Transparency International Anti-Corruption Helpdesk Answer

Central bank governance and the prevention and detection of corruption

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Well-functioning and efficient financial markets rely on confidence in private financial institutions and the central banks which interact with them. Corruption within a central bank (due to poor internal management, pressure from the government, or from the private sector), can harm the reputation of a central bank and impede its ability to function effectively.

This answer addresses the nature of the corruption risks which face central banks, as well as measures that may be taken to curb the likelihood of corruption and detect misconduct when it occurs. While there is a significant body of literature regarding central bank independence in relation to effective monetary policy, there is a more limited range of resources that address institutional design and practices with direct emphasis on corruption. Providing standardised policy prescriptions is challenging, given the variation between countries in how central banks are organised, and the scope of each bank's mandate. Notwithstanding this, many of the corruption risks central banks face are analogous to those faced by other public and private institutions, and reflect common concerns in the areas of risk-management and good governance. Furthermore, some of the historical debates around central bank independence, transparency and accountability, in the context of economic issues, are also relevant to topics in corruption prevention and detection in central banks.

The discussion below examines sources from the more general literature regarding risk-management, governance, capture and corruption. It also relies on central bank-specific materials providing insights into current standards for central bank independence, transparency and accountability, including two reports by the Bank of International Settlements (BIS) on Issues in the Governance of Central Banks (BIS 2009; BIS 2011) and a recent IMF Working Paper on Safeguards Assessments of Central Banks (IMF Working Papers, Chamoun et al. 2018).

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Query

What is the role of national central banks in preventing and countering corruption? In particular, we are interested in understanding good practices with regards to central bank governance and operations with a view to preventing and/or detecting corruption. We would appreciate an analysis of issues around: i) mandate, decision-making structure and the autonomy of central banks; ii) transparency and accountability frameworks; and iii) the internal control environment.

Contents

Main points

— Public trust in the integrity of central banks is critical to their effectiveness; corruption scandals undermine public trust.

— Central banks may face corruption risks from political institutions/government, industry and sources internal to the bank.

— Institutional and operational independence can serve as a bulwark against corruption and undue influence.

— Accountability mechanisms (including transparency, internal controls and external audits) can help central banks deter and detect corruption.

Corruption risks in central banks

Central banks occupy a key role in modern economies, and public trust is a critical component of central bank effectiveness. The expanded mandate of many central banks, beyond monetary policy, of ensuring broader financial stability, has triggered renewed debate about appropriate levels of central bank autonomy and accountability. The regulation and supervision of private financial institutions, especially, has introduced additional considerations around improper influence on central banks and accountability mechanisms. Anti-corruption measures in central banks must consequently address political, industry-related and internal sources of risk which can impede their performance and threaten public trust.

Central banks and anti-money laundering supervision

Certain jurisdictions have given their central banks responsibility or joint-responsibility for overseeing domestic financial institutions' compliance with local anti-money laundering (AML) laws. This places central banks in a powerful position to play a positive role in curbing corrupt activity within their market and globally. Effective enforcement of AML laws in one country closes that jurisdiction off as a haven for reintroducing the proceeds of crimes into the legitimate financial system.

Whether or not AML supervision falls within the mandate of a central bank, the persistent failure of a government to curb money laundering can have ramifications for the policy goal of financial stability, which nowadays is often within the remit of central banks. Illicit cross-border transactions can expose domestic private banks to heavy penalties from home and foreign enforcement agencies, as well as to significant damage to their domestic and international reputation. This can, in some cases, risk bank failure, which can in turn generate systemic risk. Remarking on the money laundering scandal at Danske Bank in 2018, the Danish Systemic Risk Council noted that, "[a]s Denmark's largest credit institution, Danske Bank is important to the Danish financial sector. The Danish financial system is highly affected by developments and risk perception in international markets. That is why the Danske Bank money laundering case poses a risk to the entire sector and to Denmark's international reputation." (Danish Systemic Risk Council 2018)

