

Central Bank Financial Reporting Working Group

Central Banks: surviving the credit crunch

The Reform Club, London
15th and 16th June 2009

Conference report

Contents

Introduction	3
Overview	4
Comments from the chair	5
Conference report	
• Tightening up systemic safeguards	6
• Ensuring stimulus spending reaches its target	8
• Strengthening risk and resource management	9
• Splitting away market supervision	10
• The limits of supervision	11
• Implications for central bank capital management	12
• Shift from autonomy to collaboration	13
Annex – IMF accounting	14
PricewaterhouseCoopers professional services to Central Banks	15
Contacts	19

Introduction

The financial crisis continues to wreak havoc across the financial markets and economies of the world, forcing central banks to juggle the potentially conflicting demands of sustaining liquidity, restoring financial stability and managing the ever increasing risks on their rapidly expanding balance sheets. Even when the crisis eventually subsides, the role of central banks and the financial and political environment in which they operate will never be the same again.

Welcome to the report on the sixth annual gathering of the PwC/CBP Central Bank Financial Reporting Working Group, which was held at London's Reform Club in June 2009.

The meeting is an important feature of the central banking conference network. It provides a unique opportunity for invited central bankers from around the world to share experiences and debate the key issues of the day in an informal but thoughtful environment. At a time when financial supervisory reform is at the top of the global political agenda, the Reform Club was a fitting venue. The club's founders were the main architects of the Great Reform Act of 1832¹ and it has been a prominent setting for debate about both the theory and the practical implementation of progressive developments in public policy ever since.

The meeting was sponsored by PricewaterhouseCoopers LLP² (PwC) and organised by Central Banking Publications (CBP). The co-chairmen were Jeremy Foster, Partner in charge of the PwC Central Banking Group and Kenneth Sullivan of the International Monetary Fund. The meeting was held under the 'Chatham House' rule of non-attribution to allow for full and free discussion.

The conference took place amid what for most participants are the greatest challenges of their careers. Although the global banking system has been pulled back from the brink, central bankers are being required to juggle the huge and potentially conflicting demands of sustaining liquidity, restoring financial stability and managing the risks on their rapidly expanding balance sheets. These challenges will shape their strategy and operating environment for many years to come.

Central bankers have also been cast into the media and political spotlight as they work with governments and financial regulators to formulate the reforms needed to prevent a repeat of the current crisis. These parties do not always see eye to eye, as was demonstrated in June 2009 when Mervyn King, Governor of the Bank of England, called for tougher powers than the UK government had currently proposed 'to prevent the size, leverage, fragility

and risk of the financial system becoming too great'. Likening his position to a clergyman of an independently minded and less than pious congregation, Mr King doubted whether he and his bank could discharge their new statutory responsibilities if all they can do is issue sermons that the parishioners can choose to ignore³. The public disagreement with the UK Chancellor/Treasury highlighted some of the wider issues discussed at the conference, including what new powers and structures central banks need to avert the risk of systemic collapse; how responsibilities should be divided between them and financial supervisors and whether international bodies should have a stronger role in macro-prudential management.

The economic dislocation and unprecedented debt that formed the backdrop to this conference, the cost and consequences of which will be met by participants' children and grandchildren, are the critical policy issues of the age. The current debates over policy and reform within central banking will therefore be critical to the lives and livelihoods of generations to come.

This summary paper is designed to provide a record of the issues debated, and a platform for ongoing discussions among the participants. The paper is set out under the following main topical areas, which are analysed in more detail in the main part of the report.

¹ By giving the vote to around a fifth of the population, the Act is seen as the first step towards universal suffrage in the UK and a major step towards greater democracy.

² "PricewaterhouseCoopers" refers to PricewaterhouseCoopers LLP (a limited liability partnership in the United Kingdom) or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate and independent legal entity.

³ Financial Times report on the Mansion House speeches 2009, 17.06.09

Overview

Tightening up systemic safeguards: Insufficient preparation and co-ordination led in some cases to confusion and delays in the response to the financial crisis. This highlights the need for clear central bank objectives in relation to financial stability and an agreed framework for working with supervisors and governments to manage systemic risk and responses to market crises.

Ensuring stimulus spending reaches its target: The aim of boosting available credit through stimulus programmes has run into conflict with the need to strengthen bank capitalisation, with banks using some of the state aid to shore up their balance sheets rather than increase lending. Central bank purchases of non-bank debt could provide a more direct and effective way to inject liquidity into the economy.

