

## CENTRAL BANK ACCOUNTABILITY

Written evidence for the UK House of Commons Treasury Committee

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### HIGHLIGHTS

Under the Government's proposals the Bank of England will have a broader mandate than in the past. A wide range of responsibilities is not without precedent. But having **explicit and distinct** mandates for both systemic financial stability and microprudential supervision, in addition to having a mandate for monetary policy, is new.

Wider responsibility will require increased accountability. The strong focus on objectives in the proposals will help in the application of a mechanism now widely used in monetary policy. This consists of requiring transparency about decisions made, actions taken and outcomes achieved with respect to clearly specified objectives and well articulated strategies.

Oversight by Parliament and the Chancellor will be a critical element in accountability arrangements for a more powerful institution. Financial stability objectives cannot be given the same degree of measurable precision as monetary policy objectives, and assessing success or failure in pursuing a strategy and achieving an objective requires a degree of judgement. These reviews will need to cover policy decisions and the consistency among monetary, macroprudential and monetary policies.

A strong, impartial and properly constituted oversight board ("Court") can play an important part in holding the central bank to account for process and the stewardship of resources. This complements the oversight of policy by Parliament and the Chancellor.

The specific issues that deserve close attention by Court are:

- The operation of, and processes used by, the various committees, including appraisal of performance against objectives.
- The question of the financial position of the Bank in the performance of financial stability and other functions.

The challenge will be to constitute Court so that its members have appropriate experience and expertise and are free of conflicts of interest. There are a range of governance procedures that can be used to help ensure that Court operates in this manner.

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<sup>1</sup> The views expressed do not necessarily reflect those of any of the institutions, bodies or fora with which I am associated. I wish to thank David Archer, Serge Jeanneau and Paul Moser-Boehm for valuable contributions.

## Introduction

The purpose of this note is to provide information that will help address the Treasury Committee's basic concern: how to make a more powerful institution more accountable? It does so by comparing the proposed new arrangements for the Bank of England with the governance arrangements of other central banks.<sup>2</sup>

It considers the breadth of the Bank's mandate, the use of separate committees for policymaking in different areas and the applicability of different accountability mechanisms to the expanded financial stability mandate. It focuses in particular on the role of oversight boards in the accountability process.

The understanding of financial stability policies and of their interaction with other public policies is developing rapidly. The distinction between micro- and macroprudential policies is sufficiently new that there is not a universally agreed understanding of their components. Nor is the distinction even universally recognised. Hence designing specific governance arrangements for these policy functions involves breaking new ground.

The BIS has just published a report on the implications for central bank governance of financial stability policies. The report was prepared by a Study Group chaired by Stefan Ingves, Governor of the Riksbank. It is entitled *Central Bank Governance and Financial Stability*. This note draws on this report and a previous one prepared under the auspices of the Central Bank Governance Forum, *Issues in Central Bank Governance*.<sup>3</sup>

## Mandate of the Bank of England

The proposals foresee supplementing the Bank of England's current monetary policy mandate with an expanded financial stability mandate covering both micro- and macroprudential policies. This will give the Bank a wide mandate, but not one without precedent. A number of central banks have as wide or even wider mandates than that proposed for the Bank of England, though there is none that has exactly the same configuration of responsibilities.<sup>4</sup> The Bank of England has, and will continue to have under the new proposals, a fairly narrow range of operational responsibilities. Unlike many other central banks, it has little or no formal role in areas such as infrastructure provision, market development, debt management and general economic advice. It does, however, issue bank notes, collect statistics, act as banker to the Government and manage the Government's foreign exchange reserves. In the area of financial stability, the Bank will have a wide, and most notably, explicit mandate with clearly articulated objectives. There is also a clear distinction between micro- and macroprudential responsibilities.

Most central banks have some form of responsibility for financial stability (see Figure 1). However, the basis for this responsibility varies, as does its character.

- In around two thirds of cases, stability of all or parts of the financial system is mentioned as a central bank objective in the governing legislation, and in most of those cases, the objective relates to the financial system as a whole and appears to be relevant to all of the central bank's activities. In other cases, the financial stability mandate is tied to legislated responsibilities for microprudential supervision and/or for ensuring the soundness of parts of the financial infrastructure (payment and settlement systems, in particular).
- A number of central banks discharge functions that are related to financial stability (such as those mentioned in the preceding point) but there is no explicit objective of financial stability associated with those functions, or for the central bank as a whole. That they discharge related functions may provide a basis for inferring the existence of a financial stability objective. However, as noted in the Ingves Report, other objectives may equally be inferred (eg consumer protection, efficiency, competitiveness). Explicit objectives make it easier to hold a central bank to account.

