an environment in which the objectives of monetary and financial policies, their legal, institutional, and policy framework, monetary and financial policy decisions and their rationale, data and information related to these policies, and the terms of central bank and financial agencies accountability are provided to the public in a comprehensive, accessible and timely manner.”

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The Quiet Revolution

Blinder, in his book *The Quiet Revolution* (2004), notes: "...thinking about how central banks should conduct their business has undergone changes that can aptly be described as *revolutionary* – although, as befits the discreet profession of central banking, the revolution proceeded quietly and has gone almost unnoticed."

He has three pieces of advice which a large number of central banks in the world have already followed. These may be interpreted as moves towards better governance in monetary policy: *transparency*, *group decision-making* and *new communication/interaction with the market*. Transparency is openness towards public scrutiny. A central bank is transparent if its actions are "easily detected", its policies are "easily understood", and its pronouncements are "free from deceit". Group or committee decision-making leads generally to better decisions in "monetary policy" than individual decision-making. This realisation is behind the creation of monetary policy committees in a very large number of central banks. While financial markets are postulated to be efficient and prices to reflect all information, there is also a realisation that the central bank should not necessarily take marching orders from the markets. A market-friendly and competent central bank can remain a leader by setting out its own sensible and comprehensive course.

Central banks have been institutionalising broad internal governance principles in a number of ways: a clear strategy and mission statement, organisational structures that pre-empt obvious conflicts of interest at the board or management level (eg an independent compensation committee), a clean oversight structure, an independent and strengthened audit function, a solid compliance function, a move towards comprehensive risk management strategies, establishment of unambiguous lines of responsibility and accountability throughout the organisation and adherence to corporate principles in the corporate/business sector of the central bank (eg in the areas of building, procurement policies and human resources policies, including rules on ethics and codes of conduct for personnel, etc). In many central banks, there is thus now a transparent and open process of bidding for auxiliary, corporate services. Also, services like the production of notes and coins have in many cases become open for bidding.

Some of these processes are driven by the desire to align the incentives of central bankers with the objectives established for the institution. Some are driven by efficiency considerations, consistent with the need to justify the use of public funds while maintaining operational autonomy with respect to policy making. Some are driven by a desire by central banks as regulators to demonstrate best practice. And some are driven by fear that performance failures with respect to fiduciary duties or ethical standards will undermine reputation and hence the ability to effectively discharge policy functions.

With regard to the last motivation, the central bank community has indeed experienced episodes of weak governance. Some such episodes have fallen short of failure to comply with the relevant rules, but have engendered reactions that highlight that perceptions and judgement by the public may drive what is considered to be good governance to a greater extent than explicit rules. This raises the question of whether internal governance arrangements within central banks can be guided use

fully by the various standards and codes established for private financial institutions and corporations, or whether the bar may have to be set differently, or higher, for central banks as public policy institutions. The next section describes some of the main private sector standards and codes and considers whether they can be applied to central banks.

IV Application of private sector governance arrangements to central banks

In the private sector, a number of recent episodes associated with weak corporate governance have sharpened sensitivities towards appropriate corporate governance.¹² It is claimed that better corporate governance may have avoided some of these scandals.¹³ Legislatures and regulators in many countries have responded by codifying minimum standards – the passage of Sarbanes-Oxley is a case in point. Guidelines by COSO,¹⁴ the IMF, the OECD and the three standard setting bodies hosted by the BIS are part of this codification process, and have also helped to raise the visibility of good governance. Three such sets of codes and guidelines seem to have greater or lesser applicability to central banks. They are described next.

¹² See, for example, the Enron, Andersen, Freddie Mac, WorldCom, Parmalat, Refco and Livedoor incidents.

¹³ De Young et al (2005): "Although very few commercial banks have failed in recent years, virtually all of these insolvencies were related to improper management behavior and ineffective controls."

¹⁴ The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a voluntary private sector organisation founded in 1985 and sponsored by five major professional associations in the US. COSO is dedicated to improving the quality of financial reporting through business ethics, effective internal controls and corporate governance. It may be seen as a major precursor to the BCSB's corporate governance.