Strengthening risk and resource management: The underwriting of bank liabilities and acquisition of assets, many of them distressed, are inflating central bank balance sheets and exposing central banks to previously inconceivable levels of credit, market and counterparty risks. The range and level of risk is beyond what was originally envisaged in an independent central bank. Central banks may therefore need outside help to tackle the weight and complexity of valuation and transaction management. They may also need to take a more strategic approach to financial disclosure in the face of intense market and media scrutiny.

Splitting away market supervision may need to be rethought: Several participants argued that poor communication and co-ordination between central banks and financial supervisors allowed serious systemic problems to fall between the cracks. While all participants accepted the need for greater supervisory collaboration, some went further by insisting that now is the time to bring monetary policy and bank supervision back under one roof.

The limits of supervision: Banking business cuts across borders and therefore an equivalent set of international regulators may be required to oversee it. Others believe that without the fiscal and political authority of a sovereign government to underpin supra-national regulation, any such move can only blur responsibility and accountability.

The benefits of own capital may be limited: Holding its own capital can enable a central bank to act independently from government. However, it would be unrealistic and uneconomic to expect a central bank to hold the level of

capital needed to deal with the recent turmoil seen in many markets. Many central banks may therefore need to re-think their approach to capital management and sharing risk with the government.

Shift from autonomy to collaboration creates cultural challenges: A more prominent role in promoting financial stability could require a cultural shift for central banks, many of whom have become accustomed to the independence of setting interest rates and controlling inflation. The scope of resources required to address a crisis means financial stability decision-making procedures will have to incorporate lenders and government policymakers. This in turn creates the need for a review and possible changes in the approach to transparency, accountability and governance.

Jeremy Foster
Partner in Charge
Central Bank Advisory Group
PricewaterhouseCoopers (UK)

Comments from the chair

The Reform Club discussions provide the opportunity for members of a wide cross section of central banks to meet and discuss common issues. For 2009, coping with the financial crisis provided the obvious theme and the discussions explored how the crisis had affected each country, and the possible consequences for central banks.

The discussions revealed the wide diversity in different countries' experiences of the crisis. The extreme liquidity crisis that affected US and European markets was not universal, though no country has avoided its effects. For some, exchange rate volatility has stressed their financial sectors, others are facing a sharp credit quality based correction. All have seen material impacts on their balance sheets and have found their central banks under increased scrutiny and demands for accountability. The previous decade's evolution of models of central bank independence and separation of monetary policy and financial system stability mandates have been found wanting by the crisis and are now under challenge.

The variety of experiences represented brought richness to discussions and reflected the diversity of central bank configurations around the world. However, none seem exempt from the challenges to their policy frameworks and configurations. As the following summary highlights, the debate regarding the appropriate configuration of monetary policy and financial stability and the central bank's role in these functions will continue beyond the passing of this crisis to define their position to face the next.

Kenneth Sullivan
Chair

Tightening up systemic safeguards

How effective were the fiscal and regulatory tools used to avert disaster and how could they be augmented and improved? As the financial system plunged into crisis, central banks were at the forefront of an emergency response that was eventually able to avert the danger of absolute collapse. However, those cases where the response was slow and confused raise questions about the level of and importance attached to preparation and co-ordination.

Some of the confusion appears to have been caused by uncertainty over central bank roles and responsibilities. Citing research carried out by the Bank of International Settlements into the mandate of central banks around the world, a keynote speaker highlighted that less than a quarter of central banks had an explicit responsibility to promote financial stability in the lead up to the crisis. Even where this objective was formally in place it was often qualified (i.e. 'contribute to') or secondary (i.e. 'supporting tasks pursued by others')⁴. The lack of clarity over objectives often led to uncertainty about when and how to intervene. This was compounded by disagreements between governments, supervisory bodies and central banks about who was responsible for what and what were the right steps to take, which allowed danger signals to be ignored or go unheeded, and when the crisis began to avalanche led to lengthy debates and delays.

Participants agreed that timing is crucial, with several noting that if, at the time of a crisis, legislation is required to change the central bank remit and ability to respond then critical time will be lost. Several participants highlighted the need for an agreed framework to ensure that all parties involved know what they should be doing in advance of an emergency. The model for such a framework was likened to a business continuity plan. The clearly defined boundaries between authorities should include regular monitoring and evaluation of the progress and success of schemes.