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<sup>2</sup> The proposals for the reforms at the Bank of England are contained in three consultation documents issued by HM Treasury. See [http://www.hm-treasury.gov.uk/consult\\_financial\\_regulation.htm](http://www.hm-treasury.gov.uk/consult_financial_regulation.htm), [http://www.hm-treasury.gov.uk/consult\\_finreg\\_strong.htm](http://www.hm-treasury.gov.uk/consult_finreg_strong.htm) and [http://www.hm-treasury.gov.uk/consult\\_finreg\\_blueprint.htm](http://www.hm-treasury.gov.uk/consult_finreg_blueprint.htm).

<sup>3</sup> Both reports can be found at <http://www.bis.org/publ/other.htm>.

<sup>4</sup> See Table 2 in *Issues* (op cit).

- Only a small number of central banks have mandates that explicitly cover macroprudential policy, or that make a distinction between microprudential policy and policies oriented to overall systemic stability. By virtue of recent legislation in the European Parliament, the central banks of European Union countries have a specific role in relation to macroprudential policy – via their participation in the European Systemic Risk Board. Some also have microprudential responsibilities. By virtue of the Dodd-Frank Act, the Federal Reserve now has a mandate that has both microprudential and distinct macroprudential elements. Following the passage of a new law in 2009, Bank Negara Malaysia, the central bank of Malaysia, now has explicit authority to take regulatory actions that are motivated by financial system wide considerations, over and above its long-standing authority to take regulatory actions motivated by considerations specific to individual supervised institutions.

In the proposed arrangements for the Bank of England, the differentiation between micro- and macroprudential policies that will be embedded in the powers, objectives, and institutional structures of the Bank is more articulated than in these other cases. The markets for wholesale financial instruments (repos, interbank claims, commercial paper, foreign exchange, etc) in which the Bank conducts its operations are critical for systemic stability. The Board of the Prudential Regulatory Authority (PRA) will be responsible for the supervision of institutions active in these markets, and the Financial Policy Committee (FPC) will be able to require or request action by the market conduct regulator to insure the integrity and continuity of these markets. If these markets are not sufficiently deep, liquid and continuous, the central bank may find itself in a position where it needs to act as market-maker of last resort.<sup>5</sup>

## Decision-making

The most noteworthy feature of the Government’s proposal is that decision-making on monetary policy, macroprudential policy and microprudential policy will take place under the roof of a single authority, the Bank of England. In the past, decisions relevant for financial stability were made by the Bank of England, the FSA and the Treasury under the tripartite arrangements. To offset the concentration of power that will result, the proposals limit the scope of the Bank’s decision-making power by giving the Chancellor the discretionary power to lay down a remit for financial stability policy. In addition, they foresee internal checks and balances in how policy decisions will be made. Instead of being made by a single board, they will be made by three different committees: the FPC, the PRA and the Monetary Policy Committee (MPC) of the Bank. Each committee will have a separate institutional grounding, a different decision-making procedure and different oversight mechanisms.<sup>6</sup>

The use of multiple committees for decision-making is not new in central banking.<sup>7</sup> They are sometimes found in countries where the central bank has a wide mandate. Malaysia is one of the few countries with a central bank with a separate committee for systemic stability.<sup>8</sup> Assigning responsibility for macroprudential policy decision-making to a specialised committee inside the central bank is one of a number of approaches.<sup>9</sup>

One of the advantages of multiple committees is that they permit more specialised expertise to be brought to bear – thereby contributing to better decisions. They also help to deal with concentration of

<sup>5</sup> See Bingham T R G (1990) “Securities Markets, Systemic Stability and Regulation: the Macroprudential Dimension”, Journal of International Securities Markets.

<sup>6</sup> The FPC will be a committee of the Bank of England’s Court of Directors. The PRA Board will be the board of a wholly-owned subsidiary of the Bank. Both of these will operate along the existing MPC which is a committee of the Bank and has a separate statutory basis that would not be altered. Decisions on the specific operational objective for the MPC – the inflation target – will be made by the Chancellor outside the Bank. The decisions of the MPC are explicitly excluded from review by Court and not subject to override by the Chancellor. The Court of Directors will continue to have responsibility for “managing the affairs of the Bank other than the formulation of monetary policy”. See “Governance of the Bank” at <http://www.bankofengland.co.uk/about/governance/index.htm>.

<sup>7</sup> See Tables 1 and 2 for information on multiple committees and decision making in central banks that are bank supervisors.

<sup>8</sup> The Malaysian case is limited by comparison with the FPC proposed for the Bank of England in that the Financial Stability Executive Committee has a mandate that is limited to considering specific proposals by Bank Negara Malaysia for regulatory actions under certain authorities. It does not have wide-ranging responsibilities to identify threats to financial stability and design policy responses to mitigate those threats.

<sup>9</sup> The recent report *Central Bank Governance and Financial Stability* (op cit) discussed four potential configurations of decision-making arrangements for macroprudential policy that involved the central bank. Under two of these configurations, the central bank had responsibility for both monetary policy and macroprudential policy; the difference between these two hypothetical cases being the location of responsibility for microprudential supervision.

power and introduce internal checks and balances to the policymaking process, particularly if there are external members (ex officio or appointed).<sup>10</sup> Multiple committees also make it more likely that conflicts between objectives and actions will be recognised. The main disadvantages of multiple committees are that extraction of potential synergies is more difficult, that more time is spent in meetings and that there is no mechanism for ensuring the coherence of multiple sets of policies. A challenge under the new arrangements will be to find some such means.

