Improving institutional governance in central banks

John Mendzela urges central banks to be leaders, not laggards, in implementing robust governance principles.

Advocating "improved governance" is fashionable, and with every justification. Central banks, faced with the consequences of poor governance at some financial institutions, are amongst the advocates. So it is ironic that the governance arrangements of many central banks would fail to meet the requirements for listed corporate entities or regulated financial institutions within their own jurisdictions. It is also worrying – those who do not practice what they preach weaken their credibility.

Arrangements for policy governance have received great attention in central banking circles. The consensus is clear – better central banking demands independence, expertise and professionalism in policy formulation and decisions. Central bank governance structures are typically designed to encourage those characteristics, and to complement the roles of internal professionals with independent external input.

Beyond policy

Yet, arrangements for institutional governance – oversight of the central bank as an independent service organisation whose business activity should demonstrably achieve effectiveness and efficiency – have received less attention. Often the governor's leadership role in policymaking has been extended to also give him a dominant role in institutional governance. In central banking, the governor is traditionally both chief executive and chairman of the board. The structures designed for policy governance purposes may do little to bring to the central bank's boardroom the skills, experience and independent perspectives that will add value to institutional governance. Without that added value, central banks are likely to respond less effectively to problems and, more importantly, fail to realise some of their fresh opportunities.

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Parkinson's Law – "Work expands to fill the time available" – affects all organisations. Efficiency is, on average, still too low in central banking. It is common to see central banks struggling to resource challenged areas while over-resourced areas languish. Career incentives and internal culture may not encourage excellence. Innovation in business processes may be lacking – for example, currency and banking functions have suffered from strategic neglect in many central banks. Better institutional governance processes can become a driver for fresh thinking.

Collectively, the central banking industry is increasingly aware of these issues. A recent report by the Bank for International Settlements, entitled Issues in the Governance of Central Banks, included comment on institutional governance issues, such as resource management. But as that report and earlier analyses observe, the roles and governance arrangements of central banks vary greatly and a set of "best practices" cannot be obviously defined. Unfortunately protocol considerations then seem to close down the discussion. Nor does institutional governance of central banks get a mention in international policy pronouncements, which assume that central banks and related agencies are governed and managed so that they can effectively deliver recommended changes. But as recent events demonstrate, responsibility arrangements that look fine on paper do not automatically translate into real-world effectiveness.

Much can be done to improve institutional governance in central banks. Many individual central banks are actively pursuing improvements to their institutional governance, either through legislative change or through conscious application of modern corporate governance practices. This article seeks to assist with that process. It aims to be forthright about how to identify and apply good practice, and how weaker institutional governance structures can be ameliorated.

What is institutional governance?

It is important to distinguish between policy governance and institutional governance. An experienced central bank governor and board member identifies the following likely roles for a central bank board:[1]

1. Ensuring that there is good corporate governance in the central bank;

2. Having a role in setting monetary policy;

3. Providing economic input and advice to the monetary policy function;

4. Monitoring the policy performance of the central bank;

5. Approving plans and budgets;

6. Monitoring the efficiency of resource use in the central bank;

7. Having a role in some senior staff appointments;

8. Helping to decide the functions the central bank will get involved in;

9. Helping maintain the central bank's operational independence; and

10. Building public understanding and support for the central bank, its objectives and its operations.

From experience, I would make explicit several further institutional governance roles:

11. Overseeing strategic management of the central bank's funding through profit determination, "dividend" policy and risk management of financial instruments;

12. Setting a "tone from the top", not only in terms of ethics, but also more culturally;

13. Actively leading and overseeing internal and external audit processes;

14. Helping to shape information flows, especially management reporting.

Roles 2 and 3 fall outside institutional governance, and roles 9 and 10 mostly do. Institutional governance then mainly comprises roles 1, 4-8 and 11-14. We can consider the potential strengths and weaknesses of particular governance structures and processes in relation to those ten roles.

Thinking ahead

Before beginning, a more dramatic illustration of institutional governance may be useful. Imagine that central bank A has an inspired policy genius as governor, who always gets policy decisions just right. However he is highly autocratic, lacks leadership and management skills, and does nothing to develop resources, systems and processes for future policy work. Meanwhile central bank B operates under effective leadership and management, and has sound and sustainable resources, systems and processes for future policy work. But it sometimes makes policy mistakes. From a policy perspective, central bank A may seem to be doing a better job. But that outcome is not sustainable. In institutional governance terms, central bank A is seriously deficient and needs major attention, while central bank B is working reasonably well and can improve through evolution.

