Global Trends and Developments in SOE Corporate Governance

Workshop on Corporate Governance for SOEs in Turkey

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Outline

- Legal and regulatory framework
- State ownership role
- Board of directors
- Disclosure and transparency
- Implementing good corporate governance in SOEs

Dealing with SOE governance is different from private sector governance

SOEs share the same challenge of aligning the incentives of SOE owner (the principal) with that of the managers (the agents). But they face distinct challenges too:

Private firms

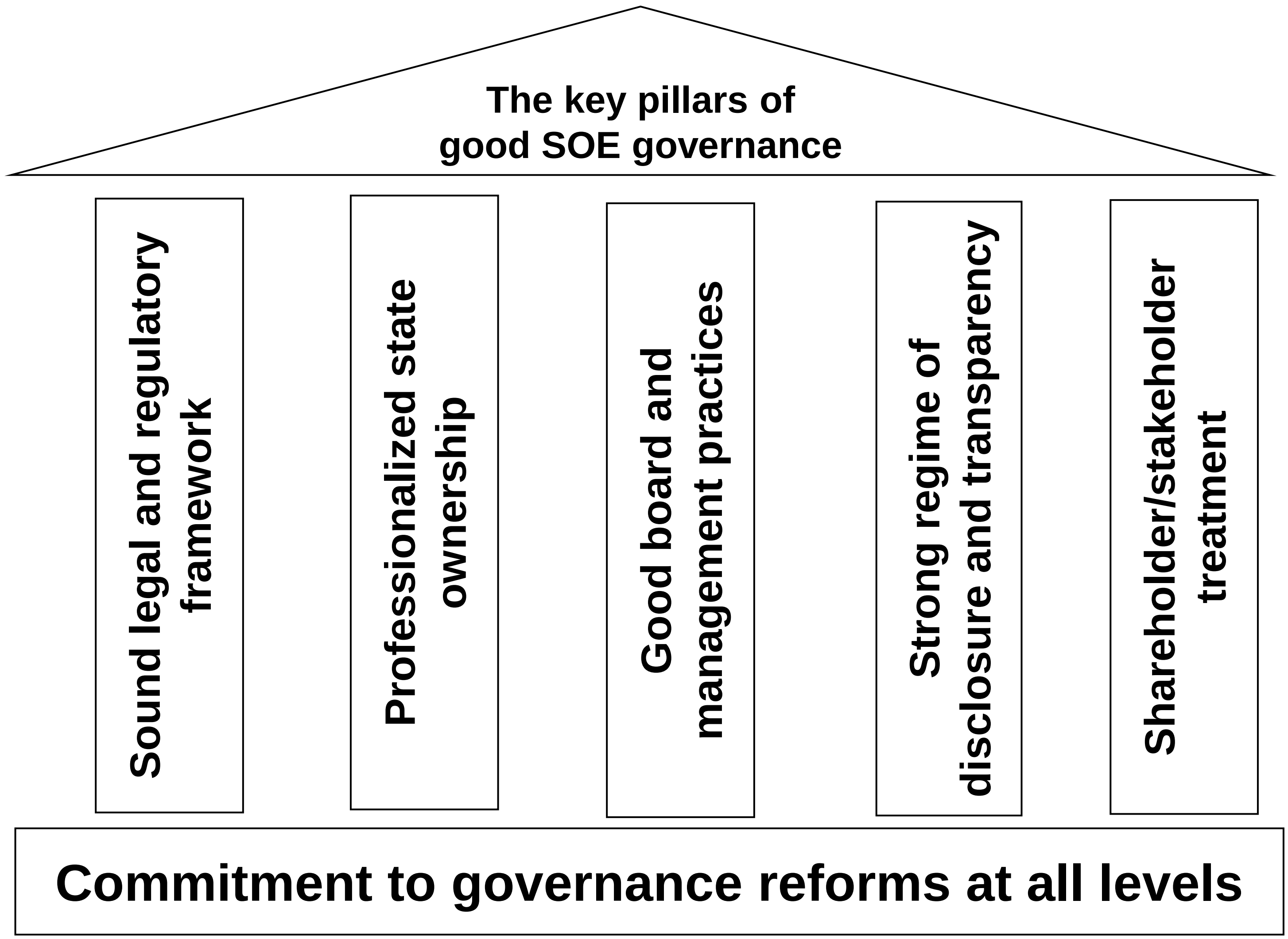
- Value maximizing
- Single agency
- Market discipline
- Incentives
- Disclosure

State enterprises

- Multiple objectives
- Multiple agencies
- Political interference
- Disincentives
- No or low disclosure

