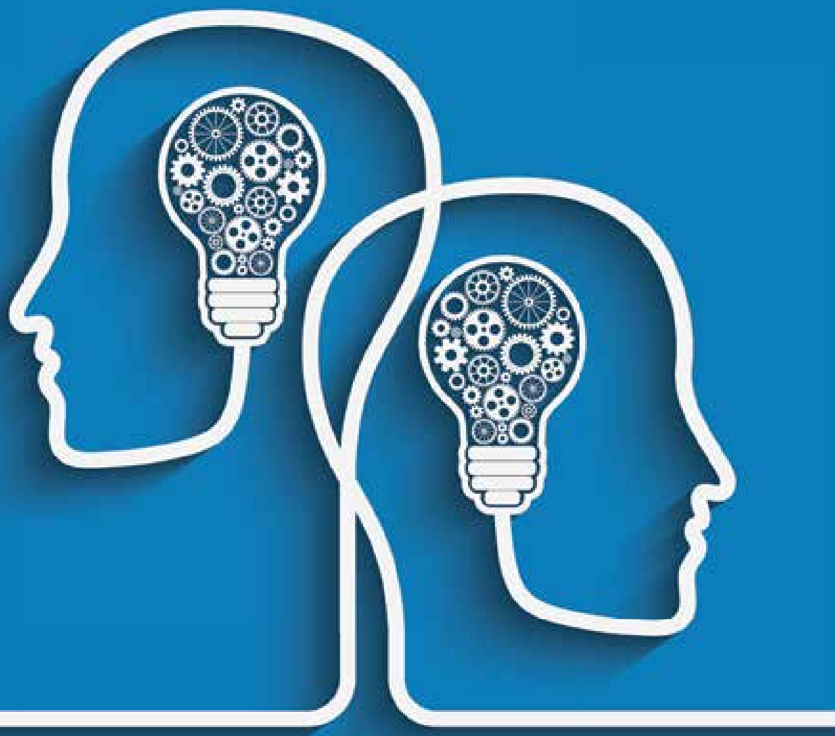
# Leadership Training Toolkit for State-Owned Enterprises (SOEs)

## *Boards and Owners*



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## Acknowledgements

This Leadership Training Toolkit for State-Owned Enterprises (SOEs) was prepared by an interdisciplinary WBG team led by Fabian Seiderer (Lead Public Sector Specialist WB and Task Team Leader) with input from PwC. The core team comprised Sarah Cuttaree and Lopa Rahman from IFC; Alexander Berg, Natalia Manuilova, Manela Karunadasa, Asif Ali and Twity Mueni Musuva Uzele from WB, Ranen Banerjee, Bruce R. Macqueen, David D. Brunell, Anjan Kumar Roy, Harsh Vardhan Kabra, Paridhi Kothari, and Agastya Yeachuri from Price Waterhouse Coopers Private Limited (PwC).

The team would like to thank Alexandre Arrobbio, Adrian Fozzard, and Martine Valcin for their overall guidance and review. The team would also like to thank James Brumby, Tatiana Nenova, Sunita Kikeri, and Henri Fortin for their review and advice. Priyantha Jayasuriya Arachchi provided administrative support.

The team is grateful to the Australian Department for Foreign Affairs and Trade (DFAT) for their support.

# List of Abbreviations

| Acronym | Description |
|---|---|
| BSC | Balanced Scorecard |
| BCP | Business Continuity Planning |
| CPSE | Central Public Sector Enterprise (Government of India) |
| CVC | Central Vigilance Commission |
| CEO | Chief Executive Officer |
| CFO | Chief Financial Officer |
| COO | Chief Operating Officer |
| CRO | Chief Risk Officer |
| CSO | Civil Service Organization |
| CSR | Corporate Social Responsibility |
| DFI | Development Finance Institutions |
| ERM | Enterprise Risk Management |
| ESG | Environmental, Social, and Corporate Governance |
| EC | European Commission |
| EU | European Union |
| XBRL | eXtensible Business Reporting Language |
| FASB | Financial Accounting Standards Board |
| GSM | General Shareholders Meeting |
| GAAP | Generally Accepted Accounting Principles |
| GRI | Global Reporting Initiative |
| GRC | Governance and Risk Management |
| GCG | Governance Commission for GOCCs |
| GHG | Greenhouse Gas |
| GDP | Gross Domestic Product |
| HR | Human Resource |
| HRM | Human Resource Management |
| IAS | International Accounting Standard |
| IASB | International Accounting Standards Board |
| IDA | International Development Agency |
| IFC | International Finance Corporation |

| Acronym | Description |
|---|---|
| IFRIC | International Financial Reporting Interpretations Committee |
| IFRS | International Financial Reporting Standards |
| IIRC | International Integrated Reporting Council |
| IMF | International Monetary Fund |
| IOSCO | International Organization of Securities Commissions |
| IPCC | Intergovernmental Panel on Climate Change |
| IPO | Initial Public Offering |
| IPSAS | International Public Sector Accounting Standards |
| IPSASB | International Public Sector Accounting Standards Board |
| IR | Integrated Reporting |
| ISO | International Organization for Standardization |
| ITB | Invitation to Bid |
| KPI | Key Performance Indicator |
| KRA | Key Result Area |
| LDQ | Leadership Dimension Questionnaire |
| LTA | Long-term Agreements |
| MCPS | Management Commentary Practice Statement |
| MD&A/ MDA | Management Discussion and Analysis |
| MfD | Maximizing Finance for Development |
| MoA | Memorandum of Association |
| MOU | Memorandum of Understanding |
| MoF | Ministry of Finance |
| MIM | Ministry of Industry and Minerals, Government of Iraq |
| NVG SEE | National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business |
| NPSV | Net Present Social Value |

| Acronym | Description |
|---|---|
| NGO | Nongovernmental Organization |
| OECD | Organisation for Economic Co-operation and Development |
| PEST | Political, Economic, Sociological, Technological |
| PESTEL | Political, Economic, Sociological, Technological, Environmental, Legal |
| PwC | PricewaterhouseCoopers/ PricewaterhouseCoopers Private Limited |
| PAC | Public Accounts Committee |
| PIM | Public Investment Management |
| PMA | Performance Management Agreement |
| PSA | Public Service Agreement |
| PSO | Public Service Obligation |
| PPP | Public-Private Partnership |
| RFP | Request for Proposals |
| RFQ | Request for Quotations |
| R&D | Research and Development |
| RBF | Results-Based Financing |
| SOW | Scope of Work |
| SME | Small and Medium Enterprise |
| SPV | Special Purpose Vehicle |
| SMART | Specific, Measurable, Achievable, Results oriented, and Time-based |
| SIC | Standards Interpretations Committee |
| SOE | State-Owned Enterprise |
| SBU | Strategic Business Units |
| SWOT | Strengths, Weaknesses, Opportunities, and Threats |
| SAI | Supreme Audit Institution |
| TOR | Terms of Reference |
| UN | United Nations |
| UNCTAD | United Nations Conference on Trade and Development |
| WBG | World Bank Group |
| WTO | World Trade Organization |

# Foreword

During the unprecedented COVID-19 pandemic, the state has become more prominent and its role has been tested. By necessity, the entire public sector mobilized to respond to and mitigate the severe socioeconomic impacts of this global health emergency and to support the recovery. In many countries, state-owned enterprises (SOEs) are at the forefront of this response, given their important roles in key public service and infrastructure sectors such as health and education, transportation, energy, and finance. Public health actions and travel restrictions affected not only SOE revenues but also expenditures, as a result of state fiscal relief and stimulus measures. This has had an adverse impact on the financial situation, and sometimes the viability, of many SOEs, thus exacerbating fiscal costs and risks already affecting governments and their stretched balance sheets.

THE SOE LEADERSHIP TOOLKIT, DEVELOPED JOINTLY BY THE WORLD BANK AND IFC THROUGH A MULTIDISCIPLINARY TEAM, LEVERAGES BOTH INSTITUTIONS' COMPLEMENTARY PERSPECTIVES, RESOURCES, AND EXPERIENCE IN WORKING WITH THE SOE SECTOR AND THE STATE AS AN OWNER.

The COVID-19 crisis has also tested the state's ownership role and the effectiveness of SOE management teams by exposing the underlying weaknesses in countries' and SOEs' corporate governance frameworks and capacity. The call to "rebuild better" post-pandemic will increasingly obligate SOEs to demonstrate sustainable approaches that take into consideration the management of environmental and social risks as well as the impact of their economic activity on climate change and communities.

Silver linings of this crisis include increased recognition of improved corporate governance standards, and practices and a sense of urgency to strengthen the performance of SOEs, to ensure their sustainability and mitigate mounting fiscal risks. The World Bank Group's new Integrated SOE Framework (iSOEF) responds to these developments and provides a holistic approach to SOE reform.

It is essential that the capacity of SOE leadership, as well as the capacity of policymakers and regulators be strengthened. Yet most developing and middle-income countries are not equipped with established SOE-specific training or capacity-building programs. Boards and senior management of SOEs require contextual training to help them effectively manage crises, improve the performance of their company, navigate the multiple principal-agent challenges, and balance competing commercial and noncommercial objectives in a transparent manner. There is also a pressing need for capacity building of government ownership and oversight entities and their staff, which often do not have the relevant business experience to effectively steer and supervise the SOE portfolio.

The Leadership Training Toolkit for State-Owned Enterprises (SOE Leadership Toolkit) serves to meet this growing demand for a practical SOE-specific training curriculum and teaching methodology. The SOE Leadership Toolkit, developed jointly by a multidisciplinary team of the World Bank and IFC, leverages both institutions' complementary perspectives, resources, and experience in working with the SOE sector and the state as an owner.

The SOE Leadership Toolkit was designed with a variety of training needs, priorities, and sponsoring organizations in mind. Using an experiential-learning delivery model, it offers executives and officials a flexible and modular approach that allows it to be readily customized to fit different country contexts and training needs. The Toolkit contains 15 modules covering 4 areas: 1) fundamentals of corporate governance (and the role of the state); 2) the board; 3) strategy, risk, and performance; and 4) control environment, transparency, and disclosure. It also includes 4 essential cross-cutting themes: (i) gender and diversity; (ii) climate risk and resilience; (iii) Maximizing Finance for Development; and (iv) corruption and integrity and proposes specific entry points and examples to mainstream these themes in any SOE training program.

We hope that this new SOE Leadership Toolkit will serve the needs of our clients and help equip SOE boards and senior management with the necessary knowledge and skills to effectively govern and improve the performance and sustainability of their organizations. The information in the SOE Leadership Toolkit should help improve the competitiveness of SOEs, leading to improved performance and financial health, and ultimately resulting in a positive impact on countries' balance sheets and growth.

The World Bank Group is committed to supporting its clients' efforts to enhance SOE competitiveness, transparency, and performance by strengthening their leadership and management. We are, therefore, pleased to make this comprehensive SOE Leadership Toolkit available as a public good and to support its customization and implementation through country programs and capacity building of ESG training providers.

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Part I

# Corporate Governance

Leadership Training Toolkit for SOEs

## Introduction

Photo: ©Cyrille Bellier

# Introductory Note

The Leadership Training Toolkit for State-Owned Enterprises ('SOE Leadership Toolkit') was developed jointly by the World Bank and IFC (World Bank Group) to support countries' efforts to build capacity of SOE boards and senior managers. It also endeavors to strengthen state ownership and oversight institutions, given the growing role and impact of SOEs on public finances, the economy, and delivery of services.

The SOE Leadership Toolkit addresses the growing need for curriculum content and teaching methodologies specifically adapted for SOEs. And it allows for use by different training providers, such as government training institutions, Institutes of Directors, corporate governance associations, and professional bodies or universities.

THE SOE LEADERSHIP TOOLKIT IS DESIGNED FOR EXPERIENTIAL LEARNING BY EXECUTIVES AND OFFICIALS AND CAN MEET A VARIETY OF TRAINING NEEDS AND PRIORITIES OF A RANGE OF SPONSORING ORGANIZATIONS.

The SOE Leadership Toolkit is designed for experiential learning by executives and officials and can meet a variety of training needs and priorities of a range of sponsoring organizations. Its flexible and modular approach can be readily customized to fit different country contexts and training needs. Its 15 modules cover 1) fundamentals of corporate governance (and the role of the state); 2) the board, 3) strategy, risk, and performance, and 4) control environment, transparency, and disclosure. Cross-cutting these modules are four themes: 1) gender and diversity, 2) climate risk and resilience, 3) Maximizing Finance for Development, and 4) corruption and integrity.

Besides building the capacity of the trainees, the SOE Leadership Toolkit aims to strengthen the expertise and skills of the public and private corporate governance trainers. Through the training, all of the parties—new and experienced directors, senior management, and the state as an ownership entity—gain a better understanding of their roles and of the value of adopting corporate governance best practices. The SOE Leadership Toolkit also includes the following features:

- **Engaging adult learners** through interactive exercises that draw on the diverse experiences of the participants
- **Providing maximum flexibility** through a modular curriculum that allows an institution to tailor programs to suit the needs of the directors it serves
- **Minimizing institutes' investment of time and resources for curriculum development** by providing a comprehensive, standardized curriculum that includes PowerPoint presentations and case studies to enhance the learning experience
- **Advancing corporate governance reforms by instilling in participants leadership values** that can help them work within their companies or organizations to adopt the best practices
- **Fostering long-term relationships** with those most likely responsible for implementing corporate governance best practices within their companies and organizations
- **Enhancing the training institution's brand and authority** in the policy-making process of developing national corporate governance codes
- **Encouraging participants to be "change agents" of corporate governance** by developing the knowledge and skills to build support within their boards for implementing best practices

# Coverage of the toolkit

## *Stakeholder coverage*

The SOE Leadership Toolkit is designed for three SOE stakeholder groups:

- **Ministry of Finance and Portfolio Ministry (PM)**—referred to as "state/ ownership entity" (also "policy makers") in the curriculum
- **Board of Directors (BOD)**—referred to as "board" in the curriculum
- **Senior Management (SM)**—referred to as "top management" or "management" in the curriculum

A training may involve a mix of these participants, so every topic in the curriculum has been assigned a degree of relevance to the different groups. Using this relevance guide, the trainer can further tailor the overall program to a particular group's needs and agenda.

## *Training framework coverage*

The SOE Leadership Toolkit curriculum is divided into four parts, each including various modules that explore the topics shown in Figure 1.

Each of the four parts of the framework comprises three to five modules that address specific topics as outlined in Table 1.

**Table 1:** Structure of the Training Curriculum

| **Part I – Fundamentals of Corporate Governance** |
|---|
| Introduction to corporate governance for SOEs |
| Role of the state as the owner |
| Protecting minority shareholder and stakeholder rights |
| **Part II – The Board** |
| Board composition and structure |
| Board's role, director's duties, and liabilities |
| Board practices and procedures |
| Improving the board's professionalism and effectiveness |
| **Part III – Strategy, Risk, and Performance** |
| Developing an effective business strategy |
| Financial planning and budgeting for SOEs |
| Financial oversight and decision-making |
| Risk governance |
| **Part IV – Control Environment, Transparency, and Disclosure** |
| Internal and external controls and compliance |
| Financial accounting and disclosure |
| Nonfinancial information reporting and disclosure |
| SOE procurement |

*Source:* World Bank Group (2021)

**Figure 1**: Coverage of the Training Curriculum

| | | |
|---|---|---|
| **Part I** | **Fundamentals of Corporate Governance** | • explores the principles of good corporate governance and the roles played by the state, boards, directors, executive managers, and other stakeholders within the corporate governance system |
| **Part II** | **The Board** | • explores the establishment of a balanced board, roles and responsibilities of the board in SOEs, directors' duties and liabilities, board practices, and improving board professionalism |
| **Part III** | **Strategy, Risk, and Performance** | • explores the development of an effective business strategy, financial planning, oversight and decision making, and risk governance of SOEs |
| **Part IV** | **Control Environment, Transparency and Disclosure** | • explores various aspects of the internal and external control environment, elements and frameworks for effective disclosure and transparency, and the procurement practices for SOEs |

*Source:* World Bank Group (2021)

See *Appendix A*: Detailed Training Curriculum for a framework of the specific topics explored in each module.

## *Training curriculum structure*

Each module includes the following:

- **Contents and schedule**—a detailed lesson plan allocates time for each activity and directs the trainer to relevant material (PowerPoint slides, handouts, case studies, and so on).
- **Handouts** provide background material and source references.
- **PowerPoint slides** support the trainer's presentation and can be modified to match the branding identity of the institution sponsoring the training.
- **Group exercises** provide an interactive format for participants to apply learnings and share their views and experiences.
- **Case studies** (for certain modules) provide experiential learning and reinforce the key learnings from the module.
- **Trainer's notes** walk the trainer through the handout material, slides, exercises, and case studies to provide guidance in conducting the training session.

## *Duration of the training program*

For each module, the time required to cover the topics adequately is 2–3 hours, depending on the complexity of the module.

The time required for the entire training program varies based on the makeup of the participant group (PM, BOD, SM, or a mix). Time allocated for each topic reflects the degree of relevance assigned to that topic for a particular group. For instance, based on 5 hours per day of classroom time, the duration of the training program for PM is 6 days, for BOD it is 7 days, and for SM it is 5 days. For directors or managers prior to their appointment, the delivery can take place over the period of one week. For senior officials and board members, it can be sequenced over a quarter.

If there is a mix of participants in the training, the trainer must appropriately design the training program to complete the series in 8 one-day sessions of 5 hours of classroom time per day.

The modular structure of the SOE Leadership Toolkit takes into consideration the potential time constraints for the target audience, and it allows for a customized/selective training delivery on specific topics relevant to the audience.

## *Training-curriculum design considerations*

To cater to the specific training needs for the state, board members, and senior management of SOEs, the contents of the SOE Leadership Toolkit follow the Organisation for Economic Co-operation and Development (OECD) principles of corporate governance and, more specifically, the G-20/OECD Guidelines on Corporate Governance of State-Owned Enterprises, 2015. See Table 2.

**Table 2:** Coverage of the G-20/OECD Guidelines on Corporate Governance of SOEs, 2015

| OECD Guidelines | Part I | Part II | Part III | Part IV |
|---|---|---|---|---|
| Rationale for state ownership | ☑ | NA | ☑ | NA |
| The state's role as an owner | ☑ | ☑ | ☑ | NA |
| State-owned enterprises in the marketplace | ☑ | NA | ☑ | ☑ |
| Equitable treatment of shareholders and other investors | ☑ | ☑ | NA | NA |
| Stakeholder relations and responsible business | ☑ | ☑ | ☑ | ☑ |
| Disclosure and transparency | NA | NA | NA | ☑ |
| The responsibilities of the boards of state-owned enterprises | NA | ☑ | NA | ☑ |

*Source:* World Bank Group (2021)

References to the OECD Guidelines are included in the modules and subtopics, with necessary guidance on frameworks, best practices, tools, and techniques that can be leveraged to achieve compliance with the guidelines.

Development of the training curriculum **leveraged numerous information sources**— primarily the **World Bank's Toolkit for Corporate Governance of State-Owned Enterprises (2014)**, the **IFC Board Leadership Training Resources Kit**[1] **developed in 2008**, and the **G-20/OECD Guidelines.** It draws on other references—from the OECD, IFC, World Bank, among numerous others—for specific topics. A detailed list of these references is included in the module handouts by way of cross-referencing, and further reading material is listed under "References" for each module.

## *Incorporating emerging cross-cutting themes*

The SOE Leadership Toolkit identifies and explores emerging themes that have an important place in today's corporate governance landscape. It incorporates these themes into the training curriculum, giving special attention to their relevance to each topic covered. These themes include the following:

### 1. Gender and diversity.

In keeping with the global focus on achieving gender equality and empowering women, as outlined in the United Nations Sustainable Development Goals, the SOE Leadership Toolkit incorporates this key theme into the training curriculum. In several emerging economies, employees at SOEs constitute a large segment of the overall workforce. Accordingly, there needs to be a strong leadership-driven focus on diversity and inclusion to ensure that SOEs are inclusive in their operations and board composition.

To sensitize the board leadership of SOEs on the issues of gender and diversity, the training curriculum incorporates, wherever applicable, a focus on the following:

- *Gender equality in HR policies and practices—recruitment, compensation, promotion, and so on*
- *Gender inclusiveness in board composition*
- *Gender-neutral perspectives for SOE operations and service delivery*

To support the understanding of the importance of this theme, the curriculum includes references to it throughout the coverage of topics and subtopics wherever applicable. Case studies further enhance the apprehension and retention of this knowledge.

### 2. Maximizing finance for development.

Several emerging economies see a future with limited foreign aid and unsustainable levels of public debt. Therefore, there is a renewed focus on domestic revenue mobilization and other innovative mechanisms to finance development outcomes. In several countries, SOEs are some of the largest commercial entities, making it imperative to recognize their potential as financing sources for development projects to drive sustainable economic growth. However, SOEs are often characterized by poor performance, unhealthy finances, and other challenges that prevent them from competing successfully with the private sector.

Given their importance, SOEs must recognize their potential role and contribution to the economy. To help SOEs recognize and realize their role in financing development outcomes and supporting economic growth, the training curriculum incorporates and emphasizes the following:

- *Understanding the importance of SOEs for financing development outcomes and driving economic growth*
- *Strategies for SOEs to create fiscal space to contribute toward financing developmental outcomes*
- *Impact of investment perspective in SOE project planning and implementation*

The key takeaways will be to understand the importance of leveraging the private sector, where there are clear-cut solutions available for doing so, and to optimize the use of scarce public sector resources. To encourage these takeaways, the curriculum includes references to these points throughout the coverage of topics and subtopics wherever applicable, along with case studies to further enhance the adoption and retention of this knowledge.

### 3. Climate change and resilience.

In today's world of accelerating global development, climate change and its economic, environmental, and social implications are fast becoming a paramount challenge in every country's growth, progress, and future well-being. It is a wide-ranging, complex, and multidimensional issue, which varies in nature, degree of impact, and consequences for each country, depending on the country's location, natural endowment, and stage of development, among other factors. Given this wide variation and the practical constraints of time, the main workshop curriculum is limited to the core high-level basics and principles of climate change that every state/ownership entity representative, board member, and key stakeholder needs to understand.

With increasingly unpredictable climate patterns and the growing number of extreme weather events seen across the world, particularly in developing countries, many investments in these countries are exposed to climate risks. Extreme weather events and gradual changes in climate cause damage to infrastructure and disrupt public services. This can have a severe negative impact on a country's development. Moreover, apart from the physical risks of climate change, inadequate or poorly planned transition to low-carbon technologies may also compound the overall risk and associated costs.

A significant portion of public investment (capital expenditure) is routed through various SOEs. Therefore, when planning public investment projects, SOEs need to be alert to climate risks and consider adaptation to climate change in the form of transition to low-carbon technologies. This helps reduce climate-related economic, social, and ecological damage through climate-resilient investments. The World Bank in collaboration with PwC (2019)[2] outlined corporate governance principles to address the risks related to climate change, including climate accountability, subject demand, board structure, materiality assessment, strategic integration, incentivization, reporting and disclosure, and exchange. (These principles are discussed in Part III, Module 4 - Risk governance.)

Consequently, considering the strategic importance of this theme, the necessary components of climate change and resilience are incorporated into the training material, which covers such aspects as the following:

- State climate policy and its role as a shareholder in promoting climate resilience
- Climate risk identification and vulnerability assessments for investment planning and project design (covering the physical and the transition risks)
- Making investments more climate resilient
- Financing climate-resilient investments

These aspects are embedded throughout the relevant topics and subtopics wherever applicable.

### 4. Integrity and anti-corruption.

Corruption remains a serious problem in SOEs and can influence the financial strength and valuation of a company, negatively affect investor perceptions, lead to the misallocation of scarce government resources, and constrain overall economic and financial growth. Better-governed companies with integrity and accountability mechanisms are likely to be less corrupt and more transparent.

The training modules incorporate integrity and anti-corruption mechanisms as appropriate, including the following:

- Incorporating integrity and anti-corruption mechanisms in company policies and procedures such as whistle-blower policy, code of conduct/code of ethics
- Putting a robust internal control environment in place to combat corruption and ethical challenges
- Enhancing disclosure and transparency in financial and nonfinancial reporting to minimize chances of corruption

These aspects are embedded throughout the relevant topics and subtopics wherever applicable, along with case studies to further enhance the adoption and retention of this knowledge.

A detailed mapping of the applicability of these crosscutting themes with various modules is included in **Annex B: Incorporating cross-cutting themes in the curriculum**.

# Key learning objectives

The SOE Leadership Toolkit covers an extensive range of topics to meet the specific learning objectives of a variety of participants. It is designed to provide them with adequate knowledge on these topics and empower them to apply these learnings in their organizations. Key learning objectives, at a broad level, include the following:

- **Improved understanding of corporate governance.** The participants will gain an understanding of the entire corporate governance landscape and of emerging trends and key issues. Most importantly, they will learn how to apply good corporate governance principles and practices in all aspects of the SOE's operations.
- **Strong understanding of the role of the state as an owner.**[3] The principal-agent relationship between the state and the board is very different from conventional relationships between owners/majority shareholders and the board. Thus it is vitally important for both the state and the board members to understand the state's role as an owner as well as principles for effective state-board relationships.
- **Recognition of the need for balanced board composition and formal board procedures.** The politicization of SOE boards is one of the most common challenges facing SOEs. It is important for board members and the state (in its ownership capacity) to understand the need for balanced boards and to adopt structured and formal processes for board member nomination and selection, with due consideration for diversity and inclusion.
- **Strong understanding of conflicts of interest and related-party transactions.** This is an important topic for SOEs as well as private sector entities. To reduce the likelihood of corruption and malpractice, board members must be alert to conflicts of interests and questionable related-party transactions and know how to identify and handle them.
- **Improved capacity for balancing commercial and public service obligations.** This is a critical area for SOEs, which often face challenges related to their dual mandate of meeting commercial objectives while fulfilling public service obligations. The curriculum addresses this topic sufficiently to equip participants to understand the key considerations and decision factors involved in finding the right balance between these multiple objectives.
- **Increased knowledge of financing sources for funding SOE obligations.** It is critical for board members to look beyond the state as a source of funding. The training shows how to explore alternative sources of financing for an SOE's commercial and public service obligations.
- **Improved understanding of internal and external control environment.** SOE boards often find it challenging to define their internal and external control environments, which makes it equally challenging to ensure compliance with control requirements. An objective of the curriculum is to help participants gain an increased understanding of and appreciation for the internal and external control environments, and to equip them with the tools necessary for enforcing compliance with control requirements.
- **Strong understanding of the need for disclosure and transparency.** SOEs often do not place enough importance on disclosure and transparency, partly because in many instances they are not subject to the same standards as those applied to private sector enterprises. For improved corporate governance, it is critical for board members to be sensitized to the need for and benefits of proactive disclosure and transparency (beyond what is expected) and to understand their impact on the SOE's performance.

- **Improved understanding of public investment management, including incorporating climate-change adaption and resilience considerations.** SOEs are often vehicles of public investment, with emphasis on the need to invest in improving the efficiency of this public expenditure. An objective of the curriculum is for participants to understand the principles and the best practices of public investment management, including planning, procurement, and implementation. The training curriculum also covers climate-change adaption and resilience considerations with the aim of sensitizing the board members to the importance of this emerging theme and its impact on public investment.
- **Increased appreciation for anti-corruption measures and integrity.** Because SOEs are publicly owned, they are subject to high standards of public scrutiny, and in the past they have been plagued with issues such as corruption. Responding to this need, the curriculum covers the relevant topics sufficiently to empower board members to strengthen the integrity of their practices and implement anti-corruption measures to improve governance.

## *Snapshot of training delivery approach*

Several critical steps are involved in formulating a structured training delivery plan. Effective implementation of these steps will help meet the training objectives, participant objectives, and learning objectives, and will improve participant commitment.

Figure 2 outlines the steps involved in formulating a training plan. A separate document in this SOE Leadership Toolkit, "Methodological Note for Trainers," discusses these steps in detail.

## *Using the prioritization matrix*

In the prioritization matrix every topic in the curriculum is assigned a degree of relevance for each of the three trainee groups: policy makers (PM), board of directors (BOD), and senior management (SM). Based on the degree of relevance, the matrix provides a standard allocation of time for each topic. (See Table 3.) Where the time allotted for certain modules results in less than five minutes, that is considered to be below the materiality threshold and is equivalent to "no relevance."

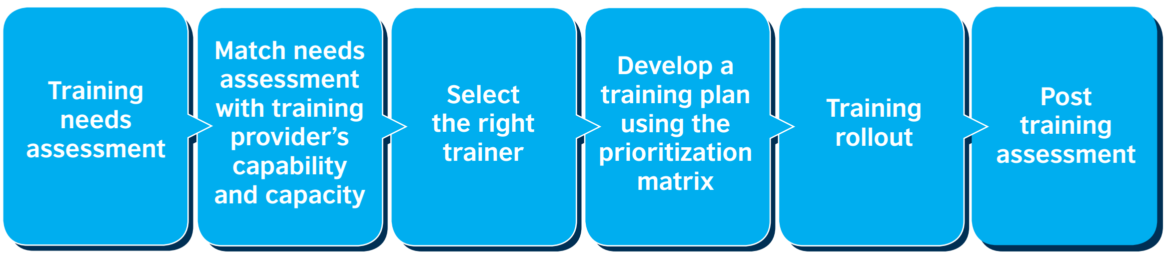
**Table 3**: Standard Time Allocation Based on the Degree of Relevance

| Degree of relevance | Time allocation (%) |
|---|---|
| Highly relevant | 100 |
| Medium relevance | 50 |
| Low relevance | 25 |
| No relevance | 0 |

*Source:* World Bank Group (2021)

The trainer institution should use the prioritization matrix to customize the agenda based on the composition of the trainee group. Customization is particularly important when the participants represent a mix of two or more of the trainee groups. The customized agenda will be a key determinant in the selection of a trainer and the follow-on training rollout.

**Figure 2**: Steps in Formulating a Training Plan




*Source*: Adapted from *Corporate Governance Board Leadership Training Resources Kit* (IFC, World Bank Group, 2008).

### *Importance of embedding experiential learning cycle (ELC) in training delivery*

By embedding ELC[4] in the overall training delivery, the trainer can ensure that the training has practical benefits for the participants. The experiential learning cycle appeals to diverse learners and incorporates practical experiences from life. This four-step learning process relates directly to adult learning. It also forms the basis for program design and session planning.

People learn best when given an opportunity to acquire knowledge and skills relevant to specific experiences. Experiential learning occurs in a circular or spiral process that involves four interrelated phases, as illustrated in Figure 3. The four phases of experiential learning:

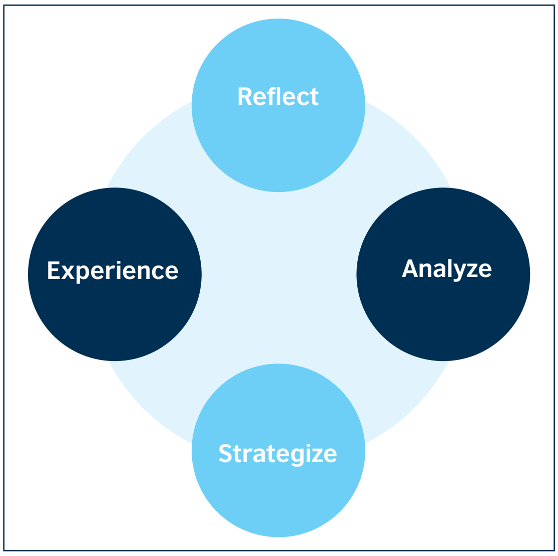
- Having an experience
- Reflecting on the experience
- Analyzing to form generalizations
- Strategizing to apply understandings to a relevant experience

Each phase in the learning cycle is related to and builds on what happened before. Learners can begin at any one of the four phases of the cycle, yet the learning process most often begins with a specific experience.

First comes the experience. Then learners reflect on the experience, considering what they observed, who was involved, and why it was significant. Next they analyze the experience to identify patterns, causes, results, and options. Using what they've learned, they strategize how to apply these lessons to relevant situations. Facing similar situations, learners will begin this process afresh. These phases are discussed in detail in the "Methodological Note for Trainers."

In the training sessions, the participants share in the experiential learning, working in pairs or groups.

**Figure 3:** Experiential Learning Cycle




*Source: Adapted from Corporate Governance Board Leadership Training Resources Kit* (IFC, World Bank Group, 2008)

## Notes:

1 IFC. 2008. *Toolkit 3: Corporate Governance Board Leadership Training Resources Kit.* Washington, DC: World Bank Group. https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/ifc+cg/resources/toolkits+and+manuals/leadershiptoolkit.

2 World Economic Forum. 2019. *How to Set Up Effective Climate Governance on Corporate Boards: Guiding Principles and Questions*. Geneva, Switzerland: World Economic Forum. http://www3.weforum.org/docs/WEF_Creating_effective_climate_governance_on_corporate_boards.pdf.

3 For the purpose of this curriculum, the terms *state* and *ownership entity* are used interchangeably unless otherwise specified.

4 Kolb, David A. 1984. *Experiential Learning: Experience as the Source of Learning and Development*. Englewood Cliffs, NJ: Prentice-Hall.