Having one and the same person chair the committees is a common mechanism used to try to foster coherence among policy decisions. He or she can ensure that matters of concern to one committee are brought to the attention of the other(s). In virtually all central banks that have multiple policy committees, the Governor serves as the chair. This clearly poses challenges in terms of time because in addition to being the chair of the policy committees, the Governor serves as the CEO and chief spokesman.

Having overlapping membership in policy committees is another common way to deal with the challenges of coordination. Examples will be found in Malaysia, Thailand and the United States. The inclusion of individuals other than the Governor in the overlapping membership helps to address the question of the concentration of power that arises when the Governor chairs all the committees. However, if the overlapping membership is confined to internal members who depend in some way on the Governor for appointment, remuneration or advancement, the checks and balances are diluted.

In principle, conflicts can emerge between any of the three sets of policies: monetary, microprudential and macroprudential. The experience of central banks that have long had both monetary policy and microprudential (ie regulation and supervision of specific institutions) mandates is that significant conflicts between these two types of policy are rare in practice though they may arise in theory. Since macroprudential policy is in its infancy, the likelihood of conflicts with other policies is difficult to predict. Still the potential risk of conflict is likely to be greater if only because macroprudential measures can be triggered by macroeconomic or market-wide developments. Clearly monetary policy choices matter for individual institution soundness and the behaviour of the overall financial system. Likewise, choices on regulatory policy, whether with a micro- or macroprudential orientation, matter for monetary policy.<sup>11</sup>

It is useful to have means to ensure coherence among the three sets of policies. The design of mechanisms for achieving this is a challenge. The proposals provide several such mechanisms. The procedures for articulating objectives and the nature of the oversight arrangements imply that Parliament and the Chancellor are ultimately responsible for the resolution of important policy conflicts. The focus of the accountability arrangements is, however, on the operation of the individual policies and the committees that make the policy decisions. The question therefore arises about how to assure accountability for the overall mix of monetary, micro-and macroprudential policies.

## Overview of accountability mechanisms

In the past two decades a number of concrete statutory and customary procedures have been developed to hold central banks to account for the effective performance of public policy tasks and the responsible stewardship of society's resources.<sup>12</sup>

## Transparency about objectives, actions and outcomes

Accountability mechanisms are particularly well-developed in the area of monetary policy.<sup>13</sup> The procedures consist of setting clear, measurable objectives and employing various mechanisms to shed light on the decisions made, actions taken and the reasons for them. There are differences across countries in how the procedures are applied. For example, in the United Kingdom the Chancellor sets an inflation target whereas in the case of the euro area the ECB announces the

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<sup>10</sup> The proposals foresee both ex officio and appointed external members for both the FPC and PRA. The MPC will continue to have appointed external members.

<sup>11</sup> For a discussion of the relationship between monetary and macroprudential policies see "Macroprudential instruments and frameworks: a stocktaking of issues and experiences", CGFS Papers, No 38 May 2010 <http://www.bis.org/publ/cgfs38.htm>.

<sup>12</sup> The mechanisms used to foster accountability are discussed in Chapter 7 of *Issues* (op cit).

<sup>13</sup> Information on the emergence of explicit targets and monitoring ranges for monetary policy can be found in Table 16 of *Issues* (op cit).

outcomes it considers compatible with its statutory mandate. In still other jurisdictions, objectives are set jointly by the central bank and the government. Irrespective of how the objective is set, the procedure permits the ultimate beneficiaries of the public good of price stability to determine whether the institution is meeting its price stability objective. This is because the objective can be measured and observed by all concerned. Because of this, there is less need for methods of control exercised by those who have different agendas, time horizons or incentives.

Similar procedures can in principle be used in the area of financial stability. The performance of policymakers, their accountability and the management of trade-offs are enhanced by clear objectives. Clarity of responsibilities in the area of financial stability is made all the more important by the need for greater collaboration with other authorities. Knowing who is responsible for what at different stages of a crisis can aid rapid decision-making. And clarity about responsibilities and powers also helps promote accountability.

The Government's proposals pay considerable attention to framing financial stability objectives for the various committees, and this should help those committees understand their respective responsibilities, and help hold them to account. The proposals provide for the establishment of high level objectives that are more fully articulated in published strategy statements. Similar arrangements exist for monetary policy in the United Kingdom. They also exist in the 2009 UK Banking Act for the current financial stability responsibilities of the Bank. The Government's proposal for objective setting for the Bank of England, and the specific committees, is consistent with this approach. The intended remit that the Treasury will publish and periodically update provides a suitable vehicle for publicly articulating a strategy.