Countries are increasingly fixing these problems to: improve delivery of critical public services; reduce fiscal burden and fiscal risk; improve access to financing through capital markets; enhance transparency and accountability in use of public assets

Key Pillars for Good SOE Governance



Aligning SOEs with Private Sector Frameworks

- Application of company legislation to SOEs
  - Easy for corporatized SOEs
  - Others need to be corporatized first
- Application of other laws and regulations
  - E.g. competition law, bankruptcy law
  - Flexibility on labor issues and procurement
- Listing SOEs on the stock exchange
  - Subject them to more stringent requirements of the exchange
  - Provide flexibility for SOEs to adjust their capital structure
  - Better monitoring of firms

Developing an ownership framework for SOEs

- **Ownership legislation** – Finland, Hungary, Namibia, Philippines, Poland, Romania
- **Ownership policies** – Bhutan, Finland, Norway, Sweden
- **Corporate governance codes/guidelines** – Egypt, Germany, India, Kenya, Malawi, Malaysia, Mozambique, Mauritius, Morocco, Peru, Poland, Seychelles, South Africa

Key issues in state ownership

- **Multiple goals** – commercial, non-commercial, political
- **Multiple principals** – line ministries, ministry of finance, regulatory bodies, inspection bodies, employment agencies
- **Political interference** rather than operational autonomy
- **Control rather than accountability**
- **Conflicts** between ownership, policy-making, and regulatory functions
- **Lack of understanding about core ownership functions**

Core ownership functions

- Voting state's shares
- Appointing boards
  - Objective selection criteria
  - Structured and transparent nominations process
  - Clear dismissal criteria
- Setting policies (e.g. dividend, financial reporting)
- Monitoring performance
  - KPI based (financial and non-financial indicators, including CG)
  - Performance contracts
  - Evaluation by independent third parties
- Promoting good governance practices in SOEs
  - Monitoring compliance
  - Training

Different models of state ownership

Decentralized model

Line ministries responsible (e.g. Pakistan)

- Most common in past, still in many countries today
- Line ministries have historical experience, sector/company knowledge
- But many limitations
  - Conflicts between ownership, policy-making and regulatory functions
  - Fragmentation of ownership
  - Insufficient "ownership" capacity
  - Lack of adequate oversight and accountability of sector as a whole
  - Scope for day-to-day involvement

Dual model

Line ministries & another ministry, usually MOF (e.g. Turkey, Mexico)

- Hybrid between decentralized and centralized model
  - Provides checks and balances
  - Promotes technical and financial oversight
- Limitations:
  - MOF focused more on financial and budgetary matters
  - Lack of capacity to be advocate for reform
  - Numerous other bodies continue to be involved

Centralized model

- **Three broad types:**
  - Advisory bodies (e.g. Norway, Sweden, New Zealand, India, S.A.)
  - Ownership agencies within the government structure (e.g. France, Indonesia, China)
  - Holding companies (e.g. Malaysia, Singapore, Hungary, Gulf countries)
- **Benefits**:
  - Separates and strengthens the ownership function
  - Ensures consistent implementation
  - Concentrates scarce skills and resources
  - Helps drive reform
- **No one size fits all solution**

Pros and cons of different centralized models

Advisory body

- Pros:
  - Ownership focus
  - Easier to do
  - Learning by doing
- Cons:
  - Continued scope for conflicts of interest
  - Continued political interference
  - Inability to influence change

Ownership agency

- Pros:
  - Implementation focused
  - Specialized capabilities
  - Better accountability
- Cons:
  - Political resistance

Holding company

- Pros:
  - Management of state enterprise sector as a whole
- Cons:
  - Portfolio management issues
  - Lack of transparency
  - Risk of capture

Enhancing the effectiveness of state ownership bodies

- Clear and focused mandate
- Sufficient authority and independence
- Proper governance structures and policies
- Dedicated resources—skilled staff, financing
- Accurate and timely reporting
- Accountability and disclosure to representative bodies such as Parliament
- Stakeholder consultations

Board composition – central to a board's functioning and performance

Typical problem:

- Boards are often composed of a mix of political, government, and stakeholder representatives -- with little commercial or financial skills needed to exercise board responsibilities and with little or no independence and objectivity

Typical result:

- Boards may ensure that political or policy goals are met….but they may put those goals over the interests of the SOE
- Scope for political interference is greatly increased
- Boards are beholden to politicians and government officials

Key contributing factors:

Political interference and lack of a clear process for the nomination and appointment of boards

Having clear selection criteria and induction of independent members strengthens boards

Selection criteria:

- Hungary – specifies degree in finance, economics, or law
- Czech Republic – CG experience, finance, law
- Italy, Portugal, Switzerland – integrity, probity
- Chile, Israel, Lithuania – additional proficiency and suitability requirements for individual boards in large SOEs
- Switzerland – specific criteria for different positions, including board as a whole, single board members, chair

Independent directors:

- OECD countries – majority of the board
- India and Malaysia – at least a third of the board
- Brazil – at least 20% of the board

No participation by political officials

- Many countries

Having a structured nominations framework for board – and CEO – selection makes the process more professional and transparent

Many countries are:

- Establishing a transparent and consistent procedure to identify qualified candidates – e.g. through:
    - → pre-qualification mechanisms, vetting of candidates, use of nominations committees, self-nomination
    - → Competitive selection, especially of CEOs
- Maintaining a database or pool of qualified candidates
- Using professional recruitment groups to identify candidates
- Delegating the process to expert panels, specialized bodies, or to SOEs themselves through nomination committees of the board
- Requiring disclosure of final results

Board responsibilities according to good practice

Boards have two important roles:

1. Set strategic direction and take major decisions
2. Appoint and oversee management

Boards ensure that the SOE is well governed, i.e. they:

- Ensure that real commitment—rather than window dressing—is present
- Ensure that good governance is in place
- Strengthen the control environment
- Oversee disclosure and communications
- Protect (minority) shareholders interests

Creating board committees to:

- **Handle a greater number of issues in a more efficient manner**
  → By allowing experts to focus on specific areas and provide recommendations to the board as a whole

- **Develop subject-specific expertise on the company's operations,**
  → E.g. financial reporting, risk management and internal controls

- **Enhance the objectivity and independence of the board's judgment**
  → Insulating it from potential undue political or managerial influence, in such key areas as remuneration, controls, oversight

- Typical committees include the Audit and/or Risk, Nominations/CG, and Remuneration committees

Board processes are important to ensure that the board is operating efficiently

Meeting frequency

- Red flags: board meets 4x or less – or 12x or more
- Good practice: As appropriate per SOE's profile
- Reference point: Typically between 6-10 times p.a.

Meeting length

- Red flags: board meets 2 hours or less – or 1 day or more
- Good practice: As appropriate per SOE's profile
- Reference point: Typically between 3-4 hours

Meeting agenda

- Red flags: Set a day ahead, w/o directors' and mgmt. input
- Good practice: Set by chairman, with directors' & CEO's input
- Reference point: Typically 1 week prior to meeting

Board papers

- Red flags: Sent a day ahead. Too much or too little information
- Good practice: Incl. financials and KPIs, clear decisions, options
- Reference point: Typically 1 week prior to meeting

Company secretary

- Red flags: Secretary to the board, not company secretary
- Good practice: Professional, advisor to chairman, respected
- Reference point: Legal, financial background, experienced

Key principles for transparency and disclosure

1. At the government level: an ownership entity or relevant body should publish an annual report on SOEs

2. At the SOE level:

   - Use of standard reporting requirements that are used for public interest entities

   - Adoption of international standards – IFRS, ISA, OECD Principles

   - Annual independent external audit based on international standards

   - Disclosure of financial and non-financial information according to international good practice

   - Listing of SOEs on the stock exchange to improve reporting and internal control practices

   - Investment in accounting and finance departments/staff of SOEs

What to disclose according to good int'l practice

1. **SOEs should disclose material information on all matters described in the OECD Principles of Corporate Governance**

    i. The financial and operating results of the company.
    ii. Company objectives.
    iii. Major share ownership and voting rights.
    iv. Remuneration policy for directors and key executives, and information about directors (incl. their qualifications, independence, other directorships, etc.)
    v. Related party transactions.
    vi. Foreseeable risk factors.
    vii. Issues regarding employees and other stakeholders.
    viii. CG structures and policies, in particular, the content of any CG code

2. **SOEs should also focus on areas of significant concern for the state as an owner and the general public, e.g.**

    i. A clear statement to the public of the company objectives and their fulfillment.
    ii. The ownership and voting structure of the company.
    iii. Any material risk factors and measures taken to manage such risks.
    iv. Any financial assistance, including guarantees, received from the state and commitments made on behalf of the SOE.
    v. Any material transactions with related entities.
    vi. The nomination procedure and experience / background of directors

CG framework is important but ***implementation*** is key

Corporate governance frameworks may be sound, yet:

- Their application is often distorted
- They guarantee compliance, not behavioral change

Many difficulties and challenges arise:

- Political interference, resistance from vested interests
- Lack of resources and capacity to implement good CG
- Lack of awareness and understanding among market participants as to benefits of good CG
- Underdeveloped or outdated legal and regulatory framework

