
Central bank corporate governance, financial management, and transparency

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This article discusses the Reserve Bank of New Zealand's corporate governance, financial management and transparency practices within the broader context of international efforts to strengthen central bank governance, transparency and risk management. The article does not address broader governance issues, such as the governance arrangements applicable to monetary policy. As noted in the article, it is possible that some aspects of the Reserve Bank's corporate governance framework might change depending on the outcome of the review of monetary policy arrangements.

1 Introduction

Much of the last decade has seen increased emphasis on improving central bank corporate governance and transparency. This follows the increased independence under which central banks are now operating and reflects the growing international focus on improving corporate governance structures and corporate financial and risk management.² Increased levels of disclosure and transparency are seen as integral to improving governance and financial management for central banks, as well as for the wider financial community.

This article:

- discusses the international initiatives to strengthen central bank corporate governance, financial management and transparency; and
- sets out the operational framework for the Reserve Bank of New Zealand's corporate governance, financial management and risk management within the context of international best practice.

2 Central bank corporate governance, transparency and financial management

Several global factors are encouraging central banks to strengthen their practices in the areas of transparency,

financial management and corporate governance. These include:

- **Leading by example.** Central banks are among the government agencies responsible for implementing international measures aimed at strengthening global and domestic financial systems. This role has encouraged central banks to promote international best practice in areas such as corporate governance, management accountability, financial disclosure and risk management for banks and other financial institutions. In pursuing these reforms, central banks inevitably come under pressure to lead by example, through their own adoption of improved management and transparency practices.
- **Increased central bank independence.** The last decade or so has seen a number of countries implement monetary policy reforms which have involved conferring a degree of operational independence on the central bank to implement monetary policy. Increased independence carries with it the need for greater transparency of decision-making and accountability, not only in respect of monetary policy, but also in respect of a central bank's other functions and the management of its resources. In turn, that has put a premium on the need for strengthened corporate governance, financial disclosure and risk management practices within central banks.
- **Emphasis on central bank best practice.** In recognition of the importance of the central bank's role in the economy, and the increasing emphasis on strengthening risk management practices and governance within public and private sector entities, there is increasing international emphasis on the need

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² See the September 2000 Bulletin article 'Reforms to global financial architecture.'

for best practice for central bank operations. Central banks have been expected to adopt specific international recommendations aimed at strengthening governance, transparency and financial management.

These factors have provided impetus for central banks to improve their operations in all areas. This section of the article specifically considers these developments in relation to central bank corporate governance, disclosure, risk management and financial management.

Central bank corporate governance and disclosure

International standards such as the OECD's *Core Principles on Corporate Governance* and the IMF *Code of Good Practices on Transparency in Monetary and Financial Policies* contain best practice principles in areas including corporate governance, accountability and disclosure. In the process of implementing these standards, central banks have been encouraged to adopt specific recommendations aimed at strengthening central bank corporate governance and transparency, and to implement relevant recommendations applicable to the wider financial community. For example, the IMF *Financial Sector Assessment Program* (FSAP) and *Report on Observance of Codes and Standards* (ROSC) are processes by which the IMF reviews the strength of a country's financial system. These assessment programs include consideration of factors concerning central bank transparency and corporate governance. The main corporate governance areas emerging as international best practice applicable to central banks include:

- transparent and well developed internal corporate governance requirements, including measures to promote effective risk management, internal audit, and management of conflicts of interest;
- high quality financial disclosure requirements, based on professional accounting standards;
- effective external audit requirements, where the audit arrangements comply with standard professional auditing principles (for example, the FSAP looks for independent external audit and publication of financial statements); and

- a robust accountability framework, requiring disclosure of public policy objectives; clear assignment of responsibility and powers for the fulfilment of objectives; disclosure of performance; disclosure of remuneration arrangements; a structure for facilitating external monitoring of performance; and credible mechanisms for removing officials for non-performance.