The objectives for sustaining financial stability should be clearly labelled. Outlining why clear labelling is so important, the keynote speaker noted that even where financial stability is an explicit and primary objective for central banks, it is a far less clear cut concept than fixed inflation targets and other such monetary goals. In particular, what different parties mean by 'financial stability' may vary markedly. Central banks may therefore be at risk of creating false expectations about what they can and cannot do, especially if they do not have the appropriate powers to back this up. They may also be in danger of being blamed for problems not of their own making or issues they do not have the tools to resolve. However, while financial stability is difficult to define, the speaker argued that it is possible to tag what tools central banks

have at their disposal and, through this, go a long way towards providing a clearly understood delineation of their supervisory remit and powers of intervention. Calling on a military analogy, the speaker cited three types of force, a ceremonial guard, a people's militia and a professional standing army, the capabilities of which to deal with a particular situation are evident from the nature and extent of their weapons and training. Mr King's analogy of being forced to rely on sermons rather than enforceable powers would be apt in this respect.

Stronger rather than new tools are needed to manage systemic risks. It was noted that far more of the Financial Stability Forum's recommendations relate to financial supervisors than central banks. In keeping with this, participants generally felt that clearer and more enforceable measures rather than a whole host of new tools will be required to stave off future crises. A number of participants outlined ways that their particular countries had avoided the worst impact of the crisis, ranging from limiting the amount of credit underwritten to a blanket ban on any products or practices that are not fully and demonstrably understood by the parties involved.

Financial reforms should focus on oversight and prevention rather than waiting for abuses or breakdowns to become evident before allowing supervisory intervention. For example, issuing a banking licence is relatively easy, withdrawal is harder and therefore central banks or other supervisors need to be more careful about granting licences, noted a participant. In seeking to avoid a repeat of the current difficulties, most participants agreed that commercial banks' capital requirements should be increased when the economy is buoyant to counter the pro-cyclical effect of encouraging excessive lending and leverage in a boom, which could then leave institutions with insufficient capital and liquidity in a subsequent downturn. However, several warned that achieving this counter cyclical smoothing could create significant political and practical challenges as both banks and governments may be reluctant to rein in on an apparent free flow of income, growth and tax revenues in the good times. This was seen as underlining the importance of grasping the current opportunity to institute reform rather than waiting until an upturn when some of the critical lessons may have been conveniently forgotten. Quoting the words of Rahm

⁴ Based on analysis of whether 'financial stability' or equivalent is specified in the objectives of 146 central banks

Emanuel, White House Chief of Staff, a participant stressed: 'Don't waste a good crisis.'⁵

Monetary and financial stability cannot be managed in isolation. As part of the discussions on systemic risk and reform, several participants noted that monetary and financial stability are increasingly interdependent and therefore balancing their management is crucial for central banks. However, this may again create conflict with governments, some of whom may be tempted to inflate their way out of debt.

Information is the lifeblood of effective supervision. However, there was some debate about whether there is sufficient data at central banks' disposal to underpin financial stability management, especially in comparison to the wealth of readily available information used to help monitor and guide monetary policy. It is notable that some participants believe that the data for financial stability is actually available; the real problem is understanding the implications.

Openness is a double-edged sword. Many believe that one of the key lessons of the financial crisis is the need for greater transparency within the banking system. However, several participants questioned whether such openness is appropriate given the often sensitive nature of central bank intervention. A participant suggested bringing problems out into the open could discourage banks from seeking help until it is possibly too late as they are scared of the stigma. In general it is a bad idea to deal with a solvency problem in a hurry and therefore it is better to keep it out of the public eye and deal with it in the mid-term, said another. Echoing these sentiments, a participant noted that it is not the markets that have to be persuaded but customers, as was demonstrated by the queues to withdraw savings from Northern Rock. Supporters of transparency countered that problems will soon enough become public one way or another, especially given the heightened level of scrutiny of banks' health, and therefore the key issue is how to manage communication rather than avoid it. Several participants cited recent instances of intervention that demonstrated that it is possible to be both transparent and successful.

The financial crisis has been what a participant described as a 'hydra-headed monster', affecting different countries in many different ways. Several presentations highlighted the particular problems faced by central banks in smaller and emerging economies. A common difficulty was how to deal with a sharp decline in depositor confidence when so many bank accounts were held in foreign currency. Central banks were often unable to provide the injection of funds to help restore confidence as matching the denomination of the deposits could have dangerously depleted their foreign exchange reserves and risked destabilising their own currency.

Participants responsible for sovereign wealth and government pension funds reported significant absolute and relative losses as a result of the financial crisis. While risk management had always been an important focus, some 'hidden' risks had not been detected. Following the collapse of Lehmans, for example, it had been difficult to identify the right legal entity within that bank's complex international legal structure. This has led to a significant change in counterparty procedures. Within the sovereign wealth portfolio, some noted that there are now more restrictions on high risk investments and fewer external mandates to help curb leverage. The models for analysing credit and market risks have also been adjusted. The approach to reporting is now more transparent, with the relative return being disclosed and the causes of any losses being fully explained. All collateral holdings are also listed publicly.

