

## Meeting on 18 November 2004 of the Central Bank Governance Network

### The Implications for Central Banks of Trends in The Governance of Private and Public Sector Entities

By

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I am very honoured to be invited by the Central Bank Governance Network to speak at this meeting. As a former central banker, it is good to see so many old friends here.

Speaking as a securities regulator, I should begin by saying that all opinions expressed here are entirely my own and not necessarily those of the Securities and Futures Commission, Hong Kong.

The issues of corporate governance for public sector bodies are so current and important that I feel it quite a refreshing change and challenging to explore all these with my central banking colleagues.

Central bankers tend to be dominated by economists, whereas lawyers dominate securities commissions. As monetary policy and financial stability and conduct issues converge in the market place, suddenly the political economy of governance comes to the fore. How can central banks deliver their monetary and financial stability objectives and be transparently accountable to their stakeholders<sup>2</sup>? How do we influence the behaviour of market participants to perform and conform to the law and ethical norms? These are the current and vital issues of private and public governance.

I shall first survey the recent developments in corporate governance, lay out an analytical framework developed by Francis Fukuyama to think about the crucial issues and finally, use two current examples to flesh out the discussion. The two examples are the question whether we should split the role of the Governor from the Chairman of the Board and the degree of independence of the central bank or financial regulatory body.

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<sup>2</sup> See particularly the work of Charles Goodhart on central bank independence.

## The Evolution of Corporate Governance Codes for Public Bodies

I tend to think of the 1992 Report of the Committee on the “Financial Aspects of Corporate Governance” chaired by Sir Adrian Cadbury as the Big Bang of the corporate governance universe. The Cadbury “Fundamental Principles” of *Openness, Integrity and Accountability* constitute the trinity on which subsequent corporate governance codes have been built. This was supplemented by the Higgs Report in the UK and the US Conference Board Report, prompted by the Enron and Worldcom type scandals. The international agency in charge of developing a Corporate Governance Code is the OECD.

A question that immediately emerges is whether the corporate governance standards for listed companies should also apply to public bodies, such as central banks. One group works for profit and has very clear bottom-line benchmarks for evaluation as to accountability. Public sector bodies, which are established for the public interest, have much broader objectives that are difficult to quantify and specify. These are increasingly subject to scrutiny and clarification so that public agencies can be made accountable for their ability to meet these social objectives.

For the public sector, the UK Nolan Committee’s First Report on Standards in Public Life in 1995 was another important landmark. The Nolan Principles” of *Selflessness, Integrity, Objectivity, Accountability, Openness, Honesty and Leadership*, which built on Cadbury’s triad, enshrined the core values for persons who chose to work in the public sector. Though almost a decade old, I find that the Nolan Principles are today more relevant than ever.

That holders of public office, or persons who guide functions carried out in the public interest – such as those performed by central banks – should take decisions mainly based on considerations of public interest seems to me beyond argument<sup>3</sup>.

Similarly, that such persons should have Integrity and Honesty so as to avoid conflicts of interest or being beholden to the influence of persons whose interests might not be wholly consistent with the public interest, seem to me to be mother’s pie.

In recent years there has been a proliferation in various countries around the world of governance practices designed specifically for public bodies. Even in Hong Kong, the Institute of Certified Public Accountants (HKICPA) has also got into the act by publishing their “Corporate Governance for Public Bodies – A Basic Framework” in May 2004.

Most recently, the IMF has proposed to operationalize best practices for the governance of financial sector regulatory agencies as contained in a

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<sup>3</sup> Gavin Bingham points out quite correctly that pride and professionalism in one’s selflessness is not totally devoid of self-interest.

draft set of 34 recommendations<sup>4</sup>. These *draft* best practices were based on the four essential components of good governance in the financial sector advocated by Udaibir S. Das and Marc Quintyn<sup>5</sup> - *Independence, Accountability, Transparency and Integrity*.