Risk of political capture

The degree of central bank independence from government is part of an ongoing debate around the best means to effect macro- and microprudential regulation, while holding public institutions accountable for the impact of their policies (Balls, Howat & Stansbury 2016). This Helpdesk Answer, however, examines questions about central bank autonomy and accountability from the perspective of the risk of corrupt conduct, that means actions that rise to the level of an abuse of entrusted power for private gain. Notably, though, corruption in central banks can lead not only to instances of direct financial loss but also to policy distortions, thereby undermining public trust and the overall effectiveness of a central bank (Lambsdorff & Schinke 2002).

The risk of corrupt political influence on central banks can take at least two forms. In its least subtle form, a member of the executive or legislature may misappropriate funds from the central bank for private benefit (for example, for purposes of funding an election campaign). Less direct improper political influence may take the form of pressuring a central bank, against its better judgement, to take certain policy related actions for short-term political gains. In the latter scenario, policy distortions are a direct consequence of corrupt political influence, and in both scenarios public trust can be damaged.

Like any public institution, where there is a very high degree of sustained (undue) political influence, and the institution acts or is seen to act for the benefit of one narrow set of interests rather than in the public interest, the central bank may be understood to be captured (OECD 2017), and its ability to carry out its core functions would be significantly compromised.

Risk of industry capture

There are three primary categories of corruption risk emanating from the engagement between central banks and private financial institutions: i) insider trading between central bank officials and employees of financial institutions (through, for example, one-off opportunities to gain from confidential information); ii) attempts by private sector participants to influence monetary policy in their favour (Carré & Gauvin 2018); and iii) attempts by private sector participants to influence the formulation or application of regulations.

In each case, the conduct may be initiated by a private sector participant or by a central bank official (for example, where an official solicits a bribe in exchange for lenient treatment of a private bank undergoing an anti-money laundering examination). The scope for corrupt activity in the case of the third category has arguably increased since 2008, as central banks have been given additional responsibilities over aspects of bank regulation and supervision (for a discussion of these expanded responsibilities generally, and their impact on governance and independence see BIS 2011 and Balls, Howat & Stansbury 2016).

Engagement with powerful private financial institutions is part of a central bank's mandate, especially when performing its supervisory function (BIS 2015), and some influence is likely, if not desirable, for proper, informed microprudential regulation. However, as with political influence, private sector power should not be permitted to capture central bank supervisory activities or policymaking.

Where a central bank's regulatory and oversight function is impaired by corrupt engagement with the private sector, not only is the regulatory purpose frustrated, but the central bank can appear to be ineffective and, once misconduct is ultimately uncovered, the integrity of the institution is further diminished. In this way, corruption can have an amplified effect on central bank credibility.

Standards and good practices for mitigating corruption risks

Independence: institutional and operational design

Undue private and political influence can be curbed where a central bank enjoys institutional independence and operational autonomy in terms of how it decides to achieve its mandate (the corresponding need for central bank transparency and accountability are discussed further below).

Formal, institutional, independence from the other parts of government is generally achieved pursuant to legal guarantees in the constitutive document of the central bank and subsequent legislation. Key contributors to a central bank's autonomy in this respect are budgetary independence, balanced appointment procedures for central bank officials, security of tenure and a clear allocation of authority to the bank for decision making on matters within the bank's mandate (BIS 2009).

Ad for budgeting and operating costs, central banks tend to be self-financing. They derive revenue from lending and other financial services they provide in the market, which often removes them from typical appropriations procedures which could be used as a source of political pressure. They must, nonetheless, budget stringently and account for their revenues and use of financial resources. Good practice requires central banks to subject themselves to independent, external audits, to, among other things, limit internal risks of fraud and embezzlement. Some (though few) jurisdictions provide for parliamentary or ministerial veto or amendment of the central bank's budget (BIS 2009).

