Good governance for central banks

Henry Schiffman spells out how central banks can improve the way they are run.

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Proper central bank governance is fundamental for monetary stability and protection of state assets. There has been increased emphasis on good corporate governance for enterprises since the OECD principles[1] were issued in 1999 and, in the past two years, corporate misconduct in the United States and Europe has brought the issue to the attention of governments, stock exchanges and international financial institutions. IFIs have recently emphasised the need for good corporate governance of commercial banks. Central banks, which are not subject to company laws or to regulation by capital market supervisors or stock exchanges, should examine whether their corporate governance practices are adequate in light of the recent recommendations and public concern.

Central banks can also benefit

While the main areas of concern and procedures for good corporate governance in central banks are similar to those in enterprises generally, there are some differences and special considerations that should be addressed. The recent reforms for enterprises seek to enhance accountability, integrity and transparency and could be of benefit, as well, to central banks that do not now employ some of the policies or procedures for good corporate governance. A proper system of corporate governance depends importantly on the competence and integrity of the board of directors, and the new rules introduce checks and balances, give directors better tools to enhance proper performance, and allow stakeholders more easily to monitor the performance of enterprises and their directors.

The reforms in company legislation and rules for listing on stock exchanges that are especially relevant to central banks are in the areas of:

1 http://www.oecd.org/dataoecd/32/18/31557724.pdf

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- Disclosure of information on performance and prospects to stakeholders;
- Structure and operations of the board of directors;
- Enhanced roles of audit committees;
- Roles for nomination and governance committees;
- Relations with external auditors; and
- Codes of ethics

Good corporate governance by central banks is perhaps even more important than for enterprises not only because of the crucial role of central banks in the economy, but also because stakeholders do not have the same recourse, should the central bank perform poorly, as do shareholders of enterprises. Shareholders can change the board of directors at the next opportunity or sell their shares. With central banks, the public at large must suffer any negative consequences of central bank policies and operations (unless they wish to leave the country).

Transparency for accountability

Some central banks merely publish an annual report with financial statements and perhaps an auditor's opinion. Many publish periodic bulletins containing macroeconomic indicators like the balance of payments, foreign exchange developments and commentary on price movements. However, for the government, parliament and the public generally to be able to evaluate central bank performance, central banks should publish an annual policy statement that describes the objectives of monetary policy for the next year (and exchange rate policy if that is also the responsibility of the central bank) and an assessment of the central bank's performance in light of the prior year's objectives. The annual policy statement should contain a discussion of the assumptions that led to the objectives for the next year and the factors that reinforced or impeded monetary policy performance for the year in review.

Monetary policy management is such an esoteric subject that only in this way would laymen be able to comprehend the policies and assess the performance of the central bank. For the central bank to be fully transparent as to its activities and achievements – or shortcomings – its objectives for the coming year and performance in the past year in areas like reserves management, payment system supervision and bank supervision (if applicable) should also be included in an annual policy statement. Indeed, many central bank laws enacted in the past ten years, principally those of Eastern European and CIS countries, contain a requirement for an annual policy statement concerning monetary and sometimes exchange rate policy.

Proper board composition

The two basic functions of a board of directors in any organisation are the establishment of policies for the operations of the entity and oversight of their implementation. If a board of directors contains executive officers, the oversight function would have an inherent conflict of interest. It would oversee its own activities. Many central banks have boards of directors composed entirely of persons who work full time in the bank and thus do not have the proper perspective for the evaluation of management. In some central banks, while all board members work full time in the bank, some do not have executive responsibilities and thus the perspective for evaluation

of management is better. However, since their professional career is tied to the central bank, they do not have the perspective that independent directors would bring.

Most of the recent changes in national legislation and stock exchange listing requirements have required independent directors to constitute a significant portion, if not a majority, of the board of directors. Independent directors must also chair certain committees of the board. Independence for board members of an enterprise means not being related to management or to principal shareholders of the enterprise by marriage, consanguinity to the second degree, employment, or business interest. The case of central banks would be somewhat simpler since central banks do not have shareholders (or if they do it is usually the government) and independence would mean not being employed by the central bank or connected with officers or employees of the central bank by family relation or business interest. For the latter, persons who provide consulting services or other services to the central bank would not be independent[2].

Governor dominance

Some recent reforms in corporate governance are directed at the dominance of board decisions by the chief executive officer or the chairman of the board of directors, who are often the same person. The reforms call for other board members to take more responsibility for the operations and performance of the enterprises on whose boards they serve. Thus, some reforms require that the chairman of the board of directors not be an executive officer and that the board appoint a lead director who will preside over obligatory meetings of the board without the chief executive officer.

Many central banks are dominated by the governor or chairman of the board either by law, bylaws or practice. Given the complex nature of monetary management, in some developing and transition countries the other board members are not considered sufficiently qualified to play a significant role in decision-making. In some countries the culture is simply for one person to dominate the organisation that they head. However, given the importance of central bank governance, countries whose central bank boards do not now act in a collegial fashion may wish to consider changes.

