CORPORATE GOVERNANCE OF STATE-OWNED ENTERPRISES: CAN THEY RISE TO THE CHALLENGE?

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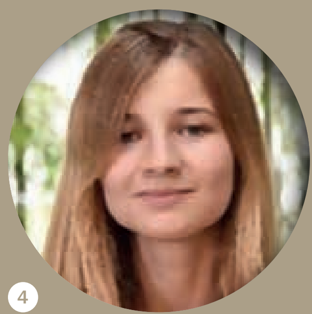

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> "The focus of the research was to understand how our jurisdictions express, structure and exercise their ownership function, what corporate governance requirements are in place, and how they differ from the rules applicable to privately owned companies."

In most EBRD economies, the state has traditionally been the owner of the country's most important companies. While the state's role has somewhat diminished over the past three decades, the Covid-19 pandemic and the ensuing economic crisis are likely to take the concept of "state as owner" to a new level, amid a time of unprecedented state spending. This is likely to put pressure on state-owned enterprises (SOEs) to perform more efficiently and at the same time pose less of a fiscal risk, which is why the corporate governance of SOEs is more important than ever.

In order to gauge whether SOEs are equipped with the correct governance rules and structures to help them rise to these expectations, the EBRD's Legal Transition Programme, in cooperation with the Office of the Chief Economist, carried out a dedicated study that aims to capture the SOE corporate governance frameworks across 37 economies of the EBRD regions.[1] The focus of the research was to understand how our jurisdictions express, structure and exercise their ownership function, what corporate governance requirements are in place, and how they differ from the rules applicable to privately owned companies.

1 Key findings of the study have also been mentioned in Chapter 2 of the following: EBRD (2020), *Transition Report 2020-21 – The State Strikes Back*, London. Also available at: https://2020.tr-ebrd.com/ (last accessed 21 December 2020).

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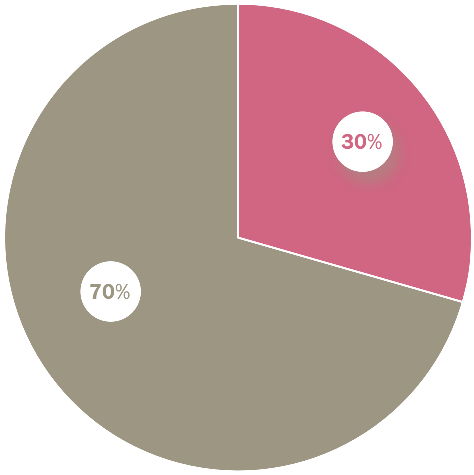
THE STATE AS OWNER – THE IMPORTANCE OF CLEAR OBJECTIVES

Just like private companies, SOEs need to have long-term objectives which define the measure of their success over time. However, unlike private investors, the state engages in ownership of SOEs to achieve wider benefits for its citizens. In so doing, it typically aims for more than just financial success: such as uninterrupted provision of vital services or universal availability of a product or service, which may even contradict the aim of being profitable. While it is almost self-explanatory as to why the state would want to own a company in the defence industry or an electricity producer, why does the state need to own car manufacturers, chemical plants or mines?

The answers to these questions should stem from clear and explicit rationales for state ownership. The OECD Guidelines on Corporate Governance of State-Owned Enterprises (OECD Guidelines) – which are an internationally accepted, albeit aspirational benchmark in the area of corporate governance of SOEs – call on states to adopt state ownership policies that set out rationales for ownership as well as the overall goals that the state wants to achieve as owner. This serves to inform the purpose of individual SOEs but also helps establish boundaries of the state's intervention in the SOEs' business, which according to the OECD Guidelines should be limited to setting high-level objectives of an SOE in a way that allows their clear prioritisation, as well as setting key performance expectations.

When it comes to OECD member and partner countries, there is a clear trend towards establishing or strengthening state ownership policies and objectives, as around two-thirds of the 28 jurisdictions surveyed in a recent OECD study[2] reported establishing or updating their ownership policies and key objectives in the period from the OECD Guidelines' adoption in 2015 until 2020.

