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Interview: John Mendzela

John Mendzela is a specialist in central bank governance and strategic management. Here he discusses the gaps in central bank governance highlighted by the crisis and presents some potential fixes

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CentralBanking.com (CB): Many central banks are now being given enhanced powers to better safeguard financial stability. What are the governance implications of this?

John Mendzela (JM): What does financial stability mean in the real world? For some years now, this concept has been discussed in an overly abstract manner. The term needs to be clarified along several dimensions in a practical, not theoretical, way. Who should do that? In practice, it will be up to the central banking community to propose and 'sell' what that means, and obtain acceptance from a critical mass of stakeholders. Only then can objectives for safeguarding it be developed.

Much has been said about requirements for new or enhanced powers. Certainly some changes are needed. More so in some places than others. But powers can only be of benefit if they are used. It is clear that the central banks and financial regulators at the heart of the crisis failed to use the mandate and powers they had, or failed to ask for more in time. The world changes, and the details of the legal and regulatory paperwork will always be out of date to some extent. So while mandate and powers were part of the explanation, the issue is more one of people and culture than law.

For mature central banks, including the most important ones, fundamental issues arise in capability and culture. Do your people have the willingness and ability to 'smell' trouble and act on that? Or are they content to keep the paperwork in order and avoid personal risk? Such matters cannot be legislated. Instead they lie at the heart of governance.

So governance, not only in decision-making but more fundamentally in the sense of institutional governance, has become crucial for central banks. As I have outlined elsewhere, central banking as an industry displays fundamental weaknesses in institutional governance, which in turn lead to institutional weaknesses. It is far from obvious that this problem will be seriously tackled. And if it is not, then central banks will be treading a road to failure - whatever the details of the regulatory frameworks might be.

CB: How should central banks alter governance arrangements to better suit the financial stability remit?

JM: I'm not sure they should alter governance arrangements. At least not solely for that reason; governance structures and processes should not be driven by one particular central bank function.

Any cursory review of central bank legislation - and experience with the actual operation of governance in central banks - demonstrates that law and practice is now unduly driven by the predominance of monetary policy. Less obviously, central bank governance is also unduly driven by the sub-profession of macroeconomics and its technically-oriented macroeconomists. That is part of the problem that has been labelled 'group think'.

Substantial rebalancing is vital. And the broader financial stability remit should be used as a catalyst to look at central bank governance arrangements more generally. Some central banks that already have external board representation may need to change relatively little, perhaps merely tuning their skill sets and processes. But other central banks - particularly those that have introverted governance arrangements or are culturally dominated by macroeconomists - should take the opportunity to fundamentally rethink both their legal arrangements and how their governance actually operates.

"Group think" is not just the result of technical training and similar backgrounds, though. It is a phenomenon of personality, potentially present in every boardroom. How do you counter it? By employing directors with the right qualities.

CB: What are the right qualities for central bank board member to possess?

JM: Good directors really need only four qualities. First, intelligent judgement, which is not the same as intellectualism. Second, integrity. Third, common sense. Fourth, a willingness to ask naïve questions, and keep asking them.

Effective directors ask the hard questions and do not rest until they get good answers. I'd suggest three conversations that could and should have occurred, but clearly didn't, in some central bank boardrooms. First, risk doesn't go away just because you move it around through clever financial instruments. So board members should have been asking where it was in the system. And what was being done about that. Second, the value added by the financial services sector became a far more significant chunk of the total value of the economy that it once was. Common sense says that is unlikely to be sustainable. So it should have been asked how it can be so. Third, it defied common sense that banks from a tiny country like Iceland were becoming so important in the European financial system. The warning signal was obvious.

CB: There is, of course, responsibility for macroprudential regulation to be considered too. What are the governance implications of

this and how can central banks best handle them?

JM: Regulation is only a means to an end, in this case to ensure financial stability. Or to put it the other way around, the function central banks must perform is better described as the regulation of financial services, with financial stability an outcome of that function.

In reality, most central banks already are, and will remain, 'full-service' central banks with direct responsibility for financial regulation. Again, those central banks may only need to tune their current arrangements. However, some central banks, especially in countries where regulatory responsibilities have been assigned to agencies outside the central bank, will need major changes to their institution and its governance.

The potential conflicts and trade-offs between monetary policy and financial stability have been much studied. But the governance and management implications are much wider, and also more prosaic. The financial regulation function encompasses several different types of activity. Conceptually, there is still much thinking to be done to define objectives. Strategically, regulatory and licensing frameworks need careful design. And one needs to look at the whole system, not just the sum of its parts. Operationally, individual financial services institutions need to be monitored.

