# Good FORM for Institutional Governance

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## Introduction

Central banks are unique institutions that play a leading role in their societies, directly and as a catalyst for economic development. Governance of a central bank demands an approach that differs in important ways from a commercial organisation.

The Global Financial Crisis demonstrated serious capability and culture gaps in central banking and financial regulation. Today's dynamic environment of economic, social and technological change demands active and creative responses, technically AND institutionally. But many central banks still need modernisation – to shift from administration to modern management. Those that have already modernised need to focus their strategic development on attaining institutional excellence.

Governance is much more than a trendy new word for management. It describes the responsibility of governing bodies to serve the interests of stakeholders, now and in the future. In any organisation, internal managers need oversight and guidance from that wider perspective. In central banks – conservative institutions where top managers and Board members often have multiple roles - institutional governance is inherently challenging.

Successful strategic change is not easy. It requires more than "paperwork" – the planning and analysis at which central banks excel. It also demands the agile implementation and human resource management skills that they struggle to acquire. Leadership, pragmatism, simplicity and practicality are essential.

It can be difficult to know how and where to begin. Independent and practical advice that is deeply informed about central banking can help.

But from a business consulting perspective, the central banking "market" presents a combination of factors – uniqueness, dispersion and introversion - that make knowledgeable and independent service delivery uneconomic. So central banks rarely obtain targeted, high-quality advice and support for their institutional governance, management and change. That has constrained their real-world effectiveness.

This brief paper is a "practitioner's note" that outlines key aspects of the approaches I have applied as an independent consultant with more than 20 diverse central banks. It also draws on my personal experience within the official sector, collaboration with international consulting firms, leadership of international forums and work with a wide range of business clients.

Central banks facing change challenges can tap into and learn from that unique experience set. This paper should be read in conjunction with other sources:

- The videos "Institutional Excellence for Central Banks and Financial Regulators" (www.Mendhurst.com/central banking) and "Strategic Change – Think, Plan and Govern" (linked from that page)
- other publications at www.Mendhurst.com/central banking, especially the article "Managing the 21st Century Central Bank"

I hope this paper helps governing bodies and top managers at central banks move institutional change management away from hasty, reactive and partial responses such as "Let's restructure!", "Let's hire more staff!" or "Let's buy best practice".

## Good FORM for Central Banking

**A central bank is an independent service organisation whose business activity should demonstrably achieve effectiveness and efficiency.** Governance and management, including the design of organizational structures and individual jobs, should support that goal. Institutional excellence is essential for success. But central bankers have traditionally focused on technical excellence, not institutional governance and management. What needs to change, and how?

Many central banks now aspire to be modern and world-class institutions. Achieving that vision for a traditionally-organised central bank demands transformation through a comprehensive, forward-looking and zero-based review of functions, structures, resources and management - conveniently abbreviated by the acronym **FORM**:

- **F**unctions -- identify and document the top-level and second-level outputs of the entire institution, as the basis for output-oriented institutional governance

- **O**rganisation -- design and implement a structure of departments, inter-departmental committees, and divisions/units to optimally deliver those outputs

- **R**esources -- identify and apply the human, technological and infrastructure resources required to fulfil output delivery through the organisation structure

- **M**anagement -- design and apply an optimal and integrated management framework to ensure output effectiveness and resource efficiency

Systemically, the governance framework that FORM delivers will comprise

- strategic and operational planning and budgeting
- performance targets for functions, outputs and business processes
- management systems for human resources, finance and infrastructure
- monitoring and reporting that delivers timely and useful information
- simple and effective management tools to support core systems, in particular project management and enterprise risk management
- greater agility for responsive evolution and crisis management

Culturally, governance will demand a focus on management and leadership skills. Performance management of organizational units and individual jobholders must establish standards and operate the right incentives. Governing bodies need to lead and sponsor that institutional change, and not "leave it to management".