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The Code of Good Practices on Transparency in Monetary and Fiscal Policies

This generic code by the IMF on transparency covers all the relevant areas of monetary policy.¹⁵ The code is structured as a series of recommendations (“should”) which, if all met, would deliver something close to full transparency. The code provides the authorities with some flexibility in implementation. Its key thrust is transparency vis-à-vis the public. For example, paragraph 2.1. of the code states: “The framework, instruments, and any targets that are used to pursue the objectives of monetary policy should be publicly disclosed and explained.” In fact, central banks are being asked by this code to establish and maintain public information services (paragraph 3.3).

The majority of the code deals with transparency of the internal governance of the central bank in the area of monetary policy, but transparency is also required in the areas of financial statements, operation, regulation, organisation and personal conduct.¹⁶

Even though complying with this code might be a tall order for central banks in smaller countries with limited personnel and financial resources, there can be little doubt as to its applicability.

The OECD principles

The OECD Principles of Corporate Governance (2004) are aimed at the corporate sector. While central bank governance and corporate governance have common features in terms of clear objectives, transparency and accountability, governance arrangements need to be tailored to their substantively different roles in the functioning of the financial system. In corporate governance the profit motive plays a key role, but for central banks making profits is not an objective; the key aim is a public policy goal, like price stability. Corporate governance should empower shareholders to dismiss management if they are not satisfied with the performance; by contrast, a substantial part of the typical central bank law is concerned with ensuring that the major shareholder – the government – cannot dismiss the central bank’s management if it disagrees with the bank’s conduct of monetary policy (see the earlier discussion under II). In the corporate world, staggered terms for board members are seen as an impediment to shareholders’ rights, but for central banks they are viewed as desirable because they prevent any single government from stacking the board with its own candidates.¹⁷

Adoption of the OECD Principles of Corporate Governance by central banks is thus not an option. However,

¹⁵ See Annex 1.

¹⁶ In terms of external governance, the relevant codes are in subsection 1.

¹⁷ See Knight (2005).

certain principles are applicable to central banks as well.¹⁸

Basel Committee on Banking Supervision guidance

In 2006 the BCBS issued guidelines to supervisory authorities with respect to the governance of banking organisations. There is no direct reference in the text to central banks. Instead, “the guidance is intended to assist banking organisations in enhancing their corporate governance frameworks, and to assist supervisors in assessing the quality of those frameworks.”

While broad, the guidelines are tailored to the banking sector and provide general principles which help banking supervisors in their task of evaluating the governance (structure) of banks or banking institutions. Item 10 of the Basel Committee paper reflects the overall thrust:

“From a banking industry perspective, corporate governance involves the manner in which the business and affairs of the 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-by-day basis; meet the obligation of accountability to their shareholders and take into account the interests of other recognised stakeholders; align corporate activities and behaviour with the expectations that banks will operate in a safe and sound manner, and in compliance with the applicable laws and regulations; and protect the interests of depositors.”¹⁹

These requirements all focus on the role of senior management and the board of directors and have an analogous application to central banks.²⁰

As with the governance principles promulgated by the OECD, the BCBS guidelines only apply to the private financial sector. The goals of the private sector and the public sector are different in substance. The OECD principles and the BCBS guidance could, however, be

¹⁸ For example, OECD corporate governance principles I, V and VI:

I. The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

V. The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

VI. The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board’s accountability to the company and shareholders.

¹⁹ For more detail, see Annex 1.

²⁰ Mullineux (2006) notes: “Banks are special because their managers have a fiduciary duty to (more risk averse) depositors as well as (more risk prone) shareholders and thus a solution to the ‘principal-agent problem’ aimed at maximising shareholder value is inappropriate.”

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adopted by the central bank where they do not conflict with the public policy role of the central bank.

Transparency, group decision-making processes and communication policies are now all areas of major concern in central banks. Resources are being allocated to these functions and key management is involved. The following section on prevention of conflicts of interest, of which the code of ethics is an example, is an internal governance area where top management involvement has been strong and noteworthy.