That diversity and range of activity has important implications. It may be appropriate to, say, contract out to another agency the labour-intensive work of monitoring individual institutions. But, as the crisis demonstrated, central banks need to have a greater understanding of financial services activity. That demands institutional governance that a group dominated by monetary policy specialists - or indeed any other single discipline or culture – are likely to be ill-equipped to deliver. And, more specifically, central banks will probably struggle to find directors who have a profound understanding of financial services but do not face actual or perceived conflicts of interest.

CB: Let's turn now to who should govern the board. Given that the vast majority of central banks are owned by the state, what are your views on the role lawmakers should play in a central bank's governance and its strategy?

JM: Again, the answer would vary with national circumstances. But to bluntly generalise, the typical skills, incentives and time frames of parliamentarians make them unlikely to play a constructive role. Even understanding the objectives and activities of the central bank is likely to prove difficult for many. So a central bank that wishes to positively and constructively interact with parliamentarians first faces a substantial education and communication challenge, and then must run the hazards of political posturing.

To invite parliamentarians to play an active role in central bank governance and strategy would undo the principle of operational independence on which modern central banking is based. Nevertheless, in some countries parliamentarians can and do play a useful role in the accountability process. It can be instructive and helpful for central banks to respond to the viewpoints and perceptions of non-specialist stakeholder representatives. But to add value, such interaction requires a mature structure and process, and a willingness from elected politicians to participate with maturity.

The impact of the central banking industry's failure to avert serious crisis is already being seen.

Governments are reeling central banks in, to get back one of the levers that they can manipulate to gain or retain power. Those efforts may be overt or covert, public or private. But they are happening in a wide range of countries. As one central banker put it to me: 'Our government wants a central bank that is independent – but obedient!'

CB: You have noted in the past that by heading both the central bank and its governing board, governors are effectively serving as both chairman and chief executive. This model has become less popular for European companies in recent decades, but many firms in the US still use it. For central banks, why do you think it is the wrong tack to take?

JM: I don't necessarily think it is the wrong tack. It is important to customise governance to the specific circumstances of each central bank. The optimal approach will depend on many circumstances, including national constitutional and legal traditions, nature and maturity of the economy, and the local political culture.

In 1988, the Reserve Bank of New Zealand was developing legislation for an independent central bank that would contract with government, and be accountable to achieve, specific policy and management targets. That central bank already operated a 'company' model of institutional governance, and even then it seemed to me only natural that one of the non-executive directors should be chairman. The governor at that time, Don Brash, had come from the commercial sector. He agreed in principle, but felt that in practice the central banking world was not ready for such an approach. So in 1988, the governor remained the chairman. But some years later New Zealand introduced, by law, an independent chairman.

The central banking world, with some variations, is now ready to apply modern governance practices. A growing group of central banks are separating the roles of governor and board chairman. And a number of other central banks in which the governor remains chairman have already established board processes in which the non-executive directors meet independently on a routine basis, and apply formal oversight and evaluation of the governor's performance.

In many countries though, circumstances dictate more caution. External stakeholders could readily become confused about who is setting policy rates if there is both a governor and chairman. And if there are two boards of governance (as would be the case in a supervisory model of central bank governance) or no outsiders at all on the board, then the question of chairmanship needs to be looked at quite differently.

An important principle that arises from this point is that central bank governance structures and processes need to be considered holistically, to adapt, not adopt, specific good practices from commercial organisations. Central banks that are governed under supervised or in-house models inherently face greater difficulty in achieving the benefits that the company model can bring. Nevertheless under any model there are likely to be practical paths forward, within existing legislation.

CB: Your argument seems to be that effective leadership and management should be distinguished from the policymaking processes. Yet in terms of determining what resources are needed for future policy work, are policymakers not going to be best placed to understand what sort of data and modelling would best enable them to do their jobs?

JM: To some extent, yes. A central bank board that did not understand the resources and business processes required to perform key functions would be inherently ineffective. But a board dominated by policymakers would be analogous to an automobile company board dominated by motorcar designers – probably nothing would be spared in R&D expenditure, but the company would be vulnerable to failure through inadequacies elsewhere.

Experience from my consulting work with central banks illustrates this point well. It is normal for experts in monetary and economic modelling to want top-quality staff, state-of-the-art tools and so on. Only thus, they will argue, can they improve the quality of their work. But often much more value can be added by making better use of existing resources and improving interdepartmental teamwork than by spending more money!