**Institutional transformation cannot be achieved by a trendy "technical fix" or isolated "restructuring". A holistic "top-down" approach, driven from a perspective of institutional governance for stakeholders, is essential.**

## Put Functions First

**The starting point for change and improvement is NOT the organisation chart.**

Without prior work on functions, even an optimal organisation structure is unlikely to achieve change. That is especially true if departments have become autonomous compartments, job documentation is sparse, and thinking about work processes is conservative and introverted.

Central banks have some commonality of function, but diversity of statute, role, economy, institution and priority across the universe of central banks is inevitable. So the functional analysis for any particular central bank cannot be "off the peg" - it needs careful customisation and tailoring to maximise relevance and usefulness.

A function-driven approach to organisation and work design is a simple and effective form of "business process re-engineering". It focuses on the outputs delivered to the external world and the specific activities required to deliver those outputs. The generic table below defines the three levels of a full function/output/activity analysis and suggests how to assess performance at each level.

| **Function** | **Target Outcome** | **Output** | **Performance Measure** | **Activity** | **Performance Standards** |
|---|---|---|---|---|---|
| A top-level, long-term or medium-term "deliverable" for the institution as a whole. Many functions will reflect an explicit statutory mandate. Others may be implicit in legislation or reflect the central bank's interpretation of goals and priorities within its overall mandate. | A top-level statement of what the central bank aims to achieve in performing that function. (Ideally the central bank would control the outcome, but in practice outcomes may not be fully controllable.) | A definable and significant medium-level component of a particular function. Typically an output will be delivered by one or a few organizational units. Most outputs are continuing in nature but some may be occasional, temporary or project-oriented. | A description of success in delivering that component. Some measures may be relatively specific and quantitative while others will be inherently more general or subjective. An external orientation should be apparent. | A particular task or set of tasks that contribute to delivery of a particular component. An activity will typically be delivered by a single organizational unit and perhaps even a single individual. Continuing activities usually have the nature of a "business process". | Continuing activities have measurable KPIs (Key Performance Indicators) of quantity, quality, time and cost. Other activities are likely to be measured using project management tools. |
| | **Key audience** | | **Key audience** | | **Key audience** |
| | External stakeholders and the Board, to evaluate institutional performance | | Internal management and (to some extent) the Board, to evaluate performance of units contributing to that output | | Managers, to monitor operations and evaluate individual performance |

Some central banks have tackled transformation by analysing and mapping business processes. As the above table suggests, the lowest level of activity in the functional analysis is indeed likely to be a process. But a bottom-up analysis is likely to have only limited effectiveness, especially if it is guided by consultants who lack a strong understanding of central banking and use generic methodologies. Outputs and activities may be too closely aligned to "how we do things now". Performance standards may be irrelevant, incomplete or isolated, and not "add up" to the integrated performance measures and target outcomes needed for good governance.

The development of a full functional analysis benefits from an iterative approach. First, draft only the function column, fully. Next, develop outcome and output columns. Use them to confirm and check the function column. Finally, articulate performance measures, activities and performance standards to complete, confirm and check a cohesive top-down framework.

Performance measures, activities and performance standards will depend on many factors. They may be numerous in a larger central bank or for functions of wide scope. Simplicity and usefulness, not attempted perfection, should guide definition.

Two examples, articulated across the first three columns only, are illustrated below. Outputs without question marks are likely to appear in the analysis for most central banks. Outputs with question marks are likely to appear for some central banks. The number of outputs for any particular function typically varies from only a few to 10 or occasionally even more.

| Function | Target Outcome | Output |
|---|---|---|
| Currency management | The notes and coins of the national currency are secure, convenient and of high quality | Note and coin design |
| | | Currency issue |
| | | Currency processing |
| | | Currency destruction |
| | | Inventory management |
| | | Quality assurance and investigations? |
| | | Research currency trends/alternatives? |
| | | Collectors currency? |
| Monetary policy formulation | Monetary policy achieves price stability and supports national economic goals | Policy development |
| | | Forecasting |
| | | Monitoring economic variables |
| | | Development of policy scenarios |
| | | Liaison with economic actors |
| | | Monetary policy statement? |
| | | Economic modeling? |
| | | Monetary statistics? |
| | | Monetary policy research? |

To produce external outputs, a central bank also needs institutional support activities such as human resource management and information technology services. Those activities can be regarded as intermediate "functions" delivered to internal customers, and should be added to the end of the functional analysis.