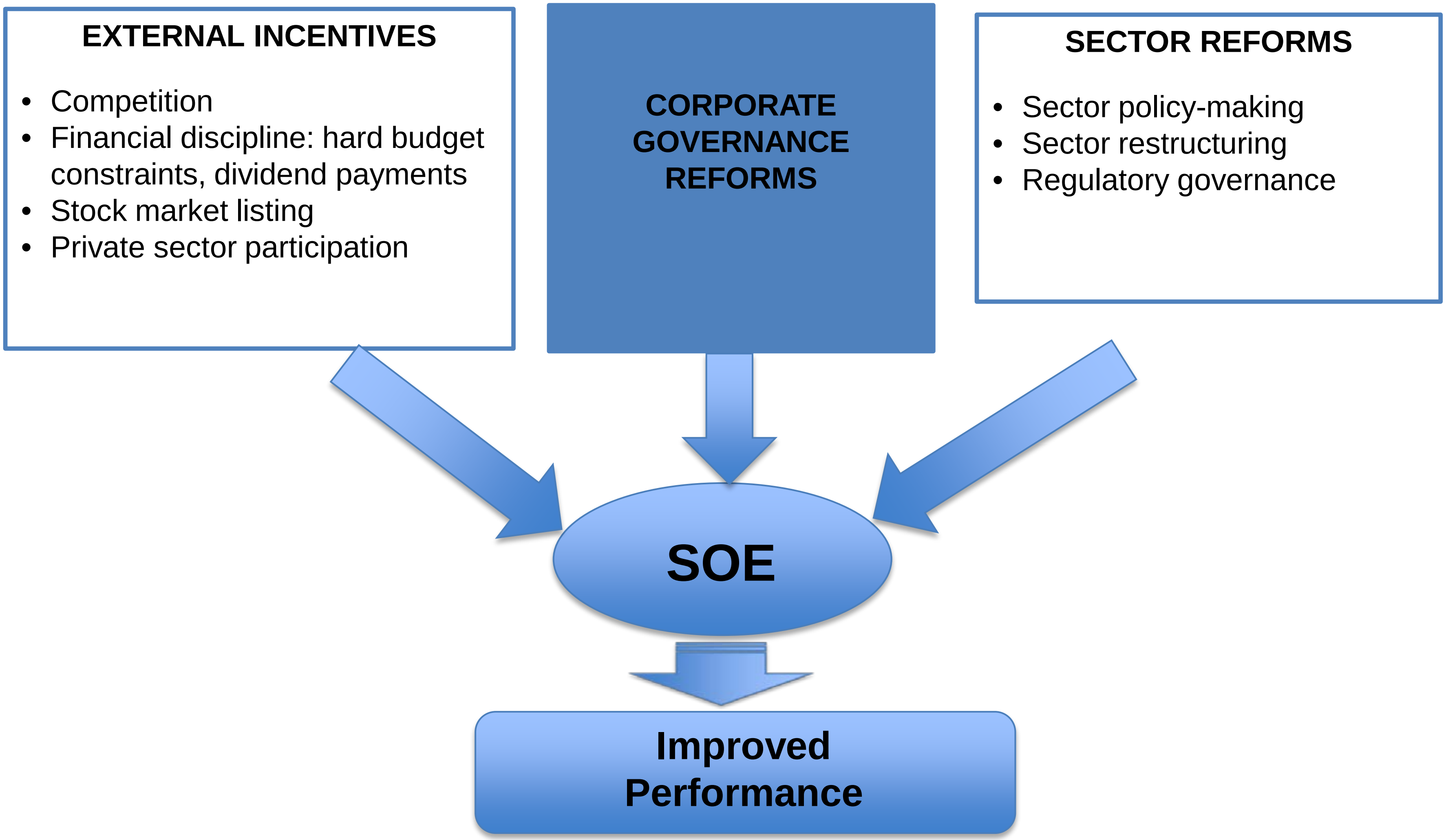
Successful implementation requires a change in mindset and behavior

… in the end, corporate governance is about **what people** in privileged or responsible positions actually **do** (or don't do) **with other people's** (e.g. shareholders' and taxpayers') **money**

Enforcement and compliance

- Political will
- Sufficient authority for ownership entities
- Dedicated resources for implementation - skilled staff, financing
- Development of guidelines, regulations, tools
- Accurate and timely reporting
- Accountability and disclosure to representative bodies such as Parliament

Good corporate governance is critical but must be accompanied by external incentives and by sector reforms to achieve and sustain gains from CG reform



Thank you