# Annex A: Detailed training curriculum

**Table 4:** Detailed Training Curriculum

| Part/Module/Topic | Time allocation as per curriculum (in mins) | | | | Prioritization (Degree of relevance) | | | Duration of each topic (in mins) | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Particulars** | **Interactive presentation** | **Exercise / Activities** | **Case studies** | **Total** | **PM** | **BOD** | **SM** | **PM** | **BOD** | **SM** |
| **PART I: FUNDAMENTALS OF CORPORATE GOVERNANCE** | | | | | | | | | | |
| **MODULE 1: INTRODUCTION TO CORPORATE GOVERNANCE FOR SOEs** | | | | | | | | | | |
| Introduction to overall program | 20 | | | 20 | ● | ● | ● | 20 | 20 | 20 |
| Defining corporate governance for SOEs | 20 | | | 20 | ● | ● | ● | 20 | 20 | 20 |
| Key principles of good corporate governance systems | 30 | 30 | | 60 | ● | ● | ● | 60 | 60 | 60 |
| Business case for corporate governance including corporate governance concerns and challenges | 30 | | 30 | 60 | ● | ● | ◑ | 60 | 60 | 30 |
| Corporate governance policies and procedures – Country and company level with an emphasis on legal and regulatory framework for SOEs | 30 | | | 30 | ● | ◔ | ● | 30 | 8 | 30 |
| **MODULE 2: ROLE OF THE STATE AS THE OWNER/MAIN SHAREHOLDER** | | | | | | | | | | |
| Defining state ownership role | 20 | | | 20 | ● | ● | ◔ | 20 | 20 | 5 |
| The core rights and functions of the State acting as owner: Overview of different ownership modules, legal framework and ownership policies | 30 | 30 | | 60 | ● | ◔ | ◔ | 60 | 15 | 15 |
| Setting the policy priorities (commercial vs public policy objectives, dividend policy) | 30 | | | 30 | ● | ◑ | ◔ | 30 | 15 | 8 |
| Ensuring competitive neutrality | 30 | | | 30 | ● | ◑ | ○ | 30 | 15 | - |
| State's ownership role over the Board (selection and removal of board members) | 25 | | 30 | 55 | ● | ◑ | ◔ | 55 | 28 | 14 |
| State's financial monitoring responsibilities | 30 | | | 30 | ● | ● | ◔ | 30 | 30 | 8 |
| Criteria for assessing fiscal risks of SOEs | 30 | | | 30 | ● | ◑ | ○ | 30 | 15 | - |
| State-Board relations and communication -the Do and Don't | 30 | | 30 | 60 | ● | ● | ◔ | 60 | 60 | 15 |
| Monitoring SOE performance via performance agreement | 30 | | | 30 | ● | ◔ | ◔ | 30 | 8 | 8 |
| **MODULE 3: PROTECTING MINORITY SHAREHOLDER AND STAKEHOLDER RIGHTS** | | | | | | | | | | |
| Importance of minority protection, international good practices and key elements | 30 | | | 30 | ◑ | ◔ | ◑ | 15 | 8 | 15 |
| Shareholder rights - minority and golden shares | 30 | 30 | | 60 | ◑ | ◔ | ◑ | 30 | 15 | 30 |
| Key stakeholders in SOEs with a focus on stakeholder identification/mapping, stakeholder engagement and external communication mechanism. | 40 | | | 40 | ◑ | ● | ● | 20 | 40 | 40 |

| Part/Module/Topic | Time allocation as per curriculum (in min) | | | | Prioritization (Degree of relevance) | | | Duration of each topic (in min) | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Particulars** | **Interactive presentation** | **Exercise / Activities** | **Case studies** | **Total** | **PM** | **BOD** | **SM** | **PM** | **BOD** | **SM** |
| **PART II: THE BOARD** | | | | | | | | | | |
| **MODULE 1: BOARD COMPOSITION AND STRUCTURE** | | | | | | | | | | |
| Characteristics of a balanced board including gender aspects | 30 | | | 30 | ● | ● | ◔ | 30 | 30 | 8 |
| Optimizing Board size | 15 | 30 | | 45 | ● | ● | ◔ | 45 | 45 | 11 |
| Types of directors and their leadership attributes | 35 | | | 35 | ● | ● | ● | 35 | 35 | 35 |
| Establish specialized board committees (audit committee, sustainability committee, risk committee, HR committee) | 45 | | 30 | 75 | ◑ | ● | ◑ | 38 | 75 | 38 |
| **MODULE 2: BOARD'S ROLES, DIRECTOR'S DUTIES AND LIABILITIES** | | | | | | | | | | |
| Board's roles and responsibilities including facing ethical challenges, anti-corruption and integrity, codes of ethics/conduct and whistleblowing | 45 | | | 45 | ● | ● | ◔ | 45 | 45 | 11 |
| Role of the state representative on SOE board | 20 | | | 20 | ● | ● | ◔ | 20 | 20 | 5 |
| Differentiate managing versus directing and identifying dilemmas | 30 | | | 30 | ◔ | ● | ◔ | 8 | 30 | 8 |
| Director's legal duties and liabilities | 45 | | 30 | 75 | ◑ | ● | ◔ | 38 | 75 | 19 |
| **MODULE 3: BOARD PRACTICES AND PROCEDURES** | | | | | | | | | | |
| Role of the Company Secretary | 20 | | | 20 | ◔ | ● | ◔ | 5 | 20 | 5 |
| Meeting preparation | 10 | 10 | | 20 | ◔ | ● | ◔ | 5 | 20 | 5 |
| Conducting meetings | 10 | 10 | | 20 | ◔ | ● | ◔ | 5 | 20 | 5 |
| Follow up and in between meeting | 10 | 10 | | 20 | ◑ | ● | ◔ | 10 | 20 | 5 |
| Communicating with the State/ Shareholder | 10 | 10 | | 20 | ● | ● | ◔ | 20 | 20 | 5 |
| **MODULE 4: IMPROVING BOARD PROFESSIONALISM AND EFFECTIVENESS** | | | | | | | | | | |
| Chairman and CEO - role separation | 30 | | | 30 | ◑ | ● | ◔ | 15 | 30 | 8 |
| Develop formal (written) policies and procedures for board operations | 30 | | | 30 | ◔ | ● | ◔ | 8 | 30 | 8 |
| Board evaluation systems | 20 | 30 | | 50 | ● | ● | ◔ | 50 | 50 | 13 |
| Characteristics of dysfunctional boards | 20 | | | 20 | ● | ● | ◔ | 20 | 20 | 5 |
| Remuneration policies for the Board of SOEs in line with Government policy | 30 | | | 30 | ● | ● | ◔ | 30 | 30 | 8 |
| Invest in board director training, including identification of general environmental and social risk issues | 20 | | | 20 | ● | ● | ◔ | 20 | 20 | 5 |

| Part/Module/Topic | Time allocation as per curriculum (in min) | | | | Prioritization (Degree of relevance) | | | Duration of each topic (in min) | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Particulars** | **Interac-tive pres-entation** | **Exercise / Activities** | **Case studies** | **Total** | **PM** | **BOD** | **SM** | **PM** | **BOD** | **SM** |
| **PART III: STRATEGY, RISK, AND PERFORMANCE** | | | | | | | | | | |
| **MODULE 1: DEVELOPING AN EFFECTIVE BUSINESS STRATEGY** | | | | | | | | | | |
| Elements of a good strategy | 30 | | | 30 | ◔ | ● | ● | 8 | 30 | 30 |
| Board's role in the governance of a company's strategy, including governance of risk | 25 | | | 25 | ◑ | ● | ◔ | 13 | 25 | 6 |
| Stratergic planning process (role of the board vs management) | 30 | | | 30 | ◑ | ● | ● | 15 | 30 | 30 |
| Tools to formulate strategy linking Performance Management Agreement (PMA) and CG code | 30 | | | 30 | ● | ● | ◔ | 30 | 30 | 8 |
| Balancing SoE public service obligations with commercial obligations<br>Role of state- setting broad mandates and objectives<br>Role of the board -setting the strategy | 30 | | 30 | 60 | ● | ● | ◔ | 60 | 60 | 15 |
| Monitoring implementation of strategy by management | 30 | 30 | | 60 | ◑ | ● | ● | 30 | 60 | 60 |
| HR policy to support strategy delivery (planning and recruitment, training and development, management, board succession) | 45 | | | 45 | ● | ● | ● | 45 | 45 | 45 |
| **MODULE 2: FINANCIAL PLANNING AND BUDGETING FOR SOE SERVICE OBLIGATIONS** | | | | | | | | | | |
| Budgeting process and management in SOEs | 30 | | | 30 | ◑ | ● | ◔ | 15 | 30 | 8 |
| Financing options for service obligations, advantages and disadvantages | 30 | | | 30 | ● | ● | ◔ | 30 | 30 | 8 |
| **MODULE 3: FINANCIAL OVERSIGHT AND DECISION-MAKING** | | | | | | | | | | |
| Financial oversight arrangements in SOEs - Board level | 30 | | | 30 | ◑ | ● | ◔ | 15 | 30 | 8 |
| Assessing financial performance and health of SOEs | 45 | | 30 | 75 | ● | ● | ● | 75 | 75 | 75 |
| Company's capital gearing, dividend policy and valuation | 45 | | | 45 | ◑ | ● | ◔ | 23 | 45 | 11 |
| Subsidiary governance | 20 | | | 20 | ◑ | ● | ◔ | 10 | 20 | 5 |
| **MODULE 4: RISK GOVERNANCE** | | | | | | | | | | |
| Concepts and nature of risk management (risk identification/ mapping, role of the board, risk function and reporting of risk) | 30 | | | 30 | ◑ | ● | ◔ | 15 | 30 | 8 |
| Risk appetite, strategy and management | 30 | | | 30 | ◑ | ● | ● | 15 | 30 | 30 |
| Risks arising from Environmental, Climate and Social factors | 45 | | | 45 | ◑ | ● | ● | 23 | 45 | 45 |
| Disaster recovery and business continuity planning | 30 | | | 30 | ◑ | ● | ● | 15 | 30 | 30 |

| Part/Module/Topic | Time allocation as per curriculum (in min) | | | | Prioritization (Degree of relevance) | | | Duration of each topic (in min) | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Particulars | Interac-tive pres-entation | Exercise / Activities | Case studies | Total | PM | BOD | SM | PM | BOD | SM |
| **PART IV: CONTROL ENVIRONMENT, TRANSPARENCY, AND DISCLOSURE** | | | | | | | | | | |
| **MODULE 1: INTERNAL AND EXTERNAL CONTROLS & COMPLIANCE** | | | | | | | | | | |
| Understanding the control environment including internal and external controls | 30 | | 30 | 60 | ◑ | ● | ● | 30 | 60 | 60 |
| Internal audit, risk assessment and decision-making frameworks | 45 | 45 | | 90 | ◑ | ● | ● | 45 | 90 | 90 |
| Importance of a comprehensive compliance program | 30 | | | 30 | ◑ | ● | ● | 15 | 30 | 30 |
| HR procedures and control (HR compen-sation, HR performance management) | 30 | | | 30 | ◑ | ● | ● | 15 | 30 | 30 |
| Effective organizational structure | 30 | | | 30 | ◑ | ● | ● | 15 | 30 | 30 |
| External audit for SOEs/Role of the Supreme Audit Institution/Parliamentary Oversight) | 30 | | | 30 | ◑ | ● | ● | 15 | 30 | 30 |
| **MODULE 2: FINANCIAL ACCOUNTING AND DISCLOSURE** | | | | | | | | | | |
| Transparency and disclosure of financial information | 15 | | | 15 | ◑ | ● | ● | 8 | 15 | 15 |
| International and local accounting environment for SOEs | 45 | | | 45 | ◑ | ● | ● | 23 | 45 | 45 |
| Financial reporting of SOEs, key users and their need for information | 30 | 30 | | 60 | ◑ | ● | ● | 30 | 60 | 60 |
| Consequences of inadequate financial information | 20 | | 30 | 50 | ● | ● | ● | 50 | 50 | 50 |
| **MODULE 3: NONFINANCIAL INFORMATION REPORTING AND DISCLOSURE** | | | | | | | | | | |
| Nonfinancial information disclosure | 15 | | | 15 | ◑ | ◔ | ● | 8 | 4 | 15 |
| Disclosure provisions under procure-ment guidelines and right to information | 30 | | | 30 | ◑ | ◔ | ● | 15 | 8 | 30 |
| Sustainability Reporting | 30 | | | 30 | ◑ | ◔ | ● | 15 | 8 | 30 |
| Narrative reporting and methods of communication | 30 | | | 30 | ◑ | ◔ | ● | 15 | 8 | 30 |
| **MODULE 4: SOE PROCUREMENT** | | | | | | | | | | |
| Good procurement principles and standards for SOEs | 30 | | | 30 | ● | ◔ | ● | 30 | 8 | 30 |
| Developing a procurement strategy and plan based on market assessment | 30 | | | 30 | ◑ | ● | ● | 15 | 30 | 30 |
| Efficient procurement processes and competencies | 30 | | | 30 | ◑ | ◔ | ● | 15 | 8 | 30 |
| Transparency and integrity of SOE procurement | 30 | | | 30 | ◑ | ◑ | ● | 15 | 15 | 30 |
| **Total (min)** | | | | | | | | **1,853** | **2,241** | **1,605** |
| **Total (hours)** | | | | | | | | **31** | **37** | **27** |
| **Total (days)** | | | | | | | | **6** | **7** | **5** |

| Legend | Harvey Ball Icon | Degree of relevance | Time allocation |
|---|---|---|---|
| | ● | highly relevant | 100% |
| | ◑ | medium relevance | 50% |
| | ◔ | low relevance | 25% |
| | ○ | no relevance | 0% |

# Annex B: Incorporating cross-cutting themes in the curriculum

**Table 5:** Cross-cutting Themes in the Curriculum

| Module No. and title | Mapping of cross-cutting themes to the respective parts/modules | MFD | Gender | Integrity and anti-corruption | Climate change and resil-ience |
|---|---|---|---|---|---|
| **Part I** | | | | | |
| 2. Role of the state as an owner/main shareholder | Adoption of professional criteria for the selection and removal of board members | | ✓ | ✓ | |
| | Fiscal risk assessment and oversight, vetting of the business case of SOE investments/MFD (when treasury guarantee or financing is sought), and performance monitoring | ✓ | | | ✓ |
| 3. Protecting minority shareholder and stakeholder rights | Shareholder rights— minority and golden shares | | | ✓ | |
| | Key stakeholders in SOEs with a focus on environmental and social responsibility | | ✓ | ✓ | ✓ |
| **Part II** | | | | | |
| 1. Board composition and structure | Characteristics of a balanced board | | ✓ | | |
| 2. Board's roles, director's duties, and liabilities | Board's roles and responsibilities, including facing ethical challenges, anti-corruption, and integrity | | | ✓ | ✓ |
| | Role of the state representative | ✓ | | ✓ | |
| 3. Board practices and procedures | Ensuring clear policies for addressing potential conflicts of interest, ethical challenges and responses, and strengthening anti-corruption and integrity measures | | | ✓ | |
| **Part III** | | | | | |
| 1. Developing an effective business strategy | Strategic planning process | | | | ✓ |
| | HR policy to support strategy delivery (planning and recruitment, training and development) | | ✓ | | |
| 2. Financial planning for SOE service obligations | Financing options for service obligations, advantages, and disadvantages | ✓ | | | |
| 3. Risk governance | Risks arising out of environmental and social factors | | | | ✓ |
| **Part IV** | | | | | |
| 1. Internal and external controls and compliance | Understanding the control environment, including internal controls and internal audit | | | ✓ | |
| | HR procedures and control (HR compensation, HR performance management) | | ✓ | | |
| | Whistle-blowing | | | ✓ | |
| 2. Financial accounting and disclosure | Disclosures and transparency | | | ✓ | ✓ |
| | Consequences of inadequate financial information | | | ✓ | |
| 3. Nonfinancial information reporting and disclosure | Sustainability reporting | | | | ✓ |
| 4. SOE procurement | Transparency and integrity of SOE procurement | | | | ✓ |

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I

# Corporate Governance

Leadership Training Toolkit for SOEs

**Part I Module 1**
Fundamentals of Corporate Governance

# Introduction to Part I: Fundamentals of Corporate Governance

> *"Corporate governance refers to structures and processes for the direction and control of companies. Corporate governance concerns the relationships among the management, board of directors, controlling shareholders, minority shareholders, and other stakeholders. Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital."*
> – International Finance Corporation (IFC)

Part I explores the roles played by the shareowners, boards, directors, executive managers, and other stakeholders within the corporate governance system, and the principles underlying a sound corporate governance system.

**Table 6**: Coverage of OECD Guidelines on Corporate Governance of State-Owned Enterprises (SOEs) in Part I

| OECD Guidelines | Coverage |
|---|---|
| Rationales for state ownership | ☑ |
| The state's role as an owner | ☑ |
| State-owned enterprises in the marketplace | ☑ |
| Equitable treatment of shareholders and other investors | ☑ |
| Stakeholder relations and responsible business | ☑ |
| Disclosure and transparency | ☑ |
| The responsibilities of the boards of state-owned enterprises | ☑ |

**Figure 4**: Contents of Part I

| | | |
|---|---|---|
| Module 1 | **Introduction to corporate governance** | • This module provides an overview of the corporate governance landscape in the SOE context, covering the key principles, elements, and guidelines for developing an effective corporate governance framework. It also discusses the business case for corporate governance. |
| Module 2 | **Role of the state as an owner** | • This module describes the rights and responsibilities of the state as an owner. It covers various ownership models, responsibilities of the state with respect to board nominations, financial oversight, and performance monitoring. It also discusses state-board relationships. |
| Module 3 | **Protecting minority shareholder and stakeholder rights** | • This module examines the importance of minority protection, shareholder rights for the minority and golden shares as well as the key stakeholder environment in SOEs. |

# Part I Module 1: Fundamentals of Corporate Governance

This session (module) covers the following topics:

1 Defining corporate governance for SOEs

2 Key principles of good corporate governance system

3 Business case for corporate governance

4 Corporate governance policies and procedures

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## Learning objectives

By the end of this module, the participants will be able to

- **Appreciate the significance and unique challenges of SOE corporate governance within a larger universal corporate governance context and vision of success**
- **Describe the types of SOEs and define corporate governance in SOEs**
- **Identify the key elements and principles of corporate governance as prescribed in OECD Guidelines for SOEs**
- **Explain the importance of corporate governance in SOEs**
- **Identify and detail the concerns and challenges of corporate governance in SOEs**
- **Identify the constituents of the corporate governance framework, both at the country level and the company level**

## Agenda

**Total time: 3 hours 10 min**

| Time | Topic |
|---|---|
| 20 min | Introduction to the overall program |
| 20 min | Defining corporate governance for SOEs |
| 30 min | Key principles of good corporate governance |
| 30 min | Exercise on principles of good corporate governance |
| 30 min | The business case for corporate governance including corporate governance concerns and challenges |
| 30 min | Case study on a business case for corporate governance |
| 30 min | Corporate governance policies and procedures – country and company level with an emphasis on the legal and regulatory framework for SOEs |

## Topic one: Defining corporate governance for SOEs

### Definition of corporate governance in SOEs

The World Bank Group (WBG) defines corporate governance as a set of structures and processes for the direction and control of companies. It involves relationships between the company's shareholders, stakeholders, board, and executive bodies for creating sustainable and long-term value. It ties together the strategy and performance dimensions of the company.

Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital. Improved governance structures and processes help ensure quality decision-making, encourage effective succession planning for senior management, and enhance the long-term prosperity of companies, independent of the type of company and its sources of finance.

Essentially, the definition of corporate governance does not distinguish between the private and public sector. The difference lies in the process of implementation and functioning of corporate governance. For example, while the functions and responsibilities of the board do not differ between the private sector and SOE, the establishment and composition structure of the board, board procedures and management will vary from the private sector to SOEs.

Owing to the prevalence of SOEs and their specific governance challenges, a need for developing tailored corporate governance principles and guidelines was identified, materializing as the OECD Principles and Guidelines on Corporate Governance for SOEs. They are the internationally agreed standard for how governments should exercise the state ownership function to avoid the pitfalls of both passive ownership and excessive state intervention.

The guidelines were first developed in 2005 as a complement to the OECD Principles of Corporate Governance. They have been updated in 2015 to reflect a decade of experience with their implementation and address new issues that have arisen concerning SOEs in the domestic and international context. The Guidelines provide advice on how governments can ensure that SOEs are at least as accountable to the general public as a listed company should be to its shareholders. Consequently, these principles and guidelines form a key part of the framework for this training curriculum.

### Defining SOEs

SOEs are known by many names—public corporations, government corporations, government business enterprises, government-linked companies, parastatals, public enterprises, and public sector units or enterprises.

The OECD Guidelines for Corporate Governance in SOEs define "any corporate entity recognized by national law as an enterprise, and in which the state exercises ownership, should be considered as an SOE. This includes joint-stock companies, limited liability companies and partnerships limited by shares. Moreover, statutory corporations, with their legal personality established through specific legislation, should be considered as SOEs if their purpose and activities, or parts of their activities, are of a largely economic nature."

The rationale for state ownership of enterprises varies among countries and industries. It can typically be to comprise a mix of social, economic, and strategic interests. Often, in sectors that have less penetration of private sector enterprises, governments invest in the establishment of industries to maximize community welfare. Also, the government's entry into the production of goods and services renders control of natural monopolies, 'regulates' competition, and facilitates the pursuit of social objectives.

### *Types of SOEs*

SOEs come in different legal forms and typically reside at the intersection of public and private law, with significant variation among countries and across sectors. SOE legal frameworks range from a full-fledged application of public law to a private law framework or a mixed approach that places some SOEs under public law, others under private corporate law, and the remaining under both. There is a wide range of legal forms for SOEs,[5] depending on the following factors:

- The level of government that owns the enterprise (central/federal, state/regional, or local)
- How the enterprise was founded
- The purpose of the SOE
- The status of the SOE if it is in the process of being privatized

Other variations include

- Full, majority, or minority ownership by the government
- Listing (or not) on a stock exchange
- Government shareholdings through vehicles such as government pension funds, asset management funds, restructuring corporations, and development lenders
- State-enabled (for example, enterprises that have been granted exclusive rights by the state) as opposed to state-owned.

In some cases, an individual SOE may be set up as a statutory corporation established by an act of parliament and governed by its special statute that gives it financial independence or certain special power (for example, authority to collect specific fees). Such SOEs are often legally assigned a specific policy goal or tasks other than profit maximization. Such SOEs are typically wholly state-owned and operate in sectors, where public authorities are the most directly involved, such as the supply of public services or utilities. More typically, SOEs are in the form of public enterprises that may or may not be corporatized.

In many countries, incorporated SOEs in the form of joint-stock companies or limited liability companies are regulated by normal company legislation as outlined in Box 1.

**Box 1: Example of Countries with SOEs under Company Legislation**

Corporatized SOEs operate under normal company legislation in many countries and sometimes under both company law and SOE law:

- *In Bhutan*, SOEs operate under the company law, they must also abide by the SOE ownership policy that is in place.
- *In Chile*, company law applies to all SOEs except for nine large SOEs that have their own separate laws.
- *In Ghana* and *Kenya*, SOEs are governed mainly by company law.
- *In India*, SOEs fall under company law but must also follow different guidelines established for SOEs as well as a corporate governance code for SOEs.
- *In Malaysia*, government-linked corporations (GLCs) are governed by company law with the GLC Transformation Program and the *GLC Transformation Manual* in place.
- *In Pakistan*, SOEs are regulated by the Companies' Ordinance and by recently issued Rules on Corporate Governance for SOEs.
- *In Peru*, SOEs fall under both company law and an SOE law that creates the state ownership entity FONAFE, with a corporate governance code in place for SOEs.
- *In Serbia*, corporatized SOEs fall under the new company law.
- *In South Africa*, SOEs operate under company law with the Protocol for Corporate Governance in place.
- *In Zambia*, most of the SOEs are legally founded under the Companies Act.

*Source:* IFC. 2008. *Toolkit 3: Corporate Governance Board Leadership Training Resources Kit*. World Bank Group.

# Topic two: Key principles of good corporate governance systems

## *Four pillars of corporate governance*

Primarily, corporate governance relies on the foundation of trust among shareowners, directors, and managers, which is built on the following:

- **Transparency.** Directors should clearly communicate any material decisions to relevant stakeholders to bring visibility into performance. Detailed and sincere financial statements are published on time.
- **Accountability.** Employees at all levels take responsibility for their actions and achievements.
- **Fairness.** All shareowners should receive equal, just, and unbiased consideration by the directors and management.
- **Responsibility.** Directors and other leaders should carry out their duties with honesty, probity, and integrity.

The mentioned principles intend to assist governments in their efforts to evaluate and improve the legal, institutional, and regulatory frameworks for corporate governance in their countries and to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance. These principles also provide the bedrock for the establishment of a corporate governance framework discussed in the subsequent sections. (*See Topic 4 in this module.*)

The principles are also applicable to SOEs and compatible with the OECD Guidelines on Corporate Governance of State-Owned Enterprises. As an indication of their universal acceptance, these six OECD principles have been endorsed by the WBG, the United Nations (UN), the International Organization of Securities Commissions (IOSCO), the Basel Committee for Banking Supervision, the Islamic Financial Services Board and all 30 OECD member countries.

## *Fundamentals of corporate governance for SOEs*

The OECD Guidelines on Corporate Governance of State-Owned Enterprises postulate specific guidance to countries on effectively managing their responsibilities as company owners and establishing a good corporate governance environment in the SOEs to make them more competitive, efficient, and transparent. (*See Handout on G-20/OECD Guidelines for SOEs, 2015.*)

The following constitute the elements of a good corporate governance system (elaborated in Table 7):

- Good board practices
- Effective controls
- Transparent disclosure
- Well-defined shareowner rights
- Board commitment
- Environment, Social, and Corporate Governance (ESG)
- Financial discipline

Table 7 illustrates the content of the seven fundamental elements of corporate governance and how they relate to the G-20/OECD Guidelines which are presented as an additional read in this material.

While Table 7 covers the fundamentals of good corporate governance, it has evolved significantly over the past decade, expanding to cover various new themes such as integrity and anti-corruption, climate change and resilience, and gender diversity and inclusion. This is further illustrated in Box 2 and incorporated in this SOE leadership toolkit as cross-cutting themes.

## Box 2: Recent Trends in Corporate Governance

The existing debates on corporate governance have gained new intensity in the face of mega-forces such as climate change, income inequality, digitalization, and so on, sweeping the globe. The past few years have seen a proliferation of statements, proposals, and revised codes of corporate governance such as the 'New Paradigm', the 'Common Sense Principles', the 'King IV Report', and the '2018 UK Corporate Governance Code', and so on. While some of these statements reaffirm conventional doctrines and practices, others call for efforts to better align the activities of corporations with society's interest in building a more inclusive, equitable, and sustainable economy.

In recent years, the environment and social dimensions of ESG have become two such emerging global governance trends. Investors increasingly demand greater focus and disclosure about climate-related risks, conflict minerals in the supply chain, workplace safety measures, or various pay ratios, for example—calls with regard to comprehensive periodic reports on companies' social and environmental performance.

Asset managers and asset owners are integrating ESG into investment decisions, some under the framework of sustainability or integrated reporting. The priority for investors involves linking sustainability to long-term value creation and balancing ESG risks with opportunities. ESG oversight, improved disclosure, relative company performance against peers, and understanding how these issues are built into corporate strategy are the key focus areas. Climate change and sustainability are critical issues to many investors and are at the forefront of governance in many countries. Therefore, 'climate change and resilience' comprise a major cross-cutting theme of this Toolkit and is discussed under relevant topics as mentioned in Annex B.

*Sources:*

O'Kelley, Rusty, Anthony Goodman, and Melissa Martin. 2018, Russell Reynolds Associates, 2019 *Global & Regional Trends in Corporate Governance*. Harvard Law School Forum on Corporate Governance.

Sharma, Abha, and Howard Dicker. 2018. *Common Sense Principles: A Blueprint for U.S. Corporate Governance?* Harvard Law School Forum on Corporate Governance.

Integrated Reporting Committee of South Africa. 2017. *Disclosure of Governance Information in the Integrated Report*. Institute of Directors, South Africa.

Financial Reporting Council. 2018. *The UK Corporate Governance Code*. London.

**Table 7**: G-20/OECD Guidelines on Corporate Governance of SOEs

| Fundamentals of Corporate Governance | G-20/OECD Guidelines for Corporate Governance in SOEs, 2015 |
|---|---|
| **Good Board Practices**<br>• Clearly defined roles and authorities<br>• Duties and responsibilities of directors understood<br>• Board is well-structured<br>• Appropriate composition and mix of skills<br>• Appropriate board procedures<br>• Director remuneration in line with best practice<br>• Board self-evaluation and training conducted | **The boards of SOEs should have the necessary authority, competencies, and objectivity to carry out their functions of strategic guidance and monitoring of management. They should act with integrity and be held accountable for their actions.** |
| **Control Environment**<br>• An independent audit committee established<br>• Risk-management framework present<br>• Internal control procedures<br>• Internal audit function<br>• Independent external auditor conducts audits<br>• Management information systems established<br>• Compliance function established | A. SOEs' annual financial statements should be subject to an independent external audit based on high-quality standards. Specific state control procedures do not substitute for an independent external audit.<br><br>B. SOEs should develop efficient internal audit procedures and establish an internal audit function that is monitored by and reports directly to the board and to the audit committee or the equivalent corporate organ. |
| **Transparent Disclosure**<br>• Financial information disclosed<br>• Nonfinancial information disclosed<br>• Financials prepared according to International Financial Reporting Standards (IFRS)<br>• High-quality annual report published<br>• Web-based disclosure | **State-owned enterprises should observe high standards of transparency and be subject to the same high-quality accounting, disclosure, compliance, and auditing standards as listed companies.** |

| | |
|---|---|
| **Well-defined Shareowner Rights**<br>• Minority shareholder rights are formalized<br>• Well-organized general assembly conducted<br>• Policy on related-party transactions<br>• Policy on extraordinary transactions<br>• Clearly defined and explicit dividend policy | • The state exercises the ownership of SOEs in the interest of the public. It should carefully evaluate and disclose the objectives that justify state ownership and subject these to a recurrent review.<br>• The state should act as an informed and active owner, ensuring that the governance of SOEs is carried out in a transparent and accountable manner, with a high degree of professionalism and effectiveness.<br>• Where SOEs are listed or otherwise include non-state investors among their owners, the state and the enterprises should recognize the rights of all shareholders and ensure equitable treatment to shareholders and equal access to corporate information.<br>• The state ownership policy should fully recognize SOEs' responsibilities toward stakeholders and request that SOEs report on their relations with stakeholders. It should clarify any expectation the state has for responsible business conduct by SOEs. |
| **Board Commitment**<br>• The board discusses corporate governance issues and has created a corporate governance committee<br>• The company has a corporate governance champion<br>• A corporate governance improvement plan has been created<br>• Appropriate resources are committed<br>• Policies and procedures have been formalized and distributed to relevant staff<br>• A corporate governance code has been developed<br>• The company is publicly recognized as a corporate governance leader | **The boards of SOEs should have the necessary authority, competencies and objectivity to carry out their functions of strategic guidance and monitoring of management. They should act with integrity and be held accountable for their actions.** |
| **Environment, Social, and Governance (ESG)**<br>• Periodic disclosure to shareholders and the public on the SOE's CG framework and practices and their conformance to the country's national CG code of best practices are disseminated.<br>• A compliance function ensures compliance with ESG policies and procedures, code of ethics and/or conduct.<br>• The company is publicly recognized, at least among SOEs, as a global leader in ESG practices. | **The state ownership policy should fully recognize the SOEs' responsibilities toward stakeholders and request that SOEs publish a report on their relationships with stakeholders. It should clarify any expectation the state has regarding responsible business conduct by SOEs.** |
| **Financial Discipline**<br>• The SOE has clearly identified and differentiated between its commercial and policy objectives<br>• The SOE's commercial and policy objectives are explicit and disclosed to the public<br>• Funding costs and sources, including any form of financial assistance from the state are transparent and disclosed to the public<br>• If any public procurement rule applies to the SOE, it does not unduly restrict the ability of the SOE to procure goods and services. | **SOEs should report material financial and nonfinancial information to the enterprise in line with high-quality internationally recognized standards of corporate disclosure, including areas of significant concern for the state as an owner and the public. This includes SOE activities that are carried out in the public interest. With due regard to enterprise capacity and size, examples of such information include:**<br>a. A clear statement to the public of enterprise objectives and their fulfilment (for fully owned SOEs, this would include any mandate elaborated by the state ownership entity)<br>b. Enterprise financial and operating results, including the costs and funding arrangements on public policy objectives, wherever relevant<br>c. Any financial assistance, including guarantees, received from the state and commitments made on behalf of the SOE, including contractual commitments and liabilities arising from public-private partnerships (PPPs) |

*Source*: Adapted from OECD 2015.

## **Topic three:** Business case for corporate governance including corporate governance concerns and challenges

### *Why is corporate governance important?*

Numerous studies conclude that well-governed companies worldwide perform better in commercial terms (refer to Box 3). Adopting corporate governance best practices:

- Improves the operational performance of SOEs;
- Increases access to alternative sources of financing through domestic and international capital markets, while helping develop markets;
- Contributes to financing for infrastructure development;
- Reduces the fiscal burden of SOEs and increases net contribution to the budget through higher dividend payments;
- Reduces corruption and improves transparency.

As mentioned in Box 3, the prevalence of SOEs begets the need for good corporate governance, which positively affects their performance over the long term in the following ways:

1. **Improved operational performance of SOEs** – Sustainable wealth creation in SOEs can only be achieved through good professional management, entrepreneurship, innovation, and better allocation of resources. Effective corporate governance adds value by improving the SOEs' performance through efficient management and better asset allocation (refer Box 4).
2. **Increased access to alternative sources of financing through domestic and international capital markets, while helping develop markets** – As governments face continued budget constraints, better-governed SOEs are more easily able to raise financing for infrastructure and other critical services through the capital markets. In turn, SOE issuances can help develop capital markets. Malaysia's government-linked companies, for example, account for about 36 percent of the market capitalization of Bursa Malaysia and about 54 percent for the benchmark Kuala Lumpur Composite Index. In India, 41 centrally owned SOEs account for 20 percent of the market capitalization of the Mumbai Stock Exchange.[6]
3. **Financing for infrastructure development** – Most public spending on infrastructure passes through SOEs. The value of SOEs lies in their potential to provide efficient, reliable, and affordable critical products and services in key sectors, such as power generation and water supply, transport, oil and gas, and hospitals. They enable expensive and

**Box 3: SOEs – A Global Snapshot**

- Accounts for 20–30 percent of gross domestic product (GDP) in transition economies and 15 percent of GDP in OECD countries
- Account globally for 20 percent of investment and 5 percent employment
- SOE global revenues is estimated to be US$8 trillion
- 30 percent of Chinese GDP, 38 percent of Vietnamese GDP, and 25 percent of Indian GDP
- Comprise more than 10 percent of worlds' 2,000 largest companies and a similar share in sales value
- Share in Fortune Global 500 is estimated at 23 percent
- 13 of top 15 biggest oil companies are SOEs
- Account for 11 percent of global FDI inflows

*Source:* Independent Evaluation Group. 2018. *World Bank Group Support for the Reform of State-Owned Enterprises, 2007-2018: An IEG Evaluation.* Approach Paper, World Bank, IFC. MIGA.