Central banks are under increasing pressure to adopt international best practice in corporate governance structures and in the disclosure of information on the nature of their policy actions, resource management and governance arrangements. In addition, the increasing independence under which central banks are operating has increased the demand for information on central bank operations. This is recognised in the design of the IMF *Code of Good Practices on Transparency in Monetary and Financial Policies*, which is based on two main principles. First, monetary and financial policies can be made more effective if the public understands the goals and instruments of policy and if the authorities make a credible commitment to meeting them. Secondly, good governance calls for central banks to be accountable to stakeholders (which for central banks may be a diverse group), particularly where monetary authorities are granted a high degree of autonomy.

The transparency and accountability of central banks require the provision of timely, comprehensive and accurate information. It is through the transparent reporting of the central bank's operations that the central bank is able to demonstrate its stewardship of the resources entrusted to it and efficiency in discharging its functions.

The central bank's annual report (including the annual financial statements) is an important accountability document. The annual report provides information that explains both the non-financial and financial aspects of the central bank's performance and the nature of its corporate governance arrangements. The annual report is a mechanism for holding the central bank accountable for policy decisions and outcomes as well as for assessing the overall management of the central bank's resources.

In addition, central banks are often involved in the development of appropriate regulatory and reporting structures for the banking and finance sector. This includes

contributing to the development of appropriate standards of financial reporting, accountability and corporate governance for banks and other financial institutions. This role requires a central bank to act as a role model by demonstrating best practice frameworks and policies in areas including corporate governance, financial management, risk management and management accountability.

The importance of transparent reporting practices for central banks extends beyond their immediate institutional interest through the contribution central banks make to developing their respective national financial systems. The operating framework and effectiveness of the nation's central bank is often critical to the sound economic development of the national financial system. Hence, achieving high quality disclosure of central bank operations is important, particularly as economies become more exposed to international capital markets.

Central bank risk management

Central banks can face significant financial risks in their operations, given that they typically hold significant volumes of financial instruments. The risks include:

- foreign currency risk from the management of foreign reserves;
- interest rate risk on foreign and local currency assets and liabilities;
- liquidity risk associated with the management of foreign reserves; and
- credit risk on local and foreign currency assets.

In addition, central banks face risks associated with general operations (operational risk) and the risk of damage to their credibility and reputation (reputation risk).

Given that significant public resources are at risk, it is important that the central bank has sound systems in place to manage these risks effectively. These include the adoption of effective risk management policies, procedures and systems and organisational structures. Public disclosure of information that demonstrates the central bank is managing risk is another important element in the central bank corporate governance structure. These disclosures are generally governed by International Accounting Standards,

and are sometimes supplemented by specific disclosure requirements applicable to central banks.

In addition, many central banks have a responsibility for supervision of commercial banks within their countries, including the formulation of policies designed to ensure sound risk management, and for the regulation of commercial bank disclosures. This provides central banks with a further incentive to lead by example, by adopting sound risk management practices.

Central bank financial management

Sound financial management is integral to the efficient and effective operation of any entity. This includes ensuring that incentive structures are appropriately designed and that internal management systems support sound resource management in the achievement of the entity's objectives.

For central banks, policy objectives are paramount. Profit is not a meaningful measure of central bank performance. A better measure of policy performance is information that explains the monetary policy objectives and other policy objectives of the central bank, and the success of the central bank in meeting them. The relevant financial performance information is the operating costs that the central bank incurs in achieving its objectives.

Information on the cost of central bank outputs (or services), particularly when actual and budgeted expenditures are disclosed together, can be a useful indicator of financial performance, as it demonstrates how efficient the central bank has been in managing its resources to meet policy objectives. Disclosure of cost information on central bank outputs allows external parties, such as the government or the public, to review the central bank's stewardship of public resources, and can demonstrate whether the central bank has been efficient and responsible in using those resources. This can enhance the central bank's credibility and contribute to preserving central bank independence.