Chart 1: Is there a government document, policy (for example, State Ownership Policy), or law that defines the overall objectives of state ownership?



Source: EBRD, corporate governance legislation and practices of state-owned enterprises, 2020 .

The aforementioned share is much lower in the EBRD regions as it appears that fewer than one-third of jurisdictions (11 out of 37) have a law, government strategy, policy or other document in place defining the overall objectives for state ownership. This suggests that in many economies neither the state nor the SOEs themselves have a well-developed framework of objectives and expectations, which may impede SOEs developing long-term strategies, creating room for inefficiencies and mismanagement as well as undue interference from the state.

When it comes to the state's ownership function, the preferred approach taken by many developed economies is the "centralised" model, where all or most SOEs are overseen by one ownership entity – separate from the regulatory authority – which has the requisite capacity and legal powers of the shareholder. This approach helps to streamline oversight efforts and to separate SOE ownership from the policymaking and regulatory functions of the state, which is vital for ensuring sound competition and a level playing field in individual sectors of the economy.

2 OECD (2020), *Implementing the OECD Guidelines on Corporate Governance of State-Owned Enterprises: Review of Recent Developments*, Paris. Also available at: https://doi.org/10.1787/4caa0c3b-en (last accessed 21 December 2020).

When looking at the economies where the EBRD invests, the approaches taken are quite diverse, with SOEs being owned by multiple entities within the state in a vast majority of jurisdictions. In 18 jurisdictions (48 per cent) we recorded ownership function organised according to the "decentralised" model (where multiple authorities – mainly line ministries – supervise SOEs in their own areas of competence). In 14 economies there seems to be a "dual system", where responsibilities are shared between two authorities, mostly between line ministries and the government, or line ministries and a ministry of finance. Only fewer than one-third of jurisdictions (10 out of 37) appear to have a system of state ownership broadly fitting the centralised model. Overall, this suggests that line ministries – which usually also exercise the regulatory function - continue to play a prominent role when it comes to exercising ownership in SOEs alongside their role in setting sectoral policies and/or regulatory framework. In fact, in nearly 45 per cent of jurisdictions (16 out of 37) at least some ownership entities also take regulatory/industrial policy decisions that affect the SOEs they oversee.

AUTONOMY OF SOEs: ARE SOEs ABLE TO ORGANISE AND RUN THEIR BUSINESS INDEPENDENTLY?

Once the vision of the state as owner has been set for an SOE, it should have autonomy to set the course of its business. This includes legal autonomy – that is, being legally empowered to adopt key decisions such as strategy and business plans and to own the assets necessary for carrying out its activities – as well as operational autonomy to make and implement day-to-day business decisions without interference by the owner.

The scope of legal autonomy can be determined by comparing the regulations applicable to SOEs to the rules that apply to privately owned companies. In this respect, our analysis found that in only a fraction of economies were SOEs operating exclusively under general corporate forms available to the private sector. This complexity creates further disparities between SOEs and private companies (and sometimes between SOEs themselves) with regards to their governance structures, labour and bankruptcy regimes and access to capital markets. One such

example involves restrictions associated with non-corporatised SOEs on owning and disposal of some key assets (for example, gas pipelines or assets forming the electrical grid that in some countries legally belong to the state rather than the SOE), which can have direct implications for the ability to use and maintain these assets in the best interests of the SOE.

When it comes to operational autonomy, this is driven partly by the governance structures at SOEs and partly by the formal and informal relations between various state actors and the SOE. As indicated above, line ministries feature heavily in these relations. On the other hand, autonomy should not mean lack of oversight. After all, the OECD Guidelines recommend the state act as an "informed and active owner", which means that the state needs to establish a regular monitoring of SOEs and hold their governing bodies accountable in instances of poor performance. Surprisingly, almost half of EBRD economies do not seem to have a clear monitoring framework by the owner. In just over half of examined jurisdictions, the regulation prescribes the main financial and (sometimes) non-financial indicators for SOEs to be monitored and we found the process and mandate for performance evaluation of SOEs to be

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comprehensively regulated in similar percentages. Still this means that almost half of the EBRD economies do not have a clear and comprehensive monitoring of SOEs' performance. The minimal annual frequency of monitoring is specified in 19 countries (at least for certain categories of SOEs), which may not be enough to ensure active engagement with SOEs.