The financial crisis has heightened exchange rate volatility within many countries. Several participants noted that reserves tend to be managed more conservatively, with an advisory board often setting benchmarks for investment type and currency distribution. Some noted the need to allocate capital to deter a run on the currency. Some had also looked to diversify their foreign exchange holdings beyond the concentration on Euro and US dollars. With further significant corrections in currency values possible, participants stressed the need to stick to long-term strategic objectives rather than being reactive and the associated requirement to manage expectations.

⁵ Quoted in a Wall Street Journal web cast, 21.11.08

Ensuring stimulus spending reaches its target

Have quantitative easing and other forms of stimulus been a success and are there alternative approaches?

Central banks are at the forefront of attempts to boost available credit and revive flagging economies, yet success has been patchy. More effective targeting of stimulus funding will be crucial.

As the credit crunch escalated, governments and central banks soon ran out of traditional remedies. With interest rates so low that no further cuts were possible, refinancing, credit guarantee and quantitative easing schemes were instituted to increase the availability of affordable credit. Charting the measures taken in their own countries, participants noted that some existing tools were extended, such as lengthening repo purchases. New measures were also introduced, such as outright asset purchase and dealing with non-bank entities.

Although the risk of deflation appears to have receded, credit and economic statistics are mixed, leading some commentators to argue that many of the stimulus programmes have been excessively expensive and poorly targeted. As was noted at the conference, any scheme designed to ease access to lending will naturally run into conflict with regulatory insistence that banks shore up their balance sheets. Several participants accepted that a significant proportion of the state aid had therefore gone to strengthen capital buffers rather than boost liquidity.

A keynote speaker argued that directing stimulus funding towards banks may be largely futile. He believes that buying debt from banks, which was the focus of initial quantitative easing in many countries, repeated mistakes made during the Japanese slump of the 1990s as its impact on lending is limited by the size of the maturing debt and the fact that capital constraints may still discourage banks from lending. He argued that it is more effective to buy debt from non-banks as this is unlimited in scope and injects liquidity directly into the productive economy. He believes that several different options are available, depending on the circumstances within the country, though success depends on close co-ordination between the government and central bank.

Access to credit is no longer a given for many governments and a more strategic approach to raising funds is therefore required. With debts rising, some government bond issues have been undersubscribed or have led to volatility in currency values. It was therefore suggested that the timing and effectiveness of stimulus and related debt management could be enhanced by closer co-ordination between fiscal and monetary authorities. Some central banks are assuming or taking back a debt management role, which includes advising on, setting the timing for and organising the auction of

government bonds on the government's behalf. In some cases, decisions over the issuance must make specific reference to foreign exchange risk. However, some maintained that an independent debt management office can offer the focus of specialist expertise and experience.

Strengthening risk and resource management

How have quantitative easing and other measures taken in response to the crisis affected central bank balance sheets, risk management, financial reporting and stakeholder communications? Expanded balance sheets and the extra risks and demands this entail are likely to be facts of life for some years to come. Many central banks are responding with a more proactive approach to risk and resource management.

Once stable balance sheets are now fraught with risk. Whereas central banks would primarily have invested in government bonds before the crisis, the need to avert financial and economic meltdown has forced them to take on a considerable amount of riskier assets. Some central banks have bought securities outright as part of quantitative easing or taken them as collateral within liquidity enhancement initiatives. Some governments or central banks have also assumed a significant level of extra risk that is not on the balance sheet through credit guarantee and asset protection schemes (APS), which essentially provide insurance.

The growing size of the balance sheet and acceptance of lower quality assets have increased the scale and potential volatility of many central banks' credit, market and counterparty risk profile. As a participant noted, the fire was so strong that water was taken from anywhere; now we have to deal with the impact. All recognised the need for changes to their risk management policies as a result. Measures include tighter scrutiny of creditworthiness and insisting on having the first call on assets.

Dealing with the newly acquired assets is stretching resources. The growth of balance sheets, the complexity of some of the assets and uncertainty surrounding many of them place a huge extra burden on valuation, monitoring and transaction management. Some participants admitted to having been overwhelmed by the technicalities of valuing collateral. The challenges are often exacerbated by the fact that under many stimulus schemes the central bank takes collateral or underwrites liabilities without actually managing the asset.

Many central banks are seeking outside help. To overcome the strain on operational resources and technical know-how, some participants have called in consultants. Others have outsourced the review of more complex or unfamiliar dealings such as mortgage backed security transactions. Some insist that the provider (i.e. the bank) values the assets on an ongoing basis and reports this to the central bank. Several demand significant 'haircuts' to reflect the level of liquidity. However, many problems remain particularly in relation to assigning values to assets in 'inactive' markets. Moreover, some participants were concerned about the lack of an agreed framework for validation of these asset valuations and the underlying

methodologies and assumptions by internal or external auditors.