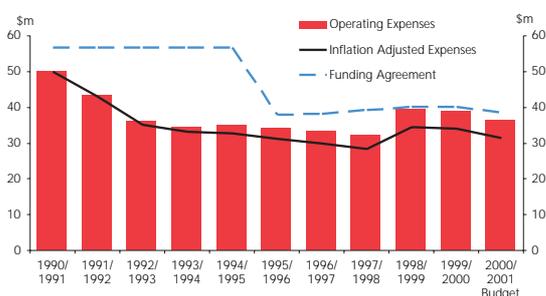
3 Reserve Bank of New Zealand corporate governance, risk and financial management

Over the last decade, the Reserve Bank of New Zealand (the Bank) has actively changed its approach to resource management. This followed a change across the entire New Zealand public sector, with moves towards accrual based funding for the provision of public sector outputs. These changes impacted at about the same time the Bank was granted operational autonomy through the Reserve Bank of New Zealand Act 1989 (the Act). The Bank responded to these changes by implementing financial management (planning, budgeting and accountability) and risk management frameworks that complemented the governance and funding mechanisms of the Act.

As illustrated in the graph below, the Bank has achieved substantial cost savings over the last ten years, progressively reducing its operating expenditure, while still performing broadly the same range of functions and reshaping its operations.

This section discusses the Bank's corporate governance, financial and risk management structures within the broader context of transparency and international best practice.³

Figure 1
Operating expenses under funding agreement
(eleven year summary)



³ This article was written before decisions have been taken in response to the Svensson Report and it is possible some changes might be made to corporate governance as a result of the Svensson Report.

Corporate governance

The Act sets out a corporate governance framework that draws from the governance and accountability model generally applied within the New Zealand public sector in the 1980s and 1990s. In this context, the Act prescribes:

- a clear set of objectives for the Bank (of which the pursuit of price stability is the major objective);
- a framework for specifying the precise price stability objective (via a Policy Targets Agreement (PTA)) between the Treasurer and the Governor;
- the functions of, and powers available to, the Bank to meet its objectives;
- an accountability structure, whereby the Governor is held accountable for the achievement of the Bank's objectives;
- transparency arrangements, both in respect of the Bank's policy actions and its financial management; and
- arrangements for monitoring the Bank's performance and facilitating external scrutiny of its financial affairs.

In all aspects of the Bank's functions, decision-making authority resides with the Governor. The Governor is appointed for a five- year term and the Act sets specific criteria under which the Treasurer can dismiss the Governor (principally relating to non-performance and incapacity to perform the duties of Governor.)

The role of the Bank's Board of Directors is different from that of a listed company. The Board's primary function is to monitor the performance of the Bank and the Governor. The Board has no governance role per se and no involvement in directing Bank policy (monetary or otherwise). As well, the Board may provide advice to the Governor on any matter relating to the performance of the Bank's functions and the exercise of its powers.

Another important function of the Board is in relation to the appointment of the Governor and Deputy Governors. Under the Act, the Board has responsibility for making recommendations to the Treasurer on the appointment or reappointment of the Governor. The Treasurer is only able to appoint a Governor recommended by the Board. In addition, the Board has responsibility for appointing the Deputy Governor(s) on the recommendation of the Governor. Most of the Board's responsibilities are carried out by the

Non-Executive Directors' Committee of the Board (ie all members of the Board other than the Governor and Deputy Governor(s)).

Under the Act, the Bank is subject to annual external audit, with the auditor being appointed by the Treasurer. The auditing arrangements are overseen by an Audit Committee of the Board, which meets regularly to monitor the external reporting and audit functions within the Bank. In addition to the standard audit arrangements, the Treasurer is empowered under the Act to engage an independent party to conduct a review of the Bank's performance from time to time.

Disclosure of the Bank's corporate governance arrangements is provided in the Bank's annual report. This is consistent with IMF and OECD principles that corporate governance frameworks should ensure that timely and accurate disclosure is made on all material matters regarding the entity, including the performance, ownership and governance of the entity.

Risk management

The main financial risks the Bank is exposed to include credit risk on foreign currency reserves and interest rate risk on both foreign and local currency assets and liabilities. In the management of its reserves, the Bank also has an exposure to liquidity risk. Like most other central banks, the nature of the Bank's operations creates exposure to a range of operational risks and reputation risk.