Technical experts inherently tend to focus on maximisation of their technical effectiveness. But the challenge of governance is optimisation, not maximisation. There is an old saying to 'beware of the man carrying only a hammer, to whom every problem will look like a nail'. Too often central bank boards include members who have not left behind the technocratic thinking that was essential in their earlier training and work. And too rarely do they have the wider business skills and experience to realise that the typical first answer to a management problem – 'we need more resources' – is likely to be the wrong answer.

CB: You have stated in the past that governing boards should have a role in setting monetary policy. First, can you be a little more explicit about what you mean by a role? Second, how do you ensure that board members are qualified to have such a role?

JM: Governing boards should certainly ensure that monetary policy is determined and applied in a thoroughly professional manner. This is, however, not the same thing as being directly involved in setting the policy rate. In fact the governance role in monitoring and overseeing the monetary policy function is one that a board should play in relation to all central bank activity.

It's worth mentioning here the tendency in many central banks to emphasise technical qualifications, particularly in relation to monetary policy. Inevitably that leads to situations where boards are highly qualified and likely to be over-involved in relation to some functions, but inadequate and uninterested in relation to others. That is one of the key respects in which central banks need to review, and in many cases reconfigure, their governance arrangements.

CB: So what pointers do you have on how boards should monitor and oversee the work of the central bank?

JM: Some central banks have governance arrangements that facilitate such monitoring and oversight, others do not. In a central bank where directors are responsible for portfolios of departments, an obvious conflict arises when the board reviews the performance of those departments. Typically a tacit agreement arises – 'you stay off my turf and I'll stay off yours' – and the group becomes ineffectual. Governance bodies that combine the roles of board member and top manager need to recognise that 'multiple hats' problem and then develop governance processes to mitigate it.

Board members obviously need to meet basic standards of competence and probity, and not have major and ongoing conflicts of interest. Typically those principles are captured in central bank law. But beyond that, it is vital to emphasise that a board should be viewed primarily as a panel of experience, not a panel of expertise.

Qualifications for board membership are tangible. Yet board culture is not. There is growing evidence that how a board operates, as a collective, may be even more important than who is on it. Here we enter the realms of psychology and style, where effectiveness may not correlate closely with formal suitability for membership.

Substance is what counts, not form. I have worked with boards that tick all the boxes on paper, but not in practice. And with the reverse.

Board members need to understand the key issues and decisions in all areas of the central bank, and not merely be expert in one of them. Individual capability and experience needs to be considered, but because the board is a collective body its collective capability and experience is what matters most.

CB: What can a governing board do to ensure that they have a role in creating and maintaining the values associated with an institution?

JM: I was workshopping with an international group of central bankers recently, and asked them to rank seven management issues typical of central banks. One working group came back having ranked only two: governance and organisational culture. They explained that if those issues are resolved, then the rest, such as human resource management, will readily follow. That's hard to argue with!

In improving management and performance, governance certainly belongs at the top of the list. Without governance, efforts to improve, either from the bottom up or from a single function such as human resources, inevitably make limited progress. And any progress such efforts do make is visible more on paper than in reality.

Values are an expression of organisational culture. They are the answer to the question 'What really matters around here?' The first thing that a board can do to create and maintain values is to ensure that the formal elements of organisational culture are understood and documented. Strategic plans need to recognise and, if necessary, aim to reshape organisational culture. Codes of conduct and other formal practices need to be in place.

But perhaps more importantly, a board should recognise that it must lead by example. That concept is usually recognised in relation to integrity, but it applies much more widely than that. If board members feud, then that will undermine cooperation throughout the organisation. A board overloaded by voluminous paperwork and petty decisions will encourage managers at all levels to be similarly afflicted. Conversely, a board that demands succinct presentations and papers, developed jointly by the departments involved, sends powerful signals about the behaviour it expects from managers and staff.

Values are tested most fiercely when things go wrong. How a board deals with serious departures from the proclaimed institutional values, among its own members or central bank staff, is likely to become a moment of truth with strong and lasting consequences for the institution.

John Mendzela has more than 20 years of experience in central bank governance and management as a consultant, adviser and

facilitator. His expertise draws on work with a diverse range of central banks in developed, developing and transition economies. Outside of central banks, John's experience includes company chairmanship and directorship, and professional consulting worldwide in business, governance and management. Further information on his work, and his publications on central bank governance and management, are available at www.mendhurst.com/central-banking.html.

Readers' comments are welcome and can be sent directly to john.mendzela@mendhurst.com

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