But, specifying objectives for financial stability policy is not easy. Turning such objectives into measurable yardsticks against which to assess progress is harder still. Assessing success or failure in pursuing a strategy and achieving an objective requires a degree of judgement. Ex post evaluation of *outcomes* against objectives is difficult, in view of time lags, and difficulties in disentangling the particular contribution of policy actions (or inactions) to such outcomes. An additional challenge in the case of macroprudential policy is that it is likely to meet vigorous resistance during the benign part of the business cycle and that its ultimate success – avoiding financial instability – has to be judged against a counterfactual. Furthermore, when a financial stability objective is added to an existing monetary policy objective, transparency alone will not help to determine which should take precedence if there is a conflict between them. For these reasons, processes of review performed by informed and impartial parties are needed to complement accountability through transparency.

## Reviews of performance of public policy tasks and the stewardship of resources

Reviews of performance are generally conducted or commissioned by parliamentary committees, government ministries, oversight boards, external auditors, public sector auditors, international organisations and panels of experts. By and large, parliamentary committees and government ministries are responsible for the review of policies, whereas oversight boards are responsible for establishing procedures, monitoring processes and overseeing the use of resources.<sup>14</sup> The two forms of review overlap and are complementary.<sup>15</sup> Although most countries make use of a combination of the various review processes, not all processes are used in every country. For example, in Chile the central bank is explicitly exempt from review by the General Comptroller of the Republic and the Superintendent of Bank and Financial Institutions for reasons of autonomy.

The relative importance of different review processes in holding a central bank to account depends on history, the political system and the place of the central bank within it. The central banks in the Nordic countries were made subject to review by Parliament from the outset because of the desire to keep control of money creation separate from the King and the government. In countries where central banks were originally organised as private chartered companies (United Kingdom, France, Netherlands) and subsequently nationalised, the government often assumed the rights of control of the shareholders. Ministerial oversight has correspondingly tended to be greater in these countries. In

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<sup>14</sup> According to *Issues* (op cit), most central banks are accountable *de jure* to Parliament and official reviews occur regularly in about two fifths of the 47 cases surveyed, whereas ad hoc reviews on special request occur in half the cases.

<sup>15</sup> Legal provisions are often framed to ensure that the board oversight will be complementary to that of Parliament and government, for example, by excluding members of Parliament and government from central bank boards, as in France, Ireland, Sweden, the United States and a number of other countries.

recent years, however, greater reliance has been placed on parliamentary committees and oversight boards because of concern about time inconsistency associated with oversight of monetary policy by the government of the day.<sup>16</sup>

The review processes need to be designed so that they do not compromise the institution's autonomy. **Financial stability policy needs at least as much independence as monetary policy.** It is subject to the same sort of time inconsistency problems. Moreover, financial stability policy, unlike monetary policy is subject to very strong pressure from vested interests, especially the financial industry, which has effective means to advance its interests. Strong accountability arrangements reinforce independence because they give legitimacy to the institution's actions, address potential conflicts of interest and help safeguard its reputation.

## Ex post reports, ad hoc inquiries and other accountability mechanisms

Ex post reports on actions taken and resources used are essential inputs into the review process, and can be a component in the transparency process if they are made public, as is often the case.<sup>17</sup> In addition to regular reports, ad hoc enquiries are commonly used to evaluate the performance of decision-making bodies. These may be commissioned by any of the review bodies. The Bank's Court has used the procedure on occasion to assess performance and process.

A number of other accountability mechanisms are also applied to central banks. They include consultation requirements, legal recourse and veto or override provisions. Rulemaking and enforcement actions are often subject to consultation requirements and the right of appeal. Both serve as checks and balances to prevent abuse of authority and ensure respect for due process.

Legal recourse is a standard and important part of the accountability framework, especially for regulatory and supervisory actions. Central banks and regulatory authorities often enjoy a degree of legal protection so they can perform their functions without facing the encumbrance of nuisance litigation, but this protection is not unlimited. Legal challenge can be made on grounds of gross negligence, misfeasance or action *ultra vires*. It is far more common for supervisory and regulatory decisions than it is for monetary policy actions.<sup>18</sup>

Override provisions exist in some form in about a fifth of all central banks, including the Bank of England. Since they permit the decisions of the central bank to be suspended or reversed, they are more intrusive than a reporting requirement or an ex post review process. Concern about autonomy has meant newer central bank legislation often does not contain such provisions. In the case of the United Kingdom, there is an explicit exemption for monetary policy. The question arises whether there should be a similar one for financial stability decisions, given the equal or stronger arguments for autonomy.

