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Lessons from the crisis for central bank management

Central banks and regulators have failed, argues John Mendzela. Here are seven lessons to help management improve performance and promote cultural change.

The past 18 months have been strenuous for central bankers. Attention has focused on policy and operational responses to the major disruptions in financial markets and the wider global economy. It is a time for action – short-term fire-fighting.

But it is also a time to think about why the fires happened in the first place, and what we can do to promote longer-term fire prevention. Central banks and regulatory agencies are institutions, so their governance and management frameworks should transcend the strengths and weaknesses of particular individuals. This article considers seven lessons from the current crisis that should aid our thinking in developing an agenda for how better governance and management can help improve fire prevention in future.

Lesson 1: central banks and regulatory agencies failed, and badly. Over the past 30 years, a "grand bargain" between central banks and their stakeholders has progressively become institutionalised. Agreeing that political incentives made them poor managers of monetary policy, governments gave central banks a high degree of autonomy for setting and achieving policy goals. In most cases central banks also retained direct responsibility for regulating, monitoring and overseeing the financial system, particularly banks. Even where direct supervisory responsibility lay wholly or partially with other agencies, central banks retained a fundamental role.

"Yes we know that", most central bankers would respond. "That is why central banks increasingly define their objectives as two-fold: price stability and financial stability. We are responsible for doing those things. Of course we should be held accountable for doing them well. And, yes, things have gone badly wrong, but..."

Then the technical explanations begin: about inflationary influences, globalisation of financial markets, regulatory frameworks, contagion from other

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jurisdictions and all the rest. Those explanations are not wrong, in that technical context. But technical explanations all too readily become a reluctance to accept the simple – and emotionally challenging – lesson stated above.

To quote from the G20 declaration of 16 November 2008: "Policymakers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions." A crash was coming. Technically and collectively, the central banking industry knew that. But it did nothing effective to prevent the crash.

Technical spin can be applied to particular issues. Many central banks can argue, with some justification, that their geographical or regulatory mandate was limited. But the technical explanations do not really stand up to scrutiny – a key feature of the grand bargain is that central bankers are the experts. The command authority and will be listened to – this is why they have a wider scope for action.

The central bank industry, therefore, failed to deliver its side of the grand bargain. So what really went wrong? The word "crash" evokes a useful analogy. Statistics on air crashes, systematically compiled over many decades, tell a consistent tale. Human error causes the majority of crashes, and so offers the greatest potential for crash prevention. Yes, improving instrumentation – or in the case of central banks, the technical features of the policy and regulatory framework – is worthwhile. But the responses and interactions of people are more vital.

Response 1: look beyond technical issues, and work hard on the institutional and "people" issues, such as governance, management and (most important of all) organisational culture.

Lesson 2: central banking is increasingly a global activity, not a national one. The fact that a global economy requires globally oriented policy and regulation needs little explanation. A strong response is already evident as countries and institutions promise decisive collective action. That will not be easy. Central banks cannot run too far ahead of their stakeholders when adopting supranational, not national, perspectives.

A more subtle effect also operates, in which the inertia of individual institutions often hinders better collective activity. This is easily recognised (though not so easily managed) when that inertia takes the form of vested interests. Mental inertia is harder to combat. In a well-known thinking experiment, individuals are given polygons of varying shapes and sizes in an unpredictable sequence, and told to make the largest possible rectangle at each stage. Most people fail early on, when one new shape demands the disassembling of an existing rectangle first – a graphic failure to "think outside the box."

Response 2: challenge institutional inertia. Respect the past and present when seeking future solutions, but demand real progress, not poor compromises.

Lesson 3: governance perspectives need to be simple and profound. As someone working practically on governance and management across many organisations and cultures, I apply a few guiding principles that

transcend differences between institutions. One principle concerns a key difference between governance and management. It suggests that people go through three stages of understanding as they grapple with issues or problems:

- the “simple and superficial” stage, in which they develop hasty and incomplete responses;
- the “complicated and profound” stage, in which they develop responses that are technically thorough, but often confusing and sometimes unworldly;
- the “simple and profound” stage, in which the responses from the second stage are distilled to identify, explain and act on what really matters.

In an organisation that has a technical role and does intricate things, the complicated and profound approach readily becomes dominant. That is fine for the technicians, but far from optimal for senior management and downright dangerous at the governance table. To keep the discussion simple and profound, governance need to consciously step back from the technical detail. That is not easy when individuals have both governance and management roles or come from the same technical and institutional background as the people reporting to them. Yet both of those characteristics are common, almost typical, in central bank governance.

Too much analytical data can create paralysis by analysis. Simple pictures and stories can help spur action. Reframing the discussion to avoid euphemisms and jargon can sharpen key messages. Because understanding and decisions have important intuitive elements, governance reporting should not be limited to analytical data. More generally, governance bodies need to focus their limited time and attention on what really matters. It is common to see central bank boards struggling with lengthy agendas of detailed matters that have been “delegated upwards” and could instead be dealt with through other processes.

Response 3: keep the content of governance discussions focused on major matters, and make the style simple and profound. Insist on short papers and non-technical recommendations. Take time to reflect on the likely outcomes of inaction.

Lesson 4: regulation can only succeed with bolder, more streetwise regulators. To successfully deter poachers, gamekeepers must know how those poachers think and feel. But the structures, processes, skills and culture of regulatory agencies often ignore that simple wisdom. Many years ago I was advising a central bank during its budget review. It puzzled me to see little budgeted for travel by financial supervisors, even though the major banks had their headquarters in a different city.