Another major area of reform in corporate governance for enterprises is the establishment of, and increased responsibilities for, certain committees of the board. The objective is to have considered in some depth at the board – and not just management level – vital matters for the integrity and performance of the enterprise. Some central banks, especially in Western countries, have monetary policy committees to determine this basic function of central banks. These committees include people "external" to the central bank especially when the board of the bank may be without non-executive directors. This reflects the thinking that monetary policy is too important to leave solely to the central bank board and a similar philosophy can be applied to other aspects of central bank responsibilities. Besides a monetary policy committee, a central bank might have a risk management committee of the board. Such a committee would consider management of the central bank's assets and liabilities including policy for credit to banks and reserves management.

2 Ministers of finance, who are often *ex officio* members of central bank boards, should probably not be considered independent as they represent the quasi if not actual shareholder of the central bank.

Audit committee responsibilities

One of the main reforms in corporate governance in Western countries is the enhancement of the role of the board's audit committee, which is to be chaired by an independent director. The aim of this committee is to ensure the integrity of the enterprise's financial statements and its systems of internal audit and controls. Such a committee's specific functions should include: establishing appropriate accounting procedures and controls for the bank and supervising compliance with such procedures; approving the strategy and budget for the bank's internal auditing; engaging (subject to shareholder ratification in companies) and terminating the company's independent auditors and determining the scope of the audit; discussing the annual audited financial statements and quarterly financial statements with management and the independent auditor; and monitoring management's efforts to correct deficiencies described in an audit or a regulatory examination.

Some central banks have "comptrollers general" who are to provide essentially the same function. Sometimes this person is appointed by the parliament as a watchdog. If this role is effective, it could suffice. Most central banks, in addition to an annual external audit, are subject to audit by the government auditor general. This is not a substitute for a committee of the board of directors as this is tantamount to an external audit.

Sometimes the function of an audit committee includes assuring the compliance of the enterprise with applicable laws and regulations. This is such an unrealistic objective, however, that it probably should not be considered for central banks other than in countries in which the audit committee would have a budget to engage qualified professionals like lawyers and accountants to advise the committee in this work.

Quality in the boardroom

Nomination committees meet relatively infrequently but have an important role in identifying qualified candidates for the board of directors. This may be even more important for central banks than for enterprises in countries in which central bank board members are selected mainly by political decision. Most central bank laws contain disqualifying factors for board members but only general affirmative requirements. If a committee of the board of directors conscientiously sought candidates who were well qualified to be members of the board, the quality of board members could be enhanced. Some central bank laws provide that the governor nominates candidates for the board of directors and this is helpful, but perhaps not as effective as if a committee of the board had to vet candidates.

Governance committees (which are sometimes combined with the nomination committee) have the basic charge to enhance the governance of the organisation. Their basic functions are to establish criteria for the evaluation of the board and management, and to provide for a programme of annual performance evaluation of the board and management. To enhance governance, a responsibility of each board committee should be to evaluate its performance annually and the governance committee should take these self-evaluations into account in its evaluation.

External audit's watch

In the absence of shareholders who could assert their prerogatives by removing the board of directors, the role of an external auditor is perhaps more important for a central bank as it must ensure that the central bank's

books of account and certain other matters are being conducted appropriately. For central banks, which require a high degree of autonomy from political interests, it would be inappropriate to allow the governmental body that appoints board members to be able to remove them annually, as is the case for most enterprises.

Most central bank laws provide for an external audit, often by internationally recognised auditing firms, but the scope of the audit is not specified. Reference should be made to an audit in accordance with international auditing standards and the scope of the audit should be specified in some important respects. There should be an evaluation of the central bank's system of internal audit and controls, reserve management should be benchmarked, and the auditor could be required to inform the minister of finance about any condition in its operations that can be expected to result in a material loss for the central bank. Since ministries of finance are responsible for recapitalisation of central banks. Should a central bank's capital become impaired, the ministry has an important interest in potential losses. Central banks that wish to be especially transparent with respect to their financial condition could publish the auditor's management letter, in addition to the auditor's opinion as is common practice.

Establishing ethical standards

Some more recent central bank laws contain an explicit fiduciary duty for central bank officials and staff, and some officials and staff are subject to general rules for civil servants to prevent exploitation of conflicts of interest. However a number of central banks are deliberately not subject to civil service rules so that they can better compensate their staff. Thus, to enhance their accountability, central banks could adopt codes of ethics for their officers and employees that require them to place the interest of the central bank before their own pecuniary interest, to keep confidential information they obtain in the course of their duties and to present annual financial statements with sources of increases in assets compared to previous years.

Codes of ethics for enterprises usually include provisions for transactions between officials or staff and the enterprise, which may legitimately occur from time to time, like the provision of services relating to procurement. However, for a central bank, except for consulting services by external board members that could be limited in amount, there is no legitimate reason why a central bank should purchase goods or services from a related party or invest in related-party business interests. One area requiring special attention is loans by a central bank to its officers and staff. Because of the various areas in which commercial banks are dependent on central banks, it is often considered inappropriate for central bank officials and staff to borrow from commercial banks and therefore some central banks provide credit to their officials and staff. To ensure that such relationships are not abused, the purposes of such loans could be specified (like for purchase of a primary residence, education and medical expenses). Officials and staff could be permitted to utilise ordinary credit cards at market interest rates and obtain credit from banks on non-preferential conditions that is disclosed. □