**Box 4: Improving the Operational Performance of SOEs**

A study of 44 SOEs in the water and electricity sectors of countries in Latin America and the Caribbean finds a positive correlation between six dimensions of corporate governance reform and the operational performance of the utilities. The dimensions include the legal and ownership framework, the composition of the board, the performance management system of the enterprise, the degree of transparency and disclosure of financial and nonfinancial information, and the characteristics of staff (for example, education, salary, and benefits). The study shows that the composite index of these dimensions is strongly correlated with labor productivity, tariffs, and service coverage.

Another recent study conducted in Indonesia reveals that the corporate governance index variables affecting the financial performance (measured in terms of net profit margin) of SOEs are Board of Commissioners, Nomination and Remuneration Committee, and the Risk Management Committee. The SOEs chosen in this study pertain to government's economic priorities, namely, food, fishery and marine, energy, industry, tourism sector.

*Sources:*

Andrés, Luis, José L. Guasch, and Sebastián L. Azumendi.. 2011. "Governance in State-Owned Enterprises Revisited – The Cases of Water and Electricity in Latin America and the Caribbean." Policy Research Working Paper 5747, World Bank, Latin American and the Caribbean Region.

Fatmawati, Rini, and Suhardjanto Djoko. 2018. "Corporate Governance and Its Influence on Financial Performance of State-Owned Enterprises (SOEs) In Indonesia." *International Journal of Business and Management Invention (IJBMI)* 7 (2).

expansive investments that are often beyond the private sector's capacity. Thus, well-run SOEs can contribute to health, welfare, education and infrastructure improvements, poverty reduction, and inclusive economic growth. By reducing internal inefficiencies, SOEs can make that spending go farther.

4. **The reduced fiscal burden of SOEs and increased net contribution to the budget through higher dividend payments** – SOEs are generally associated with persistent losses and burgeoning debt commitments, thereby creating a huge burden on the country's budget. Improved corporate governance mechanisms have the potential to augment the operating performance of SOEs, and in turn, reduce fiscal burden. Improved governance also increases the transparency of the contingent liabilities associated with SOEs, thereby reducing fiscal risk (refer to Box 5).

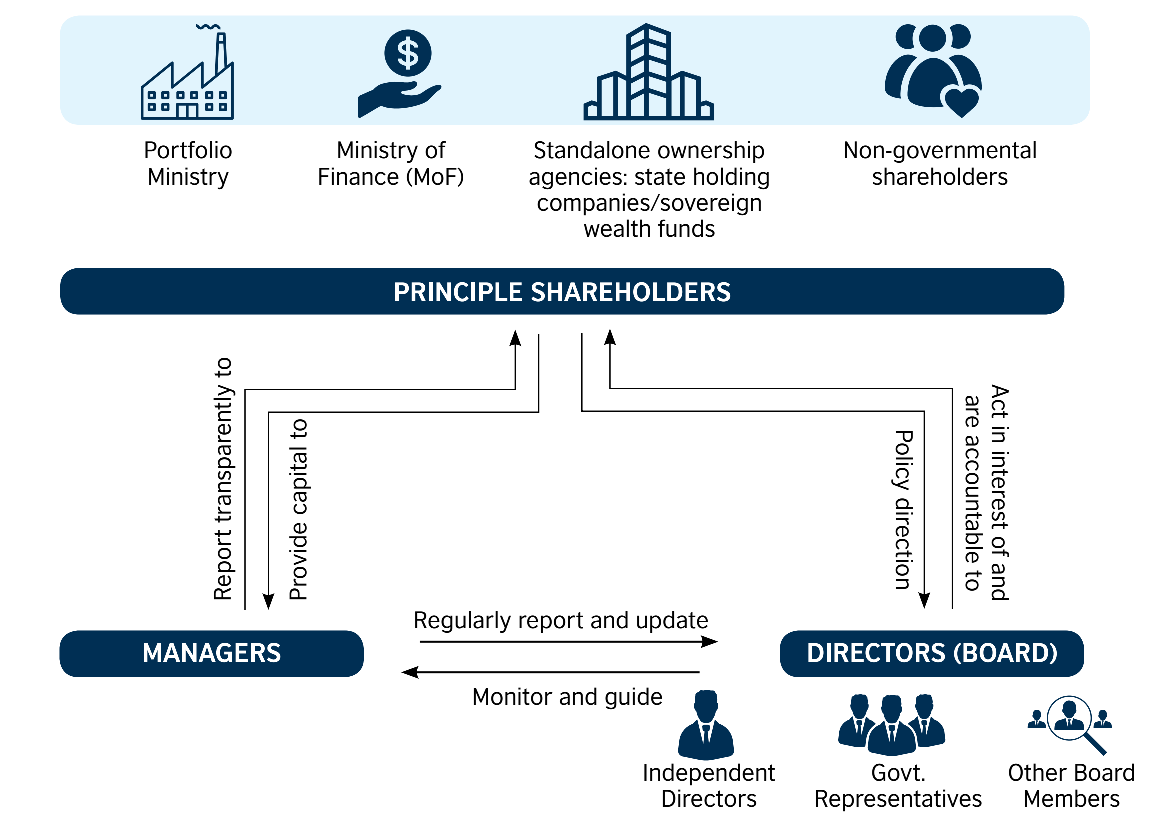
5. **Reduced corruption and improved transparency** – Corruption remains a serious problem in SOEs and can influence the financial strength and valuations of the companies, negatively affects investor perceptions, leads to the misallocation of scarce government resources, and constrains the overall economic and financial growth. Better-governed companies with integrity and accountability mechanisms are likely to be less corrupt and more transparent. Appendix A1.1C lists down the principles governing anti-corruption and integrity at SOEs by various international institutions.

## *Corporate governance challenges*

Traditional corporate governance challenges stem from the misalignment of the principal's objectives with the agent's mandate. While the basic premise stands in the SOE context, by nature of their ownership, objectives and operations, SOEs face additional governance challenges arising out of other internal and external sources. This topic discusses various corporate governance challenges faced by SOEs and explores solutions to address these risks.

Figure 5 illustrates various principal-agent relationships in an SOE and interactions between the shareholders, directors, and managers. The multiple and sometimes ill aligned principal-agent relationships may hinder the effective functioning of an SOE as described in the figure; the SOE's inability to effectively manage these multiple principals, may lead to excessive transaction costs

**Figure 5**: Multiple Principal-Agent Relationships in an SOE




*Source:* Adapted from World Bank Group 2014.

### Box 5: Reduced Fiscal Risks of SOEs

The Lithuanian government, which is working to improve the governance of its major SOEs, has estimated that annual dividends from better governance could be increased by 1 percent of GDP, helping reduce its budget deficit as part of efforts to join the Euro Area in 2014. In 2010, the Chinese government announced that it would start extracting more dividends from its SOEs with the aim of forcing them to compete more fairly with the private sector and allocating resources to social expenditures.

An article by Dag Detter and Stefan Fölster estimates that better-governed SOEs around the world would enable central governments to generate an astonishing US$3 trillion in annual returns—"more than the world's yearly investment in infrastructure including transportation, power, water and telecommunication."

*Sources:*

IFC. 2008. *Toolkit 3: Corporate Governance Board Leadership Training Resources Kit*. World Bank Group.

Detter, Dag, and Stefan Fölster. 2014. "Hidden Assets, How Countries Can Capitalize on Public Wealth". *Foreign Affairs*. November 24.

and interference, to policy inconsistency and duplicate reporting. This may in turn undermine both the state shareholder and oversight function as well as the SOE performance.

The multiple principal-agent relationships that exist in an SOE cause concern over the effective functioning of the corporate governance system in the SOE. A direct consequence of multiple principals is multiple goals, which provides scope for conflict, thus negatively affecting the performance of the SOEs. With multiple principals pursuing multiple (and often conflicting) objectives and targets, SOE board and management representation are often utilized as an effective tool to exercise influence and drive vested interests. Consequently, politically motivated representatives of various principals may often dominate the SOE boards. This leads to greater political interference and micromanagement by the principals.

While SOEs are subject to several checks and balances to ensure transparency and accountability at the state level (such as external audit mechanisms, public scrutiny, parliamentary oversight, and so on), the enforcement of such measures is often quite weak. These challenges stem from the absence or lack of proper financial reporting and of a robust performance monitoring system to ensure accountability and responsibility for the performance of the agents, particularly the board of directors and senior management. Another major issue of multiple and dominant principals is the weak protection of minority shareholders and other stakeholders.

Owing to the aforementioned challenges of multiple principals and goals, limited transparency, and accountability, most minority shareholders face challenges in exercising their rights as shareholders to the extent that controlling state shareholders may encourage SOEs to conduct transactions that benefit them at the expense of other minority shareholders. Furthermore, weak protection of minority shareholders can damage the potential of the SOEs to raise finances from the private sector, increasing its reliance on the state.

Figure 6 further elaborates on these challenges and their potential impact on the SOE's performance across various dimensions.

### *Developing solutions to address these challenges*

To address the corporate governance challenges discussed above, reforms across multiple elements of corporate governance can be explored, which included those shown in Figure 7 on the next page.

Figure 8 describes a list of potential reform steps/solutions across each of the aforementioned areas to address various corporate governance challenges faced by SOEs.

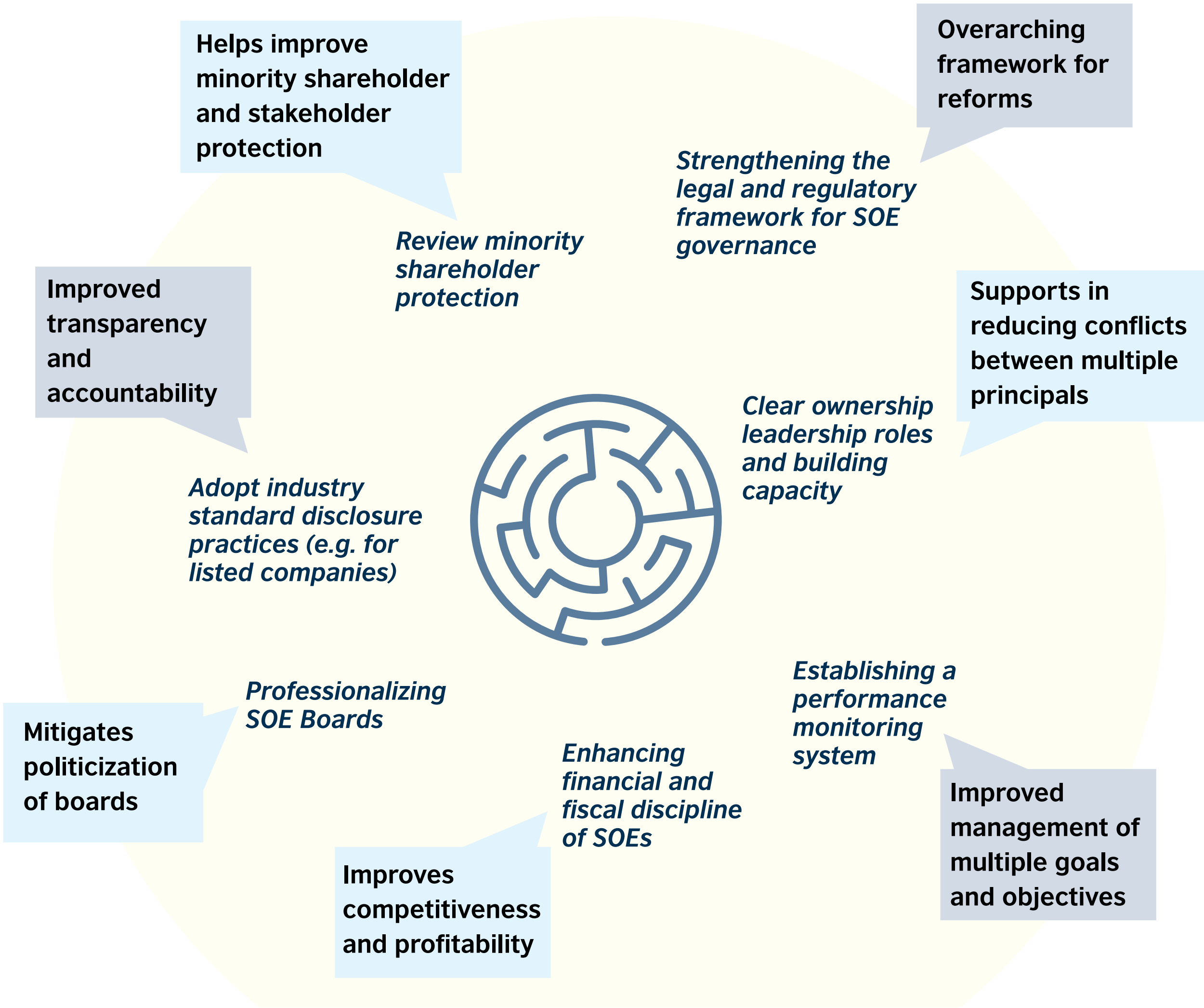
It is important to note that exploring these solutions requires a thorough understanding and analysis of challenges faced, as well as weighing their implicit and explicit costs against the benefits of implementation. These are further elaborated in subsequent modules across the training curriculum.

**Figure 6**: Consequences of Corporate Governance Challenges

| | |
|---|---|
| **Poorly defined ownership structures and responsibilities between multiple principals** | • Possibility of conflicting objectives<br>• Challenges in providing sufficient capital<br>• Interference to board operations from shareholders |
| **Pressure to balance multiple commercial and social goals and objectives** | • Challenges in pricing of services/commodities<br>• Challenges in achieving increased operational targets with reduced budgets<br>• Challenges managing transparency and accountability due to unclear reporting relationships with multiple principals |
| **Politicized boards and management** | • Difficulties prioritizing corporate strategy initiatives based on influence levels of multiple principals<br>• Capacity constraints (experience/expertise) for efficient decision-making |
| **Low levels of transparency and accountability** | • Limited information sharing to support decision-making<br>• Possible misrepresentation to shareholders<br>• Concealment of SOE debt portfolio |
| **Weak shareholder and stakeholder protection** | • Loss of confidence in SOE management<br>• Affects potential of SOEs to raise finances |
| **Protection from competition through preferential treatment** | • Affects commercial viability and profitability of other private sector competition<br>• Long-term negative impact on overall economic growth |

*Source:* Adapted from World Bank Group 2014.

**Figure 7**: Solutions to Address Corporate Governance Challenges




*Source:* Adapted from World Bank Group 2014.

**Figure 8**: Potential Solutions/Reforms Steps to Address Corporate Governance Challenges

| | |
|---|---|
| **Strengthening legal and regulatory framework** | • Higher clarity and certainty like uniform application of company laws and regulations to SOEs and private sector<br>• Listing SOEs on stock markets to create capital market discipline |
| **Ownership arrangements** | • Creating safeguards against government intervention<br>• Centralizing the state's ownership functions to bring focus, consistency, and good practices to the SOE sector |
| **Performance monitoring** | • Establishing performance agreements between owners and boards<br>• Measuring and evaluating performance and ensuring accountability |
| **Financial discipline and oversight** | • Reducing fiscal costs and risks<br>• Reducing preferential access to direct and indirect public financing<br>• Identifying, computing, and financing the true cost of public service obligations<br>• Prudent debt and guarantee management for SOEs |
| **Professional SOE boards** | • Standard Operating Procedures (SOPs) for board composition, nomination, roles and responsibilities, remuneration, evaluation, and other aspects<br>• Empowerment of board sub-committees |
| **Transparency and disclosure** | • Applying private sector principles and international standards to SOEs for audit, reporting, and disclosures |
| **Minority shareholder protection and rights** | • Encouraging representation and participation from minority shareholders<br>• Protecting against abusive related-party transactions |

*Source:* Adapted from World Bank Group 2014.

## Topic four: The corporate governance framework

The key elements of the corporate governance framework at the national level are given below.

### Laws, regulations, rules

The underlying aim of a well-defined legal and regulatory framework is to make the broad policy directions of the state and the 'rules of the game' clear for everyone. While no one-size-fits-all approach applies to all countries and contexts, the framework should achieve the following:

- Set clear boundaries and define the relationship between the government as shareholder and SOE boards and management
- Separate legitimate government control and oversight for ensuring SOE accountability

Typically, the requirements for a company's formation and its operations are specified in company legislation. However, often a body of additional laws may affect the board's behavior and decisions. These laws, regulations, and rules may involve

- Company
- Insolvency
- Director disqualification
- Safety
- Employment
- Environment
- Intellectual property
- Consumer protection
- Competition
- Financial
- Stock exchange listing rules

The directors and managers must always act within the laws, regulations, and rules.

### National corporate governance codes

Many countries now have a national code of corporate governance that recommends good practices for companies to follow. SOE codes are of three main types:

- **Voluntary codes.** Some SOE codes are voluntary, encouraging but not forcing SOEs to comply with their provisions. Voluntary SOE codes are found in Bhutan and Egypt, for example.
- **Comply-or-explain codes.** Some codes are applied on a comply-or-explain basis. All European Union (EU) countries have corporate governance codes that operate on the 'comply or explain' basis as well as requirements set out in law. In Sweden, the code goes beyond the standard 'comply or explain'. It requires companies that do not comply to explain what they did instead. The regulatory bodies in Japan including the financial services agency continue to lead reforms, with several new comply-or-explain guidelines added to the Amended Corporate Governance Code that came into effect in 2018. Like voluntary codes, comply-or-explain codes provide greater flexibility and scope for the application of a more customized approach by a company.
- **Mandatory codes.** Given the wide range of SOEs and the need to align commercial, political, and public policy goals, a mandatory or rules-based code is less common, as it may not allow the flexibility needed by different types of companies (listed SOEs, however, are required to follow the listing rules and codes of the stock exchange.) For example, in India, the Guidelines on Corporate Governance for Central Public Sector Enterprises were issued in 2007 as voluntary guidelines but based on the experimental phase, and after due inter-ministerial consultations, they were made mandatory in 2010.

Corporate governance codes can be found across various countries and companies with varying forms and substances (outlined in Box 6).

Developing an SOE code can be a way of increasing awareness regarding governance issues not only within SOEs but also within the government and the ownership entity (where one exists) and among the public. Consequently, any country seeking to develop an SOE code can consider the following steps:

Reach agreement within the government on the need for and purpose of the code and the desired outcomes. High-level support for developing and implementing a code is useful.

- Take time early on to consider the purpose of the code and develop an implementation plan, for example:
  - Consider whether the code should be used as a benchmarking tool as a model for individual SOE codes, or as a formal requirement
  - Identify an appropriate backer or champion for the preparation of the code
  - Nominate a leader or champion to be the public face of the code
  - Garner commitment from leaders (administration officials, board members, SOE executives)
  - Design complementary training and awareness-raising activities
- Identify key contributors to the code:
  - Line ministry and finance ministry officials
  - Ownership entity where one exists
  - SOE executives and board members
  - Academics
  - Private sector board members, executives, and other experts
  - High-level political supporters
- Form a working group and define its terms of reference
- Analyze and discuss existing codes
- Develop a first draft
- Disseminate the draft among relevant stakeholders, including the public, for comments
- Collect and publish the comments
- Formally adopt the code
- Roll out the code according to the implementation plan
- Periodically examine the impact of the code and adjust it and its implementation as needed

While voluntary codes and guidelines are meant to encourage SOEs to improve their governance practices, ensuring compliance can be a challenge, as companies get fewer incentives or come across no significant pressure—especially when codes are developed by third parties. In some cases, SOEs simply lack awareness of the code. Alternatively, they may lack the knowledge and practical guidance to implement the code, especially when it contains many aspirations but no clear priority. In other cases, once the code is in place, the ownership entity itself may take only modest steps to disseminate,

**Box 6: Examples of the Legal Framework Governing SOEs in Various Countries**

Some countries have general SOE framework laws. While some laws cover all the SOEs, others exclude large strategic SOEs such as utilities, natural resources, and defense, which may have their own separate laws.

- *In the Arab Republic of Egypt*, commercial SOEs fall under the Public Business Sector Law, and under the law, SOEs are also subject to the company law. Utilities and defense SOEs, however, have their own separate laws.
- *In case of the Republic of Korea*, the government-owned companies and government-invested companies are all subject to the Act on the Management of Public Institutions.

Corporatized SOEs operate under normal company legislation in many countries and sometimes under both company law and SOE law.

- *In Chile*, company law applies to all the SOEs except for nine large SOEs that have their own separate laws.
- *In Ghana* and *Kenya*, SOEs are governed mainly by company law.
- *In India*, SOEs fall under company law but must also follow many different guidelines established for SOEs as well as a corporate governance code for SOEs.
- *In Malaysia*, the government-linked corporations (GLCs) are governed by company law with the GLC Transformation Program and the GLC Transformation Manual in place.

*Source:* IFC. 2008. *Toolkit 3: Corporate Governance Board Leadership Training Resources Kit*. World Bank Group.

promote, and monitor compliance with the guidelines, even though promotion of good corporate governance practices should be a key function of such agencies.

It is also important to set out the state's implementation strategy in the national corporate governance code. It is relatively straightforward to develop corporate governance codes. The challenge lies in ensuring their effective implementation and enforcement, as evidenced by the anecdotes from some countries that their governance codes have not lived up to their promise to spur enduring improvements in corporate practices.[7] Therefore, it is pertinent to consider the following while rolling out the code:

- **Designing a suitable country tailored code.** Each country, whether developed or emerging, must devise its approach to developing and successfully implementing corporate governance codes. While all governance codes should be benchmarked against international best practices to aid comparability, they must also be customized to work in the local environment. Careful consideration during the design phase of the principal objectives to be achieved, the broader societal and regulatory context, and the optimal allocation of monitoring and enforcement responsibilities, combined with periodic refinements after their introduction to remedy shortcomings and respond to new developments, will increase the likelihood that corporate governance codes will have the desired impact.
- **Timeline for implementation.** The code must specify the timeline of implementation across different classes of SOEs. When the sophisticated requirements are rolled out to all SOEs at one go, it creates an unnecessary burden for smaller size SOEs and distracts governments from the quality application in the largest entities. With time, such push turns into a box-ticking exercise. Therefore, governments may consider a cascaded approach, that is, a phased implementation plan, which confirms whether it should be applied to the listed SOEs first or the largest SOEs in terms of market size or public utility relevance.

**Governments can take several steps to promote and monitor compliance.** They are:

- Disseminating the code to build awareness
- Developing tools and manuals to help SOEs adopt good governance practices from the code
- Providing training on the code to companies, owners, and regulators to build an understanding of the provisions and their application. In Egypt, for example, the Egyptian Institute of Directors played a vital part, not only in preparing and disseminating the SOE code but also in training SOE directors on the code's implementation and developing a manual for implementation
- Focusing on selected companies that understand the importance of good governance and using them to demonstrate an active commitment to applying the code, which can be a powerful inducement
- Developing the capacity of SOE owners and regulators to monitor and evaluate compliance and elevating their role and profile in promoting compliance
- Including compliance with the code as a critical part of the performance monitoring and disclosure systems. In India, for example, the corporate governance guidelines mandate that the annual reports of companies contain a separate section on corporate governance with details of compliance, with a certificate on compliance from auditors or the company secretary. Companies are also required to submit quarterly compliance or grading reports in a prescribed format to their line ministries, which in turn submit a consolidated annual report to the Department of Public Enterprises (DPE). Initially, only a few companies submitted reports, but the department's reminders and follow-up meetings with line ministries led to higher compliance rates over time.

## Appendix A1.1A: For reference

*See Section 1: Definition of corporate governance*

There are several definitions of corporate governance, including the following:

The **corporate governance team within the Financial Markets Integrity Group of the World Bank**[8] describes corporate governance as follows:

Corporate governance concerns the system, by which companies are directed and controlled. It is about making companies, owners, and regulators more accountable, efficient, and transparent, which in turn builds trust and confidence. Well-governed companies carry lower financial and nonfinancial risks and generate higher shareholder returns. They also have better access to external finance and reduced systemic risks due to corporate crises and financial scandals. Reliable financial reporting, timely disclosures, better boards, and accountable management also facilitate the development of stronger capital markets. They improve a country's ability to mobilize, allocate, and monitor investments and help foster jobs and economic growth. Better supervision and monitoring can detect corporate inefficiencies and minimize vulnerability to financial crises.

According to the **IFC**[9], corporate governance refers to structures and processes for the direction and control of companies. It concerns the relationships among the management, board of directors, controlling shareholders, minority shareholders, and other stakeholders. Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital.

## Appendix A1.1B: G-20/ OECD Principles of Corporate Governance

The attributes of a good corporate governance framework are drawn from the *Principles of Corporate Governance* (2015) laid down by OECD. These are:

- Ensuring the basis for an effective corporate governance framework. "The corporate governance framework should promote transparent and fair markets and the efficient allocation of resources. It should be consistent with the rule of law and support effective supervision and enforcement."
- The rights and equitable treatment of shareholders and key ownership functions. "The corporate governance framework should protect and facilitate the exercise of shareholders' rights and ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights."
- Institutional investors, stock markets, and other intermediaries. "The corporate governance framework should provide sound incentives throughout the investment chain and provide for stock markets to function in a way that contributes to good corporate governance."
- The role of stakeholders in corporate governance. "The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises."
- Disclosure and transparency. "The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company."
- The responsibilities of the board. "The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders."

## Appendix A1.1C: Principles for preventing corruption and ensuring integrity in SOEs by the G-20 and Transparency International

The G-20 high-level principles for preventing corruption and ensuring integrity in SOEs.[10]

The high-level principles are guidance for G-20 and other governments and for those state representatives that are charged with exercising ownership rights in SOEs on behalf of the government. These principles draw on general corporate governance standards, according to which the state should act as an active and informed owner of enterprises but should abstain from intervening in their daily management. Company-internal methods for preventing corruption in individual SOEs can be mandated by the state but should normally be implemented by the corporate management under the supervision of the board of directors, subject to oversight by the relevant auditing bodies. The high-level principles are as follows:

A. Integrity of the state

- Principle 1. Applying high standards of conduct to those exercising ownership of SOEs on behalf of the general public
- Principle 2. Establishing ownership arrangements that are conducive to integrity

B. Ownership and governance

- Principle 3. Ensuring clarity in the legal and regulatory framework and the state's expectations
- Principle 4. Acts as an informed and active owner with regards to integrity in SOEs

C. Corruption prevention

- Principle 5. Requires adequate mechanisms for addressing the risks of corruption
- Principle 6. Necessitates the adoption of high-quality integrity mechanisms within SOEs
- Principle 7. Safeguarding the autonomy of SOEs and their decision-making bodies

D. Corruption detection and response

- Principle 8. Establishing appropriate accountability and review mechanisms for SOEs
- Principle 9. Taking action and respecting the due process for investigations and prosecutions
- Principle 10. Inviting the inputs of civil society, the public, media and the business community

Transparency International's 10 Anti-Corruption Principles for SOEs:[11]

Transparency International has developed 10 anti-corruption principles for SOEs to help and guide them, supported by their state owners, to reach high standards of integrity and transparency. They are as follows:

1. Operate to the highest standards of ethics and integrity by the following means:
   - Embed an organizational culture of ethics and integrity
   - Commit to advancing integrity in societies
   - Commit to an anti-corruption policy and program
   - Provide tone from the top

2. Ensure the best practice governance and oversight of the anti-corruption program with the following measures:
   - Implement governance that conforms to the accepted global best practice
   - Ensure that board directors act in the best interests of the SOE
   - Apply a rigorous and transparent procedure for the appointment of directors to the board
   - Structure the SOE's board to have a balance of skills, experience, knowledge, diversity, and independent directors

- Set a clear division of responsibilities between the board and the chief executive
- Carry out vigilant oversight of the anti-corruption program and ensure accountability

3. Be accountable to stakeholders through transparency and public reporting by the given means:
   - Set and observe the best practice in accountability to stakeholders
   - Report publicly on the anti-corruption program
   - Apply organizational transparency and country-by-country reporting
   - Engage with stakeholders
   - Be transparent on the relationship with the ownership entity

4. Ensure that human resources policies and procedures support the anti-corruption program in the following ways:
   - Design personnel policies and procedures to support the anti-corruption program
   - Incentivize ethical behavior and integrity
   - Assign responsibilities for the anti-corruption program
   - Integrate the anti-corruption program into the organizational structure
   - Apply disciplinary procedures

5. Design the anti-corruption program based on the thorough risk assessment by keeping the following things in mind:
   - Risk assessment should be the basis for the design of the program
   - Identify risk factors
   - Understand the forms of corruption and related risks

6. Implement detailed policies and procedures to counter the key corruption risks and follow the given measures:
   - Implement controls to counter risks related to vulnerable functions and transactions
   - Commit to fair trading practices
   - Provide transparency of contracting and procurement processes
   - Counter the highest corruption risks
   - Establish and maintain internal accounting controls
   - Maintain accurate books and records
   - Subject the anti-corruption program to regular internal audits
   - Develop an incident management plan

7. Manage relationships with third parties to ensure that they perform as per an anti-corruption standard equivalent to that of the SOE and also
   - Apply general standards in all dealings with third parties
   - Implement controls for specific forms of third parties: controlled entities, investments and mergers and acquisitions of joint ventures and consortia of agents and other intermediaries

8. Use communication and training to embed the anti-corruption program by the following means:
   - Establish effective internal and external communications
   - Provide general and tailored training

9. Offer secure and accessible advice and whistle-blowing channels and comply with the following things:
   - Position advise and whistle-blowing channels within an organizational culture of openness and trust

- Provide accessible and secure advice channels, including hotlines
- Adopt a policy and procedure that offers secure and accessible channels for whistle-blowing

10. Monitor, assess and continuously improve the implementation of the anti-corruption program and follow the given measures:

- Implement systematic, continuous monitoring and improvement
- Undergo regular independent review
- Provide regular leadership reviews and make improvements as appropriate

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# Corporate Governance

Leadership Training Toolkit for SOEs

**Part I Module 2**
Role of the state as an owner

# Introduction to the module

The OECD's Guidelines on Corporate Governance of State-Owned Enterprises describe the rationale for state ownership as being exercised in the public interest. Consequently, the state needs to be cognizant of its roles and responsibilities as an owner, for which certain guidelines have been specified by the OECD. In this regard, the World Bank's Toolkit on Corporate Governance of State-Owned Enterprises specifies that the state's role as the owner should be clarified, fragmentation of ownership responsibilities across multiple institutions should be reduced, and accountability for results should be enhanced.

The implementation of the guideline requires an understanding of various roles and responsibilities and the structures through which the state exercises its ownership role over SOEs.

Specific guidelines have been enumerated by the OECD to provide further guidance on the state's role as an owner. These include the following:

- Governments should simplify and standardize the legal forms under which SOEs operate. Their operational practices should follow commonly accepted corporate norms.
- The government should allow SOEs full operational autonomy to achieve their defined objectives and refrain from intervening in SOE management. The government as a shareholder should avoid redefining SOE objectives in a non-transparent manner.
- The state should let SOE boards exercise their responsibilities and should respect their independence.
- The exercise of ownership rights should be clearly identified within the state administration. The exercise of ownership rights should be centralized in a single ownership entity, or, if this is not possible, carried out by a coordinating body. This 'ownership entity' should have the capacity and competencies to effectively carry out its duties.
- The ownership entity should be held accountable to the relevant representative bodies and have clearly defined relationships with relevant public bodies, including the state supreme audit institutions.
- The state should act as an informed and active owner and should exercise its ownership rights according to the legal structure of each enterprise.

This module examines these guidelines in further detail, elaborating on various ownership models, roles and responsibilities of the state, and other guidelines on managing the relationship between the state and the SOE boards as illustrated in Figure 9.

**Figure 9**: Exploring the Role of the State as an Owner

| | | | |
|---|---|---|---|
| **Defining the state's ownership role** | **Core rights and functions of the state as an owner** | **Setting the policy priorities (commercial vs. social objectives)** | **Ensuring competitive neutrality** |
| **Nomination of the board members** | **Financial oversight of the SOEs** | **Monitoring SOE performance via performance agreements** | **State-board relations and communications** |

*Source:* Adapted from World Bank Group 2014.

# Part I Module 2: Role of the state as an owner

This session (module) covers the following topics:

1. Role and rights of the state as an owner (and ownership structures)
2. State's role in setting policy priorities for SOEs
3. State's role and rights over board nomination, financial oversight
4. Negotiating and monitoring performance agreements


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## Learning objectives

By the end of this module, the participants will be able to

- **Understand the role and rights of the state as an owner**
- **Understand the different ownership models and structures**
- **Understand the state's role and rights over board nominations, financial oversight, and performance monitoring of SOEs**
- **Understand the importance of state-board relations and steps to ensure healthy relationship and communication**

## Agenda

**Total time: 5 hours 15 min**

| Time | Topic |
|---|---|
| 20 min | Defining the state's ownership role |
| 30 min | Core rights and functions of the state as an owner |
| 30 min | Exercise |
| 30 min | Setting the policy priorities |
| 25 min | State's ownership role over the board (nomination and dismissal of board members) |
| 30 min | Case study |
| 30 min | State's financial oversight and monitoring responsibilities |
| 30 min | Criteria for assessing the fiscal risk of SOEs |
| 30 min | State-board relations and communication – the Dos and Don'ts |
| 30 min | Case study |
| 30 min | Monitoring SOE performance via performance agreement |

## Topic one: Defining state's ownership role

The ownership function of the state concerning SOEs refers to the fundamental rights and normal functions exercised by shareholders when they own share in a company or when they own a company outright. It includes, for instance, the right to nominate (or appoint) members to the board and the right to vote shares at the general meeting of shareholders. Normal shareholder functions also include monitoring the performance of the company and approving or investing additional capital when necessary.