While some central bankers may resist that conclusion, or regard institutional governance as of secondary importance, good institutional governance is in fact critical to the future success of central banks. As institutions, central banks typically face a combination of challenges: "modernisation" (the shift from administration to management), substantial re-engineering of business processes and outputs (for example the shift to real-time and highly automated settlement systems), and changes to their scope of activity (for example withdrawal from some functions and recent crisis responses). Greater accountability pressures have naturally accompanied greater independence. And this is a time when the performance of central banks and regulatory agencies has been justifiably criticised as failing to meet the challenge of anticipating and averting new problems. Central banks will need to demonstrate strong institutional governance if they are to maintain their independence, effectiveness and policy priorities.

What structures work best?

Governance structures in central banks do indeed vary considerably, but diversity should not become reluctance to identify and apply good practice. Three broad models for institutional governance can be considered:

- The **"company model"**: the central bank's single board comprises one or several full-time internal directors (typically the governor and one or more deputies), and a larger number of part-time external directors. The central bank is accountable, through its board, to a minister. Parliament may have some involvement in accountability processes, for example through appearances of the central bank staff before committees, but there is no higher governance body than the central bank's own board.

- The **"supervised model"**: the central bank has two boards – an operating board, led by the governor, works internally and with continuity; while an accountability board, to which the central bank is accountable, operates at a distance and more occasionally. The operating board may have various configurations but usually comprises full-time appointees, while the accountability board usually comprises political representatives of some sort.

- The **"in-house model"**: the central bank has a single board which comprises full-time appointees, mostly or totally appointed from within the central bank, who have management responsibilities for particular parts of the organisation. External accountability operates in the same way as the company model.

Which structure is likely to be most effective in the institutional governance roles noted above? Let us first take the "company" model. If the board has the right mix of capable external directors, it will be well placed to add value in each role:

- Ensuring good corporate governance – bringing practical experience and personal reputation to the table;

- Monitoring policy performance – familiarity and comfort with external accountability and the inevitable imperfections of performance measurement;

- Approving plans and budgets – able to actively govern without descending into detail;

- Monitoring efficiency of resource use – an efficiency orientation, plus a strong working knowledge of modern management from which to challenge traditions and ask searching questions;

- Senior staff appointments – willingness and ability to dispassionately identify needs and assess both external and internal candidates;

- Setting functional scope – greater distance from internal technical priorities, plus a longer-term perspective than the government of the day is likely to have;
- Overseeing funding – experience in managing capitalisation and a balance sheet over time and through changing circumstances;
- Setting "tone from the top" – experience across a range of corporate cultures, plus high awareness of external perceptions and reputation risks;
- Audit processes – specific skills and experience in modern audit practice;
- Information flows – understanding that "more is less", and how reporting should shape data into information and knowledge.

At the other end of the spectrum, the in-house model suffers from fundamental weaknesses. Governance is not management – rather it is oversight of management. But under this model, board members will typically have both governance and management roles, making it difficult to separate those perspectives. The direct experience of long-term insiders in governance and management is by definition historical and narrow. An internal culture of departmental perspectives, bureaucratic procedures and outdated business processes is likely to heavily influence discussions. Hierarchical, costly and slow internal administration can seem normal, not outdated. Appointment processes may well focus on "who do we have", without wider thinking on "who do we need". Regardless of what happens in form, there may be very little institutional governance happening in substance.

The supervised model is difficult to generalise about. One can, however, say that an active and detailed role of the accountability board in relation to resources, plans, budgets and appointments is unlikely to be constructive, or even feasible. Responsibility for those institutional governance tasks is therefore likely to revert to the operating board, which may well suffer from the same weaknesses as the in-house model. But under this model, role confusion may well divert both groups, or even lead to conflict. Therefore, for institutional governance purposes, the three models are not equally good alternatives. No model can guarantee success in practice, but the company model offers considerable advantages in principle.

How can improvement proceed?