## Oversight boards

The Bank of England, in common with about two thirds of world's central banks, has a board consisting of a majority of non-executive directors who perform oversight functions (Tables 1 and 3). Oversight boards tend to be found in older central banks that were originally established as, or modelled on, companies with boards of directors, such as the Bank of England. In the case of the Nordic countries, the oversight boards often serve as agents of the legislature. They consist entirely of non-executive directors and accordingly have a non-executive as chair. They play an important role in the appointment of the Governor and senior policymakers, but their oversight of the day-to-day management of the Bank is not, and never has been, as close as that of oversight boards that evolved out of management boards. Newer central banks that were established *ab initio* as public agencies

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<sup>16</sup> See Table 17 of *issues* (op cit) for information on the frequency of reviews by the legislature.

<sup>17</sup> See Table 18 and Figure 41 in *Issues* (op cit) for information on statutorily written reports to the legislature and the actual frequency of such reports.

<sup>18</sup> Cases involving monetary policy decisions have been brought to court in Japan, Thailand and Latin America.

sometimes do not have oversight boards at all (eg ECB and Bank of Japan).<sup>19</sup> In these cases, the oversight is performed through some combination of the review processes cited above.<sup>20</sup>

Many of the boards that now exercise an oversight function used to make decisions on operational matters such as the interest rates applied to central bank transactions.<sup>21</sup> For example, the Court was involved in setting Bank Rate up till 1957, though in later years its involvement was a formality. In the United States, the boards of the Federal Reserve Banks still formally decide upon the discount rates that each Reserve Bank applies.

The evolution of central bank boards into bodies responsible for oversight rather than for management of the bank or policy decisions is an ongoing process. In recent decades, it has been the consequence of three developments. The first is the creation of distinct monetary policy committees responsible for deciding on key short-term rates. The second is the need for greater accountability as the counterpart for greater autonomy in the pursuit of price stability. Stronger oversight by boards of directors complemented increased parliamentary scrutiny and greater disclosure about decisions and deliberations. The third is the development of more rigorous governance principles and procedures in the wake of a series of corporate scandals and financial crises.

## Board functions

The basic function of a supervisory or oversight board is to hold management to account on behalf of the principals. In the corporate world, a supervisory board acts for shareholders whose ownership rights may be widely spread, reducing the ability and incentive of each principal to monitor and control management. In the central banking world, the motivation for a supervisory board is different. It provides an agency through which the government and legislature, which are themselves agents for principals (the wider public, including future generations), can exercise their oversight responsibilities. Oversight boards may also help shield the institution from short-term political pressures, cronyism or pressure from vested commercial interests.

The essential role of modern central bank oversight boards relates to ensuring the operational effectiveness of the institution (Table 4). This has several dimensions, including approving bylaws and codes of conduct and overseeing compliance with them, reviewing and approving risk management policies, making decisions on major organisational changes, approving the operational budget and the financial accounts, deciding on the allocation of the surplus and administering the audits. Oversight boards may also play a role in the appointment of senior officials not appointed by way of a separate statutory process and they may evaluate performance and decide on remuneration. The role that oversight boards play in ensuring the effective management of the institution can lead to the scrutiny of processes, including policy processes (Table 5).

Oversight boards often play an important role in the introduction of more rigorous governance principles and procedures, in keeping with trends to improve the productive efficiency of agencies of state (and sometimes prompted by corporate scandals and financial crises that elevate attention to good practice). The involvement of oversight boards in the hiring and firing of key policy decision-makers, in reviewing their performance and setting their remuneration, stands – like control over financial resources – at the junction of institutional effectiveness and policy. Selection of key officials and reviews of their performance must necessarily cover policy decision-making aptitude, but the assessment of policy decisions themselves is usually outside the board's purview.<sup>22</sup>

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<sup>19</sup> The United States constitutes a mixed case. The Board of Governors does not have an oversight board. However, the individual reserve banks do.

<sup>20</sup> Most central banks that do not have oversight boards are subject to audit oversight, often through a public sector auditor, though the remit of the auditor rarely extends to the assessment of policy or the policy process.<sup>20</sup> If a central bank has an oversight board, it is generally oversees the audit process.

<sup>21</sup> The distinction between supervisory and management/policy boards is not always hard and fast. Some central banks, such as the Reserve Bank of Australia, have multifunction boards that are responsible for oversight and for significant management and policy decisions. In others, policy functions have been carved out and assigned to a separate committee, but oversight and management functions are still co-mingled in the board of directors.

<sup>22</sup> The Reserve Bank of New Zealand is one of the few central banks where the board is formally responsible for keeping policy decisions under review. The Board of Directors receives all the information used to make policy decisions and assesses whether the decisions were reasonable in view of the information available at the time they were made.

## The powers of Court

The powers of the Bank of England's Court of Directors are broad in some respects; narrow in others. They are broad in the sense that the legislation charges it with the management of all of the Bank's affairs other than the formulation of monetary policy. Within the limits set by legislation, Court has the power to determine which matters are reserved for it alone and which ones are delegated. It has decided to delegate all matters not reserved to itself to the Governor. It could revoke this delegation of powers or decide to delegate certain matters to other members of Court or other servants of the Bank. Like the oversight boards of the Federal Reserve and the Hong Kong Monetary Authority (HKMA), the Bank of England's Court has the power to assess the performance of the Governor and Deputy Governors. At the HKMA the oversight board (EFAC) conducts an annual performance appraisal of the Chief Executive that is similar in character to the one applied to HKMA staff members.