Of course, the Fund had the advantage of their experience in their Financial Sector Assessment Program (FSAP) work, which suggested good governance in the financial sector is important in the maintenance of financial stability. These recommendations have also been built on a number of internationally developed codes, standards and principles of financial regulation including the International Organization of Securities Commissions' (IOSCO) Objectives and Principles of Securities Regulation, the Basel Core Principles for Effective Banking Supervision, the IAIS Core Principles of Insurance Supervision and the OECD Code on Corporate Governance<sup>6</sup>.

### Issues of Corporate Governance for Public Bodies

There are really two aspects of governance for public bodies – how they manage internal governance and what are the external (oversight) governance issues that affect their independence or operational autonomy.

What I intend to do is to survey the crucial issues involved in public sector governance. The best survey I have seen so far is the 2004 book by Francis Fukuyama on *Governance and World Order*. Since governance is all about alignment of principal-agent interests, he argued that there are at least three reasons why there is no optimal form of corporate governance models for public sector agencies: -

- First, the goals of many public sector agencies are unclear and can change rapidly with time;
- Second, formal systems of monitoring and accountability in public sector agencies either entail high transaction costs or are difficult because of lack of specificity of their operational activities; and
- Third, the appropriate degree of delegation of power and discretion (the independence issue) will vary according to the endogenous and exogenous conditions that an organization faces over time.

But the central problem of governance, other than the alignment of interest between the principal and the agent is the degree of “delegated discretion”. “The conundrum of organizational theory is that while efficiency requires the delegation of discretion in decision making and authority, the very act of delegation creates problems of control and supervision<sup>7</sup>.”

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<sup>4</sup> “Governance Practices for Financial Sector Regulatory and Supervisory Agencies” by John Dalton, Udaibir S. Das, Jennifer Elliott, Ceyla Pazarbasioglu and Marc Quintyn.

<sup>5</sup> “Financial Crisis Prevention and Management: The Role of Regulatory Governance”, Chapter 6 of “Financial Sector Governance”, Brookings Institution Press, 2002.

<sup>6</sup> See also the IMF’s Code of Good Practice on Transparency in Monetary and Financial Policies.

<sup>7</sup> Fukuyama, pg 59.

Market economies with the rule of law have a better record in efficiency of resource allocation than centrally planned economies, because decisions are delegated down to the market place and bureaucratic decisions are subject to more transparent rules which are checked and balanced by an independent judiciary. However, even democratically elected governments have difficulties implementing their mandates when the objectives conflict with the interests of their bureaucracies.

The substantial transaction costs of searching, evaluating and moving information mean that many daily decisions have to be moved to the people with the specialist knowledge and relevant information for decision. This decentralization of decision-making raises the question of control and who interprets the “public interest”, because the outcome of delegated decisions may affect (or be perceived as affecting) the different interests of principals and agents. In other words, “the problems of federalism and the relative merits of authoritarian versus democratic decision making are ultimately ones of delegated discretion”<sup>8</sup>

The problem of delegated discretion lies at the heart of the organizational structures of bureaucracy. This is known as the “top-down” hierarchical structural dilemma, as well as the “generalists” versus “functional specialists” dilemma. Both are trade-offs between efficiency, risk, costs and trust (i.e. alignment of interests between principal and agent).

This is the classic “Yes, Minister” struggle between the ministry and the operational authority, which is the same irrespective of whether there are differences between the Ministry of Finance and the Central Bank (the external dimension) or between the Governor’s Office and say, the Bank Supervision Department over matters of policy and implementation (the internal dimension).

In both cases, the “public face” bears the consequences of policy or implementation failure, but may not have total control over the design or execution of policy, nor access to all the relevant information and expertise on the subject.

Technology, specialization and division of labour must mean that decision-making has to be delegated down to specialists, such as economists, lawyers, accountants and regulators. The top leader’s decisions made without reference to specialist advice run higher risks of being wrong or flawed because he or she may not have taken into consideration conflicts with precedent, rules and past experience, the institutional memory of which lies with different parts of a complex organization. As Fukuyama acutely observes, “the complex structure of authority within an organization thus explains why they are frequently so conservative, hard to move, and indeed “bureaucratic”.”