Completion of the first three columns should provide a platform for designing top-level organisation structures (departments, top-level committees, next-level units and the positions directly reporting to department managers). The next two columns, particularly the definition of activities, then become an important driver to design individual jobs within departments and develop job descriptions for them.

Can the analysis be done internally? In principle, yes. But in practice, sponsorship, capability or credibility may be lacking. Patch protection or historical bias readily emerges. It is prudent to assure quality through skilled guidance or peer review.

**Departmental management is necessary and important, but functional governance is what matters to stakeholders. The function/output/activity analysis transcends traditional departmental thinking. It delivers an externally-oriented framework for governing and managing performance.**

## Organisation Design

**Traditionally central banks have applied a hierarchical and bureaucratic approach to organisation, resourcing and management. Silos can develop, become entrenched and resist change. Thinking can narrow and fossilise.**

The first question in regard to any structure must be "What will serve the needs of the institution and its external stakeholders best?". The requirements and implications of functions, outputs and activities should drive the design of organizational structures and individual jobs.

It is natural and appropriate to locate functional and output responsibilities within particular departments and units where work can specialise accordingly. However "form follows function" should not be followed blindly. Undue compartmentalisation limits transparency and accountability, reduces institutional efficiency, and hampers innovation. Indeed many aspects of central banking benefit from interchange of ideas and information.

So while particular departments and units will take primary responsibility for particular functions and outputs, other departments and units can constructively have review or contributory responsibilities. Many central banks already institutionalise key aspects of this principle by establishing interdepartmental committees for a few key functions and a "senior management committee" for overall management of the institution.

Taking that principle further, performance measurement and management should focus on outputs and not over-emphasise departmental boundaries. Don't obsess about "restructuring". Teamwork and an externally-oriented culture are instead likely to require fundamental shifts in thinking and culture. Target a blend of organisation, resourcing and management that is modern, integrated and output-oriented.

Key elements of that shift are outlined later or in other sources. To summarise here:

- Don't confuse governance and management. Coordinate corporate functions, but avoid an unwieldy "Governor's Office" that duplicates work done elsewhere.
- Move from hierarchical "ranks" to defined "roles", so that job evaluation and remuneration can flexibly recognise the contribution of each individual job.
- Flatten structures and widen reporting spans, so that managers have a larger number of direct reports than is historically typical in central banks. Avoid one-to-one reporting lines and superfluous "deputy manager" positions.
- Use manager roles and titles only where a position actually manages other people. Classify minor management positions as "team leader" roles.
- Make technical career paths available. Create technical professional roles – "advisers" or "specialists" – to flexibly advance individual careers and remuneration. Be prepared to switch rising stars from technical to managerial roles, and vice versa.
- Modernise the traditional practice of developing generalist "central bankers". Functions and activities are increasingly specialised, limiting the value of rotation and increasing its risk. Apply creative cultural and management mechanisms to instil a holistic and cross-functional perspective in the next generation (and the current one).
- Design enabling and less fragmented work roles suitable for policy departments

staffed by "knowledge workers" and operational departments using more technology.

- Think realistically about branches. In modern central banking, branches – if needed at all - tend to be mainly decentralised depots to store and process currency. Branch activities that are not currency-related should be continued or introduced only where a realistic analysis based on institutional functions and outputs confirms such activity is effective and efficient. (Branches should normally report through the currency management function, and not directly to the top under outdated concepts.)

- Avoid the tendency to create a "manager" and "unit" when a sole-charge specialist role or a project structure can deliver focused results and better value.