Court will play a role in overseeing the performance of the Bank's expanded financial stability functions, primarily by overseeing the use of resources and the processes that are applied. However, its role will vary from committee to committee depending on its institutional grounding. The FPC will be a subcommittee of Court and, in addition to overseeing its use of resources, Court will approve the Financial Stability Strategy and monitor performance against it. Since the PRA will be a wholly owned subsidiary of the Bank, Court will exercise some rights of ownership and control, including oversight of the PRA's financial arrangements and the appointment of Directors. However, its rights are circumscribed by the restrictions set out in the legislation that, for example, establish an ex officio chairman (the Governor). The relationship between the PRA and the Bank will be set out in the articles of association, which will be approved by the Bank. Court can help promote coherence of the Bank's policies by ensuring that these policymaking committees are appropriately resourced and adopt processes that foster synergies.

The Bank's – and correspondingly the Court's – mandate is narrow relative to some other central banks in three specific senses:

- First the Chancellor makes decisions that in a number of other jurisdictions would be made by the central bank itself. For example, the Chancellor sets an inflation target in the UK. In other countries, the target, reference level or monitoring range is set by the central bank alone or jointly by the central bank and the government.
- Second, the Bank has no formal role in shaping the legislation affecting the monetary and financial system. The Maastricht treaty provides that the ECB shall be consulted about any community or member state legislation in its field of competence. The ECB has made active use of the advisory powers that this article of the treaty gives it.
- Third, Court's decisions matter less for the financial strength of the Bank than in most other countries with oversight boards. In these countries, the oversight board decides on matters that determine how large the bank's buffer against future losses will be. In the United Kingdom, Court has less discretion. All seigniorage is turned over to the Treasury. The Bank's policy-related expenditures are covered by interest free balances placed by the banks with the Bank. The size of these balances is determined by the Treasury. Other operations such as the provision of banking services are funded with fees and charges. Half of any after-tax profit is paid to the Treasury.

The crisis radically changed the size, composition and risk characteristics of central bank balance sheets. Some of the operations that central banks undertook involved little financial risk, but on the whole the risk exposures of central banks increased. **Oversight bodies such as Court will need to make sure that the risk management procedures of the central bank are sound. They also need to ensure that the financial position of the central bank permits it to perform its monetary and financial stability functions at all times.** Measures taken in the aftermath of a crisis must also be subject to careful oversight arrangements. The authorisation of the Chancellor needs to be sought for exceptional operations that expose the public purse to loss.



## Size and composition

Smaller boards consisting of a clear majority of qualified non-executives are widely viewed as more effective.<sup>23</sup> Virtually all central bank oversight boards have a majority of non-executive directors. In some cases (eg Sweden, Switzerland), they consist entirely of non-executive directors. The changes made to the size and composition of Court in 2009 have brought Court closer the median of ten for central banks (see Tables 1 and 3). With nine external and three internal members, the former clearly dominate, particularly when a non-executive serves as the chair.<sup>24</sup>

## Need for impartial members with expertise

Boards of directors need to challenge management.<sup>25</sup> Members need to be experienced, expert and impartial. In the past, members of central bank boards were often selected to represent different segments of society and in some cases (eg Belgium, Denmark) there are still rules that lay down which industries, regions and interest groups should be represented. The trend however has been towards appointing directors on the basis of expertise rather than sector.

In a number of cases, the law sets out qualifications for board members. In fact the legislation governing the qualification of oversight board members tends to be stricter for members of oversight boards than for members of policy boards. In two thirds the 30 central banks covered in a survey of central bank boards, there are explicit professional qualifications set out in the legislation or bylaws (Table 6). The bylaws of the Hong Kong Monetary Authority stipulate that the members of the oversight board should have expertise and experience that includes knowledge of monetary, financial and economic affairs, and of investment issues as well as of accounting, management, business and legal matters. In Ireland the list of relevant knowledge is even longer. It includes accountancy, actuarial science, banking, consumer interests, corporate governance, economics, financial control, financial regulation, financial services, insurance, law, social policy and systems control. Formal procedures to identify suitable candidates are set down in Israel and Australia, where the Minister of Finance and the Governor began in 2007 to compile and maintain a list of eminent, impartial and qualified persons suitable for membership in the Board.

The expansion of the Bank's mandate could make it increasingly difficult to find members of Court who are qualified, independent and prepared to devote sufficient time to their tasks. Members of the Bank of England's Court are paid GBP 15 000 per annum, chairmen of subcommittees GBP 20 000 and the chair GBP 30 000. The pool of potential candidates who will be prepared to devote sufficient time to a wider oversight function is limited. Many of those with the relevant expertise are likely to have a conflict of interest while those devoid of a conflict of interest may not have the relevant expertise. "Grey eminences" may be one source of qualified and impartial candidates, but it will still be necessary to have effective conflict of interest provisions.