The deputy governor explained that supervisors had little need to travel, since the banks sent extensive reports to the central bank for analysis. But surely, I persisted, supervisors should visit, walk around, talk to executives and generally “smell” the atmosphere? Would that not help them understand the culture and perhaps identify issues not obvious from formal reports? “Ah, I see what you mean,” he said. “But it would be a waste of money sending the people working in supervision here – they wouldn’t smell anything anyway.”

I have seen the same fundamental gap – gamekeepers who just do not know how poachers think and feel – take many different forms in central banks. For example, it is common in regulatory agencies to see uncompetitive remuneration structures and unrealistic recruitment requirements, combined with organisational and managerial practices that discourage initiative. Savvy, ambitious staff will not stay there. Skills are one problem; culture is often another. People who have avoided risk in their choice of career will struggle to understand the risk management culture in commercial institutions. And when trouble is building, a bureaucratic regulatory culture with a bias towards inaction will almost certainly react too little and too late.

This skill and culture mismatch has no easy fix. Too much intrusive prescription would have high costs, and probably be ineffective anyway. But something needs to change. It is not reasonable to demand too much from players by way of self-regulation – business is about taking risks, reaping rewards for success and paying a price for getting it wrong. It is administrators and referees who must get the mix of rules and action right, and keep the game flowing.

Response 4: recognise the fundamental skill and culture mismatch in financial regulation, and plan realistic measures to tackle it. Begin by recruiting good staff released by commercial organisations in the downturn.

Lesson 5: unbalanced, unduly technical or drifting strategic performance measurement is dangerous. Twenty years ago, few central banks had a strategic plan. Today, few are without one. Undoubtedly, more conscious strategic management is beneficial. But measuring strategic performance is a subtle craft. It is wiser to be pragmatic and evolutionary than to demand too much from the measurements, too soon.

Some central banks have adopted methodologies that aim for too much precision at the strategic level. What is easily measurable may be incomplete or inappropriate. Even genuinely strategic measurements may need careful interpretation. For example, one could argue that enthusiasm in financial markets for a central bank governor is a danger signal; "grudging respect and trust" might be a better target.

The measurement of price stability is a centrepiece of modern central banking. The simplicity and visibility of inflation targets has delivered many benefits. But the technical efforts central banks increasingly made to define "underlying inflation" or "core inflation" may have damaged their credibility – many educated people now question inflation data. Most fundamentally, defining inflation solely and quantitatively in terms of consumer prices now looks like unbalanced measurement.

Drifting or denied measures are even more dangerous. Some commentators believe that central bankers unconsciously developed a mindset in which "preventing recession" became a policy goal, and acted in ways that encouraged complacency and increased the risk of a major crash.

Response 5: measure and improve operational performance, but proceed cautiously in the definition and measurement of strategic performance.

Lesson 6: central banks need to retain and grow a diverse capability base. One key trend in modern central banking has been a focus

on core functions. Within that trend, monetary policy has often become the core function. A common side effect has been an increasing cultural and managerial dominance of economists, particularly monetary economists.

Central banks tend to be institutionally inbred anyway, so narrowing their capability base further is risky. As recent events have demonstrated, other central banking functions have their moments too. In crisis situations, a diverse capability becomes more important. It can be handy to have, in-house, current expertise in banking, accountancy, or even international trade credit. And people who have worked in commercial businesses can usefully contribute to policy and technical decisions.

A worldly, rather than technical, culture is important too. Well before the credit crunch, I set a group of senior central bankers a simplistic workshop exercise – credit markets had got badly stuck, resulting in poor liquidity and overpriced interbank lending. Their challenge, set by the hypothetical board of the central bank, was to solve the problem. Instead the group produced a lengthy technocratic explanation of why such a situation could never arise.

Again, there is no easy fix. Central banks should focus on core functions, and resource for efficiency. But they can still do much to broaden their capability base. External inputs at level of the board can be one vital input. More generally, central banks can become attractive medium-term employers for a broad range of staff. A growing number of central banks have engaged senior business professionals to manage their non-core and internal support functions. They obtain direct benefits, diversify institutional knowledge and encourage a more worldly culture.

Response 6: plan institutional capability to balance specialised technical excellence and broader external experience.

Lesson 7: efforts to modernise institutional governance and management in central banking have so far achieved too little.
The lessons above share common themes. To generalise across those themes and the industry, one could characterise central banks as conservative and technocratic institutions, who are relative latecomers to modern governance and management.

To quote from the G20 declaration again: "we must lay the foundation for reform to help to ensure that a global crisis, such as this one, does not happen again." Those words apply internally, not just externally. Many features of the traditional institutional model applied by central banks – for example lifetime careers for all, low interest in organisational efficiency and limited disclosure – simply will not work anymore.

Fortunately many other features – such as analytical rigour, a culture of integrity, and international orientation – remain vital. Central banks need to "adapt not adopt" in order to customise new governance and management practices to their unique needs. That work is underway, and some institutions have made impressive progress. But to deliver on grand bargain of modern central banking – characterised by independence and accountability – internal reform needs to spread and speed up.

Response 7: make recent trauma a catalyst to improve capability and culture in individual institutions and across the central banking industry. ❑