Bank management ensures that strong and effective risk-analysis, management and control systems are in place for assessing, monitoring and managing risk exposure. A Risk Management Committee, comprising senior management, is responsible for advising the Governor on the monitoring and management of all risks that the Bank faces. Comprehensive guidelines control the manner in which the Bank conducts local currency, foreign currency reserves management and foreign exchange dealing operations. These guidelines contain specific provisions designed to manage the risk associated with each operation and are subject to periodic internal review.

The majority of the Bank's financial risks arise from the foreign reserves and monetary policy operations of the Bank's Financial Markets Department. Within this department, a

Risk Unit is responsible for maintaining the Bank's financial risk management framework. A separate department of the Bank (Financial Services Group) operates independent risk reporting systems that monitor and report compliance with various risk limits and policies.

The Risk Assessment and Assurance Department (which includes Internal Audit) reports to the Governors and the Audit Committee of the Board of Directors on internal audit and risk management issues. This includes advice on the Bank's risks and risk management framework. A risk-based framework, which evaluates key business risks and internal controls, is used to determine the extent and frequency of internal audits conducted. All Bank departments are subject to periodic internal audit review.

The overall risk management framework is designed to ensure that an appropriate incentive structure is created for the management of the Bank's risks. The Bank ensures the risk management framework is consistent with financial market best practice and it periodically engages external experts to assist in reviewing and modifying risk management practices and processes. However, the Bank is not exposed to all the risks that a commercial bank faces. This mainly reflects that the Bank is involved in policy-orientated activities rather than the profit-orientated activities typical of commercial banks and that the Bank's financial operations are different to those of a commercial bank. In addition, the Bank is exposed to different risks such as the risk associated with policy outcomes. Therefore, the Bank's risk management framework necessarily differs from the risk management frameworks for commercial banks.

The Bank provides information concerning its general risk management framework and information specific to interest rate, credit, foreign currency and liquidity risk as part of the annual financial statements. This information provides both general and specific information concerning the nature of the Bank's risk management framework and indicates the degree of risk the Bank is exposed to in each major risk area.

Financial management

The design of the Bank's financial management framework reflects the importance senior management place on the effective and efficient management of the Bank's resources.

The Act contains some important provisions relating to financial management, including:

- The Governor is accountable to Parliament for achievement of the Bank's policy objectives and use of resources in achieving those objectives.
- A five-year Funding Agreement, defining the funding for the Bank's operating expenses – surplus income is paid directly to the government.
- The requirement to publish audited financial statements that comply with generally accepted accounting practice – these must reflect revenue and expenses by reference to the outputs of the Bank and include a budget for the next financial year.
- The annual accounts stand referred to Parliament's Finance and Expenditure Committee, which is responsible for the overall review of financial management in government departments and other public bodies.
- Requirements that the Bank's Board constantly reviews the Bank's resource use and performance in producing its outputs. The Board is required to advise the Treasurer if it is satisfied the Bank is not adequately carrying out its functions or if the resources have not been effectively or properly managed.

The level of the Bank's expenditure is defined in a five-year Funding Agreement between the Governor and the Treasurer. The Funding Agreement specifies how much of the Bank's revenues can be retained by the Bank to meet its operating costs, with the remainder going to the government. The Funding Agreement is intended to constrain the Bank's expenditure, whilst ensuring the Bank has sufficient funds to carry out its responsibilities in a manner consistent with its operational independence.

The Bank's annual expenditure is pre-agreed for a five-year period in the Funding Agreement. If total expenditure for any year exceeds the pre-agreed amount for that year, then it must be funded by way of transfer from the Bank's retained earnings. If total expenditure is less than the Funding Agreement amount, this difference can be transferred to the Bank's retained earnings. This approach ensures that the Bank has appropriate financial incentives to manage its resources carefully.