## Conflicts of interest

As Court will exercise oversight over a more powerful institution with a wider range of responsibilities, it will be increasingly important to ensure that members are free of conflicts of interest. The relevant statutes in other countries often lay down criteria for impartiality. Although the codes of governance developed for private companies are not suitable in all respects for central banks, they often contain useful guidance on procedures to ensure the directors are independent. The 2010 UK corporate governance code contains such provisions.<sup>26</sup> In the case of South Africa, relevant provisions of the King Code of Corporate Practices are applied to board members of the Reserve Bank.<sup>27</sup>

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<sup>23</sup> See eg Agoraki, M-E et al (2009): "The effect of board size and composition on bank efficiency". And Conyon, M J et al (1998): "Board size and corporate performance: evidence from European countries".

<sup>24</sup> Prior to 2009 the Governor was the ex officio chair. Since then, the Chancellor designates the Chair from among the members. In the one instance in which this power has been used, the Chancellor decided to designate a non-executive director as chairman.

<sup>25</sup> Walker, D (2009): "A review of corporate governance in UK banks and other financial industry entities", HM Treasury.

<sup>26</sup> See <http://www.frc.org.uk/corporate/ukcgcode.cfm>.

<sup>27</sup> The Code is named after Mervyn King, the chair of the committee that in 1994 produced a seminal report on corporate governance in South Africa. Mervyn E King is a former Judge of the Supreme Court of South Africa who chaired the committee. Mervyn A King is Governor of the Bank of England.

The need to minimise and manage conflicts of interest has driven many of the changes that have occurred in the structure and operation of oversight boards. The realisation that a separation of functions offers an effective system of checks and balances is a major reason for splitting the post of Governor from that of chairman of the supervisory board and/or creating subcommittees with much clearer remits.<sup>28</sup>

Concern about potential conflicts of interest also increasingly guides the choice of board members and the limitations placed on them. For example, the Dodd-Frank Act stripped the prerogative of class A directors, chosen from banks holding shares in Federal Reserve Banks, to participate in the selection of Reserve Bank Presidents. Similarly, class C directors appointed by the Board of Governors and broadly representing the interests of society are forbidden from owning shares in any bank or bank holding company. Similar restrictions exist in France, where members of the board are permitted to undertake professional activities as long as a majority of members other than the member concerned approve. The board is explicitly enjoined to examine whether members are free of conflicts of interest. The legislation often precludes officers of financial entities serving as non-executive directors and contains provisions governing ownership or management of personal assets.

Most oversight boards overlay additional procedures and protocols designed to minimise conflicts of interest. Members are frequently required to make declarations of interest, to adhere to codes of conduct and to recuse themselves in matters where a conflict of interest exists. In Spain, for example, members of the Governing Council must place any tradable securities or financial assets which they or their immediate family members own in a blind trust.

## Access to information

In order to perform their oversight functions, board members need access to relevant information and support in analysing it. Many central bank oversight boards and their subcommittees have an explicit right to all relevant information pertaining to their institutions' activities. In Norway, for example, the Permanent Committee of the Supervisory Council has the right of access to all matters pertaining to the Norges Bank. In Malaysia, legislation passed in 2009 empowers the Board of Directors to require the Bank to produce any document or information necessary for the carrying out of its functions. Furthermore, board committees can call upon any person to provide any information or document which is relevant to their functions.

In order to minimise risk of a possible bias in the information provided to the board by management, many central banks have developed mechanisms that allow board members to obtain information through an independent audit or similar process that is controlled by the board. At the South African Reserve Bank, the Board of Directors can obtain any independent advice that it requires at the expense of the Bank.

## Resources and support

The amount of support given to the board and the degree of independence of the mechanisms for providing it vary across central banks. Support is typically provided by central bank staff. For example, at the Reserve Bank of Australia, the Board Secretariat operates under the direction of the Secretary and Deputy Secretary of the institution, who both report to a Deputy Governor. The number of staff supporting the board ranges from just a couple to up to more than 40 in the case of Singapore (where, however, the mandate of the board's subcommittees is particularly wide).

In some cases, the support for the board is provided in an autonomous or semi-autonomous manner. For example, in Finland, Parliament has appointed an independent Economic Adviser who works outside the Bank of Finland and who provides information on request to members of the Parliamentary Supervisory Council (mainly on monetary policy issues). In Norway, the Office of the Supervisory Council of the Central Bank of Norway is subordinated to the Council, and is organisationally and administratively independent of the Bank's Executive Board and Management. The Office's staff members are formally employed by the Central Bank of Norway, but the Office enjoys its own set of administrative rules. The Director of the Office is responsible for appointments, financial terms and working conditions within the framework provided by the Council.