Management of conflicts of interest and codes of ethics

The proper management of conflict is especially important for central banks. Clarity in terms of the structure of the central bank, lines of responsibility and processes are an absolute must in avoiding any potential conflict of interest.

Much of the success of central banks hinges on their credibility in markets and their standing among the public. If the public perceives a central banker as lacking good judgment on matters of personal conduct, they may – rightly or wrongly – doubt his or her good judgment on matters of policy. Serious cases of mishandled conflicts of interest are rare in central banking, particularly if one considers that the central bank community spans more than 160 institutions with more than 1000 board members and over half a million staff. Nonetheless, cases have occasionally arisen in the past few years.²¹

Many central banks have thus recently introduced or revised their codes of ethics for staff or the higher echelons of management. A recent review by the BIS across the central bank community shows that codes of conduct have been adopted by an increasing number of central banks in the last few years.^{22,23} To some extent these initiatives can be seen as a reaction to events in the private sector,²⁴ but central banks in general should also be given credit for independently reinforcing high ethical standards within their own institutions. Indeed one may argue that the observance of codes of conduct should even be more stringent for central banks than for private banks.^{25,26} The need for an especially strong code of

ethics is conditioned by the public policy function of the central bank – trust in the monetary authority is of paramount importance to the smooth functioning of the monetary economy and of the financial system. The quest for high standards of ethics is also underpinned by central banks' quest for a high degree of operational independence from the political process (see Section II). A high level of independence requires a correspondingly high level of ethics to ensure independence is not threatened. As the Governor (or Chairperson) is often perceived as the incarnation of the institution itself, his/her actions and behaviour are particularly scrutinised by the public eye.

External pressures on central banks' approach to the management of conflict of interest situations can also be relevant. According to the IMF Code of Good Practices discussed earlier, not only should central banks adhere to monetary policy transparency but also that standards for the conduct of personal affairs of officials and staff should also be publicly disclosed. Pressures from freedom of information (FOI) and/or "government in the sunshine" legislation may also be a factor in some countries. These legislative innovations have sharpened the realisation that transparency vis-à-vis the public is a force to be reckoned with. The public's interest in more information about internal governance arrangements at a central bank will be particularly sensitised to appropriate codes of conduct and the corresponding ethical tone set by management.

Codes of conduct help guide the institution and individuals towards exercising sound judgment. However, many conflicts of interest will continue to be addressed through personal integrity and judgments on what constitutes a conflict. Those judgments may depend on a blend of local customs, trends in other countries or evolving views on best practice.²⁷ Central banks as a group have generally risen to the governance challenge of more transparency and accountability in the area of ethics, and some central banks have appointed ethics officers in order to monitor the ethics codes more closely. This may be a reasonable approach, especially as the public's view of what might constitute an ethics "violation" may change.

V Work at the BIS on the governance of central banks

The evolution of interest in governance arrangements is also reflected in developments at the international finan-

²¹ See episodes at the Bundesbank (2004), the Banca d' Italia (2005) and the Bank of Japan (2006).

²² The BIS is not an official repository for central bank laws or the codes of conducts prevailing at central banks. However, we fairly regularly update the laws and codes on a global basis.

²³ While code of ethics is a first port of call, transgressions may not be avoided. Central banks generally do not have investigative units.

²⁴ While this is an important factor, there is probably also an element of peer pressure as governance structures of central banks are becoming more and more transparent and as many central banks introduced such codes during the last few years.

²⁵ These may be considered a preventive measure to contain risks, but are, however, not investigative units.

²⁶ Most codes of conduct for central banks contain a statement of principle which asks those covered by the code to observe high standards or ethical behaviour, and (in many cases) also

assure officers and staff that the central bank itself is committed to providing them with a working environment where high standards of ethics are maintained. For example, the Reserve Bank of New Zealand's Code of Conduct states that "The Reserve Bank is committed to being a good employer, and undertakes that, in achieving its mission and statutory obligations, the Bank will treat its staff ethically, honestly and with genuine interest in their individual welfare. Similarly, the Bank expects all staff to behave ethically, honestly and with a genuine interest in the Bank's welfare".