The change in the asset profile has complicated central bank accounting. Challenges range from derivative accounting and related party transactions to troubled debt restructuring and the allowance for loan losses. Participants stressed the importance of basing new accounting policies on thorough analysis of existing accounting principles and ensuring that the institution can develop and maintain an understanding of complex transactions.

The potential uncertainties over accounting policies can only heighten the challenges of disclosure at a time when central bank financial statements are facing intense scrutiny. Many financial reports have increased considerably in length, though it was recognised that there is a risk of confusing readers with unfathomable extra data and reducing the effectiveness of disclosure as a result. Several participants reported that they had learned a lot about the balance between quality and quantity from recent experience and were looking at how to modify their statements as a result. Some had even found that anomalies in their disclosure such as the indeterminate nature of the assets supporting currency in circulation had made front page news. Faced with frozen markets in some of their newly acquired assets, some participants have moved to an FAS 157-type hierarchy, which divides the portfolio into active market, derived market and own estimates of pricing so that users can judge the reliability of the valuations.

The potential for greater volatility in earnings is creating reputational risks and blurring the lines between central and commercial banks. How to communicate/explain asset write downs without incurring public outcry will clearly require care and sensitivity. The potential for 'accounting' gains and losses may be heightened under a fair value approach. Common examples cited by participants include the release of reserves or the underwriting of commercial debt, both of which could lead to a paper profit. Any significant profits could be seen as impairing the non-commercial nature of central banks. The underlying issue is whether the same accounting and disclosure rules should apply to central as commercial banks when their objectives are essentially so different.

Splitting away market supervision

Should financial supervisors and central banks be separate or should their responsibilities be brought under one roof? The financial crisis has led many to question the wisdom of splitting monetary management and market supervision.

Prior to the financial crisis, many countries had been moving to a tripartite supervisory model along the lines of the Treasury, Bank of England and Financial Services Authority (FSA) in the UK. However, the crisis has highlighted what some feel is the need for a change in the regulatory focus and balance of powers between central banks and financial supervisors. In particular, while there has traditionally been a delineation between central banks' responsibility for liquidity and supervisors' oversight of solvency, the collapse of inter-bank lending that precipitated the crisis has demonstrated that the two are inextricably linked. A participant noted that this takes us back to the principles set out by leading Victorian commentator Walter Bagehot, who insisted that paying obligations on a due date is the essence of the viability of a bank.

Some participants argued that the fragmentation between central banks and financial supervisors created blind spots and caused supervisors to either miss or misinterpret central bank warnings. Bringing both sets of responsibilities under one roof would streamline management and avoid problems falling between the cracks. A participant argued that if the supervisory and lender of last resort functions had been combined in one competent body the difficulties at a bank like Northern Rock may not have ultimately proved so disastrous and costly.

Others believe the original rationale for a specialised supervisor and an independent central bank continues to hold true. In particular, would a central bank be competent or indeed want to take on such activities as consumer protection from what was described as a quasi-government department like the FSA. Nonetheless, all recognised the need for improvements in co-ordination and collaboration. Cited examples include regular monthly meetings and the sharing of credit evaluation data, along with the pooling of operational resources in areas such as internal audit.

The limits of supervision

Should local supervisors defer to supra-national oversight and control? An international approach to regulation may reflect the nature of banking business. Yet, the financial crisis has demonstrated that national governments (and eventually tax payers) will have to come to the financial rescue if anything goes wrong.

A patchwork of local regulators will always find it difficult to oversee adequately a sector that can transfer money and risk around the world in milliseconds. A number of leading industry and regulatory figures have therefore called for greater cross-border collaboration in regulation to reflect the international nature of banking business. In June 2009, Josef Ackermann, CEO of Deutsche Bank, said that 'it has become apparent that internationally integrated financial markets and basically national supervision structures do not go together'. The choice is therefore between 'elements of supra-national supervision' or the 're-nationalisation of financial markets and the resulting losses in wealth'⁶. Earlier in the month, Lord Turner, Chairman of the UK FSA, gave his support to the establishment of a pan-European regulator that would oversee and co-ordinate the work of local watchdogs⁷.

However, if things go wrong, who will be liable for the costs? While not ruling out a role for an international supervisor, several participants countered that the financial crisis had confirmed the maxim that regulation is international in life, but national in death. It was noted in particular that Fortis had to be broken up into its national constituent parts before being rescued. This underlines what a participant described as the 'golden rule' – he or she who has the gold makes the rules. As the treasure chests are in the keep of national governments, they will be the ultimate rule-making authority.

