Maja Kadievska-Vojnovik: Recent developments in central bank governance, accountability and transparency as core drivers for effective financial supervision and the importance of board effectiveness for banks and central banks

Speaking note by Ms Maja Kadievska-Vojnovik, Vice-Governor of the National Bank of the Republic of Macedonia, at the Conference “Central Bank and Supervisory Governance”, organized by the Netherlands Bank, Amsterdam, 12 February 2016.

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At the beginning of 2016, the global economy looks set to enter another challenging year ahead. The risks for policymakers remain multifaceted as global transitions continue with adjustments happening on multiple fronts. First source of vulnerability is China as it transits from earlier main engine of global economic growth to a new phase of growth rebalancing, that is almost certain to result in a major slowdown internally and adverse spillovers externally through the trade linkages and prices of commodities. As second, is the protracted period of low commodities prices straining growth prospects for commodities exporters, including some major emerging markets like Brazil, Russia and South Africa. Third front is Europe that along with the debt crisis, now faces another challenging struggle to effectively manage the migrant crisis that has brought to a test the EU’s absorption capacity and the political system. Fourth, the US FED has launched the normalization of monetary policy leading to a policy divergence in advanced economies and building fears of potentially tighter financing conditions and declining

capital flows that may adversely affect emerging market economies. The international community response to the crisis in the Middle East and the risks of potential Brexit are additional factors that add to the geopolitical risks. Global growth prospects remain cloudy again, with IMF now (WEO, January 2016) expecting more gradual pick up in global growth from the estimated 3.1% in 2015 to 3.4% in 2016 and 3.6% in 2017 (as compared to 3.6% for 2016 and 3.8% for 2017 in October 2015, WEO). Risks continue to weigh on the downside and are particularly prominent for the emerging and developing economies given their higher vulnerability to sudden switches in global confidence, reversals in capital flows and financial markets volatility.

The challenging world translates into challenging environment for monetary policy making. Continuous vigilance on multiple fronts, while successfully juggling between difficult trade-offs in decision making is what has become the new art of central banking nowadays. The main challenge for monetary authorities, not only today, but for years back, is how to deliver the most appropriate policy mix that will support demand and activity, while safeguarding against macro-financial risks. Recent crisis has brought financial stability to the fore acknowledging the importance of central banks in financial stability, a task which they have historically performed, though to a varying degrees. According to a BIS study (2009) central banks’ arrangements for financial stability as they stood before the crisis have differed widely across countries, both for normal and crisis times. Banking supervision was not always tasked to the central bank, with many central banks lacking a clear mandate for macro prudential policies. As it comes to advanced economies, the common practice before the crisis was generally characterized by separation in responsibilities with respect to monetary policy and banking supervision, delegating each function to a different regulator. Looking at EU, the integrated model of supervision was predominating across the member states, capturing the form of unified financial and banking oversight under one single national authority, but generally, not the central bank. The situation was quite different in emerging countries where central banks tended to be the main micro prudential supervisor for banks. In response to the crisis, there was a visible convergence in both, advanced and emerging economies, towards integrated supervision under the common roof of the central bank, usually by using the “new” formula of macro-supervision. The role of sound supervision was endorsed as absolutely vital for promotion and maintenance of healthy financial system, while central banks got recognized as leading protagonists in the area of prevention, management and resolution of financial crises.

Thus, in 2010, the US has passed the Dodd-Frank Act redesigning the role of FED in financial supervision, while in EU there is an ongoing process towards a banking union assigning banking supervision to the ECB together with the national supervisory authorities of the participating member states. The benefits of integrated supervision rest on the synergies between banking supervision and monetary policy given that banks play the crucial role in monetary policy transmission mechanism. In such a context, the supervisory information regarding the individual banks' health can be highly beneficial to central banks in enhancing monetary policy effectiveness. On the other hand, expanding the central bank's mandate with additional tasks may pose challenges with respect to central bank governance. As noted by Georgsson et al. (2015) the broader the mandate a central bank has, the more often it will be forced to find a balance between different objectives, tasks and tools. Studying the implications of financial stability tasks on central bank governance, BIS (2009) underlines the need for effective governance arrangements that should be designed to deliver sustainable conduct of monetary policy functions in combination with the additional mandate to contribute to financial stability. Further, the Report stresses the importance of clarity with respect to financial stability responsibilities, policy transparency as to promote accountability, full autonomy to safeguard against political pressures and undue influence from business and industry and close collaboration with other regulators in the country. Another important aspect is the central bank balance sheet which should be sound enough with strengthened risk-bearing capacity to enable successful implementation of monetary policy and support financial stability in case of emergency.