Changes to central bank governance structures usually involve legislative reform and should not be proposed lightly. Any legislative reform will typically need to consider many issues, not just improvement of institutional governance. So to a substantial extent, individual central banks are stuck with the governance structures they have. The diversity of governance structures in central banking is not likely to dramatically coalesce around a single "good practice" model. What can practically be done to make existing structures work better? Central banks with a company model of institutional governance can follow well-trodden roads. An established body of best practices in corporate governance can be adapted to develop benchmarks, an agenda and priorities. Key features of that agenda, in order of priority, might be:

- **Mandate:** adequate legislative support for the board's institutional governance roles and activities.

- **Composition:** competency-based processes for selection and succession to establish a critical mass of directors who are managerially skilled and oriented.

- **Checks and balances:** establishment and use of an independent chairman or "lead non-executive director" position, plus a few appropriate committees. Key aspects will include evaluation of the governor's performance as a leader and manager, strategic risk management, and audit reporting. Processes that may be vital in exception situations, for example non-executive only meetings, should become routine.

- **Accountability:** an external reporting framework that articulates organisational performance and discloses how the board carries out its own responsibilities. Codes of conduct and other formal elements of good governance are vital.

- **Effectiveness:** induction of new members and evaluation of current members. Evaluation can be introduced gradually, beginning with the board as a whole.

- **Processes:** a documented framework for board roles and activities. Governance processes should focus on major matters in a way that balances varying individual contributions with collective responsibility. Some elements will be enduring (for example committee charters) while other elements will evolve over time (annual work plans and meeting agendas).

- **Style:** a board culture that asks "simple but profound" questions to challenge technical thinking about outputs, business processes and resources. Examples of simple but profound questions might include "What will be our exit path if we get involved there?", "Should we be involved at wholesale or retail level in that function?" and "What net value would be added for stakeholders by investing in technically improved quality of that output?"

Three stages

Style is subtle, but vital to good governance. It has been rightly said that people and organisations go through three stages of understanding as they grapple with issues:

- The simple and superficial stage, in which they develop hasty and incomplete responses;

- The complicated and profound stage, in which they develop responses that are technically thorough but often confusing and sometimes unworldly;

- The simple and profound stage, in which the responses from the second stage are distilled to identify, explain and act on what really matters.

In an organisation with intricate technical roles, the complicated and profound approach readily becomes dominant. That is fine for technicians, but far from optimal for senior management and downright dangerous at the board table. Insisting on short papers and non-technical expression of recommendations will help. It will rarely be necessary to start completely afresh – some existing practices will probably prove appropriate for future use. However some new approaches, such as more formal director evaluation, will need to be introduced. In other cases, such as the appointment and performance of the governor, practices will need to reflect the unique circumstances of central banking. Evolution will not always be obvious or easy, but the inherent suitability of the company model for institutional governance and ready benchmarks can guide the improvement path.

Constitutional norms

How can institutional governance be improved under the supervised model? Again it is difficult to generalise. The supervised model typically reflects, and is embedded in, constitutional norms for its society. A few key principles can, however, be applied:

- Assume that the current model will remain in place indefinitely, so that efforts to improve institutional governance should focus on optimising its application.
- Try to articulate the role of the accountability board explicitly, as a set of key tasks. Ensure new members of the accountability board understand its role and tasks.
- Clarify the tasks and interactions of the two boards in an enduring written protocol. Keep that simple – avoid unduly prescriptive and legalistic approaches.
- Accept that some overlap and tension between the two boards is inevitable from time to time.
- Seek ways to make overlaps complementary, and tension constructive. Focus on how the accountability board can add most value in its agreed roles. For example, if the accountability board approves resource budgets as a representative of external stakeholders, then it should emphasise overall "value for money" from the institution but not second-guess the details of internal resource allocations across departments.
- Consider the operating board in relation to the in-house model and proceed as outlined below.

Delegating upwards

A central bank operating an in-house model faces the greatest challenge. Under this model, governance and management are not distinguished at all. It is common to see central bank boards struggling with lengthy agendas of detailed matters that have been "delegated upwards" and should not even reach the governance table. To counter that tendency, the board members must strive to wear their "two

hats" more consciously and one at a time. They must recognise that their group sometimes works as a board, and sometimes as a top management committee. What can help?