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<sup>8</sup> Fukuyama, pg 60

It also explains why institutional or financial sector reforms are so difficult to achieve, because of “vested interests” or institutional resistance to change.

The specialisation of operations and delegation of authority for execution or implementation leads to the problem of “stovepiping” or functional “silos”. As Fukuyama points out: “stovepipes exist because they embody genuine knowledge and expertise... but they also develop corporate interest in their own survival that may not reflect the interests of the larger entity of which it is a part<sup>9</sup>.” Agent interests become misaligned over time because of changes in technology and external circumstances.

The silos may think that they know better what to do, because they feel that either they are closer to the ground conditions and have the expertise to manage the problem and shape the policy, or because they have the experience to understand what the risks and options are. On the other hand, the policy makers (the ministry) may feel that the larger public interests or perhaps the interests of other parts of government may outweigh the risks or benefits pointed out by the operational department or agency.

Fukuyama also points out that “one of the drawbacks of the principal-agent framework is the assumption the authority flows in one direction: downward. Many of the conflicts that occur between principals and agents are the result of differing interpretations of how best to achieve common goals in which the principals may not always be right or in which there are conflicting interpretations of what constitutes the principal’s best interest<sup>10</sup>”.

Gavin Bingham points out that the alternative Hamilton/Jeffersonian model of governance distributes power across different institutions or groups that have sometimes complementary and sometimes competing interests. “The key governance challenge in this world view is to establish practices, rules and procedures that generate public goods in ways that exploit the ongoing competition and cooperation of these differing power centres, none of which has ultimate legitimacy and none of which has complete dominance<sup>11</sup>.” Indeed, this model depends on a high degree of transparency with extensive checks and balances.

There is of course no perfect model of governance. It is a trade-off between efficiency and risks of concentration of power. The greater the centralization of power, the quicker the decision-making and execution of decisions. However, absolute power can corrupt, and decentralization of power ensures not only legitimacy, but also the advantage of being able to adjust to very complex environments because decision-making is diffused down to those closest to the changing environment. The trade-off is that decentralization will inevitably take time to achieve consensus and implement decisions.

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<sup>9</sup> Fukuyama, pg 73.

<sup>10</sup> Fukuyama, pg 70

<sup>11</sup> Comment to author, November 2004

In practice, there will always be policy or procedural disagreements with principals because of genuine differences in opinion over what constitutes the best interests of the principals or the “public interest”, or genuine differences in understanding or appreciation of the contextual facts or risks of different outcomes. Under these circumstances, there will be a temptation for the higher authority to overrule the delegated authority or curb its operational or policy independence.

The classic central bank policy dilemma is the outcome of tight monetary policy that may be the right policy for tackling inflation, but may also hurt the election chances of the current government. The time horizon for results is quite different between Treasuries and central banks. Ministries of Finance tend to be political and may seek quick fixes, whereas central banks may take a longer view and act accordingly.

In recent years, there has been a shift towards greater autonomy for central banks, but at the same time, the governance of central banks and regulatory bodies has been subject to a whole array of checks and balances. Going back to Das and Quintyn’s principles of *independence, accountability, transparency and integrity*, central banks have been undertaking the following: -

- Clarifying monetary objectives and embodying central bank objectives in the legislation as well as MOU with the ministry of finance;
- Being much more transparent and engaged with the media, legislature and other stakeholders to strengthen public understanding of the “public interest” decisions of the central bank and their implications for the economy and the public;
- Building in substantial checks and balances into the internal and external governance of the central bank, of which codes of conduct are one important component.
- Making monetary policy and regulatory decisions in committees, with public sector interest participants.

For example, the U.K. regulators are held to account through a variety of processes, including: -

- Parliamentary scrutiny via Select Committees (in Hong Kong’s case, the Financial Affairs Panel of LegCo)
- References to the Competition Commission and appeals to the Competition Appeals Tribunal (or, in Hong Kong, oversight by the Ombudsman);
- Judicial Review
- Transparency arrangements;
- Corporate Governance; and
- Consumer Representation.