The G-20/OECD Guidelines on Corporate Governance of State-Owned Enterprises, 2015, details the prime responsibilities of the state as an owner to fulfil its ownership function. These include the following:

- Being represented at the general shareholders meetings (GSMs) and effectively exercising voting rights.
- Establishing well-structured, merit-based, and transparent board nomination processes in fully or majority-owned SOEs, actively participating in the nomination of all SOEs' boards and contributing to board diversity.
- Setting and monitoring the implementation of broad mandates and objectives for SOEs, including financial targets, capital structure objectives, and risk tolerance levels.
- Setting up reporting systems that allow the ownership entity to regularly monitor, audit, and assess SOE performance, and oversee and monitor their compliance with applicable corporate governance standards.
- Developing a disclosure policy for SOEs that identifies what information should be publicly disclosed, the appropriate channels for disclosure, and mechanisms for ensuring the quality of information.
- When appropriate and permitted by the legal system and the state's level of ownership, maintaining continuous dialogue with external auditors and specific state control organs.
- Establishing a clear remuneration policy for SOE boards that fosters the long- and medium-term interest of the enterprise and can attract and motivate qualified professionals.

### Cross-cutting theme: integrity and anti-corruption

The state should establish ownership arrangements that are conducive to integrity. Appropriate steps should be taken by the state to prevent the abuse of SOEs for personal or political gain by

- Stating that applicable laws criminalizing bribery of public officials apply equally to the representatives of SOE governance bodies
- Prohibiting the use of SOEs as vehicles to engage in bribery of foreign and domestic public officials
- Prohibiting the use of SOEs as vehicles for financing political activities and for making political campaign contributions

## **Topic two:** Core rights and functions of the state as an owner

This topic covers the core rights and functions of the state as an owner detailed out in the following sub-topics:

- Overview of different ownership models
- Legal and regulatory framework for SOEs
- Ownership policies

### Overview of different ownership models

The ownership arrangement of the state refers to the way in which the state organizes itself to exercise its ownership rights over SOEs. In some cases, the body or entity that exercises the ownership rights is the legal owner of the assets. In other cases, the entity that legally owns the assets may have delegated the ownership rights to another entity, such as a ministry or a specialized ownership body. For example, a finance ministry may legally own SOE shares while delegating to line ministries the rights typically associated with the ownership of a corporation, such as nominating board members or making major decisions.

Thus, the term ownership arrangement, as used here, refers not just to the legally recognized owner of the assets but also to the body or entity that has the authority to exercise the state's ownership rights.

Some of the typical functions of a finance ministry concerning the state's role as an owner of SOEs are outlined in Box 7.

Ownership arrangements have evolved over time, as SOEs have changed in form and as governments have sought to improve their productive capacity. While countries vary substantially, ownership models fall broadly into the following categories:

**Decentralized model** – No one single institution or state actor acts on the responsibilities of the ownership function. Public perception often perceives line ministries to be de facto running the SOE as an extension of their ministerial powers. For each of the three ownership function responsibilities, a unique state unit or a mix of state units subsumes the role. The central body conducts all financial targets, technical and operational issues, and the process of monitoring SOE performance. Board members

### Box 7: Typical Functions of a Finance Ministry

Governments are responsible for performing a wide range of fiscal and financial functions, which may be carried out by the finance ministry or other governmental agencies. These functions can be classified as below:

**Policy functions** – involve setting fiscal policy rules or targets, managing fiscal risks, developing a debt strategy, formulating the annual budget and the medium-term budget framework, and providing advice on alternative tax policy option. With respect to SOEs, this function would involve laying down the state policy for SOEs defining financial and nonfinancial (say, climate-related) performance metrics, risk appetite, and so on.

**Regulatory function** – can be further classified into three types (a) ensuring that the legal framework for budgeting and public finance is respected and enforced by the line ministries and agencies; (b) supervision of banks and other financial institutions; and (c) supervision of specific economic sectors (for example, electricity, telecommunications, water). With respect to SOEs, this function would involve monitoring implementation of the policy framework through a performance agreement.

**Transactional (or operational) functions** – involve processing of budgetary payments, the exercise of internal control, the issuing of government securities, and the collection of taxes and other government revenues. With respect to SOEs, this function would involve provision of data and periodic reports by line ministries and SOEs.

*Source:* Allen, Richard, Hurcan Yasemin, Murphy Peter, Queyranne Maximilien, and Yläoutinen Sami. 2015. "The Evolving Functions and Organization of Finance Ministries." IMF Working Paper, WP/15/232, Fiscal Affairs Department, IMF.

are appointed in different ways, but the instrumental input comes from the central unit. This model is used in countries such as Argentina, Colombia, Mexico.

While this model still exists in several countries, it has evolved to other models on account of various shortcomings, which include the following:

- Scope for political interference
- Conflicts between ownership and policy-making functions
- Fragmentation of ownership responsibilities and diffused accountability
- Insufficient ownership capacity
- Inadequate oversight of the SOE sector as a whole

**Dual-ownership model** – To introduce checks and balances and promote both technical and financial oversight, some countries have adopted a dual ownership model in which the Ministry of Finance has responsibilities in addition to those of the line ministries. These typically include approving annual SOE budgets, subsidies, or major financial transactions and monitoring the financial performance of SOEs. Belgium and Turkey use this model.

The potential advantage of the dual ministry model over the decentralized model is that it provides for overall financial oversight of individual SOEs and the SOE sector as a whole. However, it also has its weaknesses. Finance ministries typically focus on budgetary and financial issues but may lack the authority and power that line ministries have over SOEs as well as the capacity to act as an owner and strong advocate for SOE reforms. Moreover, the dual model, like the decentralized model, allows for the continued dispersion of other key ownership functions, such as board nominations, planning and investment decisions, and monitoring of performance.

The decentralized and dual models are the more traditional ones for organizing the state's ownership arrangements. Countries are moving away from these models toward the advisory and centralized models to bring focus and professionalism to the state's ownership role.

**Advisory model** – The advisory model involves creating advisory or coordinating bodies to help professionalize the state's ownership role, promote good governance practices in individual enterprises, and bring consistency to SOEs as a whole. Specialized government units act in an advisory capacity to other shareholding ministries on technical and operational issues, and their most important mandate often is to monitor SOE performance. The more limited role of these central agencies, coupled with the autonomy that line ministries thus maintain, leads to considerable overlap with the decentralized model. India, Israel, Kazakhstan, Latvia, and Lithuania use this model.

The advisory model provides an option for strengthening the state's ownership arrangements, especially in countries with a strong public sector administrative culture and a large and diverse SOE portfolio that may make full centralization difficult. It can also be an option in countries with weak capacity and weak governance environments. In such circumstances, creating an advisory or coordinating body may also avoid the concentration of power in a single entity. However, the advisory model only partially addresses the drawbacks of the decentralized or dual models, as illustrated here:

- Line ministries remain both owners and policy makers, and sometimes regulators, allowing continued scope for conflicts of interest.
- Continued dispersion of SOEs among many ministries may allow an expanded scope for day-to-day political interference.
- Without sufficient authority or power, advisory or coordinating bodies may be ignored by ministries and SOEs.
- In the absence of skills, resources, and political backing, advisory bodies themselves may lack both the capacity to deal with ministries, companies, and other institutions, and the ability to influence and drive change.
- Absence of comprehensive and proactive fiscal risk monitoring and mitigation.

**Centralized model** – In recent years, the models discussed above have been supplanted by more centralized approaches that concentrate SOE ownership authority in a single specialized entity. Under a centralized ownership model, the specialized entity serves as the shareholder representative with oversight responsibility for SOEs. It owns the SOE shares or is responsible for exercising all ownership functions on behalf of the state as owner, while the line ministry is responsible for policy making and the regulatory environment in which SOEs operate. Two broad types of centralized entities are widely used: (a) government ownership agencies that are under the direct authority of the government; and (b) company-type structures, such as, holding companies or investment companies that have separate legal identities and greater independence from the government. Example: While China, Finland, France, Hungary, Republic of Korea, Slovenia, Spain, Sweden, and so on, follow the centralized model, Chile, the Netherlands, Norway, Poland, the Russian Federation, South Africa, and so on, follow the centralized model with exceptions.

(a) **Government ownership agencies** – Different approaches have been used to create ownership agencies under the authority of the government. These include the following:

- Stand-alone ministry
- Ownership department or unit (within a central ministry, usually the Ministry of Finance)
- Stand-alone ownership agency or company

Some examples of the same are outlined in Table 8.

(b) **Company-type structures** – These entities have a separate legal identity and their own governance bodies, including a board of directors and a chief executive officer responsible for investment, divestment, and business decisions. Broadly, company-type structures fall into two broad categories, although they have similar characteristics: (i) a holding company structure responsible mainly for managing the assets in the portfolio and (ii) an investment company structure that also acts as the government's strategic investor.

The centralized model faces one major risk of concentration of power. In several countries in Europe and Central Asia, company-type structures have been seriously considered but subsequently shelved because of this risk. Essentially, if the top management of such a holding company is captured and colludes with the government representatives at the board, such a holding company becomes a shadow government/or a center of vested interest for one particular group controlling the most lucrative and cash generating SOEs. Unfortunately, due to weak corporate governance systems and a high level of corruption, this risk is extremely high in developing countries.

Some examples of countries with centralized ownership under a company-type structure are outlined in Table 9 on the next page.

While useful for comparison and classification, the models are not rigid archetypes. Specific country arrangements often combine

**Table 8**: Centralized Ownership Under Government

| Country | Name of entity | Location of entity |
|---|---|---|
| **Ownership ministries** | | |
| Indonesia | Ministry of State Enterprises | Ministry of State Enterprises |
| **Ownership departments in a ministry** | | |
| Finland | Ownership Steering Department | Prime Minister's Office |
| France | Agence des Participations de l'Etat | Ministry of Economy and Finance |
| Norway | Ownership Department | Ministry of Trade and Industry |
| Poland | Department of Ownership Supervision | Ministry of Treasury |
| **Ownership agencies** | | |
| Chile | Sistema de Empresas | Ministry of Economy |
| China | State-Owned Assets Supervision and Administration Commission | State Council |

*Source*: Adapted from World Bank Group 2014.

**Table 9**: Centralized Ownership Under Company-Type Structure

| Country | Name of entity | Location of entity |
|---|---|---|
| **Ownership under government** | | |
| **Bhutan** | Druk Holding and Investments | Ministry of Finance |
| **Hungary** | State Holding Company | Directed by the National State Holding Board |
| **Malaysia** | Khazanah Nasional | Ministry of Finance |
| **Mozambique** | Institute for the Management of State Holdings | Ministry of Finance |
| **Peru** | Fondo Nacional de Financiamiento de la Actividad Empresarial del Estado Holding company | Ministry of Finance |
| **Singapore** | Temasek Holdings | Wholly owned by Ministry of Finance |

*Source*: Adapted from World Bank Group 2014.

elements of more than one model: for example, the split-authority characteristic of the dual model may be integrated with an advisory board. Additionally, governments may assign their SOEs to separate clusters (for example, commercial versus non-commercial enterprises) and apply a different ownership model to each group. For example, public sector banks in most countries are regulated by the central bank of the respective country.

While these structures have been successfully used across several countries, there are still **several risks that can arise, which include the following:**

- **Continued interference from the government in the absence of a strong accountability framework and culture**. Establishing an arm's-length relationship between the ownership entity and its SOEs—and between the government and the entity—can be a significant challenge. Governments may still interfere in operational decisions or impose social obligations that are not clearly defined. The central ownership entity unit may not be shielded from short-sighted political pressures.
- **Risk of capture and corruption.** High levels of politicization such as politically appointed individuals in ownership entity and the associated corruption can generate institutional instability. The resources of SOEs may often be diverted to fund political parties or electoral campaigns. This tends to weaken the overall accountability system. This issue is exacerbated in countries with political turmoil and they remain as vulnerable as ever to state capture and weakening accountability mechanisms.
- **Lack of power and authority of ownership agencies.** In other cases, ownership entities themselves may be no more than a passive adviser and owner, with little power over SOE managers, especially those directing strategic or high-profile and profitable SOEs, which are often among the biggest companies in a country. Backed by higher-level political principals, SOE managers of such companies can have their own political clout, and together with their political allies, can treat ownership entities as adversaries rather than allies.[12] In such cases, without political backing, an ownership entity may make slow progress, as it confronts opposition from vested interests
- **Lack of capacity.** Faced with difficulties in recruiting people with the necessary skills and obtaining budgetary resources, ownership entities often lack the strategic, financial, and technical capabilities needed to carry out their mandate and responsibilities effectively.

Consequently, the following **steps can be taken to minimize the risks of various ownership models and making ownership entities more effective:**

- Ensuring high-level political support and public attention
- Providing a clear and focused mandate with a high degree of autonomy

- Appointing highly qualified professionals
- Developing clear ownership policies and guidelines
- Monitoring performance of ownership entity itself

### Cross-cutting theme: integrity and anti-corruption

Ownership arrangements should be conducive to integrity, which implies:

- Clearly identifying the exercise of ownership rights within state administration as centralized in a single ownership entity or, if impossible, by a coordinating body that has the capacities and competencies to effectively carry out its duties
- Separating ownership from other government functions to minimize conflict of interest and opportunities for political intervention (non-strategic or operational) and other undue influence by the state, serving politicians, or politically connected third parties in SOEs; where ownership functions are vested in ministries with other functions related to SOEs, adequate measures should be taken to separate the two
- Clarifying and making publicly available information about the ownership structure, including linking the SOEs to the ownership entity responsible for said SOEs; this could include, for instance, recording SOEs in beneficial ownership registers
- Clarifying and disclosing the roles of other (non-ownership) state functions that may interact, whether infrequently or frequently, with the SOEs in the execution of their functions—including, among others, regulatory agencies and audit or control institutions
- Encouraging professional dialogue between the ownership entity and state authorities responsible for the prevention of corruption or other irregular practices, when appropriate and permitted by the legal system
- Setting an appropriate framework for communication that includes maintaining accurate records of communication between the ownership entity and SOEs
- Maintaining high standards of transparency and disclosure when SOEs combine economic activities and public policy objectives regarding their cost and revenue structures, allowing for attribution to main activity areas
- Ensuring that the ownership entity is equipped to regularly monitor, review, and assess SOE performance and oversee and monitor SOE compliance with applicable corporate governance standards—including those related to anti-corruption and integrity

### Legal and regulatory framework for SOE ownership

A clearly defined legal and regulatory framework for SOEs is essential for communicating key expectations to SOE shareholders, boards, management, and all other stakeholders, including the public.

While no one-size-fits-all approach applies to all countries and contexts, the framework should set clear boundaries and define the relationship between the government as shareholder and SOE boards and management, separating legitimate government control and oversight for ensuring SOE accountability from the managerial autonomy necessary in commercial decision-making.

Several countries have revised their existing SOE laws or have developed new, more modern laws and regulations to provide strength and legitimacy to the government shareholder; to codify relations among the shareholder, board, and management; and to outline reporting functions. Such laws generally aim to recast the state's role as an owner rather than as a policy maker and manager of state assets and are typically based on several key principles:

- Clear definition of SOEs versus other non-commercial parastatals
- Operation of SOEs on a commercial basis
- Separation of the state's ownership functions from its policy-making and regulatory functions to avoid conflicts of interest, real or perceived
- Professionalization of corporate governance bodies

- Greater transparency and accountability of the SOE sector

The details of more modern SOE laws differ from one country to the next, but in general, they contain several common elements:

- Designation of the state's shareholder representative or ownership entity, including its structure, composition, functions, and accountability framework
- Broad outlines of a performance-monitoring system to hold SOEs accountable for results
- Clarification of SOE objectives, and in some cases, the identification and separation of the costs and financing of specific public service obligations or non-commercial goals
- Establishment of criteria and processes for the appointment of qualified and competent SOE boards as well as processes for dismissal of board members and for identification of the rights and responsibilities of the board of directors and the management in guiding and managing SOE operations
- Financial reporting and disclosure requirements for SOEs, which are often in line with the private sector practices

These topics are further discussed in subsequent topics of this module. Appendix A1.2A discusses the accountability provisions for the state, SOE, and the SOE board that should be built in the legal and regulatory framework governing SOEs in the country.

### Cross-cutting theme: climate change and resilience

In 2015, the world agreed upon a new vision that would guide their actions in the future adopting the 2030 Agenda for Sustainable Development (2030 ASD) and signing the Paris Agreement. In line with these international agreements, countries have made specific commitments called nationally determined contributions (NDCs) and are developing long term strategies towards a carbon neutral economy. These commitments and policies are especially relevant to SOEs given their significant presence in priority sectors for this transition, including energy, transport, agriculture, industry, and infrastructure / urbanization. It is therefore essential that the State as an owner reflects these priorities in its shareholder policy beyond the normal ESG principles and that SOEs fully integrate those in their corporate plans. A brief overview of these agreements is given below:

- **2030 Agenda for Sustainable Development** – In September 2015, the heads of state and government at the UN headquarters in New York City adopted the 2030 Agenda for Sustainable Development. The international community committed to promoting the sustainable development agenda in its three dimensions—economic, social, and environmental—in a balanced and integrated manner, for which it is essential to guarantee lasting protection of the planet and its natural resources and where there is universal access to a supply of affordable, reliable, and sustainable energy. One of the key elements in the 2030 ASD includes a commitment to enhancing international cooperation to facilitate access to advanced and cleaner fossil-fuel technology.
- **Paris Agreement** – On December 12, 2015, in Paris during the 21st Conference of the Parties (COP21) to the United Nations Convention Framework on Climate Change, the international community signed the Paris Agreement, an international treaty in which for the first time all nations came together into a common cause to undertake joint efforts to combat climate change and adapt to its effects. The Paris Agreement has two fundamental pieces to fight climate change. First, foster low greenhouse gas (GHG) emissions development by incorporating carbon planning in government policy, and the second, finance flows consistent with a pathway toward a low-carbon economy.

Beyond these international commitments that guide the development trajectories, it is in the best self-interests of countries to mitigate the high and growing socioeconomic and fiscal risks stemming from climate change: (a) the risks from climate-related extreme weather events that affect their infrastructures and SOEs and represent mounting fiscal costs and risks in times of extremely stressed public finances due to COVID and (b) the risk stemming from the global transition to a low-carbon economy which will affect the business model of SOEs and sustainability of important assets.

Climate policies have often focused on the role of the state as a regulator. Meanwhile, their role as leading economic actors, especially as shareholders and investors, has been neglected. This is changing with more active shareholding policies, given the rising fiscal costs and liabilities coming from SOEs and exacerbated by climate risks and disasters. SOEs control significant shares of economic sectors, which are central to a carbon-intensive economy (for example, fossil fuels, power generation, and so on), particularly in emerging economies, and will thus be particularly affected by the transition toward a low-carbon economy.

An example of the State Climate Policy Framework in Sweden is outlined in Box 8.

For governments to respond to the climate change crisis, SOEs are one of their best instruments at their disposal. SOEs have a competitive advantage in their readiness to proactively address these risks and to seize the opportunities from this transition toward a low-carbon economy, for three reasons: corporate governance, mandate, and scale.

- **Corporate governance**: Most SOEs have an institutional structure in which there are representatives of the government. Therefore, board members representing the state would be mindful to voice and reflect the views of the government as a shareholder to safeguard and grow the SOE assets and manage the liabilities and fiscal risks stemming from climate change.
- **Mandate**: SOEs typically are seen as a means to support a country's medium-term socioeconomic development and to spur innovation and growth in their respective sectors, including through strategic partnerships and technology transfers. Thus, embedding sustainability into the corporate strategy of the SOE

**Box 8: State Climate Policy Framework**

In 2017, **Sweden** decided to introduce a climate policy framework with a climate act. It sets out implementation of the Paris Agreement in Sweden – by 2045, Sweden is to have zero net emissions of GHGs into the atmosphere. The framework contains new ambitious climate goals, a climate act and plans for a climate policy council.

- **Climate Act.** The act states the following:
  - The government's climate policy must be based on the climate goals and how work is to be carried out.
  - The government is required to present a climate report every year in its Budget Bill.
  - Every fourth year, the government is required to draw up a climate policy action plan to describe how the climate goals are to be achieved.
  - Climate policy goals and budget policy goals must work together.
- **Climate Goals.** The framework contains several new climate goals for Sweden:
  - By 2045, Sweden is to have zero net emissions of GHGs into the atmosphere and should thereafter achieve negative emissions.
  - By 2030, emissions from domestic transport, excluding domestic aviation, will be reduced by at least 70 percent compared with 2010.
  - By 2030, emissions in Sweden in the sectors that will be covered by the EU Effort Sharing Regulation should be at least 63 percent lower than in 1990, and at least 95 percent lower by 2040.
- **Climate Policy Council.** The council will be tasked with supporting the government by providing an independent assessment of how the overall policy presented by the government is compatible with the climate goals. The council will evaluate whether the direction of various policy areas will increase or reduce the likelihood of achieving the climate goals.

*Source*: Government Offices of Sweden. 2017. *The Swedish Climate Policy Framework*. Ministry of the Environment and Energy, Sweden.

is directly linked to the rationale of their existence and their mission.

- **Scale**: SOEs in the energy sector represent 70 percent of all the assets of oil and gas production, and around 60 percent of the coal power plants globally. To accelerate the recovery and the pace toward low-carbon development, size matters, and in this case, given that SOEs dominate the energy sector, a policy focused on low-carbon growth has to be led by SOEs. Conversely, if these SOEs do not adapt to the transition, they will become irrelevant and their assets will lose their value.

Based on a government's ownership status and the degree of shareholder power therein, the following array of tools may be leveraged to prompt its SOEs to reduce their emissions, protect their investments and assets, and catalyze the transformation in the sector/economy:

- **Shareholder directives and directions:** Governments can issue shareholder resolutions and other directives to the board in favor of reducing emissions and increasing its resilience to climate risks, which are then transmitted to company senior management. The state can also employ informal measures to guide low-carbon action that takes advantage of its position as the dominant shareholder, for example, by organizing periodic discussions between high-ranking government officials and company executives.

  Government directives and direction can address a wide variety of company actions that will impact emissions by influencing the choice of technology (for example, favoring the construction of low-carbon power plants rather than traditional thermal ones) or economic diversification through the adoption of low-carbon solutions (such as carbon capture and storage). Mandating greater energy efficiency in the SOE's operations is another way to lower emission, including for heavy industry and oil and gas producers.

  The government shareholders can also encourage SOEs to innovate their business practices, direct them to increase spending on research and development (R&D), encourage them to become active traders in a newly established Emission Trading System (ETS) or instruct them to join specific international collaborative efforts.

  Some examples of country policies on energy efficiency are outlined in Box 9 for reference.

- **Climate risk screening and mitigation of SOE investments:** SOEs represent a substantial share of public investments and infrastructure in many countries. Their investments and assets are directly exposed to the physical risks from climate change and climate transition risks. It is therefore essential that both the SOE investment committee and the state consider these climate risks when appraising and approving an investment, financing, or guarantee provided to its SOEs as it has a direct impact on the corresponding return on investment and contingent liabilities. Fiscal risks arising out of climate change are discussed in Part I, Module 2 under 'State's financial oversight and monitoring responsibilities'.

- **Aligning SOE corporate mandates with the government's climate change efforts, policies and international commitments:** An important way in which a government can support the engagement of its SOEs in the low-carbon transition is by ensuring that the enterprise's corporate mandate is aligned with climate goals. A study by the OECD found that policy misalignment can weaken the low-carbon transition effort, while alignment can provide important synergies.[13]

- **Senior management controls – Power of appointment and replacement:** For a government looking to shift its SOEs to a low-carbon pathway, installing/appointing senior executives, who have the commitment, vision, and managerial capacity to carry out the low-carbon transition can be useful, just as removing those who resist this path can also create the right incentives for prompting effective management action. The government can also install the executive compensation system to influence SOE senior management, including through promotions and financial benefits. SOEs may be encouraged to include climate-related targets and indicators, such as carbon emission indicators or external ESG ratings, in their management incentive schemes.

- **'Climate-friendly' middle management and other human resources policies:** While leadership at the top of a public sector company is critical to effecting change within the company, change also requires action by middle management and other staff. As a result, it is important to ensure that the company's internal recruitment and organizational and evaluation systems are aligned with low-carbon action. For example, establishing human resources policies that reward employees for innovations or other actions that lower emissions can be effective in changing business practices.
- **SOE procurement:** Governments can shape the asset base of SOEs to reduce emissions through the issuance of procurement directives (including public procurement regulations) that favor low-carbon solutions. They can direct an SOE to coordinate with other public sector purchasers to favor low-carbon technologies that in turn can help create a larger market that encourages manufacturers to build out their low-carbon product line.[14] Additionally, as SOEs are often big enterprises that purchase a large amount of goods and services themselves, governments can influence

### Box 9: Country Case Studies on Energy Efficiency

**Germany:** Germany has established a variety of coordinated policies to implement energy savings measures for industry. The federal government has entered into voluntary agreements with the German industry to reduce $CO_2$ emissions and sets targets for annual reductions in energy intensity until 2022. To encourage large companies to reach savings targets, they become eligible for a large-scale tax exemption when their savings goals are met. The German government has also established a target of obtaining 25 percent of electricity generation from combined heat and power (CHP) by 2020. The CHP Act also provides investment support in the form of a feed-in tariff, which offers an incentive payment for electricity generated by CHP. The German government has also encouraged the implementation of energy management systems for large companies, which helps energy-intensive industries achieve emissions and energy savings targets.

**Japan:** Japan has employed a mix of regulatory measures, voluntary actions, and financial incentives to encourage energy efficiency in its industrial sector. The Act Concerning the Rational Use of Energy introduced a benchmarking system for obligating businesses to achieve specific medium- (2015) and long-term (2020) energy-efficiency targets. A tax incentive scheme supports these requirements by providing a special depreciation rate for all businesses investing in specified energy conservation and efficient equipment. The government offers support to help encourage greater contribution of CHP electricity resources. Japan also dedicates a significant amount of its investment in R&D toward the industrial sector.

**United Kingdom:** The Environment Agency administers Climate Change Agreements (CCA), which establish voluntary commitments with energy-intensive companies to reduce energy use. In exchange for reaching their targets, companies receive a discount on the Climate Change Levy (CLL), a tax added on electricity and fuel bills. The government also provides tax relief to help businesses invest in specific energy-saving technologies or machinery that might otherwise be too expensive, including boiler equipment, CHP, compressed air equipment, motors and drives, and other products. A range of other measures provide additional support for CHP, including access to financial incentives, exemptions from certain fees and taxes, and the development of a strategic framework for reducing emissions with CHP in the United Kingdom.

**Sweden:** The Swedish industrial efficiency program successfully introduced energy management schemes. Those undertaking a set of measures get a modest rebate on the energy tax. The comparatively small financial signal has unleashed investments that would have been profitable but were not taken so far.

*Sources:*

United Nations. 2015. *Best Policy Practices for Promoting Energy Efficiency*. UN, New York and Geneva.

Meegan, Kelly. 2016. *International approaches to industrial energy efficiency: a comparison of countries.* American Council for an Energy-Efficient Economy (ACEEE).

the broader supply chain by mandating that their SOEs require low-carbon products and solutions from their private sector and other suppliers.

- **Reporting requirements**: The state should encourage SOEs to enhance transparency and disclosure around climate-change-related practices. These disclosures may form part of the Annual Report of SOEs or in the form of separate stand-alone statements such as Annual Sustainability Reports. Sustainability or triple-bottom-line reporting is aimed at a wide, multi-stakeholder audience. This tool reports performance on issues that stakeholders care about as well as monitors internal performance improvements. A sustainability report should form part of a broader strategy for communicating with and reporting to stakeholders on the outcome of consultations or dialogues.

  The Task Force on Climate-related Financial Disclosures (TCFD) has structured its recommendations around four thematic areas that represent core elements of how organizations operate—governance, strategy, risk management, and metrics and targets. This is discussed in detail under Part IV, Module 2. SOEs should also report on nonfinancial information around the environment and social (E&S) metrics as discussed in Part IV, Module 3.

- **Monitoring and enforcement:** It is important for a government to follow up on its guidance with monitoring plans and to put in place both rewards to support success and sanctions to address failure. This can be particularly important in contexts where SOE independence means that government shareholder directions do not necessarily translate into conforming company action. Climate change objectives and risks, therefore, need to be included in SOE statements of corporate interests or other performance contracts between the state and the SOE. Some examples of good practices in monitoring and enforcement are outlined in Box 10.

### Cross-cutting theme: integrity and anti-corruption

There should be clarity in the legal and regulatory framework regarding the operation and accountability of SOEs, whereby private sector best practices in areas such as corporate liability, accounting, and audit apply to SOEs. The legal and regulatory framework should facilitate a level playing field in the marketplace where SOEs undertake economic activities.

The state should clearly specify SOE objectives and avoid redefining these objectives in a non-transparent manner. The state's broad mandates and objectives for SOEs should be revised only in cases where there has been a fundamental

### Box 10: Good Practices on Monitoring SOE Objectives and Performance

**Saudi Arabia**: State-owned oil giant Saudi Aramco joined the 'Zero Routine Flaring by 2030' initiative by the World Bank, a flagship global effort to eliminate flaring. For over 40 years, Aramco has been investing in advanced technologies to enable greater efficiency and lower emissions in transport, carbon-free hydrogen fuels, and carbon capture, utilization and storage (CCUS). This is part of a broader effort to enable the circular carbon economy and deliver clean, reliable, and affordable energy to the world while minimizing GHG emissions.

**China**: Since the 11th Five Year Plan (2006–10), a shift in priorities has elevated environmental reform as key to growth and social stability. This has taken the form of consolidating the market share of large SOEs in energy and heavy industry, while increasing state support of SOE investment in clean energy technologies for less-polluting industries and other industries like oil and gas (Sinopec, PetroChina). These objectives have been implemented through ordered shutdowns of small, inefficient power and steel plants, as well as through selective investment approvals, credit controls, and cadre evaluation systems.

*Sources:* World Bank. 2020. *Zero Routine Flaring by 2030*. World Bank, IBRD, IDA.

Baeumler, Axel, Ijjasz-Vasquez Ede, Mehndiratta, Shomik. 2012. *Sustainable Low-Carbon City Development in China. Directions in development; countries and regions*. Washington, DC: World Bank.

International Energy Agency. 2015. *Complementary measures for decarbonization: Looking beyond pricing and regulation to motivate private businesses and state-owned enterprises*. Paris: IEA.

change of mission. The ownership entity should be assigned a role for executing ownership. When representatives of government, including those of the ownership entity, give instructions that appear to be irregular, SOEs should be able to seek advice or to report it through established reporting channels.

The state should clearly set and consistently communicate high expectations regarding anti-corruption and integrity through, among others, the processes of

- Identifying and expressing their expectations related to high-risk areas that could include investment and divestment by the state; human resource management; procurement of goods and services; board and senior/top management remuneration; conflict of interest; political contributions; facilitation payments, solicitation, and extortion; favoritism, nepotism or cronyism; offering and accepting gifts; hospitality and entertainment; and charitable donations and sponsorships
- Periodically reviewing state expectations regarding anti-corruption and integrity, based on a comprehensive analysis of existing and emerging corruption-related risks

## *Ownership policies*

To bring greater clarity and consistency to ownership issues, some countries have developed comprehensive ownership policies as a tool for communicating expectations and good practices to shareholders, boards, and management. Ownership policies were earlier conceived as a portfolio level policy. However, currently, such policies are recommended for specific sectors or homogeneous groups such as banking, insurance, power, and so on, or even for specific SOEs depending on the level of centralization of ownership. For example, in Norway, the ownership policy contains one section on the 'scope of the state's direct ownership'. It includes the list of companies covered by the ownership policy, the state's shareholding in the companies, and the ministry with which companies are affiliated. The ownership policy covers companies for which the state has mainly commercial objectives and important companies with sectoral policy objectives. While drawing up the ownership policy, an important consideration for governments is to ensure competitive neutrality, that is, SOEs should not enjoy net competitive advantages over their private sector counterparts, simply under government ownership.

As per the Commonwealth Competitive Neutrality Policy Statement of the Government of Australia, governments should not use their legislative or fiscal powers to advantage their businesses over the private sector. The implementation of competitive neutrality policy arrangements is intended to remove resource allocation distortions arising out of public ownership of significant business activities and to improve competitive processes. Where competitive neutrality arrangements are not in place, resource allocation distortions occur because prices charged by significant government businesses do not fully reflect resource costs. Consequently, this can distort decisions on production and consumption, for example, where to purchase goods and services, and the mix of goods and services provided by the government sector. It can also distort investment and other decisions of private sector competitors.[15] Therefore, if the governments ensure a level playing field between SOEs and private sector competitors, it can help prevent competitive distortion and encourage private sector investment.

Ownership policies usually cover several relevant subjects:

- **Purpose of state ownership.** This section may describe the justification for state ownership and both short-term and longer-term goals.
- **Types of enterprises covered by the ownership policy.** Enterprises are usually categorized into two broad groups—commercial enterprises providing a product or service, that is, enterprises that could be subject to competition and could operate under private ownership and enterprises with sectoral policy objectives that operate in a regulated environment (such as water and electricity). These categories are often revisited periodically to determine whether the ownership criteria continue to be met and to adjust portfolio practices accordingly.