- A reporting framework based on functions and outputs. Information systems that provide summarised data for external accountability also generate more detailed information for internal management.
- An emphasis on those functions and outputs, not departments and inputs, whenever operating as a board. Individual members must resist the tendency to be "captured" or lapse into advocacy for their own responsibility areas.
- Stronger delegation of detailed management decisions to departments, to focus board time and attention on the bigger picture. Do not let managers avoid their individual and team responsibilities by "delegating upwards".
- Reduced and simplified administration. Too many central banks still have unnecessarily prescriptive procedures, and under-use modern technology.
- Benchmarks from a range of other organisations to compare internal practices against. Benchmarking only against other central banks limits thinking and (in management) can cement in low expectations.
- Meeting agendas and processes that focus time and attention on genuine governance activities when operating as a board. Make time for strategic discussions on management concepts, for example organisation culture and human resource management practices
- Reconsidered responsibilities for individual board members. Is it really essential for them all to have specific departmental portfolios?[2]

Beyond the walls

These measures can help improve institutional governance. But most fundamentally, an in-house central bank board needs new skills to complement its technical expertise in central banking. Strong management experience in a modern setting is needed, within senior management at least, but preferably at the governance table. Employing external candidates to fill business roles such as managing internal services can be one simple route to change the mix. Engaging direct external advice to the board on specialist matters, as a complement to internal advice, can be another. This process of "reaching beyond the walls" will personally challenge many senior central bankers. Succession will take time and disappoint some internal career expectations. But greater diversity of the management oversight group is essential. Improving the in-house model is not enough. Central banks need better, and more visibly better, policy and institutional governance than that model can deliver. So in parallel with improvement initiatives, an intention to move to a better governance model within the medium term should be created. Discussions with stakeholders are likely to be an essential first step. Ideally, these would be based on a persuasive internal paper that is supported by authoritative expert opinion.

Planning change

The resources and forums of international institutions can help benchmark practices, advise on legislation and provide mutual learning opportunities for better institutional governance. But individual central banks should customise improvement initiatives around their own specific needs and wants. As a collective body with ongoing succession, a central bank board can follow an evolutionary path to improve – and also to demonstrate – its institutional governance. But the path should be planned, not haphazard. What might the change plan look like? Who is responsible for what?

Under the company model, implementation can often be planned by the board itself, and utilise mainly the experience of external board members. External input is likely to be desirable, but may not be necessary. Under the other models, external input becomes more essential. The supervised model requires two groups to develop complementary roles under agreed and enduring principles, even where some statutory ambiguity may be inherent. Expert advice and facilitation can help resolve differences of view and achieve practical solutions. Finally, under the in-house model (and as noted before, for many operational boards under supervised models), purely internal efforts will rarely suffice. There is inherent introspection at the board table, and internal employees who report to the board are poorly placed to drive change. Because differentiation of governance and management is the key requirement, changes to improve institutional governance are likely to be part of a broader management reform requiring the targeted use of external expertise. Every change plan will be unique, but the analysis in this article can be used to start the discussion and establish key principles.

Customising governance principles

One could characterise central banks as conservative and technocratic institutions that are often latecomers to modern institutional governance. Furthermore structures designed for policy governance purposes are often far from optimal for the purposes of institutional governance. Too often internal culture is overly technocratic, or preoccupied with legacy management issues that crowd out strategic management and institutional governance reform. Central banks are now under increasing pressure to demonstrate better institutional governance. They need to “adapt not adopt” – customising good institutional governance practices to their unique needs.

The first step – more systematic and rigorous thinking about the issue – is not difficult. An evolutionary path is available and some institutions have already made impressive progress. But more vigorous action across the central banking world is needed to deliver its current promises to stakeholders and realise the future potential of central banking. Central banks are under more scrutiny than ever before and cannot expect to be exempted from the demands they place on others. Better, indeed exemplary, institutional governance can and should become a core characteristic of central banking. ❑

Notes

1. See Peter Nicholl’s chapter in *Central Bank Management*, a new book by Central Banking Publications.
2. Sweden’s central bank, which operates an Executive Board under a supervised model, has applied new ideas here. See Chapter 5 of *Central Bank Management*.