²⁷ See BIS (2006).

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cial institutions.²⁸ The Bank for International Settlements (BIS) held its first formal special-purpose meetings on governance topics in the mid-1990s.²⁹ These were meetings of central bank governors who voiced a particularly strong personal interest in topics of central bank governance. Initially, there were ad hoc meetings, but since 1999 such meetings have been taking place on a regular basis. In order to formalise this process, the BIS adopted a charter for the operation of the “Central Bank Governance Forum” in 2006 which lays down the governance rules/structure for central bank governors’ meetings in this domain (covering, for example, number of Governors, chairmanship, and appointment procedures).

Alongside meetings of Governors on governance topics, the BIS established a central bank governance network. The Governors of about 45 central banks appoint representatives from their institutions to participate in the governance network. Additionally, since 2004, various study groups on issues in central bank governance have been created; the study groups deal with topics such as central bank capital, strategic planning or the governance of risk management.

Most recently, in 2006, the BIS created a Central Banking Studies unit with the aim of providing improved factual, theoretical and empirical underpinnings to the governance issues in the central banking community.

The BIS has thus been an intermediary on governance related questions for the central banking community for the better part of a decade now, bringing together information on how central banks are managed and run. These efforts are not aimed at recommending, let alone prescribing, specific governance arrangements for central banks, but are more geared towards describing and analysing existing structures or processes and raising awareness of options.

It is probably true that central banks operate in such a wide diversity of institutional/legal, economic, political, cultural and historical settings that it would be extremely difficult to produce a single set of best practices for their governance. Nonetheless, we believe that it is useful for central banks to compare governance structure, processes and decision-making rules and to learn from their peers.³⁰ Central banks today are keen to learn from each other (and lean on lessons to be derived from the private sector). The BIS is a facilitator of this process for central banks and keenly assists the central banking community in comparing their scoreboards in the area of governance.³¹

²⁸ This paper excludes governance issues related to the international financial institutions themselves, such as the IMF, the World Bank, the OECD or the BIS.

²⁹ The author is not in a position to assess any similar processes at other international financial institutions.

³⁰ Knight (2005).

³¹ The BIS itself has recently introduced a new governance framework, and its management is actively pursuing a policy of “improved” internal governance. However, the central banks themselves are the owners of this process and in a more real

sense, the BIS is in fact owned financially by the central banks and thus acts in the common interest of the central banking community.

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Table: A stylised governance environment

Level of governance	Goals	Operation	Output	Governance principles	Indicative literature	Related literature	Governance indicators	Governance of governance
International financial institutions	Growth or better income distribution	Efficient cooperation	International financial stability	Literature available but no consensus emerging	Kenen et al (2004); Santor (2006)	International financial architecture	Kaufmann et al (2003); Acemoglu et al (2002)	No direct rules but eg IMF inherent
Central banks (regulators)	Low inflation contributing to growth	Cost conscious (policy driven)	Building integrity and reputation in the domestic financial system	Emerging by and for the central banks (see this paper)	Berger et al (2006)	Optimal decision-making under uncertainty	In process of development	Non-homogeneous legal requirements; new (SRO) rules
Corporate (financial) sector	Growth engines	Profit driven (mainly)	Maximising shareholder value	Have been developed by and for the private sector	OECD (2004); BCBS (2006); IADI (2006); Litan et al (2002)	Principal agent literature	As described by OECD (2004), BCBS (2006)	Exercised by BCBS, IADI, IAIS, OECD supported by FSF

Conclusion

Like all organisations created to undertake activities on other peoples' behalf, central banks face governance issues related to the attempt to ensure that they act in the long-term interests of their principals. In the central banking case, however, there are striking differences compared with the case of the private corporation, which limit the comparability of specific governance arrangements. Those differences arise from the fact that central banks are creatures of the legislature, usually have their specific objectives set by the government, and account for their performance to politicians. These politicians are themselves agents – with their own interests – of the true principal: the public at large.

