Glenn Stevens: Governance arrangements for effective public financial policies – a central banker's perspective

Remarks by Mr Glenn Stevens, Deputy Governor of the Reserve Bank of Australia, to the APEC Business Advisory Council, the Asian Bankers' Association and the Pacific Economic Co-operation Council Symposium on Promoting Good Corporate Governance and Transparency in APEC Financial Institutions, Melbourne, 19 October 2005.

*   *   *

There is, these days, a great deal of discussion about corporate governance. This is largely because governance arrangements thought (with hindsight) to be deficient shared the blame for some spectacular corporate failures in the latter stages of the US tech boom of the late 1990s. Of course such problems are not that new. Indeed, one could safely assert that governance problems, broadly defined, can be found in the margins of most of the financial debacles of history; on plenty of occasions, they played a starring role. In Australia's own case, the collapses of the empires of some of the celebrated 'entrepreneurs' of the 1980s revealed serious failures of a governance nature (though not only of that nature).

Given that so much has been written on the topic, there is probably not much that I could say which would be new. In fact, the most important principles of good governance are surely little changed over the long run of history, and are mostly simple good sense, combined with integrity. A sense by directors of fiduciary duty, independence, honesty, diligence, accountability and assurance surely have always lain at the heart of good governance, be it in corporations, governments or the local school canteen. Much of the current work on governance seems to be trying to embody such principles in a more explicit framework.

Rather than trying to extend any of that detailed discussion, I want to focus on a few high-level principles for governance arrangements affecting national financial systems. I will interpret the term 'governance' broadly, to include not just the structure of decision-making in *organisations* but the general set of arrangements in the *system*. I will speak from the perspective of a central bank – which is where my experience as a Board member lies.

Let's begin by asking what we want from a financial system in a market economy. In brief, we want a set of arrangements which facilitate:

- the intermediation of private saving and investment, fostering resource allocation so that saving earns the highest risk-adjusted return, and that those with the skills to deploy capital can get it, and at the cheapest price;
- an efficient, reliable and safe way of making payments;
- mechanisms for private economic entities to manage their risks (either paying others to take the risk or accepting payment to take on risk);
- availability of suitable financing for public-sector activities;
- the avoidance of financial crises, if at all possible, or, if not possible, at least minimisation of their severity.

This is a rather ambitious agenda. For several centuries we have been groping towards better arrangements, and it would be arrogant to assume we have nothing further to learn.

But we have learned a few things about the importance of governance. One is that in banking, while the normal principles of corporate governance apply, that is not quite enough. Banking isn't just any other business. Its role in facilitating the business of the nation means that when banking goes seriously astray, the economy suffers more badly than it would if, say, the retailing industry got into trouble (as serious as the latter would be). Hence, certain higher standards of prudence are required of banks than of the average corporate entity, and there is more intrusive supervision of their activities. This is very important, but I will say no more about it, since the Chairman of APRA will speak later this morning.

Let me focus instead on two other issues at more length. In particular, I shall cover first, governance arrangements for central banks, and second, relationships between governments and private financial markets.

1. An independent central bank committed to monetary and financial stability

A key central bank commitment is to preserve the value of money. A system where people are prepared to part with their money in order to facilitate the deployment of capital rests heavily on the idea that when they get it back, its purchasing power is not eroded by high inflation. Central bank governance is critical to achieving that. The central bank must, of course, have an adequate legislative basis – a legal standing that gives it powers and defines its objectives, including price stability. But apart from that, about the most important governance condition is independence in the day-to-day conduct of policy, so that an appropriate focus on the long run can be maintained.

The idea of central bank independence from the political process is widely accepted now in the western industrialised world. This is a result partly of academic thinking about the structuring of the decision-making process, but mainly of long experience of the alternative model. I am not sure whether such independence is as widely accepted in Asia. Of course, the need for strong independence so as to enhance anti-inflation credibility has not been as big an issue in Asia as in some other regions, because inflation performance in Asia has mostly been very good. But the same principle arises in the conduct of bank supervision, whether that be in the central bank or another body: the officials in charge need to operate within a clearly understood framework, but without political interference in their day-to-day decisions.

Central bank independence needs to be more than just of the political variety though: it also means the central bank having a capability of resisting the short-termism of financial markets (and, for that matter, the occasional intellectual fad which emanates from academia). Key to a central bank's role in fostering financial stability will be a capacity and willingness, on occasion, to cast a sceptical eye on pricing of assets and risk, and to question the idea, always heard in times of euphoria, that 'this time it is different'.

Naturally, this comes with countervailing disciplines on the central bank of a governance nature. With operational independence comes the requirement to inform the public what we are doing, and why, and an acceptance that we will face public and Parliamentary scrutiny for our actions. So communication, to facilitate accountability, is important. There are some differences between central banks here: some communicate more fully and more frequently than others. But the similarities are probably greater than the differences. In most cases these days, the schedule of decision-making meetings is known; the goals of policy are fairly clear; and policy makers release a great deal of information about the way they are reading the economy and why they took the decisions they did.