- **Criteria under which SOEs operate.** These criteria might address the commercial sustainability of SOEs; the importance of shareholder value or equity value, relative to social objectives; associated performance measures; and the calculation of (and compensation for) costs of non-commercial objectives/public service obligations.
- **Roles and responsibilities of specific institutions.** The respective roles of the state, the ownership entity, the SOE board, SOE management, and independent regulators as well as the separation of financial and policy oversight should be specified.
- **Requirements for transparency and public disclosure.** Both the state and SOEs are held accountable for their financial and social performance. Financial reporting requirements are established. Public disclosure covers both financial and nonfinancial information and describes the means of dissemination.

The process of setting formal ownership policies is easier when there is a centralized ownership entity in place that can drive and manage the process of developing the policy. Where ownership responsibilities are fragmented among different line ministries, building support and managing the process can be more difficult and time-consuming, especially when parliamentary approval is required. Developing a coherent policy can also be more difficult when there is a large and diverse portfolio of SOEs, with many different legal forms.

## Topic three: Setting the policy priorities

Throughout the world, governments have created SOEs as commercial entities and often imposed non-commercial public service obligations (PSOs) on their operations. Also referred to as community service obligations, or public service agreements, PSOs enable governments to pursue public policy objectives through SOEs in addition to regular budget channels, often with little transparency, particularly concerning the financing of PSOs.

This is also recognized in the OECD's Guidelines on Corporate Governance of State-Owned Enterprises (2015), and corresponding recommendations have been proposed to help create transparency around SOE public service/social objectives and to lend credibility to the processes involved in putting these public service/social objectives into practice. These guidelines include the following:

> "Where SOEs combine economic activities and public policy objectives, high standards of transparency and disclosure regarding their cost and revenue structures must be maintained, allowing for an attribution to main activity areas. Costs related to public policy objectives should be funded by the state and disclosed." – OECD Guidelines on Corporate Governance of State-Owned Enterprises (2015).

Besides, the World Bank's Toolkit on Corporate Governance for State-Owned Enterprises (2014) also elaborates on the recommendations outlined in the OECD Guidelines specifically with regard to

- Formalizing PSO mandates
- Implementation of PSOs
    - o Defining and calculating the cost of PSOs
    - o Practices for financing PSOs
    - o Monitoring the performance of PSOs

These are detailed further in this topic.

### *Formalizing PSO mandates*

The state, with the primary ownership and oversight function over the SOEs, defines the mandate for the respective SOE and sets out its objectives. The mandate and objectives laid out by the state can be formalized through the legal framework (based on which the

SOE was constituted) and the SOE's charter, among others. The overall mandate of the SOE indicates whether the SOE's operations are commercially oriented or are constituted for achieving specific socioeconomic public policy objectives. While an SOE can be expected to fulfil both commercial and public service obligations, the formal mandate set out by the state defines the SOE's primary objectives.

Box 11 outlines certain country case studies on defining PSOs for SOEs.

In addition to the overall mandate, the state also plays an important role in defining short- and medium-term objectives for the SOEs, wherein SOEs can often be instructed to prioritize PSOs over commercial considerations. Examples of these instances can include utilizing SOEs for correcting market distortions and failures and achieving specific public policy objectives. These priorities are communicated periodically, and are usually aligned to the budget cycle, wherein specific policy priorities are also communicated by the ownership entity, in addition to the financial information regarding resource availability and support, debt ceilings, and so on. These are formally incorporated into the SOE's budget and annual/medium-term strategy for implementation.

## *Step-by-step implementation of PSOs*

In addition to formalizing these PSO mandates in legislation or regulations disclosed to the public at large, the OECD Guidelines suggest three steps for implementing PSOs without compromising SOE efficiency relative to other market players:

- Define and calculate the costs of PSOs
- Finance these costs through a specified budget transfer to the SOE so that the cost is explicit both in the budget and in the SOE's financial statements
- Monitor the performance of PSOs to enhance transparency and ensure their relevance and effectiveness

**Step 1: Define and calculate the costs of PSOs** – A PSO must be defined clearly and separated from the regular commercial activities of the SOE. Calculating the cost of a mandated PSO can be a complex exercise, as these obligations involve offering public goods for which the price, by definition, is difficult to determine. Nonetheless, estimating costs is an important process, for it allows governments

### Box 11: Country Case Studies on PSOs for SOEs

**In Netherlands**, specific non-commercial objectives may be imposed on SOEs in one of the following fashions:

1. **Performance contracts**. This is the preferred form of imposing specific objectives for individual SOEs. The advantage is that, if the SOEs operate in a competitive environment, a level playing field can be maintained by offering the contracts in tender.

2. **Regulation/legislation**. The sectoral legislation and attendant regulation by the line ministries apply to all enterprises regardless of ownership. However, in the (relatively few) sectors, where an SOE has a monopoly, the exercise of regulatory powers is effectively equivalent to establishing company objectives.

3. **Shareholder action**. The shareholder (Ministry of Finance, pursuant to cabinet decision) retains the right of approval for the corporate strategy, major (dis-) investments and remuneration and dividend policy. There is no 'instruction right' for any shareholder under Dutch law, but the state can thus effectively block major decisions that are not aligned with the intention of its investment.

**Non-commercial priorities for New Zealand Post**: New Zealand Post is the designated postal administrator for New Zealand and is the operator of the only nationwide postal network. The government has a deed of understanding (administered by the Ministry of Business, Innovation and Employment (MBIE), and periodically reviewed) with NZ Post to set social, price and service undertakings that must be met within the postal services market. Essentially, this ensures that NZ Post's rural and urban postal services are provided at universal pricing (despite the likely higher costs of provision of rural services), whilst enabling other postal operators to offer competing services, including services, which access NZ Post's national network at fair and transparent cost.

*Source:* Christiansen, Hans. 2013. "Balancing Commercial and Non-Commercial Priorities of State-Owned Enterprises." Working Papers No. 6, OECD Corporate Governance, OECD Publishing.

to assess whether the services being provided are worth the cost. SOEs typically have an incentive to overestimate the true costs of PSOs. If information asymmetries between the SOE and the government are significant, the SOE may be overpaid for fulfilling those obligations. However, the government tends to underestimate the cost of PSOs.

Various methods of calculating PSO costs are discussed in the OECD's Accountability and Transparency Guide for State Ownership (OECD 2010). Following are the four main methods and their associated pros and cons:

- Marginal costs. While reflecting the real opportunity cost of supplying the service, the estimation of marginal costs can be daunting due to practical difficulties such as treatment of common and joint costs, depreciation, and variations in demand.
- Fully distributed costs (or average variable cost plus a mark-up to cover fixed costs). These calculations tend to overestimate costs.
- Avoidable costs (or costs associated with an additional block of output, including variable and capital costs whenever additional capacity is required). This is a commonly used method.
- Stand-alone costs (or costs for producing an output in isolation). This method ignores economies of scale and scope and usually results in significant overestimation of the real cost.

In some settings, SOEs are required to maintain separate accounts for commercial and non-commercial activities. SOEs tend to benefit from privileges that are not available to the private sector. These benefits include state aid in a variety of forms such as the following:

- Outright subsidization. Includes monetary or in-kind subsidies received directly from the government to sustain commercial operations.
- Concessionary financing and guarantees. Include a line of credit received directly from the government or a state-owned financial institution at below-market interest rates; explicit or implicit state guarantees, which help the SOE to borrow competitively compared to the private sector.
- Other forms of preferential treatment that may lead to financial distortions in the market include exemption from costly regulatory regimes applicable to private firms that aid in the reduction of operating costs of SOEs.

The European Commission (EC) uses a tool known as the 'transparency directive'[16] to achieve competitive neutrality between public and private firms, which requires public companies to have separate accounts for commercial and non-commercial activities to demonstrate how their budget is divided. This tool has been used in many sectors, including postal services, energy, and transport.

A more radical approach requires the structural separation of the business and nonbusiness parts of an SOE, which is the easiest way to prevent cross-subsidization. However, efficiency gains may be lost if economies of scale cannot be realized through a joint provision of commercial and non-commercial activities. Similarly, separation of activities may not be advisable if the provision of commercial (or non-commercial) activities is very limited compared to the rest of the SOE's activities.

A basic principle holds that governments should not mandate PSOs, whose cost exceeds their value to the public. Yet, it is more difficult to determine whether a PSO could be replaced by another mechanism that could achieve the same objectives at a lower cost more effectively or with fewer market distortions. Potential alternative mechanisms include direct subsidies or (conditional) cash transfers to targeted populations, vouchers, contracting out services to private providers (where they exist), and regulatory provisions. To this effect, distributional impact analyses form an important tool to decide on the optimal mode of fulfilling a government's public service obligations.

This is briefly outlined in Box 12 on the next page.

**Step 2: Financing PSOs directly from the budget** – In line with good practice, once PSOs are defined and costed, they can be funded directly from the budget, and the size of the government transfer can be divulged. The government can then purchase PSO services from SOEs under arm's-length commercial contracts and signal the price to non-SOE suppliers, against which to compete as a future provider of those services. Where PSOs are met through restrictions on competition or other regulatory distortions, a similar costing and value-for-money exercise should be conducted. The economic costs of preferential regulatory treatment should be assessed against the value of the objectives achieved.

The procurement process should be transparent and competitive, in line with the national procurement rules which often apply to SOEs. Procurement policies and procedures should ensure clear selection criteria in advance; and there should be fair and equitable treatment in the selection of suppliers. Unfair barriers, if any, must be removed to ensure fair and non-discriminatory selection processes or when such barriers cannot be removed, they should be appropriately disclosed to all potential bidders. Principles of competitive neutrality must be adhered to while undertaking any procurement (refer to Part IV, Module 4). High standards of integrity and ethics must be ensured during the entire procurement process.

**Step 3: Monitoring and disclosing PSOs** – This is critical to ensuring their relevance and effectiveness. Monitoring is usually conducted through the overall performance-monitoring system for SOEs. A specific review can also be carried out separately with the involvement of concerned departments and stakeholders. Progress in meeting PSOs and their attendant costs should be disclosed to the public to enhance transparency.

**Box 12: Distributional Impact Analysis (DIA)**

Distributional impacts relate to the extent to which there are differences in the way impacts affect different groups in society. DIA concerns the study of the distributional consequences of interventions due to the participants' heterogeneous responses or participation decisions. In particular, DIA investigates features beyond the gross total gain of a program by studying where the gains/losses of a program—if any—were produced, and who wins or loses as a result of program participation.

Mean impacts constitute a natural first summary statistic to describe the effect of a policy. Thereby, it provides the central piece in any cost-benefit analysis. However, a decision-maker usually requires information on the effects of a policy beyond its mean impact. For example, mean impacts allow to calculate the total gain from a program or policy, but do not allow to say anything about the distribution of the gain or how the outcome distribution is affected by the program beyond changes in its mean. Even a purely welfare-maximizing social planner with no normative concerns for particular demographic groups, inequality or not harming anyone will often need information on program impacts beyond their average.

Many outcomes, such as educational attainment and health status, cannot feasibly be redistributed themselves. To redistribute the welfare gains derived from such outcomes, one needs to know the relation between the outcomes and individual utility, which can usually at best be approximated. In practice, transfers may be costly and implementing the optimal transfer scheme requires some knowledge of the distribution of gains and losses, that is, an evaluation that goes beyond the mean impact. Finally, some interventions may work well for particular subgroups of the target population, such as those living in urban areas, while there may be better options for rural populations. Knowing which groups benefit more or less can help improve the way policies and programs target and thereby allocate limited resources more effectively.

Finding answers requires thinking about the impact of a program or policy as a collection of distributional parameters rather than a single scalar parameter such as the mean. This is where distributional impact assessments are useful. An equity assessment can complement the cost-benefit analysis of an initiative undertaken by an SOE. This can help in efficient allocation of scarce public resources by the SOE.

*Source:* Guadalupe, Bedoya, Bittarello Luca, Davis Jonathan, Mittag Nikolas. 2017. "Distributional Impact Analysis, Toolkit and Illustrations of Impacts Beyond the Average Treatment Effect." Policy Research Working Paper 8139. World Bank Group, Washington, DC.

Examples of monitoring and disclosing PSOs are outlined in Box 13.

In addition to PSOs, the state also has an important role in defining the dividend policy of the SOE. Dividends paid to the government usually reflect the profitability of the enterprise and the need to retain profits for investment in capital assets. Higher dividends may not always be desirable as they may reflect monopoly profits or deprive SOEs of funds they may require for investment in new capital assets. As an alternative to dividends, governments may establish a policy of retaining funds in the enterprise to increase shareholder value.

A dividend policy for SOEs would divide its after-tax profit into two parts: retained earnings to finance investment and dividends to finance public spending by the government. As such, the rationale for a sound dividend policy is twofold: first, it has the potential to enhance the efficiency of investments financed by the retained earnings of SOEs and second, it may improve the overall allocation of financial and fiscal resources.

In most countries, the general practice is for SOE dividends to be paid to the finance ministry for general public uses, regardless of which government department acts as the state shareholder, as dividends are considered public financial revenues and should be managed as such. Countries with separate ownership agencies or holding companies may receive SOE dividends and retain a portion for reinvestments in SOEs; however, a share of dividend payments is usually made to the finance ministry. In some cases, dividend payments from the ownership entity to the finance ministry may be based on a fixed percentage that the entity itself receives from SOEs in its portfolio, or on a percentage of the capital employed by the SOEs in the ownership entity's portfolio, or some combination of the two.

A challenge for policy makers arises in the case of SOEs delivering public service objectives through the pricing of their services below cost (for example, postal services, sale of fuel, electricity). This would translate into lower profitability of such enterprises compared to their private sector competitors, and as such a commercial rate of return may not be guaranteed for these SOEs. As discussed in step 1 above, such services need to be accounted for and compensated transparently while ascertaining a suitable dividend policy.

Strengthening corporate governance and dividend policy should lead to greater scrutiny of capital allocation, thus making it more difficult for managers to invest in bad projects and enhancing shareholder wealth while minimizing the financial and fiscal risks of SOEs. Profitable SOEs should provide funds for public spending to improve the equity of key public services, such as education and health.

### Cross-cutting theme: climate change and resilience

Climate-induced risks significantly affect strategic planning processes and operational capacities of enterprises. PSOs enable governments to pursue public policy objectives through SOEs rather than through regular budget channels. While assessing PSOs, manifestations of climate change and its associated impact including higher temperatures, altered rainfall patterns, and more frequent or intense extreme events

### Box 13: Country Case Study on Disclosing PSOs

In a study, it was found out that only 4 countries of over 30 countries surveyed produce aggregate reports (Lithuania, Norway, Sweden, and Turkey) in an attempt to produce distinct reporting on the costs related to SOEs' public policy objectives and (where applicable) the related funding provided from the state budget. In Lithuania, a section of the aggregate report is dedicated to the estimated costs taken on by SOEs for the implementation of 'special obligations', and the amount of compensatory funding provided by the state. In Norway, the aggregate report provides an index of all SOEs and the value of state subsidies provided to each over the course of the year.

*Source:* OECD. 2018. *Ownership and Governance of State-Owned Enterprises: A Compendium of National Practices.*

such as heatwaves, drought, and storms, and so on, should inform the formalization of PSO mandates. This would result in climate-informed project appraisal and selection, improved risk management, a more climate-consistent policy framework and targeted investments thereof.

**The World Bank Climate and Disaster Risk Screening Tools**[17] provide a systematic and transparent way of considering climate and disaster risks at the early concept stage of national policy planning processes. Developing an understanding of the vulnerabilities of SOEs to climate risks is the first step in the development of exhaustive policy frameworks and strategic processes required to operationalize them in providing services tailored toward stated public policy objectives. The simple, self-paced tools provide step-by-step guidance to help users connect climate and disaster information to their planning components. The tools provide relevant climate and disaster information through the web-based World Bank Climate Change Knowledge Portal and its Country Adaptation Profiles.

The development of the **National/Policy level Climate and Disaster Risk Screening tool** integrates an **Exposure–Sensitivity–Adaptive-Capacity framework** that incorporates elements of the risk analysis framework **adapted from the work of the Intergovernmental Panel on Climate Change (IPCC)** and the framework for vulnerability assessment used by the U.S. Agency for International Development (USAID), with some modifications. Hence, to effectively leverage the tool and derive insights required to inform policy making, the state officials and SOE managers need to first understand the following key aspects:

- **Exposure.** It refers to the degree of climate stress upon a particular unit of analysis and may be characterized by a long-term change in climate conditions, or changes in climatic variability including the magnitude and frequency of extreme events in the urban context (IPCC 2007). Depending on the type of hazard the SOEs are exposed to, which in turn depend on the magnitude of climate stress and the SOEs' respective geographical areas of jurisdiction and the sectors served therein, and to better understand how they are vulnerable, it becomes imperative to assess where, what, and how these hazards might affect the concerned locations and sectors.
- **Sensitivity.** This means "the degree to which different systems and sectors of the population are affected by climate-related hazards" (IPCC 2007). Understanding sensitivity to climate change requires the state to think not only about the geography of a place but also to consider its socioeconomic context—the level of poverty, the prevalent unemployment rates, or the access to basic services, and so on, within the ambit of which the SOEs operate. Such non-climate-related factors can influence an SOE's vulnerability. They make it more difficult to recover from a disaster, avoid it, or respond to it effectively, and this results in them being more vulnerable to its damaging effects. These characteristics vary widely across different districts, different administrative divisions and local economies and must be carefully thought of to suit the ulterior objectives of the SOEs' policy implications.
- **Adaptive Capacity.** It refers to "the ability of a system to adjust to climate change to moderate potential damage, take advantage of opportunities, or help cope with consequences" (IPCC 2007). This is integrally dependent on the institutional strength of SOEs, the potential and integrity of which must always be realized through appropriate staffing and regular training of personnel, climate-resilient infrastructure, and so on.

The quantified rates of vulnerability to risks based on the stated components (exposure, sensitivity and adaptive capacity) will generate insights, which can be leveraged to inform not only the policy framework for the SOEs but also the identification of appropriate sectors and project sites, wherein they ought to provide services as part of their public service agreements (PSAs). This, in turn, can help in fine-tuning effective and targeted financial management mechanisms toward the provision of the said services.

## Topic four: Ensuring competitive neutrality

Given the importance of SOEs in many economies and sectors, from natural monopolies to sectors with important private sector presence, it is essential for governments to assess the role and market effects of SOEs in their countries with the goal to increase SOE efficiency, mitigate negative market effects, and encourage private sector growth to improve overall welfare. Departing from fair competition and fair conduct norms could harm consumers or distort the market, thereby reducing overall welfare. This calls for the assessment and safeguarding of 'competitive neutrality' of SOEs and reflecting this in the shareholder's policies and public service obligations as well as subjecting SOEs fully to competition law and agencies/ regulators.

A definition of competitive neutrality adopted in Australia is outlined in Box 14 on the next page.

Competitive neutrality policy initiatives directly address the market advantage of SOEs. Competitive neutrality policy recognizes that SOE activities should not have a competitive advantage vis-à-vis the private sector merely by virtue of government ownership and control. Market advantages in this context may manifest in several ways. Distortions by advantaged SOEs may be direct in their statute, mandates or through state aid or it may unintended and more subtle, through insufficiently costed and compensated public service obligations assigned to SOEs. Such distortions result in crowding out of private investments, which in turn inhibits the SOE's efforts of maximizing finance for development.

Competition distortions can take different forms as summarized in Table 10.

Given the numerous potential distortions and their detrimental impact on consumers and the economy, the state needs to maintain a level playing field. The main building blocks in ensuring competitive neutrality are as follows:

- **Streamline government businesses either in terms of corporate form or the organization of value chains.** Two things need to be addressed: the degree of corporatization of government business activity and the extent to which commercial and non-commercial activities need to be structurally separated. Separation makes it easier for commercial activities to function in a more market-consistent way. Incorporating public entities with an emphasis on commercial activities and operating in competitive, open markets, as separate legal entities aids in enhancing transparency.
- **Ensure transparency and disclosure around cost allocation.** Identifying the cost of any given function of commercial government activity is essential if competitive neutrality is to be credibly ensured. For incorporated SOEs, the major issue is accounting for costs associated with fulfilling PSOs. For unincorporated entities, problems arise when they provide services in the public interest as well as perform commercial activities from a joint institutional platform.
- **Devise methods to calculate a market consistent rate of return on business activities.** Achieving a commercial rate of return is an important aspect of ensuring that SOE's activities are operating like comparable businesses. If SOEs operating in a competitive environment are not required to earn a market consistent rate of return, an inefficient producer may seem cheaper to consumers than an efficient one.
- **Ensure transparent and adequate compensation in the discharge of public service obligations.** Competitive neutrality concerns arise when PSOs are imposed on SOEs which also operate in the marketplace. Therefore, such entities need to be adequately compensated for any non-commercial requirements based on the additional cost incurred for such PSOs.

**Table 10**: Types of Preferential Treatment for SOEs

| Type | Description |
|---|---|
| **Preferential financing from state banks or other (state-backed) financial institutions** | Preferential financing can include the following: (a) favorable requirements concerning the rate of return on capital of SOEs; (b) favorable requirements for dividends of SOEs; (c) direct financial support from the state; (d) recapitalization of SOEs at lower than market rates; (e) provision of finance at below-market interest rate; (f) provision of state-backed guarantees. |
| **Privileged access to information** | If SOEs are privy to privileged information from the state, including classified intelligence, confidential cabinet decisions, and so on, this amounts to unfair advantage that can, in turn, have an impact on market confidence. SOEs may also have access to data and information, which may not be available to their private sector counterparts such as planned regulation, procurement, environmental laws, sanitary rules, technical specifications, and so on. |
| **Outright subsidies/ tax concessions** | Some SOEs receive direct subsidies from their government or benefit through other forms of financial assistance to sustain their commercial operations. |
| **In-kind subsidies** | These benefits include land usage, rights of way at prices lower than market rates or what private competitors would have to pay under similar circumstances, and so on. These relaxations artificially lower the SOE's costs and enhance their ability to price more efficiently than their competitors. |
| **Grants and other direct payments** | This includes (a) policies that support R&D, environmental and green programs; (b) general economic development policies (for example industrial policies); (c) sector- or product-specific policies; and (d) support for the provision of public services; all of which if not provided equally to competitors on the same market could create a non-neutral situation. |
| **Privileged position on the domestic market** | SOEs are at the time, entrusted with exclusive or monopoly rights over some activities that they are mandated to pursue such as postal services, railways, and so on, in some countries. Where SOEs continue to benefit from a legal or natural monopoly, this may be of little practical consequence for the competitive landscape, but several SOEs in the network industries operate as vertically integrated structures with incipient monopolies in parts of their value chains. This can have a direct effect on relative competitiveness, and it may also allow them to influence the entry conditions of would-be competitors. |
| **Explicit or implicit guarantees** | State guarantees for SOEs result in reduced cost of borrowing and enhance their competitiveness in relation to private firms. |
| **Exemptions** | For example, exemptions from bankruptcy rules for SOEs in some sectors. State equity is like lock-in capital and SOEs can generate losses for a long period without fear of going bankrupt. Other examples include exemptions from antitrust enforcement may lead to anti-competitive behavior that may in turn lead to predatory pricing. |
| **Preferential regulatory environment** | This includes (a) simplified procedures to obtain license or permits, (b) granting of special rights to extract resources, (c) exemptions from regulatory compliance under environmental laws, (d) relaxation in disclosure requirements, (e) exemptions from building permits, (f) unjustified denial of approvals to potential competitors, and so on. |
| **Preferential treatment in public procurement** | Preferential access to information about upcoming public procurement tenders (that is, technical or other specifications essential for contract award) or outright favoritism of SOEs in awarding contracts can give a relative upper hand to SOEs. |
| **Price support** | Refers to policy measures that can create a gap between domestic market prices and reference prices of a specific commodity. |
| **Support in the form of commercial diplomacy** | Reliance on the government's backing and diplomatic relations to pursue business opportunities, otherwise not commercially possible without such support or not available to competitors, can give a comparative advantage to SOEs. |

*Source:* Adapted from World Bank Group 2014.

### Box 14: An Australian Definition of Competitive Neutrality

Competitive neutrality requires that government business activities should not enjoy net competitive advantages over their private sector competitors, simply by virtue of public sector ownership.

The implementation of competitive neutrality policy arrangements is intended to remove resource allocation distortions arising out of public ownership of significant business activities and to improve competitive processes. Where competitive neutrality arrangements are not in place, resource allocation distortions occur because prices charged by significant government businesses need not fully reflect resource costs. Consequently, this can distort decisions on production and consumption, for example, where to purchase goods and services, and the mix of goods and services provided by the government sector. It can also distort investment and other decisions of private sector competitors.

Competitive neutrality requires that governments should not use their legislative or fiscal power to advantage their own businesses over the private sector. If governments do advantage their businesses in this way, it will distort the competitive process and reduce efficiency, more so if the government businesses are technically less efficient than their private sector competitors.

*Source:* Australian Government. 1996. *Competitive Neutrality Policy Statement*.

- **Ensure that SOEs operate in the same or similar tax and regulatory environment.** SOEs must operate in the same or similar tax and regulatory environment as private companies to ensure competitive neutrality. Where SOEs are incorporated according to company laws, tax and regulatory treatment, it is generally similar or equal to private businesses.
- **Ensure debt neutrality.** This involves avoidance of concessionary financing to SOEs and subjecting them to similar financial market discipline. However, many SOEs continue to benefit from preferential access to finance in the market due to their explicit or perceived government backing.
- **Promote competitive and non-discriminatory public procurement.** Ensuring competitive neutrality in public procurement includes (a) competitive and non-discriminatory practices in procurement and (b) allowing all public entities to participate in the bidding contest.

Country case studies of competitive neutrality frameworks and oversight are outlined in Box 15.

### Box 15: Country Case Studies on Competitive Neutrality Frameworks and Oversight

Many governments express commitment to address aspects related to competitive neutrality in the context of SOEs. This commitment is often not manifested explicitly in the form of policy frameworks or laws. It may be expressed implicitly through competition policy and a myriad other laws or guidelines that apply to the operations of SOEs. It may take the following form:

**Explicit policy statements** – Countries like Denmark, Australia, Finland, the Netherlands, Spain, the United Kingdom, and so on, have explicitly addressed and built-in the enforcement of competitive neutrality to their national policies, these are either comprehensive competitive neutrality frameworks or competition law.

**Competition laws and policies** – In most countries, aspects of competitive neutrality are dealt through competition laws and policies.

**Constitutional commitments** – In countries like Brazil, Chile, China, Hungary, Mexico, Peru, Russia, and so on, the overall commitment to a level playing field is enshrined in the Constitution.

**Rules on state aid and transparency** – The EU and European Economic Area (EEA) countries are subject to EU rules which explicitly address the issue of competitive neutrality through the EU Rules on State Aid and the Transparency Directive.

*Source:* OECD. 2012. *Competitive Neutrality – National Practices.*

## **Topic five:** State's ownership role over the board of SOE (selection and removal of board members)

In most countries, the nomination or appointment of SOE directors is a government responsibility. While in some countries there is at least formal self-nomination by boards first (for example, through nomination committees), it is usually exercised by the relevant ministers or through some form of inter-ministerial process. In exercising this power, ministers should safeguard overall public interests rather than acting as private owners of companies. According to the degree to which the state has centralized its enterprise ownership function and the size of the state's ownership stake in an SOE, this authority may rest with individual ministers or the entire cabinet and/or executive power.

In countries, where the state enterprise ownership function is centralized, for example, through a dedicated state enterprise ownership unit—such as in China, Korea, Sweden, and Thailand—this ownership unit has the direct responsibility for nominating or approving members to wholly owned SOE boards, whereby the decision often benefits from advisory functions. In countries, where ownership is more decentralized like Egypt, India, Malaysia, Morocco, and Vietnam, the agency exercising a central state function and sectoral ministries often shares responsibility for board nominations. Line ministries exercise most of the power but finance ministries sometimes oversee the process through some degree of coordination. In the case of partially owned SOEs, such nominations must in principle be further vetted by shareholders in a general meeting for appointment to the board.

In some countries, there is a continuum of dependency on the ownership function regarding board composition with varying degrees as follows:

- Appointment of direct representatives from the ownership function
- Other directors for the state, who by law or statutes, are tasked with representing the government interest. In some countries, individuals can be selected from the private sector or academia and tasked to act in the interest of the state, but in most cases they are, civil servants
- Directors that are picked at the discretion of the nominating minister or the ownership function
- Independent directors picked according to national or SOE-specific definitions of 'independent'

The board should include people with a mix and balance of skills and understanding to match and complement the SOE's business and its strategic aims. Therefore, the appointment of directors to SOE boards should be based on well-defined eligibility criteria and not merely on account of holding office in the government. In Korea, for example, since 1999, public officials or civil servants cannot become members of SOE boards as stipulated in the 'Act on the Management of Public Institutions'. If it is less than three years since the person was removed from her/his office as a public official, she/he should not be qualified for a director of an SOE or quasi-governmental institution.

The OECD Guidelines on Corporate Governance for SOEs recommend that the recruitment process should be based on eligibility rules and appropriate vetting mechanisms (that is, nomination committees) before the ultimate decision of ministers and shareholders. Where SOEs have minority non-state investors, their adequate board representation should also be ensured. The board nomination decision should be facilitated by the consistent policy framework that enables boards to play a role in identifying potential members with appropriate expertise and knowledge. The policy framework entails setting clear minimum qualification criteria for board appointments, vetting mechanisms for ministerial board nominations, establishing nomination committees or taking a tailored nomination approach, and ensuring shareholders' right to elect board members.

Accordingly, the mentioned topic explores the adoption of professional criteria for the selection and removal of board members as well as the development of a structured nomination and appointment process.

## *Adoption of professional criteria for selection and dismissal*

As more and more countries move toward including independent directors and are moving away from the practice of filling board positions with political figures and government representatives, professional criteria for the selection of directors become all the more important. While the specific skills required will vary from board to board, governments are identifying the competencies, skills, and experience needed to exercise independent judgment and lead the SOE successfully—including industry-specific knowledge and financial, legal, corporate governance, and other skills—and striving to appoint directors, who match those profiles. The aim is to create professional boards with independent judgment and a wider range of talent and perspectives.

**Selection criteria** – More rigorous qualifications have accompanied efforts to bring greater professionalism to the makeup of boards. In addition to minimum requirements for education and experience, industrial, financial, business, legal, and corporate governance skills, as well as private sector backgrounds and experience, are carrying more weight. Other skills such as integrity, ability to add value, and critical faculty are also important. While specialized expertise has been targeted for inclusion, certain backgrounds are also being identified to disqualify candidates.

Table 11 provides an overview of qualification requirements for board directors.

Given the state's role over SOE board nominations, it also has an important role to play in ensuring gender diversity of the boards. The state should actively ensure that adequate gender representation on SOE boards is implemented and can also develop and implement policies to help enforce the same. Besides, the state should also ensure that integrity and ethical standards are incorporated as part of the selection criteria to help improve the board's effectiveness and professionalism.

**Profile of board skills** – The sharper focus on the competency of boards is attracting greater

**Table 11**: Qualification Requirements for Board Directors

| Priority | Example of Qualification Requirements |
|---|---|
| **Reduce participation by ministers and other high-level public officials** | **Estonia:** Ministers and ministerial secretaries-general can serve on the boards of foundations but not companies.<br>**Israel:** Ministers, deputy ministers, and parliamentarians cannot serve as SOE directors; additional rules are established to prevent possible conflicts of interest.<br>**Slovenia:** High-level public officials cannot serve on SOE boards, and no more than two civil servants can serve on a supervisory or management board at any one time. |
| **Specific expertise required: Criteria may be the same for all SOEs or special criteria may apply only to certain SOEs or positions** | **Czech Republic:** Requirements include experience in corporate governance and knowledge of economics, financial statements, and the commercial code.<br>Hungary: A degree in finance, economics, or law is required.<br>Romania: Most of the board members must have experience with profitable private sector companies. |
| **Skillset differentiation for particular positions or the board as a whole** | **Chile, Israel, and Lithuania:** Additional proficiency and suitability requirements apply for candidate board members of large SOEs; the required expertise of each director position is specified to ensure that the board has an appropriate skills mix.<br>**Switzerland:** Qualifications are divided into three categories: (a) for the board as a whole (team functions, strategic skills, relevant market and professional knowledge); (b) for single board members (integrity, independence, professional skills); and (c) for the chair (specific leadership skills). |

*Source*: Adapted from World Bank Group 2014.

attention to developing profiles of board skills as an important tool for better management of board appointments. These profiles detail the skills needed for a board as a whole or for particular positions. Such efforts have grown out of the need for the government and its boards to bring greater professionalism to the makeup of boards, especially as they take on a bigger role in strategic business planning and board evaluations. Since directors have finite terms, SOE owners need to be aware of the duration of all appointments and include succession planning in medium-term skills profiles. Developing a profile of board skills is especially important for the board chair and specialist industry skills.

**Dismissal criteria** – Board members should be appointed for a fixed term, usually for the span of one to three years. In many cases, even though board members have finite terms, they may be rotated or removed for no substantiated reasons or, conversely, may be subject to unlimited renewals. In both cases, clear criteria should guide the process of removing directors. Company legislation generally provides that shareholders may seek to remove a director. However, dismissal standards may need to be stricter for SOEs than for private sector companies to avoid the risk of arbitrary dismissals for political or other reasons unrelated to performance. A non-performing director (for example, one who fails to attend board meetings) can jeopardize the health of the company, but a board member should not be subject to removal simply because of an election result.

### *Developing a structured nomination and approval process*

Especially under the decentralized model of SOE ownership, line ministries typically lead the nomination process for board directors. This approach can allow for considerable political influence and result in varied nomination procedures from one SOE to the next and a lack of transparency. To reduce the ministerial influence, many countries, therefore, have adopted governance reforms that delegate part or all of the nomination processes to an advisory body, expert panel, centralized ownership entity, or the SOEs themselves.