The internal issues of governance have to do with how the central bank should be run in order to best deliver its objectives with transparent

accountability. Historically, central banks tend to be quite hierarchical, and are known to have good esprit de corps, with high levels of integrity and efficiency because they happen to be: -

- (a) the public sector agency that is closest to the market;
- (b) used to quick decision-making such as dealing with financial crisis; and
- (c) able to attract high quality staff because of the reputation for high integrity, prestige and professionalism.

Indeed, it would be true to say that in most emerging markets, central banks tend to have the strongest staff in their public sector bureaucracies<sup>12</sup>.

Part of the reasons for better quality performance of central banks is that their objectives are reasonably clear, covering monetary stability, financial stability and payment systems robustness and efficiency. However, since the area of financial stability ranges from having no supervisory authority over financial issues (pure monetary board) to super central banks (such as the Monetary Authority of Singapore that oversees the whole range of financial services supervision and promotion in its jurisdiction), the design of organizational goals cannot be clear cut.

Central bank objectives in the monetary policy area are by and large quite clear. But the more they have supervisory and other functions, such objectives can often be unclear, contradictory, or otherwise poorly specified. Thus, it makes a lot of sense to hive off the supervisory function from the monetary policy function. But the best practice may differ for each jurisdiction depending on its contextual conditions. In many emerging markets, the supervision powers cannot easily be separated from the lender of last resort function of central banks.

To my mind, the essential component in achieving transparency and accountability is letting the public know what is going on. The central banks achieve this through publication of monetary policy board decisions and through media and public education. As long as the public supports and understands what the central bank is doing, it gives the legitimacy and support for its autonomy or independence.

The public needs to be assured constantly that the independent body is accountable for meeting its objectives and would be assessed accordingly. This is true for a central bank both in its monetary policy functions and its regulatory functions. The public needs to be assured that the duty of central banking is carried out selflessly and considers not only the immediate public interest, such as prevention of financial crisis, but also long-term interests, such as pre-emptive monetary measures against inflation. The public is also interested in the “signalling” role of central banks, to warn governments of rising fiscal deficits or dangers of irrational exuberance.

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<sup>12</sup> Gavin Bingham also points out that central banks have financial autonomy because they are profitable. This is not always the case in developing countries where central banks have to bail out problem banks or guarantee public sector external debt.

One needs to caution against assuming that the public or one's stakeholders necessarily understand the complexities of monetary policy or how central banks operate through different monetary instruments. There is a trust element between the public and central banks, which assumes that the central bank is selfless, professional and competent, with the highest of integrity.

Challenges to or weakening of that trust can only be to the detriment of the credibility, capacity and ability of central banks or regulators to undertake their difficult jobs.

### ***Two Case Studies: Executive Responsibility and Independence***

I do not intend to get into how the corporate governance within central banks should work, because each central bank has its own legal, institutional and social history to consider in the design of its own governance structure<sup>13</sup>.

I would like to discuss two aspects of central bank governance: whether the comprehensive powers traditionally vested in the Governor should be divided between two persons and the question of the independence of central banks and financial sector regulatory agencies.

Since different jurisdictions have different institutional arrangements for corporate governance at the regulator level, I shall focus on the split between the Chairman of the Board and the Chief Executive of the central bank. Recently, in Hong Kong, there has been a proposal to the Legislative Council to amend the law to split the role of the Chairman and the Chief Executive of the SFC.

In 1999, the UK parliamentary Joint Committee on Financial Services and Markets recommended the splitting of the posts of Chief Executive and Chairman of the nascent Financial Services Authority ("FSA"). It also recommended that a non-executive member of the board should hold the Chairmanship of the FSA. The job was split in 2003 between an executive Chairman and a CEO.

By the time Derek Higgs published his "Review of the role and effectiveness of non-executive directors" in 2003, the practice of splitting the functions of Chairman and CEO were so commonplace that Higgs described it as "one of the strengths of the U.K. corporate governance regime" in the corporate sector.