Alongside this accountability comes an increased focus on the role, composition and processes of the body which makes the policy decision. In some central banks, that body is a group of full-time experts; in others, it is a single individual. In our own case at the RBA, the decision-making body includes a majority of non-executive directors who generally bring a wide range of expertise and experience from outside the specialised field of central banking.

There is, from time to time, discussion about which set of arrangements is best, and reasonable people can and do differ on this. But experience seems to be that several types of decision-making structure can work acceptably well. The question 'who is on the board?' is important, but perhaps not as important as the questions 'what are the board's goals?' and 'does the board have the tools, and the independence, to pursue them?'

It goes without saying that a central bank must also have the highest reputation for probity, which carries obvious requirements for the behaviour of board members, Governors, management and staff. But in addition, as in the commercial arena, it must also have, and be seen to have, strong formal internal governance processes – in financial management, audit (including external audit) and risk management – so as to be able to provide appropriate assurance to its community. As in the commercial world, risk management is a rapidly growing area in central banks. It is likely, moreover, that an increasing share of the assistance given to emerging market countries in the next decade will be in helping them develop their own risk management and auditing capabilities.

2. Arm's length dealing with financial markets

The second key arrangement for a well-functioning financial system – again using a fairly broad definition of the word 'governance' – is that the public sector deals at arm's length with financial markets. In other words, markets set financial prices and allocate financial resources.

There are two dimensions here.

First, governments should pay the market price for resources that they seek to use for public policy purposes. This means borrowing in the market (if borrowing is needed) at the market rate, not at an artificially reduced rate from banks or the central bank. (This is, of course, a key element of central bank independence. A central bank can't seriously hope to run an independent monetary policy if the demands of government finance dominate its balance sheet.) For markets to be able to price government borrowing properly, they need some information about governments' intentions – a degree of fiscal transparency is required. Such transparency is a good 'governance' principle for public policy anyway; countries which have adopted it, including Australia, find this is ultimately repaid by governments being able to obtain funding more cheaply.

Second, care must be taken when governments direct financial resources by using their ownership stakes in financial institutions. At early stages of development, there may be a strong case for extensive public-sector involvement, where the private system is in its infancy. This was seen to be the case in Australia in earlier times. But as time goes by and the private sector becomes more vibrant, the benefits of extensive public-sector participation have to be weighed against the problems that it can bring.

One such problem is the potential conflict between being a participant in the commercial sector and a regulator of it. This was a feature of the RBA itself, which began life as a publicly owned commercial bank and then saw central banking functions grow in importance to the point where the two were separated in 1960.

In addition to managing such potential conflicts, governments have to be mindful of the financial risks to which they can be exposed in having ownership stakes in financial institutions. There are a host of governance issues associated with public ownership of business enterprises, which have been extensively canvassed elsewhere.[1] There seems no good reason for the general governance principles for publicly owned enterprises espoused by bodies like the OECD not to be applied where the enterprises are financial ones. These stress a strong legal framework, a clear role for boards, appropriate relationships with other shareholders, disclosure requirements, etc.

But it should be stressed that in a financial institution, more so than perhaps in most other businesses, prudent management of risk is critical, and governance arrangements have a key role to play. In Australia in the late 1980s and early 1990s, governance of banks owned and guaranteed by State governments, in particular, evidently was not strong enough to ensure those banks and their associated entities were managed prudently. As a result, some State-owned banks got into trouble and the owners – i.e. the taxpayers – of two States bore the losses. This was funded by higher taxes for some years. Whatever good reasons there might once have been for publicly owned banks – such as, in Australia's early history, to engender some public confidence in the banking system in its formative stages, or (later) to provide competition for the private banks – the costs seem to have outweighed any benefits by this time.

Today, there are no government-owned banking entities in Australia, and the principle of 'arm's length' dealing between governments and private financial markets is well entrenched. That allows markets to play their proper function in the long run of allocating resources effectively (even if not optimally at every moment). It also keeps public-sector entities focused on their roles as custodians and regulators of the system, without adding the conflicts and risks associated with being an owner of capital at risk in the system.

---

[1] See, for example, the *OECD Guidelines on Corporate Governance of State-Owned Enterprises* (2005) (http://www.oecd.org/document/33/0,2340,en_2649_37439_34046561_1_1_1_37439,00.html), or in Australia, *Review of the Corporate Governance of Statutory Authorities and Office Holders* (Uhrig Report), (2003) (http://www.finance.gov.au/GovernanceStructures/docs/The_Uhrig_Report_July_2003.pdf).

Conclusion

These are just two of many elements in getting the institutional and governance structure right in a national financial system, and no doubt more can be said. But generally speaking, policy-makers will want to foster competition, disclosure of information and well-functioning private markets on the one hand, and strong and independent public policy institutions operating within a clearly articulated policy framework on the other. Particular care is needed in cases where public ownership of enterprises has the potential to compromise the public interest.

I trust that your discussions on governance today will be fruitful.