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<sup>28</sup> The Governor still serves as chairman of the board in about half the central banks that have oversight boards. In these cases, explicit use is often made of subcommittees and/or a senior non-executive or lead director to mitigate conflicts of interest.

At other institutions, dual reporting arrangements are employed for central bank staff supporting the board. In South Africa, for example, the Secretary of the Bank serves as Secretary of the Board of Directors. The Secretary is appointed by the Board and can only be dismissed by the Board. Moreover, he has free and unrestricted access to the Chairpersons of Board committees. However, he reports to the Governor, who conducts his performance appraisal and reports the results to the Board. Similarly, at the Federal Reserve Bank of New York, the Board appoints the Corporate Secretary (and the Assistant Corporate Secretaries) who support the Board, but the secretaries are directly responsible to the President.

## Conclusions

Greater responsibility will require stronger accountability arrangements tailored to the nature of the expanded mandate and increased financial risks revealed by the crisis. Reviews of performance and processes by a Court composed of qualified, impartial members can help in this. It can also help achieve coherence across multiple decision-making bodies and complement the oversight of Parliament and the Chancellor.

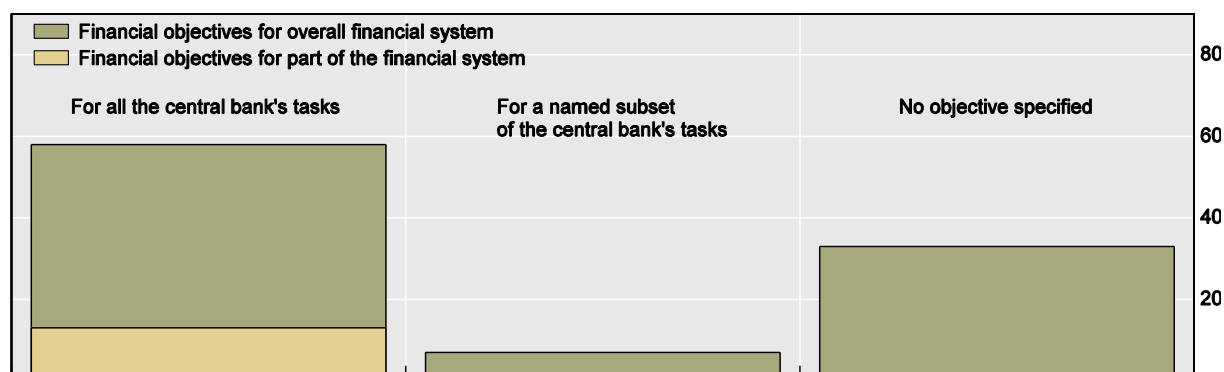
## Annex

Figure 1

### Financial stability objectives in central bank laws

Percentage of central bank laws that mention “stability” or a synonym

At end-2010



Note: Based on review of 95 central bank laws and statutes.

Source: BIS.

Table 1

### Selected types of central bank boards, and their frequency

Board function specified in the law	Per cent of central banks		Median number of board members	Per cent of boards	
	One board of this type	More than one board of this type		Multiple functions	Governor as chair
Oversight	66	2	10	21	39
Monetary policy	64	0	8	83	97
Other policy	43	9	7	82	89
Management	66	4	7	60	97
Advisory	17	2	11	20	30

Note: Data are drawn from a survey of the central banks in the Central Bank Governance Network. The 12 national central banks of the Eurosystem which are in the Network are not counted as having monetary policy boards, given the centralised nature of decision-making in the euro area; nor are those 12 central banks counted as having a formal advisory role on monetary policy.

Source: BIS (2008b), and BIS analysis of central bank laws and websites.

Table 2

**Decision-making in central banks that are bank supervisors**

	<b>Industrialised countries</b>	<b>Emerging market economies</b>
Number of central banks in sample <sup>1</sup>	20	21
Central bank is bank supervisor <sup>2</sup>	8	16
Of which:		
• A multipurpose board makes policy decisions in both monetary and microprudential supervision domains	-	10 <sup>4</sup>
• Has both an MPC and a board dedicated to microprudential policy	1 <sup>3</sup>	2 <sup>5</sup>
• Has an MPC; microprudential policy decisions taken by a multifunction board	1	2
• Has a board dedicated to microprudential policy decisions		2
○ Monetary policy decisions taken by a multifunction board	-	-
○ Member of Eurosystem	6	-

<sup>1</sup> From a 2008 BIS survey.

<sup>2</sup> Where the central bank indicates that it has at least a substantial responsibility (shared or solo) for bank supervision.

<sup>3</sup> The case of New Zealand, where arguably the respective boards are advisory to the Governor rather than decision-making.

<sup>4</sup> Includes two cases of currency boards, where monetary policy decisions are typically limited in scope.

<sup>5</sup> Includes the case of Malaysia, where the Financial Stability Executive Committee (FSEC) has limited powers with respect to microprudential policy decision-making. Indeed, the FSEC might better be classed as a macroprudential policy decision-making board.