According to Higgs, such a split "avoids concentration of authority and power in one individual and differentiates leadership of the board from running of the business", or the Chairman's and CEO's principal roles, respectively.

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<sup>13</sup> In this regard, I agree with Gavin Bingham that there is no single "best practice" model of governance for any particular central bank.

There are currently three possible models, with different pros and cons. The current practice in most economies – what I call the first model of central bank governance – is that the Governor is an Executive Chairman and Chief Executive, although a Deputy Governor could be the Chief Operating or Administrative Officer, taking the lead in governance issues. Under this model, the Governor is effectively both Chairman and CEO and simultaneously the chief spokesman or public face of the institution. The Chairman of the U.S. Federal Reserve is clearly a full time executive and so is the Governor of the Bank of England.

Under the second model, the Governor is the CEO in command of running the operational and executive functions of the central bank but the Chairman of the governing board could be someone else, such as a former Prime Minister/Deputy Prime Minister holding the post of Chairman of the MAS or the Financial Secretary chairing the Hong Kong Exchange Fund Advisory Board, effectively the governing board of the HKMA. In this case, since the minister of finance and/or the prime minister is the Chairman of the board, the political and monetary policy interests are aligned. Some may argue that the central bank can lose its independence under this model, but equally, because the principal and agent interests are aligned, the central bank could be granted considerable autonomy and political backing. This is true in a currency board system. Much depends also on the memorandum of understanding between the central bank and its finance ministry.

There is currently a third model, which has now been adopted by the Bank of England. Under this model, the Governor is both Chairman and CEO, but the Chair of Court is the senior-most non-executive director who heads the Non-Executive Governance Committee, which determines the remuneration and terms and conditions of the central bank top management, including the governor, and heads all the audit, remuneration and internal ethical and governance committees.

The regional US Federal Reserve Banks also have Presidents rather than Chairs, because the Chairman of the regional bank, such as New York or Boston, tends instead to be a local luminary.

From the legal standpoint, there would be no significant difference between the chairman's legal and statutory responsibilities and liabilities and those of the CEO and other members of the board, whether executive or non-executive. In practice, the Chairman acts as a policy check or sounding board for the CEO before he acts on any particular decision.

Since many decisions are highly technical and time critical, it is important that the Chairman has a good technical grasp of the issues and that there is full co-operation between the two persons. The trade-off between delegating decision making to one person or to two key persons is between efficiency and checks and balances. If the two happen to disagree, then decision-making could be delayed or compromised.

There can only be one public face that is held accountable to the public. In such cases, the final decision should lay with the person who is accountable for making it, which suggests that identifying where ultimate accountability rests is an essential element in deciding on the practicalities of the division of functions.

### Independence or operational autonomy?

The other issue I would like to discuss is the independence of the financial sector regulatory agency from political or commercial pressure. The trend internationally is to grant independence to the central bank. The old question remains, whether this is independence *of* government, or *within* government, since the central bank is a public sector arm of the government in the execution of monetary or financial policy.

I am grateful to Charles Goodhart for pointing out the Fischer distinction between goal independence and operational independence. In the UK, the Chancellor sets the goal and the central bank is independent in achieving that goal. Where there is a single, quantifiable objective, it is easier to separate goal and operational independence than when there is a trade-off between objectives inherent in any decision<sup>14</sup>.

At the heart of the issue of independence is who interprets the public interest and determines the checks and balances on decision-making in a society. In a democratic society where there is division of labour between the Executive, the Legislature and the Judiciary, there is a social contract where the powers of decision-making are divided amongst three branches of government. Some may argue that there is a fourth branch, which is the media. As the Executive branch of government becomes split into the politically accountable [elected] executive and an array of independent regulators [from competition regulators to super regulators], there is increasing need to ensure that the regulators' independence must be accompanied by an effective framework of accountability. This is a fundamental requirement of regulatory certainty, providing incentives for optimal decision-making, and maintaining the credibility of the regulatory framework<sup>15</sup>".