Shielding the appointment and dismissal of senior bank officials from improper political influence is also important to maintaining independence. While a member of the government executive branch is usually responsible for selecting a bank governor, the candidate must often also be approved by a second body, such as the national legislature. An additional protection, in some jurisdictions, is that the governor serves for a term that exceeds a single political election cycle. For example, governors of the US Federal Reserve serve non-renewable terms of 14 years, and heads of eurozone central banks serve for non-renewable eight year terms (Balls, Howat & Stansbury 2016). The most common term of office is five years, which is renewable (BIS 2009). BIS notes that staggering board members' terms of office is also widely practiced, contributing to insulation from political influence as well as continuity in leadership (BIS 2009).

To provide security of tenure, the grounds for dismissal of a senior central bank official should be spelled out in legislation and for the limited reasons of gross negligence, criminal misconduct or unethical behaviour by the official (BIS 2009). However, some jurisdictions allow for removal for failure to achieve policy goals – though this is atypical (BIS 2009). Clear, statutory conditions for dismissal as well as the opportunity for judicial review can be helpful in ensuring that removal only occurs when merited and not for ulterior purposes. The European Court of Justice affirmed in a recent case that removing the governor of the Latvian central bank without providing sufficient indications of serious misconduct amounted to a violation of central bank independence (European Central Bank v Republic of Latvia 2019).

Care should also be taken to insulate the remuneration package of senior central bank officials from political pressure. In many central banks this is achieved by having the most senior salaries set by an external supervisory board (BIS 2009).

Private sector capture is another relevant consideration in senior central bank appointments. Technically qualified candidates who have knowledge and insight into financial markets are desirable, though an official with heavy personal interests in the banking sector can create risks of bias, or the perception of bias, in interactions with supervised financial institutions. The possibility of conflicts of interests, or perceived conflicts of interest, can be addressed using thorough interest disclosures (discussed in connection with codes of conduct below), collective decision making, and recusal processes (OECD 2017 and BOE 2017). In addition, central banks can limit the risk of private capture by using "cooling off" periods: time limits on how soon a senior official may be employed by a regulated private institution following the end of service in the private sector. Cooling off is used by many central banks (Frisell, Rosbach & Spagnolo 2009), including eurozone central banks (Single Code of Conduct, Article 17 2019) and the US Federal Reserve (Federal Reserve Act, Section 10).

Where a central bank's mandate requires examination of private financial institutions for AML compliance or other legal requirements, controls can also be used to limit the risk of private capture. These include taking steps to: ensure the central bank is not dependent on subscriptions or funding from the financial institutions it regulates, stay apprised of examiners' potential conflicts of interest (including frequent updates of interest disclosures), rotate examiners between private banks every few years, have a separate review of examination findings by a different set of staff than those responsible for carrying out the examination, and keep copies of draft supervisory letters and correspondence (including recordings of discussions with bankers) (US Government Accountability Office 2019).

The purpose of establishing a fairly high degree of institutional independence is to facilitate autonomy in decision making and in the operation of the central bank (historically independence has been shown to correlate with bank's achieving their monetary policy objectives).

As previously noted, following the global recession in 2008, many central banks' mandates have expanded to include promoting financial stability. The relationship between central bank independence and this particular mandate (financial stability) is not yet settled. The degree of optimal independence may be affected by factors such as whether a country's economy is advanced or emerging as well as its degree of political stability (Balls, Howat & Stansbury 2016).

This broader mandate requires higher levels of engagement and coordination by the central bank with other parts of government and with the private sector (Balls, Howat & Stansbury 2016). As such, even as the role of independence under these new mandates is explored, regard should be given to the increased potential for undue influence and the risk of corrupt interactions both with the government and private sector.

Accountability and transparency

Transparency and accountability operate as checks and balances on the significant independence and corresponding power which central banks typically enjoy. Given the degree of their autonomy, their considerable resources and their engagement in financial markets, ensuring that central banks are accountable for their actions is relevant for reducing the risk of corruption and for detecting and punishing instances of corrupt conduct.