- For one-off needs, apply project not committee structures and concepts. Emphasise the role of project sponsor. Use project management roles as a learning and development opportunity for talented staff, or (for specialised and risky projects) as a way to engage skilled external resources without losing control.

- Ensure committees serve a real purpose. An extensive committee structure disempowers managers, wastefully consumes resources and delays decision-making. A committee should exist only where it has an inherent on-going and inter-departmental role that cannot be properly fulfilled by line management or project management –NOT to oversee established and objective procedures, or to "intermediate" between departments that should be cooperating directly.

- Committees are expensive, so maximise their net added value. Avoid unduly senior chairmanship or membership. Focus terms of reference and agendas tightly, on policies and decisions. Aim to process technical detail outside the committee.

- Rethink work practices during job design. Take an output perspective. Blend human resource issues and technological perspectives and allow for evolution.

- Allocate and manage secretarial support only at the departmental level. Vary the type, quality and quantity of secretarial support between departments to respond to modern circumstances and how specific professionals will perform future work.

- **Anticipate the future. Major restructuring should not be frequent. Ensure structures can flexibly and selectively evolve to respond to changing needs.**

## Resource Principles

**Central banks often approach change by designing a new structure and asking "Who do we have?" to resource that structure. That is the wrong question.**

If some cards are missing from the pack, it will be impossible to "deal a good hand". So if a central bank lacks key technical and managerial capability for its future needs, external recruitment is essential. Fresh thinking often brings wider benefits too.

"Who do we need?" is a better question. But that still only recognises the human dimension of resourcing. Employing staff may not be the best solution, especially for temporary needs or when technology or other change factors need to be considered. Broaden processes for recruitment and succession planning (focused on individuals) to create processes for capability planning (focused on institutional capacity).

The best first question – "What do we need?" – is normally answered by sourcing an optimal mixture of staff, technology, infrastructure and relationships, drawn from internal and external sources. Achieving that optimisation is of course not easy.

Pragmatism is crucial. Ideal structures that cannot be resourced will achieve little. Understand what is likely to be available. Avoid unrealistic job descriptions and supplier specifications. Be prepared to rethink organisation design or even institutional functions to ensure that activity will be properly resourced.

For internal resources, a cry for quantity – "We need more resources!" is often the first response to problems. Only after Quantity (more resources) fails do more fundamental questions get asked: "Do we have the right Quality of resource? The right Type? Have we created the right Motivation for our resources to be effective?"

Reverse that. **For internal resourcing, apply MTQQ (Motivation, Type, Quality and Quantity)**:

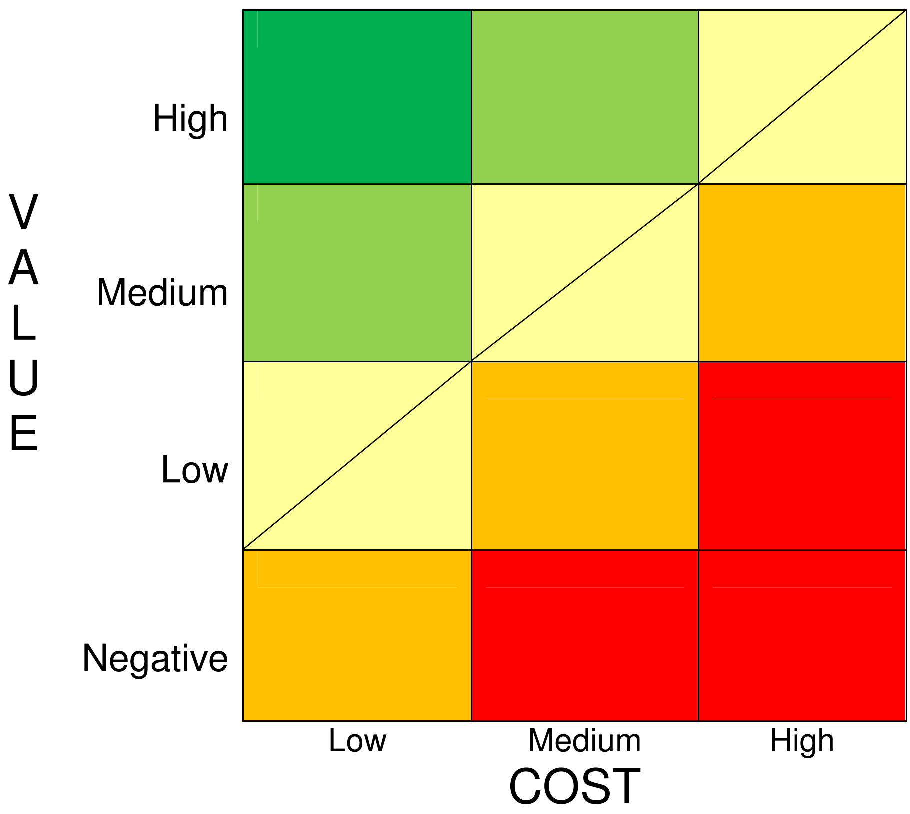
1. Do culture and incentives maximise our resources? If not, what must change?
2. Do our resources have the key characteristics they must have to succeed?
3. Do our people, technology and infrastructure resources meet high standards?