Some participants went further by insisting that any mandate to supervise must be accompanied by the resources to cover failure. Without this, there is a risk that the balance of power will shift beyond the boundaries of responsibility and accountability. Even worse, countries may use such international structures as an opportunity to pass the buck and avoid paying their due.

Supporters of a supra-national approach within the conference stressed that local solutions cannot be achieved in isolation. In particular, it can be hard to find sufficient expertise at local level. It can also be difficult for a supervisor sitting in one country to identify and disaggregate where the risks lie. Effective regulation therefore requires pooling of resources, co-ordination of reporting and international oversight of risks. Some of the

firmest advocates of greater co-operation came from smaller countries with a large foreign-owned presence within the banking sector. Particular difficulties had arisen when attempts to curb excessive lending had been bypassed by putting the loans on the company's home state books. Others noted that there is a growing risk that some banks have moved from being too big to fail to being too big to save. The collapse of a bank like Lehmans can be absorbed within a large market, but would be calamitous if it were to have had a significant operation in a small country

⁶ Reuters, 24.06.09

⁷ Daily Telegraph, 10.06.09

Implications for central bank capital management

The benefits of own capital may be limited. Capital confers credibility on a central bank and can enable it to respond to problems before they escalate. Others counter that only a government has the financial resources to solve really tough crises.

What does a central bank need capital for? While there has always been some debate over whether a central bank needs to hold its own capital, this has been heightened by the financial crisis. Some participants believe that the need to act with speed and decisiveness requires the authority and autonomy conferred by independent financial resources. Waiting for political approval could complicate the situation and lead to damaging delays. They also feel that strong capitalisation can enhance confidence in the institution.

Others countered that the money for bail outs on the scale of the recent months has had to come from governments, rendering central bank capital holdings as something of an irrelevance. They also stress that under commercial banking rules most central banks would be vastly under-capitalised. Holding more capital carries an opportunity cost. It has always been tempting for cash-strapped governments to seek to tap into central bank reserves.

IFRS is seen by some as a threat to central banks' ability to maintain adequate capital. With the growth in central bank balance sheets, and the increased risk inherent in the assets they hold, IFRS fair value rules can lead to greater short-term volatility in reported results. The asymmetric nature of central banking laws will tend to result in a progressive erosion of central bank capital as reported profits are distributed to government, but losses are not recovered. A possible alternative raised at the conference is to move away from IFRS by taking unrealised gains and losses directly to reserves and thereby reducing short-term volatility in the income statement.

Shift from autonomy to collaboration

Are we seeing an end of the 'golden age' of independence for central banks as pressure from government to play a stronger role in sustaining financial stability erodes their autonomy? The independence gained by central banks in managing monetary policy may come to be seen as a distant golden age as autonomy gives way to the political pressures and heightened scrutiny that will come with greater collaboration with government. Will central bank autonomy as we know it survive or will it morph into a functional independence for monetary and a shared responsibility for the stability of the financial system. Where is the boundary?

Central banks can no longer go it alone. The growing role of central banks in managing financial stability is likely to require greater operational co-operation with governments, markets and supervisory authorities, which will conflict with the autonomy built up in relation to monetary policy. The financial crisis has also required central banks to manage a far more complicated risk profile and higher level of resources than were envisaged under the typical current model. Key considerations include capital adequacy and its role in sustaining independence from government.

Many participants felt that central banks can no longer operate in isolation. Closer interaction between financial stability and monetary policy will require greater co-operation with other authorities. Central banks are also facing overt pressure from governments and greater scrutiny from the media. However, while financial stability is likely to be the most prominent focus, central banks must not lose sight of price stability as their core aim. Price stability is not everything, but without it, everything is nothing.

Are current developments a sea-change or a temporary blip? Whether the immediate pressures might ease and allow central banks to resume more of their previous 'behind the scenes' role was seen as being dependent on events. However, most participants felt that an early withdrawal/unwinding of asset purchases and other intervention measures are unlikely and therefore the high profile will continue for some while.

A greater role in financial stability creates issues for governance and decision-making. A keynote speaker asked if monetary policy and financial stability can in fact be managed together and if so how? Should the same people sit on the key monetary policy and financial stability committees? Who would arbitrate if there are potential conflicts? Several participants looked towards a mixed operational model in which monetary policy continues to be functionally independent, while the management of financial stability is collaborative.