Formal lines of accountability of central banks to legislatures, ministers or supervisory boards (or a combination thereof) are typically laid out in the legislation governing a national central bank (BIS 2009), and, as discussed above, dismissal for misconduct is one strong mechanism of accountability. Direct accountability to the public is also generally available through court processes (including judicial review of a central bank's supervisory activities), though jurisdictions may provide central banks with some level of statutory immunity from civil suits, for example, limiting cases to claims of bad faith or dishonest conduct (BIS 2009; IMF Working Paper, Khan 2018). Individuals and entities who are affected and aggrieved by the actions of a central bank, or central bank official, may also seek redress by lodging a complaint with an ombudsman, where provided for under domestic law or policy (for example, through the complaints scheme in the UK Financial Services Act 2012). Notably, few central banks indemnify their officials from liability (IMF Working Paper, Khan 2018).

Transparency often facilitates the accountability of central banks. To detect and address wrongdoing, authorities within and outside the bank need to be aware of, or have access to, information about the central bank's activities. Naturally, this is true not

only for instances of misconduct but also for accountability for policy and performance failures. For this reason, many central banks already have reporting frameworks for communicating and justifying their policies and actions to the government, financial market participants and the general public.
Central bank communications can take the form of public statements, testimony before legislators, quarterly and annual release of reports and audits, as well as the release of the minutes of board of governor meetings. In addition, government officials may be entitled to attend and monitor certain central bank meetings (though they are rarely permitted to vote at them) (BIS 2009).

To facilitate accountability directly to the public, central banks may also be subject to the national freedom of information (FOI) laws, though generally with some limitations (BIS 2009). Exemptions vary by country but may include: i) confidential information relating to financial institutions regulated or examined by the central bank (for example, in the US, UK, Australia and Ireland, information with commercial value that would be destroyed by disclosure may be exempt) (FOI, Central Bank of Ireland; FOIA, US Federal Reserve; FOI, Bank of England; FOI, Reserve Bank of Australia); ii) information that is reasonably expected to interfere with enforcement proceedings (FOIA, US Federal Reserve); and iii) actions taken with respect to financial institutions for stability reasons (FOI, Bank of England).

Where a central bank has supervisory responsibility, accountability for that function can be facilitated via disclosure to the public of information related specifically to supervisory activities. The Basel Committee on Banking Supervision has identified the following categories of information for public disclosure in periodic reports: "the number of authorizations approved, examinations conducted, enforcement actions taken, and details of supervisory actions initiated during the year" (BIS 2015).

Some central banks go further and publish information reflecting their own supervisory performance measured against pre-determined goals (BIS 2015). Accountability and effectiveness of the supervisory function can also be aided through requirements for coordination, cooperation and information exchanges, both domestically and across borders (in each case, with appropriate regard for confidentiality requirements and independence). This allows for gaps in supervisory knowledge and approach to be identified and addressed, and lax regulation can be improved.

In the context of AML in particular, the Financial Action Task Force (FATF) recommends higher levels of engagement at the domestic and cross-border levels between supervisors, policymakers, financial intelligence units and law enforcement to improve enforcement generally and better address the international nature of many money laundering schemes (FATF Recommendations 2 & 36-40 2012-2018).

The scope and quality of information provided by central banks, together with specialist analysis thereof, is an important factor in risk-management efforts, including the ability to detect corruption. Good practices for financial reporting include: the use of internationally recognised standards for accounting, engagement of an independent external auditor selected via an audit committee and rotation of external auditors to prevent entrenchment (IMF Safeguards Assessments of Central Banks 2017).

In addition to outward facing transparency and accountability, audit committees, internal audit functions and internal controls are a means for central banks to keep their own house in order, limiting the risk of corrupt activity occurring and increasing the prospects of detection.

Central banks should have in place a system of internal controls which includes, but is not limited to, financial controls. Internal controls should be tailored for the bank's structure and objectives and should be assessed periodically and updated as needed. Consistent with governance principles for private and other public institutions, internal controls should provide measures to report and address suspicious activity that may be evidence of corruption.