Going back to banking supervision, besides the institutional setup, another important question raised by the crisis relates to the role of transparency and accountability in promoting more effective banking supervision. According to the literature, for supervision to be considered effective it should be able to effectively develop, implement, monitor and enforce supervisory policies under normal and stressed economic conditions. BIS (2012) defines several preconditions for effective supervision in practice: 1) sound and sustainable macroeconomic policies as a core precondition for stable financial system; 2) a well established framework for financial stability policy formulation i.e. clear framework for macro prudential surveillance and financial stability policy formulation; 3) proper regulatory environment; 4) a clear framework for crisis management, recovery and resolution; 5) an appropriate level of systemic protection (or public safety net) such is a system of deposit insurance which contributes to public confidence in the system and thus limit contagion from banks in distress and 6) effective market discipline. Transparency is another factor that gains growing importance in recent years. Thus, in order to restore confidence and rebuild financial stability there was a strong push towards supervisors to increase their transparency to the markets and the public. One supporting argument for these trends is the role of transparency as prerequisite for accountability. Higher transparency enhances the legitimacy of the supervisor, also safeguarding his independence. When transparent, the supervisory actions become more predictable thus helping to shape expectations and foster linkages across institutions and markets. Finally, transparency sets the ground for careful and consistent decision-making, reducing the scope for arbitrary decisions. Empirical research (Arnone et al., 2007), finds a positive correlation between the transparency of the supervisor and the effectiveness of banking supervision. They also report higher transparency of banking supervision (based on adherence to the IMF code) in industrial countries than in emerging economies. Another, more recent research (Liendrop at al., 2011) suggests that the overall level of transparency of supervisors in industrial countries is very similar to transparency of supervisors in emerging economies indicating to positive movements in emerging markets in the area in recent years. Indeed, supervisors seem to endorse transparency. In 2006 the Basel Committee on Banking Supervision, in the Basel Core Principles for effective banking supervision, first mentioned that supervisors should follow transparent processes. This means that supervisors should disclose their objectives and framework and be held accountable for performing their duties in line with those objectives and framework. The Capital Requirements Directive IV (CRD IV) stipulates that supervisors need to publish relevant information on the laws, regulations, administrative rules and guidance, information on options and discretions, the general criteria and methodologies used in the supervisory review and evaluation process, and aggregate statistical data on the implementation of the prudential framework, including the number and nature of supervisory measures taken and administrative penalties imposed.The European Banking Authority (EBA) acknowledges the need for supervisory transparency and has set up guidelines for supervisory transparency (CEBS, 2010) intended to increase the transparency of supervisory practices and to enhance the comparability of national practices. Furthermore, EBA publishes relevant information of all EU countries on supervisory laws and regulations and statistical data on national banking sectors, risk indicators and supervisory actions.

While the benefits of greater transparency in supervision are broadly recognized, the level of disclosure remains a challenging issue. This relates to the specifics of the supervision as it obtains sensitive information with respect to the state of individual banks that if publicly disclosed may affect its competitive position. Given this, what one could expect is for supervisors to continue to increase transparency when it comes to the authority itself disclosing more information on the supervisory model and the methodology used to evaluate the risk profile of individual banks, while retaining their "secrecy" when it comes to sensitive information concerning individual banks. This should enable markets to better understand the supervisory actions, enhance accountability of the supervisors in front of the general public while protecting market-sensitive information.

Tackling the issue of board effectiveness, there is a growing consensus nowadays that well-designed committee makes important prerequisite for qualitative decision-making in central banks. The role of the committee for sound policy making is probably best noted by Warsh (2015) in his observation that "monetary policy is made neither by rule nor by discretion. It is made by committee". The literature shows that the institutional setup of the board indeed matters for monetary policy (Morgan, 2005; Maier, 2010; Sibert, 2006) suggesting guidelines for optimal committee design. Thus, according to Maier (2010) the optimal committee should have clear objective and independence; should not be too large in size (up to five members) and have measures to avoid free-riding and discourage polarization and group think. When it comes to practice, the number of decision-makers, decision-making protocol, and principals in attendance diverge markedly among the leading central banks, suggesting for committee dynamics to be appropriately adjusted conditional on the institutional set-up and specifics of the central bank.