Annex – IMF accounting

IMF transactions have in the past been entered on the central bank balance sheet. Narrower asset and liability definitions under IFRS make this approach less certain. The capacity in which the central bank is operating and the nature of the transaction in hand all have to be taken into account when deciding whether to allocate IMF transactions to the government or central bank balance sheet, and if so how.

IMF transactions are with the government not the central bank, which may act as the conduit for the funds. The central bank will always be the banker, holding the IMF No 1 and No 2 accounts as principal. Under IMF rules, the central bank will also always be the depository, but not necessarily the fiscal agent.

There are various types of transaction, all denominated in special drawing rights (SDRs): purchase of membership, allocation of SDRs, sale of SDRs for other currency, sale of SDRs back to IMF and borrowing from the Fund. Some borrowing is in fact not from the Fund itself but from other resources managed by the IMF.

Payment for membership is split into a reserve currency payment to the Fund and a promissory note for the remainder (which are in domestic currency though subject to revaluation), which in practice resembles a contingent liability. One current issue is whether the full membership cost (the quota) should be recognised along with the full liability, including the promissory notes, or just a net presentation which, is equivalent to the Reserve Tranche Position (RTP).

The SDR allocations are commonly held by the central bank, though issued to the government, with a corresponding liability to the government. They may be held in the foreign exchange reserve portfolio. The bank can sell these SDRs as part of foreign reserve management. Members have often found it cheaper to hold a basket of reference currencies rather than the SDR.

When a country wants to borrow from the IMF, the first stage is to sell the RTP to the IMF for currency. Only after the RTP is used up can borrowing from the IMF be recognised.

The most confusion centres on whose balance sheet the transaction should be entered. The IMF's view is that the fiscal agent, although an agent for the government, should

record the transactions. However, as more banks adopt IFRS, auditors are increasingly questioning the compliance of this approach with IFRS as the accounts should be held on the balance sheet of the principal, not the central bank. However, it is normally the responsibility of the central bank to report the position to the IMF. By convention this has normally led to the IMF position being shown on the balance sheet of the central bank.

SDRs are held as foreign currency even though they are issued to the government. It is suggested that they are held as liabilities to the government. In its depository role, the central bank holds the IMF No 1 and No 2 accounts as principal and as liabilities to the IMF. As fiscal agent, the central bank does not record assets and liabilities on its balance sheet unless the government transfers the real risks and rewards.

PricewaterhouseCoopers professional services to central banks

Central Bank Advisory Group

The financial crisis has highlighted the susceptibility of modern financial markets to severe systemic risk and thus underlined the critical importance of central banks in shaping and sustaining the health and viability of the financial system. Underlying challenges facing central banks include the continuing developments in regulation, financial reporting and stakeholder scrutiny.

Through our global network, PricewaterhouseCoopers is helping central banks and regulators to tackle the challenges of today's increasingly complex and diffuse marketplace. This includes providing audit, accounting and advisory services, underpinned by research, market analysis and engagement with central banks, regulators and their stakeholders. With your help, we have developed a unique client service culture and technical deliverables, which clearly differentiates us from our competitors.

Our client services are managed through our local office network around the world and co-ordinated by our Central Bank Advisory Group, (CBAG). Our CBAG is a unique specialist team based in London, which develops and delivers a wide range of support activities specifically aimed at ensuring our global network of client service teams are at the forefront of thought leadership and technical advances in their work with central banks. Our teams communicate through a specially created PricewaterhouseCoopers intranet, with product methodology, a technical discussion forum, and a quarterly newsletter. The CBAG team regularly contributes to publications and speak at conferences.

Audit services

We have in recent years served as the central bank auditor in 8 of the 10 leading industrial countries⁸ with the US Federal Reserve, Bundesbank, Canada, Italy, Switzerland, Netherlands, Russia and the Bank of England as our clients. We recently completed 5 years as the inaugural auditor of the European Central Bank and our recent audit portfolio includes the central banks of Australia, New

Zealand, South Africa, Spain, Portugal, Ireland and Turkey, as well as the Bank for International Settlements – the banker to the central banks. Emerging market central banks are as important to us, with clients extending through Central Europe, former Soviet states, into China, Asia and Africa. Our signature is on the audit opinions and Audit Committee reports of more central banks than any other of our competitors.

Our Central Bank Advisory Group supports this global client network through audit proposal support, a specific central bank audit methodology, technical IFRS solutions for financial reporting, and a methodology of risk and quality which ensures our local teams deliver the high quality service our clients expect from PwC.