**Delegation to an advisory body or expert panel** – An SOE advisory body may play an informal role, providing advice, as requested, to line ministries. However, without a systematic structure or process in place, their role and inputs may be minimal. Giving them a more formal role in the process usually yields better results and helps improve the prospects of identifying more qualified and merit-based boards.

Advisory or coordinating bodies are assigned a formal role in countries such as India, New Zealand, Sweden, and the United Kingdom. In these cases, they usually prepare shortlists of candidates, evaluate and propose candidates, maintain a database of potential candidates with different terms of reference, and keep records of board memberships and directors' terms.

A special panel or expert committee may also be created to provide supplementary advice for board nominations. Suitable panel members are usually experienced directors from the public or private sector.

**Control by centralized ownership units** – While advisory bodies typically support and advise line ministries on the nomination process, centralized ownership entities may have direct responsibility toward board nominations.

**Responsibility of SOE nominating committees** – The majority of the countries rely on a top-down nomination process led by ministries, an advisory body, or an ownership entity. However, some use a bottom-up process led by the SOEs themselves. SOE-led nominations are more common in developed countries for mixed-ownership companies, and for SOEs listed on an exchange with regulations that call for a board nomination committee.

An SOE-led process is potentially vulnerable to interference and manipulation of the nomination process. The government can influence shortlisting, while a type of self-censorship may occur since the nomination committees may be reluctant to propose candidates that they know stand with little chance of approval. However, integrating the

SOE into the nomination process may help identify the backgrounds most needed in board directors.

Below are some **practical guidelines for SOEs to follow in leading the process for board nominations:**

- Set up a nomination committee as a specialized committee of directors (refer to topic on establishing specialized board committees in Part II, Module 1 on recommended role and composition of a nomination committee).
- Nomination committee must reach out to institute of directors or equivalent bodies to access a pool of qualified candidates trained on corporate governance issues.
- Staff the committee with a majority of independent directors and employ independent external search consultants, as needed.
- Ensure that the nomination committee supports the objective of a formal, merit-based, and transparent process for the nomination of board members with specific skills.
- Ensure adequate succession planning to avoid board positions becoming and remaining vacant.
- Ensure that these committee objectives and procedures are documented with full information on the process and that board nominees be made available to shareholders and the public.
- Audit the process.

**Creation of a directors' pool** – Ownership units in countries such as India and Thailand have generated databases of qualified candidates to assist in future nominations. Created by the advisory body or ownership entity, the databases are developed through open advertisement, specialized screening, search committees, the use of professional recruiters, and consultations with other ministries and government agencies. Candidates are pre-screened and interviewed to ensure their competence and credibility. Such databases are one of the ownership unit's most valuable tools for professionalizing SOE boards.

## *Barriers to women in boards and senior management, and business case for gender diversity in boards*[18]

The private sector has made significant strides in ensuring board gender diversity compared to the public sector including SOEs. Therefore, at multiple places, this section talks about the best practices from the private sector that can act as a guide for the SOEs to advance their efforts toward ensuring greater board diversity.

### The business case for board gender diversity

It is important for the state as an owner to recognize that gender-diverse boards are not only essential for gender parity and inclusion considerations but that they also have a positive impact on SOE performance. An IFC study emphasizes that firm performance is not the only reason why governments and business leaders should embrace diversity. First, the social case for diversity is strong enough in itself: for example, businesses in the South East Asia Region have increasingly diverse workforces, where women play crucial roles in almost all the operational aspects, from the shop floor to senior management. There is no reason that company boards should not reflect this diversity. Second, senior female leaders have similar academic qualifications to their male counterparts, which suggests that there is no shortage of talent.

Increasing women's presence on company boards widens the talent pool from which they can draw driving operational excellence and bring unique insights and fresh perspectives, which enable stronger decision-making. For example, women may bring different leadership traits, introducing a more varied and comprehensive set of competencies to the boardroom. It has also been suggested that women can (in general) be more flexible in their views, more open to different ways of thinking, and less command-oriented than men, facilitating more open discussion among the board members, thus reducing groupthink and improving relations between the board members and employees. Evidence also shows that women are interested in engaging in environmental, social and governance (ESG) issues, which are vital for enhancing a firm's reputation and impact.

Country case studies of initiatives toward promoting gender diversity are outlined in Box 16.

However, there are several **challenges faced by women to be appointed and function effectively in boards** and senior management, which include the following:

- Board appointments are typically based on the old-boy networks
- Risk of tokenism—appointing women solely to fulfil a quota, appease investors, or make the firm appear more progressive and diverse
- Women in senior executive posts can be 'invisible'
- Boards lack an understanding of the benefits of a diverse board
- Lack of minimum access to mentoring, networking, and training
- Weak regulatory enforcement of current guidelines on gender diversity
- Lack of family-friendly policies, including childcare
- More male champions for gender diversity are needed
- Lack of gender-disaggregated data or minimum reporting on gender metrics
- No supportive tone at the top to change company culture

### Drivers of board gender diversity

Advancing gender diversity requires a combination of country- and company-level initiatives. Over the past two decades, efforts to encourage board gender diversity have relied on both direct measures, such as introducing gender quotas and developing or revising corporate governance standards and indirect measures, such as promoting greater female labor force participation or gender equality in general.

**Country-level factors that drive board gender diversity:** Quotas and corporate governance standards are the most common top-down policy tools for increasing board gender diversity. Other policy tools that aim to develop more gender diverse societies can also indirectly influence board gender diversity—for example, increasing female labor force participation and introducing gender equality policies. Western European countries have generally taken the lead in imposing top-down direct measures, the most visible of which are mandatory quotas. Norway first established mandatory quotas in 2003, and several EU countries have since followed suit. While useful in theory, some studies conclude that quotas may be too narrow a policy tool to address some of the more systemic issues of female under-representation.[19] For instance, a 2011 study by IFC suggested that quotas encouraged tokenism and a lack of commitment from the existing board members.[20] However, a 2017 study by Solimene et al. found that the introduction of quotas supported a significant rise in the share of women on the boards of some of Europe's largest companies.[21]

Beyond quotas, other direct measures include revising corporate governance codes. This is seen as a less burdensome top-down method of achieving board gender diversity. These codes can require companies to publicly disclose the number of women on

**Box 16: Country Case Studies on Gender Diversity Promotion in Company Boards**

Western Europe remains the world leader in board gender diversity, with women holding more than 20 percent of board seats in many countries, and significantly more in countries such as Norway (42 percent), France (40 percent), and Sweden (31.7 percent). Since France and Italy established quotas in 2011, the share of board seats held by women in these countries has skyrocketed, from 12 percent in 2010 to 37 percent by 2016 in France, and from 5 percent to 30 percent in Italy. Over the same period, the share of board seats held by women in Germany increased from 13 percent to 27 percent. However, despite being an early champion of gender equality in the boardroom, in the United States, women hold only 14.2 percent of board seats. A lack of proactive policies has resulted in the country falling behind its European peers in recent years.

*Source:* International Finance Corporation. 2019. *Board Gender Diversity in ASEAN*. Washington, DC: World Bank Group.

their boards, consider gender diversity for boardroom appointments, and publicize their policies on gender diversity and their progress toward achieving it. This 'comply or explain' approach—adopted in countries such as Canada and the United Kingdom—provides a middle ground between implementing quotas and taking a laissez-faire approach.

Other macroeconomic factors such as greater female labor force participation and policies promote gender equality function as external drivers of board diversity. A 2016 study by the International Monetary Fund (IMF) found a stronger correlation between gender diversity in senior positions and the financial performance of companies in sectors where women accounted for a larger share of the labor force.[22] Similarly, a 2016 study by the Asian Development Bank (ADB) found that government policies promoting gender diversity in business leadership improved the social conditions required for gender equality, which can have a trickle-down effect on board diversity.[23]

**Company-level factors that drive board gender diversity:** No two firms are the same, but research has shown that factors such as the industry in which a firm operates, ownership structure, and diversity in leadership, can determine the likelihood of a company having a higher or lower proportion of female board members. The following company-level drivers that can potentially influence board gender diversity, ranging from company image to the desire to attract more investors are:

- SOE's recognition of the benefits of board gender diversity. Recognizing such benefits provides a much-needed push for companies to diversify their boards.
- Companies may be able to attract a variety of investors by increasing female board membership. Indeed, a 2017 Deloitte study[24] found that investors were among the most influential advocates for change and that some had even been pushing back on companies that were not doing enough to promote boardroom gender diversity.
- The third driver is the company's desire for a better reputation or business image. As a 2012 Credit Suisse study[25] explained, when a company appointed more women to its board, it sent a positive signal to the market about its focus on corporate governance. It could also indicate that the company was doing well.
- Finally, shareholder activism provides an impetus to appoint more women on boards. A 2011 Global Economic Symposium study[26] found that institutional shareholders were pushing to nominate and create their databases of diverse directors.

### Impact of board gender diversity on company performance

The global literature on the impact of board gender diversity on company performance is mixed. Many studies comprehensively show improvement across at least one of the indicators of performance in firms that have more women on their board.

However, many studies have found either a negative or neutral association between gender diversity and performance, as outlined in Box 17 on the next page.

The benefits of increased gender diversity in boards on company performance is summarized in Figure 10 on the next page.

### Opportunities for advancing board gender diversity

There are numerous opportunities to make progress toward achieving greater board gender diversity. Certain policies are critical to this effort, such as, expanding parental leave to include men and changing codes of corporate governance to include gender diversity disclosures. Companies and business leaders must also commit to improving diversity (for example, through mentoring and sponsorship programs), and must be proactive in promoting its benefits to their peers. Lastly, women can establish intra- and cross-company networks to facilitate peer-to-peer support and promote their skills and experience. This section talks about the key opportunities to enhance board gender diversity in the region, at both the country and company levels.

Country-level opportunities for advancing board gender diversity:

## Box 17: Empirical Studies on the Relationship between Board Gender Diversity and Financial Performance Globally

A 2012 Credit Suisse report found that companies with at least one woman on the board outperformed—in terms of share price performance—those with no women on the board over the course of six years. Adams and Ferreira (2009) studied a sample of US firms and found that female directors performed better in terms of committee attendance and participation, allocating more effort to monitoring responsibilities. However, their results suggested that the average effect of gender diversity on company performance was negative. In contrast, the latest research from Morgan Stanley Capital International Environmental, Social and Governance (MSCI ESG) shows that companies with strong female leadership generated an ROE of 10.1 percent per year, compared to 7.4 percent for those without such leadership. Similarly, a 2015 study on women on the boards of Australian companies found a positive association between board diversity and company financial performance (Return on Equity, Return on Assets, and Tobin's q) after controlling for several firm-specific and governance variables.

*Source:* IFC. 2019. *Board Gender Diversity in ASEAN*. Washington, DC, World Bank Group.

- **Corporate governance codes are the most cost-effective public intervention.** Changing corporate governance codes to promote board gender diversity is almost universally seen as the key mechanism for increased female representation in boardrooms. To a large extent, this is because relying on corporate governance was seen as imposing less of a burden on companies than measures such as quotas.
- **Power of networks.** The 30 Percent Club is a global initiative that aims to achieve at least 30 percent female board membership on Financial Times Stock Exchange 100 boards, the critical mass of female representation needed to perpetuate further diversity. The club supports sustainable, business-led voluntary change designed to improve the current gender imbalance on boards. In July 2017, the 30 Percent Club launched a mentorship program with PwC Malaysia, where women identified as 'board-ready' are paired with experienced directors or existing board members. The program aims to mentor 100 women by 2020.
- **Family-friendly policies are needed, as are changes to social and cultural norms.** It is widely recognized that there is a need for policies that will help women to manage responsibilities as both business leaders and parents. This combination of family responsibilities takes a toll on the amount of time and effort women in the region can dedicate to work, which in the long term affects their likelihood of reaching top positions in the C-suite or the boardroom. Among the **various**

**Figure 10**: Business Case for Increased Gender Diversity on Boards

| Enhanced firm performance | Increased board effectiveness | Influence nature, extent, and monitoring of reporting |
|---|---|---|
| • Better results on assets and sales<br>• Stronger earnings quality<br>• Enhanced firm value<br>• Tighter internal controls<br>• Increased ethical and social compliance<br>• Reduced incidence of fraud, insider trader, and other unethical practices | • Stronger control over companies' strategic direction<br>• More active board meetings<br>• Reduced levels of conflict<br>• Greater emphasis on board development<br>• Increased willingness to replace underperforming CEOs | • Reduced risk of financial restatement<br>• More conservative approach to earnings statements<br>• Increased transparency and disclosure |

*Source:* Adapted from IFC. 2018.

**strategies that can be implemented at the country level** to tackle this problem, policies that support men to play a larger role in childcare are crucial.

- **Stock exchanges can do what governments have yet to** (for listed companies only). Through their financial regulators, governments can play a key role in establishing the groundwork for board gender diversity by making changes to corporate governance codes. The directors of national stock exchanges can take the lead in promoting disclosure of gender diversity targets, pay parity, parental leave, and flexible work policies, and can help to foster networking and training for female leaders.
- **Make them known: the importance of directories and data.** Publicizing the efforts of women who already sit on boards can be a simple yet effective way of expanding the female talent pool for companies seeking to fill vacant board seats. IFC recently published Sri Lanka's first directory of this kind: Women on Boards of Companies Listed in the Colombo Stock Exchange[27]. Beyond directories, greater availability of gender-disaggregated data could help advocacy groups, researchers, and the media to understand the current levels of gender diversity, and to track progress over time.

**Company-level opportunities for advancing board gender diversity:**

- **Change must begin from within the company, and senior leaders need to play a bigger role.** At the company level, it is vital that the leadership supports board gender diversity and proactively adopts strategies in pursuit of this goal. According to a 2016 study by McKinsey & Company, CEO commitment was one of three 'game changers' that helped certain firms rank in the top tier for gender diversity. The study found that a committed CEO—male or female—ensured that gender diversity became a strategic priority for the firm and that senior managers were on board with this priority (although the trickle-down effect weakened at the middle manager level). An unequivocal statement of intent, supported by a clear and transparent action plan and communicated from the top of the organization, was identified as the first and most important step toward achieving organizational change. Boards and their nominating committees must consciously broaden their search criteria and present a more diverse pool of female and male candidates for consideration. Encouraging mentorship programs within companies is also an important mechanism for increasing the number of women in senior management.
- **Pipelines and networks for women are crucial game changers.** Companies can actively develop a long-term pipeline of female talent, focusing on both internal and external candidates with the right expertise, rather than those with previous board experience. After identifying these candidates, companies can provide dedicated board training and take steps to avoid 'leakage'—for example, by starting a dedicated return-to-work program for women, who have taken time off. The importance of introducing policies that would help to retain female employees and hopefully provide the company with a larger candidate pool to choose from when appointing board members in the future cannot be underscored. Possible policies include providing flexible work hours, promoting gender equality throughout the business, and running diversity events. Most countries already have some type of national directors' network in place, where female directors can play a role in promoting diversity.
- **Advocacy groups can also promote board gender diversity.** Dedicated diversity groups and councils also help to promote board gender diversity in various countries. This includes specialist advocacy organizations such as the 30 Percent Coalition and 2020 Women on Boards in the United States, and the 30 Percent Club in the United Kingdom, all of which have implemented various initiatives dedicated to increasing board gender diversity. For example, the Thirty Percent Coalition's 'Adopt a Company' letter campaign[28] targeted more than 150 major listed companies with no women on their

boards and managed to get 22 of them to recruit women into board positions. In response to apathy at the federal level regarding board gender diversity, 2020 Women on Boards decided to lobby state governments in the United States and succeeded in passing a resolution in Illinois that urged companies to have a minimum number of women on their boards.

- **Make work flexible and help women return to work.** This should include providing child-friendly working hours, or work hours that can fit in with other family commitments: working from home, teleworking, or arrangements to work part-time temporarily. Furthermore, companies should publicize their willingness to accept flexible work and highlight the business case for this (that is to retain talented female employees) to avoid any impression that women are getting an 'unfair advantage' from these arrangements.

Demonstrating a visible commitment to board gender diversity is critical. There is evidence that diversity tends to promote further diversity, prompting more widespread and inclusive searches for talent among a company's own ranks. Once a critical mass of diversity has been achieved, the push for even greater diversity tends to become automatic. Therefore, in the context of an SOE, the state has a key role to play to set the right tone at the top and facilitate the trickle-down effect of maximizing board gender diversity.

## Topic six: State's financial oversight and monitoring responsibilities[29]

Many studies have highlighted how the failure of SOEs can result in huge economic and fiscal costs. A survey[30] analyzed a series of episodes, in which contingent liabilities materialized over the period 1990–2014. The study concluded that the maximum cost of those episodes involving SOEs was 15.1 percent of GDP, and the average cost was 3 percent of GDP which is significant.

SOEs were the second-largest category of fiscal risk after the financial sector (which includes many state-owned financial institutions). Moreover, the number of episodes involving SOEs and their average fiscal cost doubled between the 1990s and the 2000s. To contain such risks, an effective regime for the financial supervision and oversight of SOEs should be put in place.

In this topic, the essential building blocks of an effective framework for the financial oversight of SOEs are discussed. These elements include the policy, legal, and institutional frameworks for the oversight of SOEs, a robust system of financial controls and approvals, and arrangements for measuring and monitoring SOEs financial performance and their quasi-fiscal activities.

### *Financial oversight mechanisms*

An effective framework for the financial oversight of public corporations requires a clearly defined ownership policy backed by strong legal and institutional arrangements. In some countries, the laws and regulations governing business enterprises will provide much of the required legal framework for public corporations. Such laws include those related to the structure and powers of the management board, requirements on financial reporting, and independent audit arrangements. However, for public corporations, these laws need to be supplemented by a public-sector-specific oversight framework that defines the respective goals, power, and responsibilities of the corporation, the Ministry of Finance, and any line ministries involved. Three main components of this framework are described below:

**Ownership policy** – An effective framework for the financial oversight of SOEs requires a clearly defined ownership policy backed by strong legal and institutional arrangements. The ownership policy should explicitly address the following elements: planning or budgeting requirements, reporting requirements, pricing and tariffs, dividend policy, financial assistance from the government including guarantees, and contractual commitments. The policy should also ensure that all these elements are included in the government's financial monitoring and reporting framework.

**Legal framework** – To establish the respective roles of the government and its SOEs clearly in financial management, many countries have found it helpful to prepare a framework law on SOEs. **The legal framework should include the following elements:**

- A clear definition of the financial oversight function, whether the Ministry of Finance would carry out this role, a sector ministry in consultation with the Ministry of Finance, or possibly an independent agency.
- A statement of the powers of the government to receive, comment on, and approve the financial plans, financial targets, and annual financial statements of SOEs; set financial performance targets; and respond to requests by SOEs for compensation of public sector obligations, capital injections, borrowing, or government guarantees.
- A statement of the public reporting requirements for all corporations, including a full annual financial statement (containing a statement of operations, a cash flow statement, and a balance sheet) prepared following national or international accounting standards.
- A requirement for the government to publish an annual report on whether SOEs are achieving their policy and financial objectives and complying with their obligations to prepare regular and timely financial reports.
- A requirement for the annual accounts of the public corporation to be audited by a reputable, independent auditing body that is recognized internationally, and to publish the audit report.

**Institutional framework** – Because shareholders have the right to approve SOEs' corporate and financial plans and dividend policies and to receive financial reports, the ownership and financial oversight functions overlap with each other. For this reason, some countries have chosen to locate both the ownership and financial oversight functions in a central agency, often the Ministry of Finance, the Treasury, or the Presidency (examples are Brazil and Sweden). Other countries apply a more decentralized ownership model or a mixture of the centralized and decentralized models.

## *Financial controls over SOEs*

In exercising their ownership functions, governments need to strike a balance between maximizing the operational autonomy of SOEs and minimizing fiscal risks. Countries have begun to delegate major decisions to SOE boards, particularly those of larger SOEs or listed SOEs, but may still fall short of full delegation (refer to Part II, Module 2 for an example on 'Delegating decision-making powers to SOE Boards in India'). **Although financial control mechanisms vary from country to country, they typically include some or all of the following elements:**

- **Financial and policy objectives.** Good financial management depends critically on a clear and operational statement of the government's financial and policy objectives related to each SOE. The former may be expressed in terms of the SOEs dividend, profit, return on equity, or other indicators discussed below. The latter may include the maintenance of universal access to infrastructure services, provision of certain strategic outputs, or provision of services at below-market prices, all of which should be compensated through transfers from the government's budget.
- **Financial plans**. The ownership of a majority of the voting interest gives the

government a veto power on all major decisions regarding corporate policy and financial plans. **When assessing an SOE's financial plan, governments should ensure the following:**

- o Financial targets, prices and tariffs, capital levels, and targets for dividends are appropriate;
- o The balance between commercial objectives and any public service obligations is adequate;
- o Investment plans take government priorities and related activities into account;
- o Financial and operational risks are actively managed;
- o SOEs do not create subsidiaries as a means of transferring the control of public assets to private interests.

- **Borrowing.** The government in some countries with the formal approval of the legislature may establish ceilings on the borrowing of SOEs as a whole and/or individually to limit the contingent liability to the government itself and the impact on the wider economy.
- **Guarantees.** Governments in some cases either prohibit entirely or strictly control the issuance of guarantees by SOEs to third parties, as this impairs the government's equity in the corporation and is typically more expensive than extending the guarantee directly from the government.
- **Sale/pledging of assets.** SOEs' nonfinancial assets, such as land or buildings, are often provided to them by the government free of charge (in some cases, the legal ownership of the assets remains with the government rather than with the SOE itself). Therefore, to protect its equity in the SOE, the government may restrict the sale of these assets or their use as collateral in financial transactions. It may similarly restrict the pledging or securitization of future revenue streams.
- **Mergers/acquisitions.** Given the impact that mergers and acquisitions may have in terms of the SOEs operations and finances, as well as the environment for competition, governments typically require their approval before an SOE can merge with or acquire another enterprise.
- **Raising private finances.** SOEs are being increasingly encouraged to explore alternate sources of financing to reduce their reliance on the state. However, given that this avenue would have an impact on the capital structure of the SOE, the state must be consulted on all such decisions, especially where equity divestment is involved.

### *Vetting business case of large SOE investments*

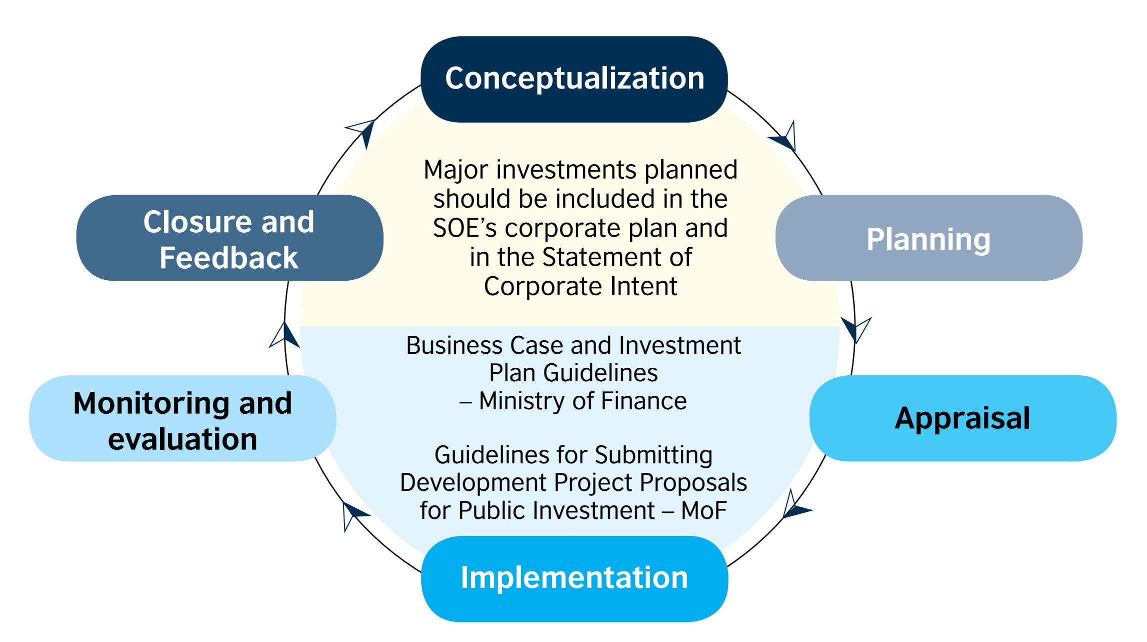
When SOEs initiate large capital investment project proposals that are submitted to the Ministry of Finance for review, notably when such projects require co-funding from the budget; or it imposes recurrent expenditures on the budget; or seek government guarantees, it requires a standardized framework to systematically appraise and vet the business case of such large SOE investments.

The framework is ideally applied in two steps during critical decision points in the project and budget cycle, at the planning and appraisal stage as given below. This framework entails a more rigorous project preparation and appraisal, which can be onerous and should, therefore, be applied in priority to large or risky projects (from a social or environmental point of view), as outlined in Figures 11 and 12 on the next page.

Completed project proposals should be submitted to the state/ownership entity/ portfolio and finance ministries for assessment and approval through the board of directors. Upon receiving the proposal, MOF will conduct the appraisal in two stages:

- ***Preliminary assessment/concept stage.*** The preliminary assessment, which will check the project rationale and sustainability issues, will examine the strategic importance of the project, an assessment of costs and benefits, a pre-feasibility study of the project and will verify whether a sufficiently wide range of alternatives has been considered. If the proposal lacks essential information/data, additional information will be requested

**Figure 11:** Project Cycle




*Source*: Authors.

**Figure 12:** Workflow of Investment Appraisals

| | | | | | | |
|---|---|---|---|---|---|---|
| Classical PIM review process | Ministries and Agencies | Planning | External Financing when applicable | Budget | Cabinet | |
| SOE investment review process | SOE/ Ministry | MOF SOE depart. | Planning | External Financing when applicable | Budget | Cabinet |

*Source*: Author.

from the SOE in a given time frame (to specify in the policy/regulation).

The principal criteria to be used for appraisal of a project at the initial appraisal stage are (a) whether the project has been formulated in line with national and sectoral policy priorities and objectives of the government, (b) what specific development challenges it aims to address and how this can be measured, (c) the result of the socioeconomic benefit analysis, (d) affordability and financing capacity of the SOE, (d) potential fiscal risks and contingent liabilities, and (e) the proposed project team. It will further assess SOE specific dimensions such as the impact on the market and competitive neutrality, the corporate governance of the SOE and more recently the climate risks (physical and transition risks).

- ***Comprehensive assessment/appraisal stage.*** A detailed appraisal is carried out once the detailed project has been submitted along with a feasibility study in the second stage. This is accepted as the final step before a project is approved by the state after the merits and acceptability of projects are determined under established criteria. The feasibility of the project is set out at this stage to scientifically assess whether the objectives remain appropriate; the costs are reasonable; the project is technically, economically, socially and environmentally feasible; and the mitigatory measures are identified for risks.

The Ministry of Strategy and Finance of the Republic of Korea applies such a differentiated project appraisal process for large investments from public institutions (which includes SOEs): https://www.kdi.re.kr/kdi_eng/kdicenter/pimac_cp-law.jsp

### Cross-cutting theme: maximizing finance for development (MFD)

With a future view on the limitations of foreign aid and unsustainable levels of public debt in several emerging economies, there is a renewed focus on domestic revenue mobilization and other innovative mechanisms to finance development outcomes. According to the new MFD approach of the World Bank, the focus of many governments regarding catalyzing private financing to advance development goals has shifted. This also includes the transformation of sectors that provide essential services or are critical to economic growth. Many businesses offer valuable skills, resources, and access to markets, and therefore, represent a unique opportunity to catalyze private investments instead of displacing them.

While the private sector has the necessary resources to invest in advancing development goals and efforts are being made to tap these resources, which will add to the scarce public resources, there is another line of resource available for the governments to maximize finance for development, that is, SOEs. With SOEs as some of the largest commercial entities in several countries, it is imperative to recognize their potential as financing sources for development projects to drive sustainable economic growth. As representatives of the state, the Treasury officials acting as directors on the SOE board must advocate for leveraging financing from various private sector sources to promote a sustainable growth trajectory of the SOE and prevent unduly reliance on government funding, while being mindful of the fiscal risks and contingent liabilities generated. This requires a careful analysis and sharing of risks and appropriate risk mitigation measures.

Financing of the project could be done via different forms not limited to funding from the national budget. SOEs must consider the least expensive and most feasible solution when planning an intervention, and in line with the MFD strategy, they are encouraged to identify ways to integrate private sector financing.

SOEs must systematically appraise and vet the business case of large SOE investments to avoid duplication of activities with other projects and agencies to minimize fiscal costs and risks for the state. The state representative should support the SOE to ensure relevance, efficiency, and effectiveness in resource allocation and maximizing finance for development by which the state is the fund provider of last resort, not first.

### Box 18: Principles for Crowding-in Private Sector Finance for Growth and Sustainable Development at a Country Level

The Principles on Crowding-in Private Sector Finance is an initiative of G-20 member countries and the multilateral development banks (MDBs) such as the World Bank, to foster effective approaches to maximize the mobilization and catalyzation of private sector resources to support countries with the implementation of the 2030 Development Agenda—including through financial and management resources and innovation. It is a set of seven principles:

- Recognizing the primacy of country ownership
- Creating an investment-friendly environment; enhancing market liquidity and strengthening project management capabilities and governance
- Expanding and standardizing credit enhancement instruments in the form of guarantees, insurance products, blended finance, equity investment, and liquidity backup facilities
- Prioritizing commercial financing – pursue cost-effective, non-government-guaranteed commercial financing, contributing to the optimal use of scarce public resources
- Blending concessional resources and private capital in an optimal way
- Reviewing incentives for crowding-in and catalyzing private sector resources

*Source:* G20-Internaltional Financial Architecture Working Group. 2017. *Principles of MDBs' Strategy for Crowding-in Private Sector Finance for Growth and Sustainable Development.*

Certain principles outlined by the G-20 member countries and multilateral development banks to support decision-making concerning leveraging private sector financing are outlined in Box 18.

## *Monitoring SOE's financial performance*

**Financial reporting and auditing standards.** Monitoring the financial performance of public corporations is greatly facilitated if public corporations follow International Financial Reporting Standards (IFRS) for financial reporting and auditing. Compliance with IFRS ensures a high-quality source of primary data on public corporations, including their financial oversight. By providing a true and fair view on the accounting for assets and liabilities, IFRS enhances the reliability of financial information, which is also more readily understood and comparable, both domestically and worldwide. Compliance with IFRS also facilitates the consolidation of financial data on public corporations with data on the general government sector in countries that follow International Public Sector Accounting Standards (IPSAS), Government Finance Statistics Manual (GFSM) 2014, or related standards.

**SOE monitoring reports**. These reports present the overall summary of the financial performance of the sector as a whole as well as provide information on individual SOEs. Its broad contents include

- An overview of the sector and highlights of public corporation activities during the year
- A full list of the companies owned by the government
- An overview of how the government has exercised its ownership policy
- Special topics
- Information on individual companies

The above contents have been further elaborated in Part III, Module 3. Handout 3.3A is a case study on the contents of Sweden's 2017 Annual Report of State-Owned Companies.

## *Assessing fiscal risks of SOEs*

Public sector balance sheets provide the most comprehensive picture of public wealth. They bring together all the accumulated assets and liabilities that the government controls, including SOEs, natural resources, and pension liabilities. IMF's Fiscal Monitor of October 2018[31] presents a comprehensive estimate of public sector assets and liabilities for a broad sample of 31 countries, covering 61 percent of the global economy. Estimates of public wealth reveal that the assets are worth US$101 trillion or 219 percent of GDP in the sample, which includes 120 percent of GDP in SOE assets.

Although SOEs hold a significant share in global assets and market capitalization, there are also several vulnerabilities associated with them. For example, in China, general government net financial worth has deteriorated to about 8 percent of GDP, largely because of subnational borrowing and underperforming SOEs. Off-budget debt and the weak performance of SOEs both entail risks for the future.

Governments provide significant support to financial SOEs (mainly capital injections) and nonfinancial SOEs (predominantly recapitalizations and debt assumptions), with the maximum annual support to financial and nonfinancial SOEs reaching 18 and 16 percent of GDP, respectively (an updated version of the database by Bova and others 2016). SOEs that operate in the airline, banking, mining, railway, and utility sectors are among those that required costly support.

For example, Italy's national airline is under bankruptcy protection and has received large loans or transfers from the government in the past few years. Similarly, South Africa's government-owned power company, Eskom, is receiving a rolling government bailout of 2.33 percent of GDP over three years, although the cost may turn out larger (IMF 2019b). In Belarus, over the past years, the government on average provided 1.5 percent of GDP in subsidies and about 2 percent of GDP in additional off-budget support (Richmond and others 2019).

In some countries, the debt of SOEs exceeds 20 percent of GDP and in several cases constitutes half or more of the public sector debt stock. In other countries, SOE external debt exceeds 25 percent of the countries' exports of goods and services (see also IMF 2020). Even if the debt was incurred to develop a natural resource, as in oil-exporting countries, the debt may increase the vulnerability of the government to shocks (for example, a fall in oil prices). In addition to debt, SOEs may have significant obligations to private parties through joint ventures, PPPs, and power purchase agreements.

A recent update on the fiscal risks posed by SOEs and the optimal means for governments to utilize SOEs in times of financial or economic crises are outlined in Box 19.

If an SOE does not perform well, the government faces a financial risk. Implicit payments to SOEs may lead to a systematic underestimation of the risk. For example, many SOEs enjoy implicit government guarantees, and therefore, have cheaper borrowing cost. The government's goal in managing SOE-associated fiscal risks should be to determine the actual amount of risk, manage that risk through appropriate debt management rules, and encourage better SOE performance.