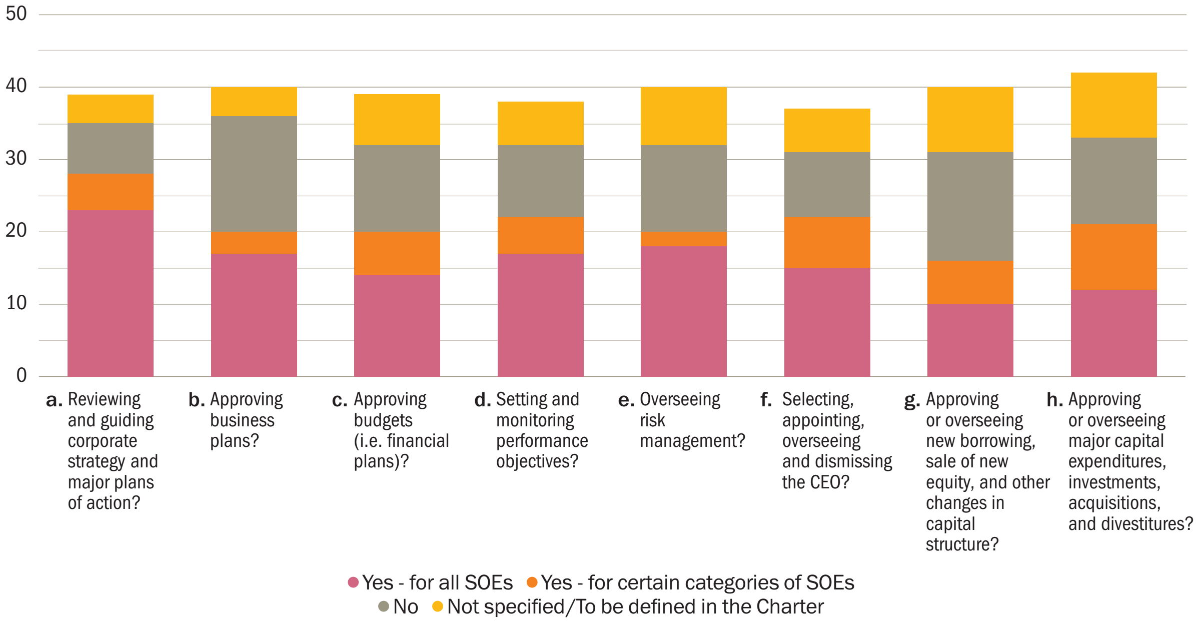
SOE BOARDS: NEED FOR LEGAL IMPROVEMENTS AND PROFESSIONALISATION

Most corporate governance standards devote much of their attention to the board[3] as a company's governing body in charge of driving its key decisions. OECD Guidelines are no exception in this respect as a whole chapter deals with the boards' responsibilities and functioning. In order to be effective in this crucial role, it is traditionally understood that boards need to be entrusted at least with the responsibilities for setting strategy and budget and monitoring their implementation, overseeing the system of internal controls, supervising management, appointing and removing the CEO and setting executive remuneration.

Unfortunately, our analysis has shown only a limited share of SOEs (mostly those organised as companies) across EBRD economies have a governance structure which envisages a body tasked with strategic oversight over the company. Moreover, in most of the jurisdictions analysed, boards lack comprehensive strategic authority and have limited autonomy to make decisions. Our analysis did not reveal a single jurisdiction where SOE corporate legislation would equip the boards with all the responsibilities necessary to duly exercise their roles (for example, approval of strategy, budget and risk appetite, appointment and removal of executives, approval of capital expenditures and oversight of management performance). Fewer than 20 per cent of economies seemed to empower all their SOE boards with a range of essential duties, still subject to various limitations, such as for example – managerial appointments, approval of capital expenditures (and risk management) which are missing in several jurisdictions.