Central banks may benchmark their internal controls against widely accepted financial industry standards (BIS 2009; Liikanen 2017). For example, the US Federal Reserve requires that each of the state reserve banks adhere to an internal control framework established by the Committee of Sponsoring Organizations of the

Treadway Commission (US Federal Reserve Annual Report 2017), while the Bank of England voluntarily complies with an adapted version of the senior managers regime framework, with respect to lines of accountability (Bank of England Annual Report & Accounts 2017–18).
Internal audits should provide senior central bank staff with an assessment of the effectiveness of the institution's risk-management (including corruption risks), internal control and governance mechanisms (IMF Working Papers, Chamoun et al. 2018). The internal audit function should have a high degree of independence from the central bank's management, should have clearly defined duties and should have direct access to senior bank officials (the board of governors and audit committee), as well as open access to bank records and personnel (IMF Working Papers, Chamoun et al. 2018).

Based on a study of 64 central banks over a seven-year period, the IMF identified capacity constraints on internal audits as a significant limitation on their effectiveness in central banks. These constraints included a lack of specialist expertise, training, seniority and number of staff (IMF Working Papers, Chamoun et al. 2018). The IMF noted that the internal audit function of a central bank should comply with international standards, and refers to the International Standards for the Professional Practice of Internal Auditing (promulgated by the Institute of Internal Auditors), as the primary benchmark in this respect (IMF Working Papers, Chamoun et al. 2018).

In the context of central bank audit committees, the IMF observed that, in many banks, audit committee oversight was hampered by a lack of expertise and inadequate composition (senior staff at the bank often served as members of the audit committee and so had inherent conflicts of interest) (IMF Working Papers, Chamoun et al. 2018).

Organisational and industry culture (understood as attitudes and practices) towards misconduct is increasingly highlighted as a relevant factor in financial market risk assessments, one that central banks should be attuned to in performing their supervisory function (Chaly et al. 2017). It is important here that the supervisory institution itself be beyond reproach and set the tone for the market which it regulates. Establishing and enforcing a code of conduct is one method of articulating for employees and the public an institution's standards of ethical conduct.

On 1 January 2019 the European Central Bank's Code of Conduct for High-Level ECB Officials (Single Code of Conduct, 2019) came into effect. The code applies to each of the 19 governors of the eurozone national central banks and, among other things, requires that governors declare their (and their partner's) interests with respect to "previous occupational activity, private activities, official mandates and financial interests". These declarations are made public via the ECB website (Article 10). The code also sets value limits (€100) on any gift, hospitality or benefit given to a central bank governor in connection with her duties (Article 13).

The relationship between mandate, independence and accountability

A continuation of the trend towards greater central bank transparency is not guaranteed in the context of central banks' new responsibilities involving broader financial stability. While central bank effectiveness generally favours transparency for accountability and managing market expectations, the benefits of transparency are not clear-cut with respect to financial stability, especially in crisis scenarios. BIS notes that, "[f]or financial stability related activities of the central bank, legal requirements or formal commitments to extensive disclosure have been rare compared to monetary policymaking…[t]he decision to publicize a given financial stability action may trigger a destabilizing market reaction, making it necessary to delay disclosure" (BIS 2011).

It is possible, therefore, that tension could arise between a central bank's anti-corruption and accountability objectives and the need to address urgent systemic risk. Notably, BIS does not advocate for complete non-disclosure in matters involving financial stability but rather that timing for disclosure may need to be sensitive to the immediate circumstances surrounding the central bank's actions. BIS indicates that delaying disclosure may be more appropriate when the information affects a particular institution, but can be more immediate when the information is of a generalised nature (BIS 2011). Even where information is sensitive and full public disclosure is delayed, more immediate reports to closed sessions of select government committees can facilitate a measure of transparency and accountability (BIS 2009).

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