Estimation of fiscal risks associated with PSOs and SOE contingent liabilities is challenging. It is, therefore, sensible to focus on those SOEs that pose large fiscal risks. IMF (2005) outlines a set of criteria for identifying SOEs that expose the government to large risks.

Some of the key terminologies associated with fiscal risk monitoring are outlined in Box 20 on the next page.

These criteria focus on the government's involvement with the SOE, its financial and operational track record, the quality of the SOE governance, and its strategic importance to the government (see Table 12 on next page).

### Box 19: SOEs in the Time of Covid-19

The COVID-19 pandemic has highlighted the role of the public sector in saving lives and livelihoods. SOEs are part of that effort—in the form of public utilities that provide essential services of public banks that provide loans to small business. But some are also struggling and adding to the burden on government finances. These range from national oil companies that are dealing with a large fall in oil prices, to national airlines without enough passengers traveling.

At their best, they can help countries achieve economic and social goals. At their worst, they need large bailouts from taxpayers and hinder economic growth. Which version taxpayers get boils down to good governance and accountability.

At a time when governments are facing increasing demands and struggling with high debt, the IMF in its April 2020, Fiscal Monitor says – a core principle for state-owned enterprises is not to waste public resources. IMF has laid down four main recommendations for how countries can improve the performance of SOEs:

- Governments should regularly review if an enterprise is still necessary and whether it delivers value for taxpayers' money.
- Countries need to create the right incentives for managers to perform and government agencies to properly oversee each enterprise. Full transparency in the activities of the enterprises is paramount to improve accountability and reduce corruption. Including state-owned enterprises in the budget and debt targets would also create greater incentives for fiscal discipline. Many aspects of these practices are in place, for example, in New Zealand.
- Governments also need to ensure SOEs are properly funded to achieve their economic and social mandates, such as in Sweden. This is critical in responding to crises—so that public banks and utilities have enough resources to provide subsidized loans, water, and electricity during this pandemic—and in promoting development goals.
- Ensuring a fair playing field for both SOEs and private firms would have positive effects by fostering greater productivity and avoiding protectionism. Some countries already limit preferential treatment of state-owned enterprises, like Australia and the European Union.

Well-governed and financially healthy state-owned enterprises can help combat crises such as the pandemic and promote development goals.

*Source:* Gaspar, Vitor, Paulo Medas and Ralyea John. 2020. "State-Owned Enterprises in the Time of COVID-19" *IMF Blog* (blog), May 7, 2020.

**Table 12**: Criteria for Assessing Fiscal Risks

| Category | Nature |
|---|---|
| **Managerial independence** | ***Pricing policies:*** Are prices of the SOE in line with international benchmarks (for traded goods and services); set at cost coverage (nontraded goods); is the tariff-setting regime compatible for the long-term viability of the SOE and compatible with private firms (regulated services)?<br>***Employment policies***: Is this independent of civil service law? Does the government intervene in wage setting and hiring? |
| **Relations with the government** | ***Subsidies and transfers:*** Does the government provide direct or indirect subsidies or explicit and implicit loan guarantees to the SOE, not offered to private firms? Does the SOE provide special transfers to the government?<br>***Quasi-fiscal activities:*** Does the SOE perform uncompensated functions or incur cost not directly related to its business objective?<br>***Regulatory and tax regime:*** Is the tax and regulatory regime in the industry the same for the SOE as for private firms? When appropriate, is the fiscal relationship with the SOE being managed by the large taxpayer unit? |
| **Governance structure** | ***Periodic outside audits:*** Are these carried out by a reputable private audit firm according to international standards and are audit reports published?<br>***Publication of comprehensive performance reports:*** Are these published on an annual basis?<br>***Shareholders' rights:*** Are minority shareholders' rights effectively protected? |
| **Financial conditions and stability** | ***Market access:*** Can the SOE borrow without a government guarantee and at rates comparable to private firms?<br>***Less-than-full leveraging:*** Is the SOE's debt-to-asset ratio comparable to that of private firms in the industry?<br>***Profitability:*** Are the SOEs' profits comparable to those of private firms in the industry, or if no comparable private firm exists, higher than the average cost of debt? |
| **Other risk factors** | ***Vulnerability:*** Does the SOE have sizable contingent liabilities, or is it a source of contingent liabilities for the government, say, through guaranteed debt? Is there a currency mismatch between revenues and debt obligations?<br>***Importance:*** Is the SOE large in areas such as debt service, employment, customer base? Does it provide essential services? |

*Source*: Adapted from World Bank Group 2014.

## Box 20: Guarantees and Contingent Liabilities – Key Terminologies

A **government guarantee** legally binds a government to take on an obligation should a clearly specified uncertain event materialize. Thus, with a loan guarantee, the government will be committed to making loan repayments on behalf of a non-sovereign borrower that defaults. Governments provide a number of loan guarantees (for example, to farmers, small businesses, home buyers, students, and SOEs) and other financial guarantees, including trade and exchange rate guarantees, income, profit and rate of return guarantees, and minimum pension guarantees. Guarantees are a common feature of PPP contracts and other purchase arrangements between the government and the private sector.

A guarantee is a broader set of obligations of government that gives rise to an **explicit contingent liability**. Beyond guarantees, such obligations arise mainly from government insurance schemes, including deposit, pension, war-risk, crop and flood insurance, but they can also be the result of warranties and indemnities provided by the government, and outstanding and potential legal action against the government. It should be noted that pension and social security obligations of the government (as distinct from guaranteed minimum pensions under private pension schemes or government insurance of pension savings) are not contingent liabilities. While these are contingent for individuals given uncertain life expectancy, aggregate pension and social security obligations can be measured with some precision.

An **implicit contingent liability** arises when there is an expectation that the government will take on an obligation despite the absence of a contractual or policy commitment to do so. Such an expectation is usually based on past or common government practices, like providing relief in the event of uninsured natural disasters and bailing out public enterprises, public financial institutions, subnational governments, or strategically important private firms that get into financial difficulties. The government may also be expected to cover some costs that are extraordinary (for example, those related to war reparations, and national reconciliation and reunification).

*Source:* Fiscal Affairs Department, International Monetary Fund. 2005. *Government Guarantees and Fiscal Risk*.

These criteria cannot be applied mechanically and require significant information on the SOEs beyond what is readily available. Identification of SOEs that pose large fiscal risks, therefore, need to be part of an in-depth assessment of fiscal risks related to these enterprises. An assessment performed by the IMF on SOEs identified that very few SOEs were meeting the standards required to assess fiscal risks in comparison to their commercial counterparts. In this regard, the IMF developed revised criteria to identify fiscal risks.

Establishing the SOEs' baseline financial conditions and the financial relationship with the government budget as well as predicting how that budget relationship would be affected by changes in macroeconomic conditions, developments in the industry where the SOEs operate, and operational management of the SOEs are important. Factoring in quasi-fiscal activities is also important for establishing this baseline (refer Box 21).

Some country case studies on how countries are managing their fiscal risks arising from SOEs are outlined in Box 22.

The state as an owner must engage in deliberations on the illustrated categories

### Box 21: Examples of Quasi-Fiscal Activities

- Charging less than commercial prices
- Provision of noncommercial services (for example, social services)
- Pricing for budget revenue purposes
- Paying above commercial prices to suppliers

In **Tajikistan**, for example the main quasi-fiscal activities for SOEs are pricing of goods and services at below-market or below-cost recovery levels; provision of noncommercial services by SOEs; soft budget subsidies like tolerance of SOE arrears; barter arrangements between government and SOE or between SOEs themselves; operating inefficiency like unbilled consumption, theft, and so on; subsidized lending and rescue operations and bailouts; and subsidies related to the exchange rate system.

*Sources:*

International Monetary Fund. 2007. *Manual on Fiscal Transparency*.

World Bank. 2014. *Policy Notes on Public Expenditures, Policy Note No. 5, Fiscal Risks from State-Owned Enterprises*. The World Bank, Washington, DC.

### Box 22: South Africa – Managing Fiscal Risks from SOEs

**South Africa** has a relatively well-developed oversight framework for monitoring SOE performance. The Public Financial Management Act (PFMA) and Treasury Regulations require SOEs to submit corporate plans annually, covering a period of three years, and outlining the strategic objectives, agreed with the government, key performance indicators for assessing the entities performance, a risk management plan, and a financial plan. The financial plan must include projections of revenue, expenditure and borrowings, asset and liability management, capital expenditure programs and dividend policies.

The PFMA sets controls on borrowing and contingent liabilities of SOEs. The Minister of Finance must authorize the issuance of guarantees or indemnitees. Some SOEs must also obtain the Minister's approval before borrowing and all SOEs may not borrow in foreign currency above a prescribed limit set by the minister. Entities that are permitted to borrow must submit annual borrowing programs to the National Treasury as well as quarterly reports on actual borrowing.

A Fiscal Liability Committee has been established within the National Treasury to advise the Minister on these matters as well as short and medium-term risks related to SOEs. The committee receives reports on the financial performance of SOEs and their compliance with any condition attached to fiscal support, which are assessed as part of its aggregate fiscal risk monitoring.

SOEs are required to submit audited annual financial statements in accordance with generally accepted accounting practices within five months of the end of the financial year to the shareholder minister and the National Treasury. SOEs are also required to submit quarterly reports to their shareholder minister.

*Source:* International Monetary Fund. 2016. *Analyzing and Managing Fiscal Risks—Best Practices*. Washington, DC.

and supplement the questions with context-specific risk factors to be able to adequately and accurately assess fiscal risk. **The state can reduce its exposure to fiscal risks from SOEs by**

- Reducing the overall state participation in commercial activities and the size of quasi-fiscal activities;
- Limiting exposure to contingent liabilities by ensuring that there is a clearly defined set of criteria to govern the provision of any explicit government guarantees, prohibit or control the issuance of guarantees by SOEs to third parties, and where appropriate, restrict the sale or use of their assets as collateral in financing transactions;
- Strengthening governance arrangements, for example, through appointing independent boards based on the transparent and merit-based nomination processes, holding them accountable for financial performance, ensuring there is operational autonomy, and legislating high standards of financial reporting and subjecting annual accounts to external audit;
- Legislating explicit no-bailout clauses to reduce exposure;
- Ensuring there is transparent and appropriate compensation for SOEs executing quasi-fiscal activities to achieve government goals and that subsidies for these activities are appropriately expensed in the budget;
- Finally, as for other risks, ensuring there is fiscal space to absorb retained risks through, for example, a general contingency reserve to cover any call on government guarantees to public corporations or to cover the unforeseen costs in case of their restructuring or liquidation.

Table 13 outlines an example of step-by-step fiscal risk management of SOEs given by IMF.

### Cross-cutting theme: climate change and resilience

The adverse effects of climate change on the economy are likely large but difficult to predict, and therefore they increase fiscal risks, whereby fiscal outcomes may differ substantially from projections. Assessing and managing fiscal risk from climate change can prevent an abrupt increase of public debt and improve governments' ability to raise new debt or refinance it. Since SOEs affect the government's budget and also form part of the public sector balance sheet, any adverse effect from climate change that have an impact on SOE's operations and finances will also have a bearing on the country's overall fiscal outcome and balance sheet.

**Key policy instruments**: There are various strategies that the state/ownership entity can adopt to improve fiscal risk management including climate change.

- **Identifying fiscal risks:** Fiscal risks may arise out of the financial, moral, and legal

**Table 13**: Fiscal Risk Management for SOEs[32]

| 1. Identify and quantify | 2. Mitigate | | | 3. Provision | | 4. Accommodate |
|---|---|---|---|---|---|---|
| | Direct controls | Indirect controls (regulation and charges) | Risk transfer instruments | Expense | Contingencies | |
| Quantify explicit exposures; Monitor financial performance; Scenario analysis or stress testing | Reduce the size of the SOE sector | Hold boards accountable for performance; Reporting requirements | Explicit no-bailout clauses | Appropriate expected subsidies and QFAs | Provision for cost in case of restructuring | Fiscal headroom for residual risks |

*Source:* Adapted from IMF 2016.

**Table 14**: Identification of Climate Related Fiscal Risks

| Risk factor | Climate-change-induced risks | Potential fiscal risk |
|---|---|---|
| **Climate-sensitive SOEs** | Climate-sensitive SOEs suffer losses due to extreme weather events. | Sovereign loan guarantees are called; Expectation that the government will cover SOE losses. |
| **Commodity prices** | Increased frequency and severity of extreme weather events increase the volatility of global commodity prices such as crude oil, petroleum, and so on. | Sudden change in commodity prices may affect the overall SOE revenue pool and in turn the state's dividend share. It may also generate contingent liabilities. |
| **Public-private partnerships** | Climate change may potentially threaten the financial viability of PPPs. | PPPs may entail contractual obligations and/or implicit public guarantees with important fiscal implications. |
| **Natural disasters** | Climate change increases the frequency and severity of natural disasters. | Disasters can disrupt production in fiscally important sectors and may require large-scale relief and reconstruction spending. |
| **Public health emergencies** | Rising temperatures and extreme weather events increase the risk of epidemics. | Epidemics can radically increase health spending and may adversely affect employment, production, and trade. |
| **Judicial awards** | Courts may determine that an SOE is liable for climate-adaptation measures. | Adverse court judgments may result in huge unexpected spending and contingent liabilities. |

*Source*: Adapted from Pigato 2019.

obligations of SOEs/public corporations and their stakeholders and private-public partnerships, and there need to be systematic, harmonized and decentralized responsibilities to identify fiscal risks and produce a more comprehensive appraisal (Table 14).

- **Quantifying fiscal risks:** Once fiscal risks are identified, they need to be quantified. The macroeconomic costs of climate change can be grouped into three categories: mitigation, adaptation, and residual costs. Mitigation includes all costs incurred by policies that slow the pace and limit the severity of climate change, particularly via reduced GHG emissions. Adaptation includes all costs incurred by efforts, both preventive and remedial, to reduce the social, environmental, and economic impact of climate change. Residual costs are effects of climate change that cannot be offset through mitigation or adaptation.

  Most macroeconomic models focus on assessing mitigation costs and residual costs. **Integrated Assessment Models (IAMs)** are used to quantify the damages caused by climate change and the cost of efforts to limit its extent. These models apply damage functions that approximate the relationship between global temperature changes and climate-related phenomena such as rising sea levels, more frequent cyclones, lost agricultural productivity, and degraded ecosystem services. Most IAMs treat climate-related damages as a polynomial function of global mean temperature and examine its impact on the stock of capital at either the regional or the global level. Apart from IAMs, a general equilibrium model can capture the impact of climate change by estimating its effect on the depreciation rate of physical capital. In this model, adaptation reflects the extent to which public bodies/SOEs reduce the negative influence of climate change on the capital depreciation rate.

- **Disclosing fiscal risks:** Disclosing fiscal risks can improve management. It can also improve risk identification, by increasing public accountability and lead third parties to provide information voluntarily. This is also important to inform private investment decisions induced by the SOE investments (for example, housing built around new public infrastructure and utilities which also need to internalize the risks). These risks should be presented in the performance agreement signed between the state and SOE with a ceiling in terms of the risk appetite.

- **Reducing fiscal risks:** Investments in a risk management capacity, physical risk reduction and climate-smart technology, for example, increased use of clean energy to progressively reduce GHG emissions intensity; reducing freshwater consumption per unit of production, and so on can minimize fiscal costs and risks. As most countries have yet to fully internalize climate change into development planning and sector regulations, opportune adaptation measures can usually be found to reduce fiscal risks. Making SOEs and their public assets more resilient to the effects of climate change reduces the government's direct exposure to possible future financial losses. Public investments, fiscal incentives, and regulatory measures that increase the resilience of private assets and economic activity to climate change indirectly reduce fiscal risks. Fiscal tools, such as price policies (for example, carbon taxation, subsidies for mitigation action and low carbon investment); spending and investment; and public guarantees to secure private sector participation, are critical. Beyond this, the state can also set liability caps to reduce the size of contingent liabilities, such as, expenditure for natural disaster relief and recovery.
- **Managing residual fiscal risk:** The residual fiscal risk can be managed via a range of risk transfer and risk financing tools. Governments can implement some of these measures before the risk materializes (ex ante measures). For instance, governments can establish dedicated reserve funds; or insure/reinsure against specific climate-related risks; or emit catastrophe bonds, that is, bonds, the interest repayment of which is delayed, reduced, or forgiven in case a disaster occurs. There may be a benefit in cross-country collaboration, such as, to collectively ensure against risks from natural disasters. Ex post financing measures also exist, such as budget reallocation, taxation, or borrowing from multilateral organizations or foreign countries.

Table 15 presents a taxonomy of how governments are managing climate change risks, including risk reduction, risk financing, and residual risk management. Also see Box 23 on the next page.

### *Building capacity for oversight of SOEs*

Putting in place a system for overseeing SOEs that meets all the requirements discussed above can be challenging for developing or emerging market economies, as it requires time and resources. Advanced economies have spent many years building and refining

**Table 15:** Approaches for Managing Climate Change Risks

| Theme | Sub-theme | Action |
|---|---|---|
| **Risk reduction** | Reduce vulnerability | • Diversify economy into climate-resilient production and livelihoods<br>• Mainstream climate change into public investment management systems |
| | Reduce exposure to hazards | • Improve buildings codes, land-use planning, and zoning<br>• Strengthen natural buffers (reefs, beaches, forests, and so on)<br>• Improve ecosystem management |
| **Risk financing** | Risk retention | • Contingency and reserve funds<br>• Ex ante contingent credit<br>• Ex post borrowing |
| | Risk transfer and pooling | • Insure public assets<br>• Multicountry sovereign disaster insurance<br>• Catastrophe bonds |
| **Residual risk management** | Post-disaster response | • Livelihood support<br>• Budget reallocation<br>• Humanitarian relief |

*Source*: Adapted from Pigato, 2019

## Box 23: Good Practice in Climate Fiscal Risk Management

**Africa Region**: More than 30 African countries are signatories to the treaty that establishes the African Risk Capacity (ARC). ARC pools risk between countries exposed to different weather risks, strengthening their management.

**Caribbean Region**: In 2007, countries in the Caribbean Region established the Catastrophe Risk Insurance Facility, the first multi-country risk pool. The pool aims to reduce liquidity constraints that massive natural disasters, such as, earthquakes and cyclones, impose on small developing economies. Since 2007, it has made disbursements of about US$130.5 million.

**Colombia**: The country has estimated fiscal risks from natural disasters by considering its (i) public property exposure and (ii) the exposure of private property of underprivileged groups, for which, the government took responsibility. It has also improved its climate-related fiscal risk management capacity, for instance, by signing a Catastrophe Deferred Drawdown Option, that is, a contingent line of credit that guarantees immediate liquidity upon the occurrence of a natural disaster.

**Ethiopia**: The country has set up a contract, referred to as weather derivative, in which an international reinsurer covers against the precipitation level falling below the Ethiopia Drought Index (EDI).

**Mexico**: The country has taken a number of ex ante risk financing and transferring measures. For instance, in 2006, Mexico shifted part of its public sector catastrophe risk to capital markets and the reinsurance sector. It has also established a Fund for Natural Disasters (FONDEN), to which it allocated a share of the annual budget, and this helps cover natural disasters' losses that Mexican states and federal agencies would not be able to cover independently.

**Philippines**: The 2013 Fiscal Risk Statement of the Philippines' government incorporated a debt sustainability analysis that included a natural disaster scenario analysis.

*Source:* World Bank Group, Climate Action Peer Exchange (CAPE). 2018. *About us.*

these systems. In less-advanced economies, a cautious step-by-step approach is required.

In many countries, inefficiencies and fiscal risks are concentrated in a relatively smaller number of SOEs, which should be subject to the most intensive monitoring. Moreover, many of the 'best practice' solutions discussed above have a substantial cost and require a high degree of competence within the government and the SOEs. Some of these reforms may not be practicable in the short term in low-capacity countries. In such cases, a risk-based and sequenced approach to building an oversight regime for SOEs is strongly recommended.

- In the short term (up to one year), the government could ensure that a full inventory of public sector entities with commercial or quasi-commercial functions is taken and that these entities are classified according to the latest international standards (GFSM 2001/2014). The government must also ensure that a basic reporting framework for SOEs that are high risk, or have a large fiscal or budgetary impact, is established and that the role and responsibilities of the President's Office, the Ministry of Finance, and line ministries participating in the oversight of SOEs are determined.
- In the medium term (up to three years), the legal framework relating to the SOEs could be established (or revised), providing the Ministry of Finance (or another approved entity) with the required power to review the financial plans of SOEs and monitor their performance. An SOE ownership policy should be developed. The Ministry of Finance should strengthen its capacity to supervise SOEs and the financial oversight unit could start publishing a consolidated annual report on SOEs.
- In the long term (more than three years), the government could further enhance the framework for monitoring the financial performance of SOEs by developing a more elaborate set of performance indicators and targets. The cost of delivering public service obligations and other quasi-fiscal activities should be fully funded in the budget and disclosed in the financial reports prepared by the government and the SOEs, and the government could carry out a review of the economic and financial status of business enterprises and whether they should continue to be classified as SOEs.

## Topic seven: State-board relations and communication

SOEs, including any enterprise, in which the state is a minority shareholder, should identify their shareholders and keep them duly informed in a timely and systematic fashion about material events and forthcoming shareholder meetings. They should also provide them with sufficient background information on issues that will be subject to the decision. It is the responsibility of SOE boards to make sure that the enterprise fulfils its obligations in terms of information to the shareholders, for which specific communication policies are often developed to help manage shareholder relations. Furthermore, there are several situations, for which the **SOE board needs the support of its shareowners, particularly the state**, which include the following:

- Obtaining financial support from the state (in the form of loans, guarantees, and so on)
- Changing the capital structure of the SOE
- Issuance of shares/dividends
- Exploring alternative financing sources
- Appraisal and approvals of major investment decisions
- Mergers and acquisitions
- Changing/updating strategy and direction
- Addressing corporate governance concerns and poor SOE performance

Conversely, the state's responsibility as an owner is to know and understand the context in which SOEs operate. A surprising number of ownership entities (and especially coordinating bodies) do not meet with boards and management of the companies in their portfolio and thus know little about them or about the sectors in which they operate. An initial meeting should have some basic goals: to introduce the ownership entity and its role and mission, to identify key points of contact in the company for future communication, and to address initial questions about critical missing information, especially financial reporting.

The mentioned topic explores the dos and don'ts for effective state-board relations and communications, which will support the state to act as an active and informed owner as well as the SOE board to better manage the SOE's direction and performance.

**Ensuring healthy state-board relations hinges on the following principles:**

- The state refraining from exerting undue political influence over the SOE—this is typically manifested in the form of board appointments, interference with board and management decisions (managing conflicts of interest and related-party transactions), and company strategy. This results in a negative impact on SOE's performance and competitiveness.
- The state refraining from micromanagement of SOE operations through the issue of numerous circulars, prescribing the aspects in great detail that should be the prerogative of SOE management (for example, approving CEO's foreign trips, sub-contracting decisions, hiring, and so on.)
- The board ensures transparency and timely and accurate disclosures of all the information required by the state in its capacity as an owner—this includes financial and nonfinancial performance reporting, reporting on other conflicts of interest and related-party transactions that need to be disclosed to ensure good corporate governance.

To facilitate the said relationship, active engagement between the state and the board is required. This would require assigning clear responsibility for managing the state-board relationship as well as developing formal and informal lines of communication to facilitate the same. At the same time, it is also important to ensure equitable treatment of all shareholders including minority shareholders. This is further discussed in Part I, Module 3: Protecting minority shareholder and stakeholder rights.

State-board relations and communication also involve active participation by the state in the Annual General Meeting (AGM) as well as periodic meetings to review the SOE's performance and corporate governance practices. The state should move from pure compliance driven supervision to more risk-based supervision (further discussed in Part III, Module 4 Risk governance). The role of state representatives on the SOE boards also acts as an important communication channel between the state and the SOE board. These communication channels are further discussed in Part II – the Board.

## Topic eight: Monitoring SOE performance via performance agreements

Monitoring SOE performance is a core function of the state as an owner to ensure transparency and accountability in the use of public funds. The state's ownership entity (ies) must see that each company meets the targets and objectives set for it and must act if the objectives are not met. A fundamental challenge for ownership entities in creating performance frameworks is that SOEs are usually established (and continue in government ownership) because they have both commercial and non-commercial objectives.

In many cases, the nonfinancial goals will carry financial costs, making it difficult for the board and senior executives of the SOE to resolve their competing priorities. Information asymmetries can also allow managers to conceal poor performance or exceed their mandate. These asymmetries can also affect the negotiation and monitoring of performance because inside managers have a far better understanding of the performance and operations of their company than external reviewers.

A sound performance-monitoring framework addresses these inherent tensions by explicitly identifying the core financial and nonfinancial objectives of the SOE and by spelling out the government's priorities for the various strategic objectives of each SOE. In this process, the ownership unit must develop appropriate performance targets that reflect these priorities.

Performance agreements form an important tool to support the establishment of a formal performance-monitoring framework for SOEs. A large part of preparing performance agreements is to set company mandates and strategies. Clearly defining the mandate of each wholly owned company is necessary for defining accountability, determining the scope of public services or other special obligations, and forming a basis for more specific targets for the company's operations.

Once the mandate is agreed upon, an ownership entity can develop a framework for communicating the government's expectations for SOE performance to each SOE and the public. **Performance agreements are widely used for this purpose and typically include the following elements:**

- Its mandate and the scope of activities that the company (including subsidiaries) will undertake
- A short description of the company's vision and strategy
- A clear description and explicit financial cost estimate of the company's non-commercial objectives, such as access, coverage, and affordability for low-income consumers
- Financial and nonfinancial performance indicators as well as targets for those indicators, to measure the performance of the company against its strategy (see Sweden's example in Box 24 on the next page)

**Box 24: Snapshot of Financial and Nonfinancial Targets for Sweden's SOEs**

Financial targets using indicators like return on equity (profitability), equity/assets ratio (capital structure), dividend.

Sustainability targets like gender distribution for chairman, directors, CEO, and senior management; energy consumption; CO2 emissions; customer and employee satisfaction using customer satisfaction index, share of motivated employees, and so on.

Public policy targets vary sector-wise and may not be uniformly applicable to all the SOEs.

*Source:* Government Offices of Sweden. 2017. Annual Report State-Owned Enterprises 2016.

- Standards of corporate governance
- Risk management – State's risk appetite across different types of risks such as business risk, financial risk, legal and regulatory risk
- Frequency and procedures for reporting
- A statement describing the dividend policy (refer Box 24 for country example)

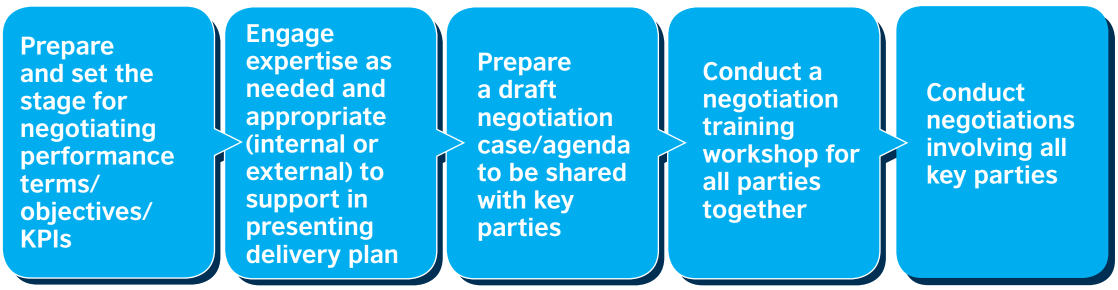
Before the performance agreement is finalized, the ownership entity and the SOE must discuss it and negotiate its contents. To properly negotiate the agreement, the ownership entity normally has good knowledge of the industry based on research, experience, and dialogue with the company. In many countries, the performance agreement is made public and presented to the parliament to establish the links in accountability. The government's expectations of the SOE be formally, clearly, and publicly communicated. Figure 13 illustrates the process of negotiating performance agreements.

**Monitoring Performance Agreements** – Monitoring the company's performance against the agreed objectives and performance targets of the company as set out in the performance agreement is generally done on an annual basis; but for more important portfolio companies, more regular monitoring (biannual or quarterly) may be warranted.

The monitoring process can be streamlined by requiring SOEs to provide standard-form financial and nonfinancial data. These forms have varying degrees of complexity, from simple spreadsheet-based templates to dedicated online data entry portals. More sophisticated systems can facilitate data analysis by identifying trends, producing cross-sector or intertemporal analysis, and generating aggregate reports.

Where more complex uses of the data are not required, the risk of elaborate data entry systems is that they fall into disuse. Where possible, the data required should conform to the existing data requirements imposed on the company. For instance, requirements should preferably align with the relevant accounting

**Figure 13**: Process for Negotiation of Performance Agreements




*Source:* Adapted from World Bank Group 2014.

**Box 25: Germany's Reporting System to Monitor SOE Performance**

In 2016 the German Federal Ministry of Finance implemented a 'standardized monitoring system' (Standardisiertes Beteiligungs Monitoring, SBM) for state-owned SMEs on request of the German Parliament. Currently, the SBM is conducted at the beginning of each year based on the company's financial statements for the previous fiscal year. The uniform calculation of financial ratios and description of each company's business situations in one standardized data sheet per SOE increase transparency and comparability within the portfolio of the federal holdings' management.

*Source:* OECD. 2020. *Implementing the OECD Guidelines on Corporate Governance of State-Owned Enterprises: Review of Recent Developments.* OECD Publishing, Paris.

standards that the SOEs must adopt for their financial statements. However, the state needs to gradually advance from purely compliance-driven supervision to a more risk-based and performance-focused oversight. The state's role in the risk governance of an SOE is discussed in Part III, Module 4 Risk governance.

**Periodic monitoring instils a culture of accountability that serves multiple aims:**

- Initially, the ownership entity can ensure that the SOE is completing all periodic reports and actions (for example, preparation of annual financial statements and external audits) and delivering them on time.
- All variances between the actual financial and nonfinancial results and the agreed results (as set out in the relevant performance agreement) should be documented.
- SOE management can be asked to document reasons for any unexpected variances, or the principals of the SOE can give explanations in face-to-face meetings with the ownership entity.
- Large or unjustified variances from planned results should be reported up through the system. As a result, for instance, the major issues arising out of the performance review could be discussed between the chairman of the SOE and the head of the government ownership unit. Depending on the national accountability structure, significant issues could be reported to the minister or a legislative oversight committee.
- Variances may give rise to consequences under the performance agreement.
- Periodic public disclosure can be made of SOE performance against the agreed objectives or relevant benchmarks and can act as a strong incentive for managers and boards to improve the performance.

Some of the critical success factors for successful negotiations of performance agreements are included in Figure 14 on the next page.

### Cross-cutting theme: integrity and anti-corruption

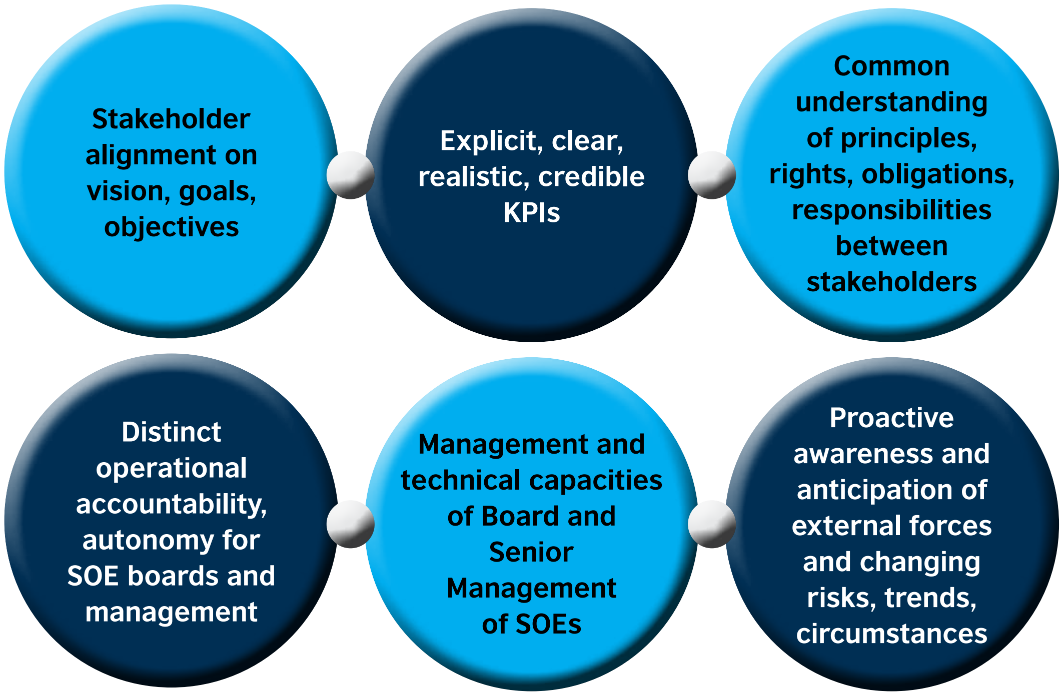
The state should act as an active and informed owner concerning anti-corruption and integrity in the companies they own. Its respective and **prime responsibilities regarding anti-corruption and integrity in SOEs should include, but are not limited to**

- Assessing SOE compliance with applicable corporate governance standards and evaluating their alignment with the state's expectations about integrity and anti-corruption. Sources used in monitoring and assessment should facilitate an adequate understanding of SOEs' corruption-risk management.
- Developing capacity in the areas of risk and control to best monitor and assess SOEs' application of relevant standards and owner expectations and engaging in discussions about corruption-risk mitigation efforts with SOE boards.
- Building a disclosure policy that identifies what information SOEs should publicly disclose, the appropriate channels for SOE disclosure and SOE mechanisms for ensuring quality of information. With due regard to SOE capacity and size, the types of disclosed information should follow

those suggested in the SOE guidelines as closely as possible and could additionally include integrity-related disclosures. The state should consider developing mechanisms to measure and assess the implementation of disclosure requirements by SOEs.