On the technical question of accountability, the U.K. Select Committee on the Constitution made the following recommendations<sup>16</sup> [numbered below] relevant to the division of responsibility between regulators and the Government: ~

3. "We welcome the move towards more collective board structures, rather than sole regulators, as one of the principal mechanisms for improving the quality and consistency of

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<sup>14</sup> Comment from Charles Goodhart, November 2004

<sup>15</sup> UK Government, "The Regulatory State: Ensuring its Accountability: the Government's Response, Appendix 3, July 2004

<sup>16</sup> "The Regulatory State: Ensuring its Accountability: The Government's Response", House of Lords, July 2004.

regulatory decision-making and urge that this should be the norm for regulatory regimes.

4. Government should explicitly accept overall responsibility and accountability for regulatory policy and the regulatory framework, while devolving responsibility under defined circumstances to independent regulators.
5. Ministers should remain responsible for appointing regulators, subject to Nolan rules, to ensure proper responsibility and accountability.”

In order to separate the central bank from partisan politics, there are several ways of handling this in different countries. In the Bundesbank, the President is normally appointed by the ruling party and the Deputy President from the opposition party. In the United States, the Federal Reserve Board Chairman is appointed by the President, but there is congressional endorsement of that appointment. The Governor of the Bank of England is appointed by the Queen, so that the Governor is not seen to be politically partisan.

In Hong Kong, the SFC reports to the appropriate branch of government and the Commission’s established practice of reporting periodically to the Financial Affairs panel of the Legislative Council, both accord with the IMF’s recommended practice <sup>17</sup> and serve to maintain the Commission’s accountability.

However, in any political environment, the central bank or regulatory agency will be subject to lobbying or media pressure. There has to be a transparent process for dealing with such pressures. The SFC, in its regulatory decision-making is subject to an independent Process Review Panel, which is free to examine the processes of the Commission in all its functions for due process and fairness. Central bankers also regularly write in the press to explain what they do and why they take certain decisions. Joseph Yam, for example, writes a weekly column in Hong Kong that explains clearly the functions of the HKMA and the context in which monetary policy is taken. This is very well received and appreciated by the public.

Central banks have to take very tough decisions. Its operational independence depends on its transparency, accountability and track record. If the public supports its policy objectives, it will have its independence. In my personal opinion, it is not laws that grant the central bank independence, but its moral authority that safeguards it.

This leads me to my final point. Developing governance structures in the public sector is not a matter of mere box ticking. It is all about the art of balancing different interests, with one clear objective of meeting the public interest and achieving it with transparency and accountability. Central bankers and financial regulators know that they are not in the popularity game. The best traditions of central banking demand that these tough decisions are taken daily in the public interest.

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<sup>17</sup> Being subject to parliamentary and or ministerial accountability through reporting.

The box-ticking/one size “best practices” approach towards improving governance raises issues similar to the complexity of the principles versus rules debate that is raging in the implementation of standards and codes. The debate over governance of central banks or regulators raises even more complex issues where many view central banks as special or unique institutions within the public sector.

The IMF’s desire for clear “best practices” could be to give guidance and background information to IMF staff, as well as to country officials involved in reforming their regulatory institutions and framework. The advantage of a formal list of “best practices” is that it is a useful checklist of what constitutes elements of good governance for a central bank. The danger is that one can conform to the form, but not the substance of what central banking is all about.

The principles approach can be characterised, as “you don’t need to tell them precisely what to do or not to do. They can be trusted, given that there is sufficient transparency, to deliver an acceptable outcome<sup>18</sup>.” The rules-based approach can be characterized, as “you need to tell them precisely what to do or not to do. Otherwise they can’t be trusted, however much transparency there is, to deliver an acceptable outcome<sup>16</sup>.”

Speaking personally as a former central banker of the old school, the substance of central banking lies in its independence and ability to deliver its monetary and regulatory objectives. This is much more important than having independence in form only. This is why central banking and governance still remains more an art than a science.

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<sup>18</sup> Don Cruickshank, “The Same – but Different: Hard Rules or Soft Principles: Perspectives from London on US and EU Capital Market Issues.”, London Stock Exchange, November 2002