The importance of incentives is further reflected in the most recent Funding Agreement, where the method for calculating expenditure has changed from that which previously applied. Previously, the Bank retained a given sum of money from its income to pay for its operating expenses. Under the new arrangements, the Bank retains a smaller sum of money plus the income from some specified revenue-generating activities. This is to encourage the Bank to maximise the return from some specific activities. Previously, all revenue earned by the Bank went directly to the government, while the Bank carried the costs associated with revenue generating-activities. This may have created a disincentive for the Bank to incur additional cost, where that cost would give rise to enhanced income from revenue-generating activities. The financial incentives are now appropriately designed to ensure the Bank maximises the return to the government from these revenue-generating activities.

The Bank's framework for financial management is structured around systems of internal accountability, budgeting, internal charging, external accountability and financial reporting. Each of these areas of financial management is now briefly outlined.

Internal accountability

The Governor delegates accountability for departmental expenditure to departmental managers, and accountability for expenditure on each of the Bank's outputs to the Deputy Governors. The Deputy Governors then assign responsibility for oversight of output expenditure to the departmental manager most directly involved with the output.

The Bank has adopted a number of mechanisms for reviewing expenditure. The current measures include:

- a *monthly report* of the Bank's income and expenditure to Governors and the Board that includes explanations of material variances from budget;
- *quarterly reports* to the Board that outline qualitative and quantitative variances from plans; and
- *half- and full-year reviews* of actual expenditure against departmental plans and budgets, by Governors, with each departmental manager.

These accountability mechanisms facilitate the delegation of responsibility to departmental managers. This allows departmental managers to be held accountable for the consequences of their resource allocation decisions and to demonstrate the efficiency with which they manage their resources, while meeting their policy or operational objectives.

Planning and budgeting

The Bank's process of planning and budgeting is vital to the efficient management of resources within the Bank. The planning and budgeting process:

- establishes benchmarks or targets to be achieved;
- allocates available resources so that the Bank can provide functions in an efficient and cost effective way;
- requires managers to review and plan their activities and to take greater responsibility for managing their respective areas; and
- provides a tool for monitoring and evaluating management performance.

The planning and budgeting process commences with an annual high level strategic retreat for the Bank's senior management. This forum reviews strategic plans for each of the Bank's outputs, including strategic direction, significant projects, and areas of change and resource implications for the forthcoming year. Broader output plans form the base for detailed department plans. Department plans specify the actions proposed to achieve the Bank's priorities and identify any material changes in the quantity or quality of outputs, new initiatives/projects, resource requirements and the cost and timing of proposed capital expenditure.

The department plans are then quantified by the preparation of budgets. Budgets are completed from a "bottom up" perspective. This means that each manager completes a budget at a detailed input level. The degree of budget detail ranges from an incremental budgeting⁴ approach for items that are relatively constant from year to year (eg phone

⁴ Incremental budgeting is the budgeting approach of taking the previous year's actual expenditure and adjusting it for expected changes in the current year.

expenses and rates) to a zero-base approach⁵ for areas such as staff training and travel.

One of the key aspects of the planning and budgeting process is that budgets are "owned" by the managers who control the resources and who make the resource allocation decisions on a day-to-day basis. This forms an important part of the accountability process, as those who prepared the budget and who are responsible for managing the resources are also responsible for budget variances.

Internal charging

The Bank operates an internal charging system that assigns the costs of internal services⁶ to the departments that consume them. The rationale behind this system is twofold:

- The Act requires the Bank to account for revenue and expenses by reference to the outputs the Bank provides. The system of internal charging allows the Bank to allocate internal service expenses to the Bank's external outputs.
- Charging for internal service provision helps make consumers of services accountable for the costs of the services they receive and assists in cost-effective decision-making. This contributes to an appropriate incentive structure for the supply and consumption of internal services.

Under this framework, the Bank's service providers account for the costs of providing internal services (such as direct labour and materials). Charging mechanisms are used to allocate the service cost to the consumers of the internal services. The charging systems include direct charging mechanisms, based on price and consumption, and indirect charging mechanisms (such as overhead allocations), based on pre-determined "cost drivers".