Regulatory and advisory services

We coordinate our Regulatory Advisory services through regional groups across the globe, able to respond to the specific demands of each territory and to support our offices. We meet regularly with regulators to discuss topical issues. We are working closely with many regulators concerning Basel II and IFRS, and we have completed an extensive consultation, funded by the European Commission, to study the impact of Basel II on the financial services industry and the economy of the EU. We have advised several financial regulators on a number of key areas, in particular on the impact of IFRS on central banks and on the financial services industry they regulate. We are spearheading an initiative in the Middle East to advise regulators on the implications of corporate governance for the financial services industry, and the importance and relevance of these developments for central banks themselves.

Central banks come to us to discuss corporate governance-related issues, in particular associated with committee structures (including Audit Committee); risk management and internal controls; establishment and measurement of effective Internal Audit Departments; and corporate governance standards for the banking industry. Through CBAG, we ensure that the latest developments in these specialist fields are made available to support local teams in their projects.

⁸ G8/G10 countries where the central bank appoints external auditors

Our professionals contribute to advancing thought leadership, with PricewaterhouseCoopers representatives chairing meetings at financial regulators, IMF, World Bank, ECB and other leading institutions.

PricewaterhouseCoopers' commitment to ensuring central banks achieve the best practices in financial reporting is underlined by our contribution to this meeting.

To see our latest financial services thought leadership and to find out more about our work with central banks please visit our website at www.pwc.com/banking. Alternatively please contact our global Central Bank Advisory team leaders in the relevant territory.

PwC Advisory services

Without providing information on specific projects, the following table gives an indication of the scope of PwC advisory (and audit) services delivered in recent years.

Governance projects include reviews of corporate governance, organisational structures and human resources, as well as reorganisation and change management projects. Regulatory / supervisory projects include the design and implementation of supervision procedures and delivery of training in areas such as risk-based supervision, Basel II, anti-money laundering & IFRS, as well as direct assistance in the liquidation of commercial banks. Financial reporting projects include IFRS and ESCB implementation, as well as audit support. Risk / reserve management projects include specification of reserve asset management software and implementation of operational risk management structures. Internal controls projects include extensive work with Internal audit functions as well as IT & security audits, process reorganisation / improvement and external assessment of the adequacy of central bank control functions.

Americas

	Governance advisory	Regulatory /supervisory	Financial Reporting	Risk / reserve management	Internal controls	Audit
Barbados	✓					
Canada			✓			✓
Panama		✓				
Paraguay					✓	✓
Uruguay			✓		✓	✓
USA			✓		✓	✓
Audits in Aruba, Bahamas, Bolivia, Dominican Republic, ECCB, Ecuador, El Salvador, Honduras, Peru and Netherlands Antilles .						

Asia / Pacific

	Governance advisory	Regulatory /supervisory	Financial Reporting	Risk / reserve management	Internal controls	Audit
Bangladesh	✓					
India		✓		✓	✓	
Indonesia			✓		✓	
Malaysia	✓	✓			✓	
Sri Lanka	✓					
Thailand					✓	
Audits in Australia, Cambodia, Fiji, New Zealand, Papua New Guinea, the Solomon Islands, Tonga and Vanuatu.						

Commonwealth of Independent States / Middle East / Africa

	Governance advisory	Regulatory /supervisory	Financial Reporting	Risk / reserve management	Internal controls	Audit
Armenia			✓			
Azerbaijan	✓	✓	✓			✓
Bahrain		✓				
Cape Verde			✓			
Georgia	✓		✓			
Ghana		✓			✓	
Malawi					✓	
Moldova			✓			✓
Nigeria					✓	✓
Oman		✓			✓	✓
Pakistan		✓				
Qatar	✓	✓				
Russia		✓	✓			✓
Saudi Arabia		✓				
Uzbekistan			✓			
Zimbabwe	✓				✓	
Audits in BCEAO, Botswana, Kazakhstan, Kyrgyzstan, Kenya, Kuwait, Lesotho, Liberia, Mozambique, South Africa, Swaziland, Uganda, Ukraine and Zambia.						

Europe

	Governance advisory	Regulatory /supervisory	Financial Reporting	Risk / reserve management	Internal controls	Audit
Austria		✓				✓
Belgium		✓				✓
Bulgaria						✓
Croatia				✓		
Czech Republic		✓				✓
Cyprus					✓	✓
ECB				✓	✓	✓
Greece		✓				✓
Guernsey	✓					
Hungary					✓	✓
Ireland	✓	✓				✓
Latvia		✓	✓		✓	
Netherlands		✓				✓
Norway			✓			
Romania			✓			
Russia		✓	✓			✓
Spain				✓		
UK			✓			✓

Audits in Croatia, Germany, Italy, Lithuania, Luxembourg, Macedonia, Malta, Moldova, Montenegro, Poland, Portugal, Serbia, Slovakia, Slovenia, Switzerland and Turkey.

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