Foreword

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Central banks are not commercial banks. They do not seek profits. Nor do they face the same financial constraints as private institutions. In practical terms, this means that most central banks could lose enough money to drive their equity negative, and still continue to function completely successfully. For most central banks, one would have to go far to construct a scenario under which they might have to compromise their policy objectives in order to keep paying their bills.

The problem is that not everyone appreciates that a central bank's accounting equity can be negative without any reason for alarm bells to ring. Markets may instead react badly in the false belief that losses imply a loss of policy effectiveness. Politicians may also object, if they leap to the conclusion that bad decisions have been made at the taxpayer's expense, or that the central bank now depends on the government for a rescue. Such harmful self-fulfilling prophecies are in nobody's interest.

Even high-quality, lucidly presented financial statements will not always prevent such misperceptions from arising. Central banks should therefore ideally be equipped with the financial resources and financial mechanisms they need to keep performing their socially useful functions even during crisis periods. Avoiding these risks probably requires sufficient resources and mechanisms to keep equity positive in the face of losses caused by socially beneficial actions. In short, central bank financial independence is important.

The finances of central banks have not traditionally attracted much attention. But it makes sense to revisit this topic now that many central banks are operating far beyond traditional policy limits. The BIS has repeatedly raised concerns about the burdens associated with the unprecedented policy actions taken by some central banks. From the perspective of their own finances, central banks commonly have the strength they need to sustain such burdens, and we have no doubts about the central banks that are currently shouldering extraordinary financial risks. But our confidence is based on an understanding of the special character of central banks that may not be shared by markets and others.

This paper asks what level of financial resources is sufficient and what kind of financial mechanisms are suitable for this purpose. Inevitably, the answers are complex, depending greatly on the individual central bank's economic and political environment, as well as its functions. The paper provides a framework for thinking about these questions, and identifies some preferences.

One element we consider especially important is a properly designed surplus distribution arrangement. Such arrangements have two key characteristics. First, retentions and distributions should be strongly linked to a target for financial resources that is in turn scaled to the potential need for such resources in times of crisis. Second, payouts should be avoided from unrealised revaluation gains and income on particularly risky assets as if these represent final profits.

For the sake of trust-building, it is desirable that unrealised income and income on particularly risky assets are *transparently* ring-fenced from distributions, rather than hidden from the distribution scheme by accounting policies. This would mean fair value treatment for financial instruments whose changes in value are likely to be of particular interest to taxpayers. Of course, central banks carry many assets and liabilities where changes in value are just not relevant, even under International Financial Reporting Standards (IFRS). But where distribution arrangements cannot be structured to match the key characteristics mentioned in the preceding paragraph, two accounting policies could make sense for central banks. The first is the use of revaluation reserves – and especially in an asymmetric manner, treating unrealised gains and losses differently – even for securities actively traded for policy reasons. The second is the use of general risk ("rainy day") provisions. Revaluation reserves have the advantage of being transparently rule-driven. General provisions have the advantage of flexibility. These accounting policies may not be fully consistent with IFRS, but there are good reasons for their adoption.

For some central banks, arrangements that transfer risk to the fiscal authority may also be worth considering. Government indemnities for the financial consequences of unusual policy actions have been useful in certain cases. These are not, however, without problems. Public finances may be under stress at precisely the same time as those of the central bank. And given the implications of risk transfer for the public purse, such arrangements clearly work best in situations where society would prefer decision-making responsibility to be shared with, or even fully retained by, elected officials.

We also suggest that parts of the central bank's balance sheet might on occasion usefully be ring-fenced and treated separately. This could make sense especially in the context of certain risk-transfer arrangements, but also for the purpose of communicating the non-standard and temporary nature of some financial exposures acquired in crisis circumstances. Two simple examples of such arrangements are subsidiaries and special purpose vehicles. When used to reduce transparency, subsidiaries and special purpose vehicles work against trust-building. But when they are used to clarify the evolution of a central bank's finances and the nature of the links with policy actions, they can be helpful.

All these measures are best put in place in normal times, in anticipation of future stresses. This is because a central bank may need far greater financial resources in a crisis than in normal times, and these may not be available from strained public finances. The upshot is that the scale of the resources that a central bank might need to have on hand in case of a crisis could seem excessive to many people during tranquil times. Achieving the desired level of prepositioning of financial resources may therefore be politically difficult. The transfer of risk associated with properly designed surplus distribution arrangements, as well as special purpose risk-transfer arrangements, may also appear to conflict with political preferences. Yet, it is in the interests of society that central banks can continue performing their socially mandated functions, even during times of extreme stress.

Central banks therefore need to identify the minimum set of financial arrangements that will allow them to keep operating in such periods, in readiness for opportunities to establish fully robust financial foundations. These arrangements will naturally vary from country to country, so a common benchmark is not feasible. Instead, this paper is intended to help build an understanding of the thought process that might be used by a country seeking to identify minimum and desirable arrangements for its own circumstances.