Only when all those tests are positively met should "more resources" be considered!

External resourcing – "outsourcing" – is subject to the same general considerations, but not to the same degree of control. Experienced judgment becomes crucial. The value delivered by external resourcing does not necessarily correlate with its cost!

**For external resourcing, target staying "above the value line".** The colours illustrate the net value added by an external resource, ranging from bright green (high value at low cost) through neutral yellow and finally red (value far below cost):

THE VALUE LINE CHALLENGE




Let's begin with the potentially huge payoff from low-cost resources – those that are free or cost little.  That usually means technical assistance from the "official sector" of other central banks and multinational institutions.  In principle, that may seem like the best option.  But in practice, it may not be.  Why?

The processes applied by the official sector to source "technical assistance" are weak or unreliable.  Multinational organisations tend to surround projects with clumsy bureaucracy, and they inevitably have their own agendas.  Some consultants are excellent, but others are terrible.  Even good consultants may place a higher priority on "writing a good report" for their sponsor than on adding direct value for clients.

No two central banks are really the same.  Benchmarking within the introverted world of central banking in a search for "best practice" can deliver only limited insight. What works well at a sophisticated and mature central bank, focused on core functions and supported by the institutions and infrastructure of an advanced economy, will not readily transfer to a central bank operating in a very different environment.  To be effective, institutional governance and management must be customised to local circumstances and culture.  The advice of technical "experts" may turn out to have limited practical value in the local environment, and can even be damaging.

So low cost frequently means low value, especially in institutional governance, management and change – fields where the official sector itself is weak.  To apply low-cost resources but stay above the value line, central banks need to be selective and skeptical.  If what is being offered is not really what you need, don't accept it.

Value endures long after price is forgotten. So central banks sometimes turn to high-cost resources at the other end of the value line.  Omnibus international consulting firms offer advice and methodologies for governance, risk management, strategic planning, organisation design, business process re-engineering, culture change, leadership development, and anything else that is profitable to sell or "hot".  But their business model generates highest profit when work has been delegated down too far and the client is too naïve or too captive to notice.  Central bank buyers beware!

Staying above the value line for high-cost resources is a game that central banks play at a competitive disadvantage.  That disadvantage cannot be negated by "tender procedures".  Business nous and strong governance are essential to avoid being dazzled by elegant diagrams, slick presentations and compelling proposals.  Target proposed interventions (buy only what we need, not everything they want to sell) and insist on getting the right people involved (and only those people).