For this reason, governance arrangements for central banks are intrinsically bound up with political economy considerations relevant for each country. These considerations set the governance tone for the central bank. Many governments today follow a policy of "tying one's hands", that is, creating governance structures that leave the monetary policy domain free from political interference. Such a policy of autonomy has proved to be in the best longer-term interest of the public at large.

Central bank autonomy makes transparency and accountability key elements of the governance of central banks. Recently, central bank laws have become more explicit about governance arrangements that promote and utilise transparency and accountability. However, there is usually considerably more depth to central bank governance than that captured by a central bank law. In this regard, good governance guidance currently emanating from the public and private sectors is helping central banks internalise better governance for their own institutions. International standard setting bodies hosted by the BIS have released guidance for good internal governance for commercial banks, insurance companies and deposit insurers. This guidance has found wide currency within the central banking community, but has to be tempered by central banks' overriding role as public policy institutions.

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Annex 1

From code of Good Practices on Transparency in Monetary and Fiscal Policies, IMF, 2000:

1.1 The ultimate objective(s) and institutional framework of monetary policy should be clearly defined in relevant legislation or regulation, including, where appropriate, a central bank law.

1.2 The institutional relationship between monetary and fiscal operations should be clearly defined.

1.3 Agency roles performed by the central bank on behalf of the government should be clearly defined.

2.1 The framework, instruments, and any targets that are used to pursue the objectives of monetary policy should be publicly disclosed and explained.

2.2 Where a permanent monetary policy making body meets to assess underlying economic developments, monitor progress toward achieving its monetary policy objective(s), and formulate policy for that period ahead, information on the composition, structure, and functions of that body should be publicly disclosed.

2.3 Changes in the setting of monetary policy instruments (other than fine-tuning) should be publicly announced and explained in a timely manner.

2.4 The central bank should issue periodic public statements on progress toward achieving its monetary policy objective(s) as well as prospects for achieving them. The arrangements could differ depending on the monetary policy framework, including the exchange rate regime.

2.5 For proposed substantive technical changes to the structure of monetary regulations, there should be a presumption of in favour of public consultations, within an appropriate period.

2.6 The regulations on data reporting by financial institutions to the central bank for monetary purposes should be publicly disclosed.

3.1 Presentations and releases of central bank data should meet the standards related to coverage, periodicity, timeliness of data and access by the public that are consistent with the International Monetary Fund's data dissemination standards.

3.2 The central bank should publicly disclose its balance sheet on a pre-announced schedule and, after a predetermined interval, publicly disclose selected information on its aggregate market transactions.

3.3 The central bank should establish and maintain public information services.

3.4 Texts of regulations issued by the central bank should be readily available to the public.

4.1 Officials of the central bank should be available to appear before a designated public authority to report on the conduct of monetary policy, explain the objective(s) of their institution, describe their performance in achieving their objective(s), and, as appropriate, exchange views on the state of the economy and the financial system.

4.2 The central bank should publicly disclose audited financial statements of its operations on a pre-announced schedule.

4.3 Information on the expenses and revenues in operating the central bank should be publicly disclosed.

4.4 Standards for the conduct of personal affairs of officials and staff of the central bank and rules to prevent exploitation of conflict of interest, including any fiduciary obligation, should be publicly disclosed.

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Annex 2

From “Enhancing corporate governance for banking organisations”, Basel Committee on Banking Supervision, February 2006:

Principle 1

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.

Principle 2

The board of directors should approve and oversee the bank’s strategic objectives and corporate values that are communicated throughout the banking organisation.

Principle 3

The board of directors should set and enforce clear lines of responsibility and accountability throughout the organisation.

Principle 4

The board should ensure that there is appropriate oversight by senior management consistent with board policy.

Principle 5

The board and senior management should effectively utilise the work conducted by the internal audit function, external auditors, and internal control functions.

Principle 6

The board should ensure that compensation policies and practices are consistent with the bank’s corporate culture, long-term objectives and strategy, and control environment.

Principle 7

The bank should be governed in a transparent manner.

Principle 8

The board and senior management should understand the bank’s operational structure, including where the bank operates in jurisdictions, or through structures that impede transparency (ie “know-your-structure”).

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