The system of direct charging is essentially the creation of an internal market, where the supply of services is measured and a price per unit is charged to the receiver of the service. Direct charging is practical where the service can be identified in respect of a particular user, the amount of service provided

⁵ Zero-base budgeting is the approach of detailing and justifying all budget items.

⁶ Such as office rental, computer network maintenance, accounting services and security.

can be measured, and a price can be charged for the service (for example, the provision of office accommodation). However, it is important to ensure that the operation of direct charging mechanisms is cost effective and to ensure that the charging framework does not generate perverse incentives for users to make departmental savings at the expense of overall Bank efficiencies.

The alternative to direct charging is an overhead allocation process. This process allocates pools of costs to service users using causal factors referred to as "cost drivers" (eg the cost of payroll services could be considered a function of the number of staff; therefore, the "cost driver" for allocating payroll services could be staff numbers). The overhead allocation process is completed by identifying and agreeing "cost drivers" and distributing costs to users on the basis of these "cost drivers".

External accountability and financial reporting

Overall, the financial management framework facilitates the efficient and effective management of the Bank's resources. The Bank is then able to demonstrate stewardship through the publication of audited annual financial statements. These are prepared in accordance with generally accepted accounting practice and the Governors certify that the financial statements fairly reflect the operations and financial position of the Bank.⁷ The independent auditor's report is also published with the annual financial statements. The annual report stands referred to Parliament's Finance and Expenditure Committee and is made widely available to interested parties and published on the Bank's internet website. In addition, the Bank publishes monthly information on the website including:

- foreign reserves information consistent with the format prescribed for foreign reserves reporting by the IMF *Special Data Dissemination Standard*; and
- the Bank's monthly balance sheet.

Given the relevance of cost as an accountability tool to measure resource utilisation, the annual financial statements contain extensive disclosures of operating expenditure by output and compared to budget. Explanations for material budget variances are included.

The Bank's approach to public disclosure of the annual report is consistent with best practice as recommended by the IMF, Basle Committee on Banking Supervision and the OECD. These groups are united in recommending the public disclosure of audited financial statements. For example, the IMF recommends that the central bank should publicly disclose audited financial statements, and the OECD Principles of Corporate Governance recommend that information should be prepared, audited and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure and audit.

The Bank is committed to preparing high quality financial statements in accordance with New Zealand accounting practice. Moreover, the Bank is responsible for the supervision of commercial banks in New Zealand. The New Zealand approach to supervision is based around public disclosures of information by commercial banks. Therefore, the Bank has committed to preparing its financial statements according to best practice accounting and disclosure requirements as applicable to a central bank. In pursuing this objective, the Bank attempts to set an example for commercial banks to follow in areas of common financial statement disclosure. The application of best practice accounting and disclosure by the Bank has been recognised through the Bank winning first prize in its category in five of the last eleven years in the national annual report awards run by the Institute of Chartered Accountants of New Zealand.

4 Conclusion

Over the last decade, a number of international forums have identified ways to strengthen the global financial architecture. These forums have made recommendations placing

⁷ Pursuant to the Act, the Bank's financial statements are required to include a statement from the Governor and Deputy Chief Executive that: 1. They have been responsible for the preparation of the annual financial statements and for the judgements used in them. 2. They have been responsible for establishing and maintaining a system of internal controls designed to provide reasonable assurance as to the integrity and reliability of the Bank's financial reporting. 3. In their opinion, the annual financial statements for the year fairly reflect the financial position and operations of the Bank.

significant emphasis on improving governance structures, improving approaches to financial and risk management and increasing the overall levels of disclosure within both the domestic and global financial systems.

The development of international standards and codes, and the increasing emphasis on high quality corporate governance and financial disclosure, have significant implications for central banks. Central banks, along with

other public and private sector agencies, can be expected to come under continued pressure to adopt and maintain high quality corporate governance, risk management, and disclosure frameworks in the years ahead. Within this context, the Reserve Bank is committed to maintaining, and where possible enhancing, the structures for managing its resources and risks.