Medium-cost resourcing looks like a lower-risk buying option than high-cost resourcing – and often it is.  Independent consultants or contractors, specialised consulting firms and individual advisers are more likely than high-cost firms to genuinely serve clients rather than themselves, and to seek business success through integrity and reputation rather than branding and salesmanship.  Their commitment to building internal capability is often more genuine too.  The value-line challenge in medium-cost resourcing is to "match and target" – select and apply the right resources in the right way at the right time, to add high value for medium cost.[1]

What about negative value – value destruction?  Can that really happen?  Certainly. Any change initiative involves not just cost but also risk.  By definition, change alters or removes what existed before.  A change initiative that is poorly targeted, weakly

[1] The author, as a "medium-cost resource" himself, also applies the match and target principle in reverse to check mutual expectations or decline potential assignments where high added value does not seem feasible.

sponsored or badly delivered can deliver outcomes worse than the status quo. That should not however lead central banks to indulge conservative cultural instincts, and defer necessary change. **To succeed in the increasingly dynamic real world, the risks of change must be managed, not avoided.**

## Management Practices

**Management is a craft – a blend of science and art. Successful management must combine good management systems with the right internal culture.** For example, even superb early-warning systems will achieve little in a culture that does not stress acting on information received.

How management systems should be designed and what organisational culture should be encouraged are pragmatic questions, to be resolved in a customised and sustainable way. The overriding question should be "What will serve the needs of the institution and its external stakeholders best?". Watch out for staff capture - internal considerations of career paths and impacts on individuals must stay secondary.

Balancing operational continuity with institutional change is not easy. Other Mendhurst sources discuss optimal management practices at length. In this short paper, only a few key points about management practices can be mentioned:

- State an inspiring vision and aspirational values. But plan – realistically – how to make them reality. Avoid "paper" commitments that can't be or won't be attained.
- Treat external accountability and disclosure as positive motivation, not burdens.
- Emphasise effectiveness, but don't neglect efficiency. An efficiency orientation sparks change and innovation. Tolerance of inefficiency degrades to ineffectiveness.
- Customise sound principles to the special features of central banking and to local conditions. Don't copy some supposed "best practice" or adopt some fancy methodology implemented by junior consultants. Develop "right practice for us".
- Build a complete and integrated governance and management framework that speaks one language. Apply a true functional, and not merely departmental, lens.
- Ensure strategic plans apply choice and focus, plus exploration and innovation.
- Keep management systems and specialists lean and focused. Avoid "interesting" complexity that does not add value for managerial users of the systems.
- Balance training and "succession planning" – focused on individual development – with capability planning focused on institutional needs.
- Expect managers to be leaders who nurture talent and develop the skills of their staff. Beware "fastest gun" technocrats who hoard knowledge or discourage others.
- To build human capital, create competition and fresh thinking. Recruit internally <u>and</u> externally, through rigorous processes. Employ senior staff and change agents on fixed-term contracts. Demand tangible returns from training investments.
- Drive budgeting mainly from planning. A budget quantifies and checks a plan.
- Cost outputs and projects, not just inputs and departments. Keep it simple!
- Design incentives to target key goals <u>plus</u> demonstration of institutional values.
- Try to ensure performance management cascades simply from institutional,

functional and departmental assessment through to individual staff performance appraisal. But accept the inevitable imperfection of measurement. Create rich dialogue and clear prioritisation at all levels, rather than search for perfect systems.

- Drive “risk management” from a top-level perspective of enterprise governance. Delegate management of operational risk to line managers and audit controls.
- Keep project management simple and focused on business outcomes. Avoid inflexible methodologies with high overheads. Recognise the key role of sponsors.
- Don't speak lightly of "managing change" or “culture change”. They are the toughest challenges! Behavioural change needs determined sponsorship, thoughtful planning, serious resourcing, capable management and systematic monitoring.
- Recognise that continued evolution will be necessary. Watch out for reversion.

And a final word. **Don’t promote good technicians into bad managers! Demand everyone with a management role operates management practices well, and becomes at least adequately capable as a manager and leader.**