- Disclosing all financial support by the state to SOEs in a transparent and consistent fashion.
- Using, as appropriate, benchmarking tools to assess the overall risk exposure of the state through its ownership of SOEs. Where appropriate, such tools should also be used to encourage improvements in corruption-risk management among SOEs.

**Figure 14**: Critical Success Factors for Negotiating Performance Agreements




*Source:* Adapted from World Bank Group 2014.

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## Appendix A1.2A Accountability provisions in SOE's legal framework

The legal framework governing SOEs must contain provisions to the following effect to define accountability of each stakeholder:

**Classification of entities:** The legal framework must spell out the criteria for the classification of different types of SOEs operating in the country, say those that do not draw on the state's annual budget for revenues and those that do. The state shall from time to time review the classification and form of an entity or a group of entities to assess whether the classification and form are the best suited to the efficient, effective, and economical achievement of the mandate of the entity.

**Portfolio minister:** The portfolio minister for an SOE shall be the minister assigned with the ministerial responsibility for the SOE by the Head of State or parliament. The law must state the agency to whom the portfolio minister remains accountable and the responsibilities within its purview. He/she is tasked with the SOE under his or her responsibility to achieve the performance specified in the performance agreement. The portfolio minister is also responsible for approving the annual plan for the ministry and together with the Minister of Finance, for approving the Business Plan/Corporate Statement of Intent for an SOE. The law may further state actions that the portfolio minister is prohibited from doing such as awarding procurement contracts, matters relating to the hiring, dismissal, promotion, pay or other or employment arrangements, and so on. The law may also stipulate the nature and frequency of reporting arrangements.

**Minister of Finance:** Define the minister's responsibilities regarding SOE's governance. This can include the following:

- Reviewing and approving the financing intentions including the forecast financial statements and dividend proposal in the Business Plan of the SOE;
- Approving the government loans and guarantees for SOEs;
- Approving significant financing proposals for SOEs;
- Setting and enforcing the government's ownership expectations for SOEs;
- Monitoring the financial performance and risks of SOEs;
- Approving the Code of Corporate Governance to be applied to SOEs; and so on.

**Board of SOE:** The law should stipulate the responsibilities of the board of an SOE. The primary objective should be to operate as a successful business and to earn a similar return on the owners' funds over the medium term as that earned by comparable businesses not owned by the state. In case this law is the only one dealing with SOEs and there is no separate framework law, these provisions will have to be elaborated further.

**Performance Contract and Business Plan (BP):** The board may be required to submit details required under a Performance Contract or Agreement (known as Statement of Corporate Intent (SCI) in some jurisdictions) with the portfolio ministry and BP for the SOE and all its subsidiaries to the portfolio minister and Minister of Finance by a specified time. The law may, by way of schedules, specify the content of these documents. The procedure to devise a suitable dividend policy may also be specified in the law. In addition to these, the board may be required to submit periodic reports, a Mid-Year Report and an Annual Report for the SOE and its subsidiaries, including financial statements within a specified period. The Act may also provide for public disclosure of these documents.

**Annual Plan for the ministry:** The law must specify the procedure and timing for submission of the Annual Plan by the ministry. The Annual Plan of a ministry shall include the following:

- Strategic priorities for the medium term that reflect the goals and plans;

- Description of how the entity is responding to the changing environment including the description of significant changes from the previous Annual Plan;
- Nonfinancial performance including measurable indicators;
- Payments on behalf of the government including grants, benefits, and subsidies to be paid;
- Significant capital developments;
- Description of intentions to develop the capability for physical, intellectual, human, and other resources including measurable indicators where feasible;
- Summary budget, which shall include forecast financial statements;
- Financial and other assumptions;
- Statement of fiscal risks; and
- Other matters required by the finance minister.

The ministry may also be required to submit mid-year and audited annual reports within a specified timeline. These may be required to be published on the ministry's official website.

**Other matters:** The law may further state the accounting standards applicable to SOEs and whether SOEs are required to follow the state's financial year.

**Schedule on contents of Annual Report for a ministry:** Each Annual Report of a ministry or agency shall include the following:

- Strategic priorities and outcomes in the Annual Plan;
- Nonfinancial performance delivered including measurable indicators;
- Significant variations in performance from the Annual Plan;
- Payments made on behalf of the government including grants, benefits, and subsidies to be paid;
- Progress with significant capital developments;
- Advances or issues in capability for physical, intellectual, human, and other resources including measurable indicators where feasible;
- Financial performance, which shall include audited financial statements;
- Financial and other assumptions;
- The auditor's report on the financial statements;
- Report on fiscal risks;
- The remuneration paid to each director including the value of benefits in kind for the agency (not applicable to ministry);
- Statement on Public Service Obligations (PSOs) undertaken during the year by various SOEs; and
- Other matters required by the minister responsible for finance.

**Schedule on the contents of Performance Agreement/Statement of Corporate Intent of an SOE:** Each SOE shall have a Statement of Corporate Intent for the entity and its subsidiaries with a medium-term scope and a focus on the forthcoming financial year and shall include the following:

- The objectives of the group;
- The corporate governance of the group and measures to strengthen it;
- The nature and scope of the activities to be undertaken;
- The ratio of consolidated owners' funds to total assets, and definitions of those terms;
- The accounting policies;
- The expected performance for the medium term of the group concerning its objectives;
- A statement of the principles adopted in determining the annual dividend together with an estimate of the amount or proportion of annual earnings after tax (from both capital and revenue sources) that is intended to be distributed to the government;
- The information to be provided to the portfolio and finance ministers by the SOE during those financial years, including the information to be included in the in-year reports;
- The procedures to be followed before any member of the group subscribes for, purchases, or otherwise acquires shares in any company or other organization;

- Any activity, for which the board of directors seeks compensation from the government (whether or not the government has agreed to provide such compensation);
- A statement of social responsibility; and
- Such other matters as agreed upon by the portfolio and finance ministers and the board of directors.

**Schedule on contents of Business Plan for an SOE:** Each SOE shall have a Business Plan that shall include the following:

- Details for the forthcoming financial year of the expected performance targets and other measures by which the performance of the group may be judged with its objectives in the Statement of Corporate Intent, which shall include the performance indicators required by the minister responsible for finance;
- Explanation of variations in performance from the previous Business Plan;
- Forecast financial statements including an estimate of the anticipated profit for each of the three forthcoming years and the dividend to be paid to the government, with sufficient detail for the forthcoming financial year to enable meaningful assessment against those expectations after the end of that financial year;
- Any proposed major investment and financing transaction;
- A statement of any arrangement or proposed arrangement to provide goods or services for less than the cost of those services or to receive services from a government entity for less than the cost to provide the goods or services;
- A statement of risks and intended management of these;
- Other matters as are agreed by the portfolio and finance ministers and the board of directors; and
- Additional information prescribed for a plan in the establishment law of the SOE.

**Schedule on contents of an Annual Report for an SOE:** Each SOE shall have an Annual Report that shall include the following:

- A report of the operations of the SOE and those of its subsidiaries during that financial year with information as is necessary to enable an informed assessment of the operations of the entity, including a comparison of the performance of the entity with the Statement of Corporate Intent and Business Plan;
- The dividend payable to the government by the SOE for the financial year, to which the report relates;
- Audited consolidated financial statements for that financial year consisting of statements of financial position, profit and loss, changes in financial position, and such other statements as may be necessary to show the financial position of the SOE and its subsidiaries and the financial results of their operations during that financial year;
- The auditor's report on the financial statements;
- Report on fiscal risks;
- Statement on Public Service Obligations (PSOs) undertaken during the year;
- Report on compliance with the statement of social responsibility;
- The remuneration paid to each board director including the value of benefits in kind;
- The remuneration paid to senior management including all the benefits in kind presented in the form of the number of employees within salary bands; and
- Such additional information, as is necessary, to enable an informed assessment of the activities of the SOE against the Statement of Corporate Intent and Business Plan.

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I

# Corporate Governance

Leadership Training Toolkit for SOEs

**Part I Module 3**
Protecting minority shareholder and stakeholder rights

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# Module 3: Protecting minority shareholder and stakeholder rights

This session (module) covers the following topics:

1 Importance of minority protection

2 Shareholder rights – minority and golden shares

3 Key stakeholders in SOEs, their role, and relationships in SOEs

## Learning objectives

By the end of this module, the participants will be able to

- **Identify the stakeholders of SOEs and describe their role in SOEs**
- **Describe in detail the rights of minority shareholders**
- **Define minority shareholders and golden shares in SOEs**

## Agenda

**Total time: 2 hours 10 min**

| Time | Topic |
|---|---|
| 30 min | Importance of minority protection, international good practices, and key elements |
| 30 min | Shareholder rights: minority and golden shares |
| 30 min | Case study |
| 40 min | Key stakeholders in SOEs with a focus on stakeholder identification/mapping, stakeholder engagement, and external communication mechanism |

## **Topic one:** Importance of minority protection, international good practices, and key elements

### *Minority shareholders in SOEs*

The legal definition of minority shareholders, as per Merriam Webster dictionary, is "a shareholder whose proportion of shares is too small to confer any power to exert control or influence over corporate action." When the shares of an SOE are held by stakeholders other than the state, those stakeholders are referred to as minority shareholders. There is a fundamental difference between the positions of minority shareholders in an SOE, compared to the position of minority shareholders in a normal business enterprise.

The relationship between the state as a controlling or significant shareholder and the minority shareholders is particularly delicate in SOEs, particularly in those commercial SOEs that are not listed (listed companies are subject to increased regulation as part of the listing compliances, and increased scrutiny by regulators). As a dominant shareholder, the state may be in a position to abuse minority shareholders, as the former can make decisions in GSMs without the approval of the latter. It is also usually able to control the board's composition. Moreover, the state is likely to have other political and policy objectives, which might be implemented at a cost to the minority shareholders.

In several jurisdictions, government policies conflict with or undermine minority shareholder rights. Government policy on board appointment or approval of extraordinary transactions may simply ignore the presence of other shareholders. Similarly, shareholder rights related to control changes or capital increases are sometimes not respected when the government plans the sale of a major stake or when the SOE plans a capital increase at the government's request. SOE policies should acknowledge and respect shareholder rights as spelt out in law and relevant corporate governance codes or policies. For example, in India, Peru, and South Africa as well as in many OECD countries, shareholder rights are recognized through the relevant company acts and rules for listed companies; such documents prohibit companies from discriminating between shareholders and reinforce government SOE policies as well.

The mentioned rights may be defined in the general legal framework concerning companies, that is, the commercial company code, the company law, or corporate governance codes. They also may be more specifically defined or referred to in the charter of an SOE or in specific founding laws, where they exist. Finally, the equitable treatment of other shareholders may be a general principle adopted by the ownership entity or the government in relation to SOEs. This is the case, for example, in Norway, where the first one of the government's 10 principles of good corporate governance for SOEs is that all shareholders shall be treated equally.

A crucial condition for protecting minority shareholders is to guarantee a high degree of transparency among all shareholders. However, few countries document the provisions taken, if any, to ensure that the ownership entity does not make any potentially abusive use of the information it receives as a controlling shareholder. In the case of listed SOEs, listing requirements and regulatory authorities oversee SOEs and shareholding entities in this regard. In Italy, it is specifically required that listed SOEs do not share such information to the ownership entity that it does not share with the minority shareholders, to fulfil the requirements regarding equal treatment of shareholders.

For non-listed SOEs, specific mechanisms and procedures would need to be put in place by the ownership entity and at the SOE level. It is not clear whether such mechanisms exist in many OECD countries and if they are effective in ensuring easy and equitable access to information by minority shareholders of SOEs.

### *Golden shareholder*

Traditionally, when SOEs have undergone partial privatization, the state has retained a so-called golden share that gives it special rights beyond its voting shares (for example, approving control changes or other major transactions or in making a certain number of board appointments). These rights might be enumerated in the company articles, included in a licensing agreement accompanying the privatization, or be attached to shares with special rights. In many countries today, the state no longer retains such power because the same is seen as an unnecessary restriction on shareholder rights. However, at a minimum, these special rights should be fully disclosed.

The special rights or golden shares have usually been introduced in the context of privatization; they allow the state to divest itself of national flagships but without relinquishing its control over them. Whilst from the financial benefits of privatization, the state retains specific power over the future ownership, control, or strategic conduct of a private company. As such, it can significantly affect the wealth of private shareholders unpredictably.

As mentioned, the 'special rights' come in all shapes and sizes: in some instances, they are stipulated in overall framework laws underpinning the government's privatization programs, with specific decrees for individual companies. In others, they consist of special shares directly inserted in the articles of association of a privatized company. The beneficiaries vary since special rights can be attributed to the government directly or to any other entity of public authority. They may grant those public authorities a bevy of exceptional privileges, for example, the right to oppose investments beyond a certain threshold, vetoes of mergers and acquisitions, prior approval of other strategic management decisions, or enhanced voting power by limiting other investors' voting rights.

Given the special rights accorded to the state, golden shares may negatively affect the rights of minority shareholders. Therefore, its use should be restricted to special circumstances. In this regard, the 2015 G-20/OECD Guidelines on Corporate Governance says that, "The use of golden shares should be limited to cases, where they are strictly necessary to protect certain essential public interests such as those relating to the protection of public security and proportionate to the pursuit of these objectives."

## Topic two: Shareholders' rights

The OECD Principles of Corporate Governance name several **basic rights of shareholders:**

- The right to attend and vote in the shareholders' meeting, including voting for board members
- The right to share in the profits of the SOE and receive dividends proportional to share ownership
- The right to participate in major decisions, including changes to the company's articles, issuance of new shares, and approval of extraordinary transactions
- The right to expect transparent procedures for control changes, and under certain circumstances, the ability to sell shares on the same terms as the main shareholder or to block the transaction.
- The right to understand the capital structure of the SOE, including any special right retained by the state (golden shares), different classes of shares the SOE may have, and shareholder agreements between the state and other significant shareholders.

Good practice dictates that board members pay attention to the interests of all shareholders equally. Not only is this a fair, and in some jurisdictions, a legal obligation, but also it is important for maintaining the confidence of those investors and for sustaining the share price of the SOE and its access to capital.

Company laws and national corporate governance codes set out the rights that all shareholders should enjoy so that all shareholders are treated equitably. Many of these rights will be spelt out in the company law, which typically governs an SOE that has other shareholders. If an SOE is formed under its act, then the founding law or articles of association should contain similar provisions for non-state shareholders. When SOEs have strategic investors from the private sector, the rules on the equitable treatment of shareholders are normally established through detailed shareholder agreements between the strategic investor and the government. However, when private sector shareholders are more dispersed—including large SOEs that may have millions of shares held by individuals, pension funds, insurance companies, and mutual funds—general policy controls are important for ensuring equitable treatment of all shareholders.

**Encouraging participation in the shareholders' meeting:** In many SOEs, minority shareholders are actively encouraged to participate in general shareholder meetings. This is usually done by the adoption of specific mechanisms at the company level, including facilitating voting in absentia or developing the use of electronic means to reduce participation costs. These mechanisms often also include facilitating employee-shareholder participation or a system, facilitating the collection of proxy votes from employee-shareholders, as employees in many countries are the most numerous individual shareholders in partially privatized enterprises (refer Box 26 for example).

**Allowing representation of minority shareholders on SOE boards:** Empowerment of minority shareholders may be achieved in different ways. For instance, to nominate a board candidate, small shareholders may be allowed to provide input to the nomination committee (if the board has one). Alternatively, small shareholders may be permitted to nominate candidates directly, if, for example, a certain percentage of shareholders support the choice. At the time of board elections, a cumulative voting rule can be used, in which shareholders may not only vote 'yes' or 'no' but also cast all their votes (for all their shares) for a single nominee. Alternatively, the election process could designate one or two board positions, for whom only small shareholders may vote or adopt some form of proportional representation.

**Protecting against abusive related-party transactions:** Transactions, in which board members, management, or influential shareholders have a conflict of interest, are prone to abuse. In private sector companies, all too often related-party transactions have channeled resources away from the company and minority shareholders. In SOEs, most of the guidance on these conflicts of interests focuses on the role of the board and disclosure. For example, India's corporate governance guidelines for central public sector enterprises call for potential related-party transactions to be reviewed by the audit committee, approved by disinterested board members, and disclosed to the public.

**Box 26: Examples of Minority Shareholder Participation in Annual Meetings**

Brazil's Sabesp provides 30 days' notice of its annual meeting (rather than the standard 15) and widely publicizes the event. In addition, Sabesp's bylaws allow shareholders to deliver documentary evidence of their status at any time up to the moment the meeting is called to order. (The usual practice in Brazil is to require documentary proof of share ownership at least 48 hours before the meeting.)

In Burkina Faso, even SOEs wholly owned by the government, are required to have an annual meeting presided over by the council of ministers and the prime minister and open to the public. During the meeting, problems are exposed, directives issued, and resolutions taken. The ability of the public to participate helps explain the success of these meetings.

*Source:* World Bank Group. 2014. *Corporate Governance of State-Owned Enterprises: A Toolkit.* Washington, DC: World Bank.

In addition to the above discussed good practice requirements, listed companies including listed SOEs—will often require shareholder approval of any related-party transaction that exceeds a certain size or crosses another specific threshold. In some jurisdictions, only disinterested shareholders—usually those that are not the controlling shareholder—may approve a related-party transaction before it takes place. Rules such as these may be established as statutory requirements for all SOEs or may be part of the articles for specific SOEs.

**Grant of preemptive rights:** In several OECD countries, pre-emptive rights under the general company legal framework serve to protect minority shareholders. Qualified majorities for certain shareholder decisions may also be useful and are granted according to the general company law in many OECD countries, or by specific SOE bylaws. In Austria, for example, minority shareholders enjoy significant rights at GSMs via threshold arrangements. In the Slovak Republic and for votes on fundamental matters, the approval of two-thirds of shareholders is required, and it is possible to extend further this requirement to more than two-third of present shareholders.

Finally, qualified majorities for some board decisions might also be made mandatory in the case of some SOEs. This is the case in Belgium, where special majorities have been stipulated in shareholders' agreements in the decision-making power of the boards of the telecommunications and airport companies, where private investors hold a significant part of the shares. Similarly, in Spain, specific requirements or procedures for specific transactions are set out in the Public Limited Companies Act.

Regarding the right of redressal, minority shareholders do enjoy in most OECD countries the same rights in SOEs as in other companies, based on the general company legal framework. In Poland, for example, based on the Commercial Companies Code (CCC), every shareholder, who voted against a resolution that was adopted by the GSM, and who holds even only one share, can challenge this resolution in the courts. One can sue the company for an annulment of a resolution, which contravenes the statutes or good practices, harms the interests of the company, or aims at harming a shareholder.

## Topic three: Key stakeholders in SOEs

Stakeholders are commonly defined as actors that have personal interests in the corporation, affect its functioning, are committed to specific actions on its behalf, and whose personal interests the company is obliged to consider in its actions.

The key stakeholders of firms within the realm of corporate governance include shareholders, directors, and managers. However, compared with private sector companies, SOEs are different due to the uniqueness of their key stakeholder (that is, the state), strong political and administrative influences exercised upon SOEs, as well as ambiguous goals and performance objectives of SOEs. Moreover, while describing the state as the key stakeholder, it is also imperative to remember the fiduciary responsibility of the state, which makes the public (and taxpayer) a distinct stakeholder of the SOEs.

Hence, from the modern corporate governance in SOEs' point of view, management boards' members, supervisory boards' members (in case of two-tier board system), the Minister of Finance and the ministry officials constitute the SOE's key corporate governance actors. Also, SOEs' employees, trade unions representing them, local communities, regulators and ruling political coalitions, and the informal institutions such as civil society organizations (CSOs), which tend to be particularly important in emerging markets, are the other key stakeholders of SOEs.

**The stakeholder groups for an SOE are as follows:**

- State and other shareholders
- Directors and employees
- Suppliers and vendors
- Communities affected by SOE operations
- Public and taxpayers

Figure 15 illustrates some of the obligations of the SOE toward various stakeholder groups.

In comparison with private sector enterprises, **SOEs tend to have a greater obligation to stakeholders. These obligations relate to**

- Interaction with government, for example, Ministry of Finance, portfolio ministry, central state ownership entity, supreme audit institution (SAI), and so on
- Communication and engagement with all stakeholders, for example, state as the owner, civil society organizations, taxpayers, or public at large
- Disclosure and reporting to all stakeholders, for example, in some countries, SOEs are subject to national access to information policies, unlike private sector companies

Stakeholder mapping involves creating a visual diagram to help analyze and prioritize stakeholder groups. Such a mapping is undertaken by the management of the SOE. Once a company identifies important stakeholder groups, it must then ensure that the engagement takes place with appropriate representatives of that group. For engagement to be perceived as credible, it should be as open and transparent as possible. Not all community members will have the same interests or opinions. Even shareowners can have very different opinions and interests, based on the different information they have. Transparent stakeholder engagement allows reducing information asymmetry and better-informed discussions among stakeholders.

Engagement and dialogue with stakeholders lead to better decisions/implementation. The broader practice of 'stakeholder engagement' emerged in the 1990s, as it became clear that companies needed to be aware of a wide variety of stakeholders affected by their operations or affecting their operations and build long-term relationships of constructive engagement. Besides shoring up the corporate reputation, this approach has been shown to help companies anticipate and manage risk more effectively as well as to

**Figure 15:** SOE Obligations to Stakeholder Groups


*Source*: Adapted from IFC 2008.

identify new business opportunities by tapping unique stakeholder perspectives. Engagement, as opposed to 'top-down' management, is often characterized by dialogue—a two-way process, in which stakeholders are not merely consulted or listened to, but the company makes a sincere attempt to respond to stakeholder concerns in seeking to determine shared values around areas or issues of mutual interest or common concern.

Consultation tends to be a one-way flow of information, where a company solicits input from stakeholder groups. Dialogue is a more robust conversation. It allows companies to provide context for their operational issues, and also means recognizing the potential for engagement to influence the behavior of regulators, investors, consumers, competitors, and suppliers. Online consultations are important to ensure inclusiveness and transparency. They can be complemented by face-to-face meetings, notably with stakeholders that are the most closely linked or affected by a company. Open houses, public forums, and disclosure may suit the needs of other stakeholder groups. Formal engagement can take many forms, from partnerships with nongovernmental organizations (NGOs), to formal community engagement programs or advisory bodies.

In addition to being an important part of corporate accountability, stakeholder engagement can be useful as a learning and information tool for company leadership. While board members are often tasked with maximizing shareowner value, different blocks of shareowners may have different interests and ideas about how value should be maximized. Engagement and dialogue can help the board better represent these disparate interests and reduce the risk of capture by vested interests. This is particularly important regarding climate change risks, given the strong externalities which are not always internalized by the different stakeholders.

Effective stakeholder engagement promotes corporate learning and innovation. This is possible when the engagement is transparent, inclusive, and responsive, and is undertaken with the intent that useful information will be applied. If companies think about critical stakeholders as a strategic asset, a source of information and learning that can be a competitive advantage in shaping and informing the direction of the company, it makes sense to engage with stakeholders early and often to build trust and understanding through defining mutually understood shared values that address their respective interests.

Follow-through is important to any relationship and this certainly applies to relationships with stakeholders. Whether or not a company can implement what it has learned from stakeholders, there is an obligation to report, to make it clear that stakeholder concerns and interests were heard, considered, and valued. In addition to reporting to specific stakeholder groups, sustainability or triple-bottom-line reporting provides companies with an opportunity to communicate environmental, social, economic, and governance performance to a wider range of stakeholder groups. It can also involve reporting on the process of stakeholder engagement itself, providing transparency about who was consulted or engaged on what topics, and with what results.

Standards for stakeholder engagement have been established to guide companies in improving their engagement efficiency and effectiveness with key stakeholders. These include the AA1000 Stakeholder Engagement Standard and the IFC Performance Standard one (included in references for further reading).

Reporting should include a clear understanding of key stakeholder groups—who they are and their main needs and positions —as well as a description of stakeholder engagement processes and a summary of how the company is responding to and addressing stakeholder priorities. In addition, there should be evidence of how feedback and engagement processes have been integrated into the company's decision-making processes, supported with examples of results from this integration.

## *Handout H1.3A: IFC Progression Matrix for Shareholders Rights*

| | 1. Basic Practices | 2. Intermediate Practices | 3. Good International Practices | 4. Leadership |
|---|---|---|---|---|
| • **Exercise of Ownership**<br>• **Rights by the State** | • The state has identified an entity, agency or unit within the state administration to exercise its ownership rights on the SOE. | • The ownership entity monitors SOE performance and voices any concerns through formal channels. | • The ownership functions, with respect to all SOEs, are centralized in a single entity under one ministry.<br>• A performance agreement or MOU is in place between the ownership entity and the SOE and is made publicly available.<br>• The State has not been vested with golden shares or other types of special rights which would allow the state to block major corporate decisions. | • The ownership functions, with respect to all SOEs, are centralized in a single independent entity.<br>• Formal ownership policy is in place and publicly available.<br>• The framework to monitor SOE performance includes adequate valuation methods and systematic benchmarking against both private and public-sector entities. |
| • **Minority Rights** | • All shareholders of the same class have equal voting, subscription, and transfer rights.<br>• Minority shareholders receive adequate notice and the agenda for all shareholders' meetings and are permitted to participate and vote at shareholders' meetings. | • Effective representation of minority shareholders through cumulative voting or similar mechanisms and economic rights such as inspection rights, exit rights, and tag-along rights.<br>• The SOE has a dividend policy and does not issue dividends to the state outside of the scope of this policy.<br>• Policies are clearly communicated and enforced regarding the treatment of minority shareholders during of control transitions, including privatizations and re-nationalization. | • Effective shareholder voting mechanisms are in place to protect minority shareholders from concentrated ownership or strong conflicts of interest with controlling shareholders (e.g., supermajority or "majority of minority" provisions).<br>• Shareholders vote on executive compensation. | • Treatment of shareholders consistent with best international market practices.<br>• Executive compensation subject to shareholder approval. |
| • **Protective Rights** | • 4. Holders of all securities of the same type and class have access to equal information (fair disclosure).<br>• 5. Shareholders are provided with accurate and timely information regarding the number of shares of all classes held<br>• by the state and other major shareholders. | • Well-understood policy and practice of full and timely disclosure to shareholders of all material related-party transactions and shareholder agreements.<br>• Rules on related party transactions specifically address transactions with the government and other SOEs and require recusal by interested shareholders and board members.<br>• Annual report discloses material risks to minority shareholders associated with the state ownership, other controlling shareholders, ownership concentration, cross-holdings, and voting-power imbalances. | • 6. Well-understood policy and practices of material transactions that could potentially affect the rights of minority shareholders. | • Related-party transactions (over 2.5% of net assets or $150,000) subject to shareholder approval or stricter requirements.<br>• No special type of shares is held by the state. |

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I

# Corporate Governance

Leadership Training Toolkit for SOEs

**Part I**
Caselets

# CASE STUDIES

## 1. Business case for corporate governance reforms at an agricultural chemical manufacturer

### Background

Founded in 1955, a state-owned manufacturer of plant protection chemicals underwent partial privatization and got its shares listed on the national stock exchange. Because it had been solely under state oversight earlier, the SOE had limited experience with the corporate governance systems that characterized joint stock/listed companies in countries with more developed capital markets. The SOE's understanding of the value of corporate governance emerged as the result of practical, day-to-day operational experience. In addition, better governance was linked to the strategic goal: for the company to succeed in its plans to expand internationally and enter the European market, it would need to upgrade its governance.

### Corporate governance reforms implemented by SOEs

Table 16 summarizes the key corporate governance related changes made by the SOE.

### Tasks

What do you think has been the impact on the organization of making these corporate governance changes?

In each category in the table below, identify whether you expect the impact to be

- None
- Weak
- Moderate
- Strong
- Substantial

**Table 16:** Summary of Key Changes

| Theme | Key challenges | Key changes |
|---|---|---|
| **Board composition** | The five-member board did not include any women or independent directors. Directors were continually re-elected, with terms extending up to 12 years. Lack of diversity in gender, skills, experience, and viewpoint limited discussion and negatively affected decision-making. | • Increased the number of board members to seven<br>• Identified new directors based on skills, knowledge, and expertise<br>• Appointed two female directors<br>• Appointed independent director with expertise in internal audit<br>• Altered the mix of executive and non-executive directors. |
| **Board effectiveness** | Without a corporate secretary to coordinate, communicate, and track board processes and activities, the board was not as efficient or effective as it could have been. | • Created a full-time corporate secretary position<br>• Hired a qualified individual for the corporate secretary role |
| **Transparency and disclosure** | The SOE did not share information about its policies and procedures. This posed risks to shareholder protections—a core value for the company. The lack of disclosure also meant that the SOE had not been in line with international corporate governance standards, making expansion into new markets difficult. | • Redesigned website to include a section for investor relations and corporate governance<br>• Uploaded relevant information to the site for easy access by shareholders, investors, and the public<br>• Added new information as it became available; updates continue promptly |

*Source*: Adapted from World Bank 2014.

**Table 17:** Impact Level for Each Category

| Category | Impact level |
|---|---|
| Board composition | None / Weak / Moderate / Strong / Substantial |
| Board effectiveness | None / Weak / Moderate / Strong / Substantial |
| Transparency and disclosure | None / Weak / Moderate / Strong / Substantial |

*Source*: Adapted from World Bank 2014.

### *Trainer notes*

Distributes the case study handout. Allows 30 minutes for reading and discussion.

### *Key discussion points*

ABC puts a high value on its governance. Good corporate governance practices are central to its operations and help it leverage its relations with its customers, donors, and commercial lenders. During the first round of corporate governance reforms, ABC established key board committees to enhance the board's independence and effectiveness. ABC underwent an IFC Corporate Governance Assessment in 2008. The review led to several key corporate governance reforms at ABC. The impact of these reforms is reviewed in Table 18 below.

**Table 18:** Impact of Corporate Governance Reforms

| Category | Impact level |
|---|---|
| Board composition | Substantial (by appointing a diverse board that includes women directors, the SOE is a model for other SOEs in the country, sending a message to the business community about the importance of representation from varying backgrounds, experiences, and perspectives) |
| Board effectiveness | Strong (appointment of a corporate secretary led to a stronger corporate governance system that aided the SOE to lay down a robust foundation for future prosperity and sustainability) |
| Transparency and disclosure | Substantial (addition of a standardized approach to disclosure led to the SOE's listing on the blue-chip index of the National Stock Exchange) |

*Source*: Adapted from World Bank 2014.

## *2. Adoption of a transparent and structured nomination process, based on professional criteria for the selection, and removal, of board members*

### *Background*

In Egiland, there is currently an absence of a well-defined legal and regulatory framework that specifies the selection criteria and nomination process of the board of directors. The Minister of Public Sector Business nominates and appoints the board of directors of public enterprises with input from the General Assembly, which collects and reviews applications from candidates.

In several SOEs, the directors do not seem to have a strong command of the strategic issues in the sector, in which the company operates, mainly because of the absence of a clear and transparent nomination process. In practice, nomination processes for board posts in Egiland are often based on criteria other than competence, and board membership is sometimes used as a compensation award for retirees.

In Egiland, a director's length of service as a board member and tenure on various board committees is not properly defined for most companies, and the attendance records of board members at board and committee meetings are not standardized, as is the practice in most companies. Meanwhile, the qualifications of board members are not disclosed, the links between remuneration and company performance and commercial and non-commercial objectives are not well defined, and the remuneration policies for executive and non-executive directors are not developed.

### *Tasks*

As a representative of the state, contemplate the following:

- What reforms can be implemented to adopt a transparent and structured nomination and removal process in Egiland? This can be based on the World Bank Toolkit and the OECD guidelines
- What measures can be introduced to avoid politicized boards in SOEs?
- What sort of criteria can be introduced for the professional selection of board members? What mechanisms can be introduced to facilitate dialogue with SOEs to understand their skill requirements to define the selection criteria?

As a representative of an SOE in Egiland, contemplate the following:

- In what ways might the existing nomination process factors affect (directly or indirectly) the enterprise mission, performance, and long-term outcomes negatively and/or positively?
- All things being possible, what three changes would most contribute to long-term success, and why? What are the obstacles/challenges in the way of such changes?

### *Trainer notes*

Distribute the case study handout. Allow 30 minutes for reading and discussion

### *Questions to focus discussion*

- How important are legal reforms to ensure a transparent and professional process for board member selection and appointment?
- What tools can be used to define selection criteria and identify suitable candidates for board nomination?
- What is the impact of poor/inadequate nomination and removal processes on the SOE's performance?

## *3. State-board relations and communication—the dos and don'ts*

Breakout groups' exercise (self-generated real case) (Groups of 3, 4, or 5 depending on size or plenary)

### *Tasks*

Consider the SOE/Public Enterprises (PE) state-board relationships you have been associated with, or observed from either perspective:

- Half the breakout groups assess the relationship from the state perspective – noting the purpose, nature, frequency, and modes of communication. The other half breakout groups assess from the SOE/PE perspective.
- From the perception of each of the sides of the relationship and communication: What were the key factors affecting the functionality/dysfunctionality of the relationship, also enterprise performance and state desired outcomes?
- From the vantage point of each of the sides: What changes would you recommend for both state and enterprise to mutually optimize their separate and shared goals?
- What are the obstacles/challenges in the way of such changes?

### *Trainer notes*

Divide the participants into groups and explain the exercise; allow 30 minutes for discussion.

### *Questions for focus group discussion*

- What are the key issues and challenges affecting state-board relations?
- How do good state-board relationships contribute to the SOE's performance and competitiveness?
- What tools can be used to improve communication between the state and the boards of SOEs?