3 For the purposes of the analysis, the term "board" refers to an SOE's governing body entrusted with strategic and oversight functions as opposed to day-to-day management of the company.

Chart 2: Which of the following are defined in the law, regulations and code as the explicit responsibilities of SOE Boards?



Source: EBRD, corporate governance legislation and practices of state-owned enterprises, 2020.

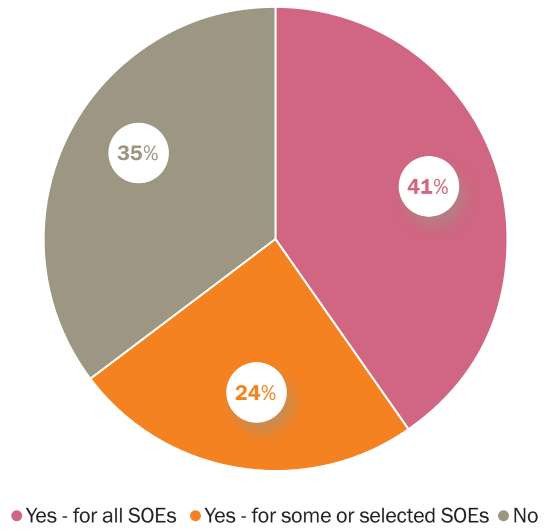
Note: Although the number of reviewed jurisdictions was 37 for all topics covered in the chart, in some bars a higher number was exhibited because of the complexity of the framework applicable to different categories of SOEs. For example, the same responsibility could be assigned as a default under the corporate legislation, whereas for non-corporatised SOEs it would have to be explicitly envisaged in the SOE's charter.

Strikingly, in almost half of jurisdictions SOE boards do not approve strategies or budgets and the two often seem to be developed separately and without connection to each other. In addition to lack of clarity on the strategy, authorities for approving the business plan and/or budget and for overseeing the risk management and internal control framework are the ones most frequently missing. It seems that in most jurisdictions risk is not seen as integral to the strategic planning and implementation monitoring processes, as overseeing risk management is an explicit responsibility of the boards for all SOEs in only 45 per cent of them (18 countries). In only six countries does the framework have a reference to board responsibilities related to managing the environmental and social risks and factors in the company's operations. This suggests that the environmental, social and governance and climate change-related risks do not play a major part in the decision-making on strategy and its monitoring activities.

In addition, it seems little attention is paid to how boards are composed and how they function. The board nomination process is frequently inconsistent and lacks transparency: only 16 per cent of countries in the EBRD region have a requirement for a nomination policy that would set out the desired profile of an SOE's board. In 81 per cent of countries there are no existing pools of potential directors in place to be drawn on for future appointments. SOE boards often lack independence and the board composition is often not appropriate to ensure effective and independent supervision over SOEs. A requirement for independent directors on SOE boards is in place for all SOEs only in 40 per cent of EBRD economies (15), and for some or selected SOEs (mostly for SOEs operating in the form of companies or listed SOEs) in nine other countries. However, over one-third of jurisdictions (13 of them) still do not reflect such a requirement in their legal frameworks. In any event the definition of independence and the test over the "independence of mind" has room for improvement in the vast majority of jurisdictions.

When discussing committees, it seems some (mostly audit committees) are required in at least some categories of SOEs in almost 60 per cent of EBRD jurisdictions. However, composition of SOE board committees is not strictly limited to board members in over 60 per cent of jurisdictions, which makes us wonder if these committees can be considered board committees and whether they contribute to the work of the board in any way.

Chart 3: Is there a requirement for independent directors on SOE Boards?



Source: EBRD, corporate governance legislation and practices of state-owned enterprises, 2020.

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DO SOEs HAVE APPROPRIATE INTERNAL CONTROLS?

Proper internal controls are essential in SOEs, not least because of their susceptibility to corruption[4] and the potential fiscal risks which seem to be exacerbated in cases of SOEs that are used to provide subsidies to the wider population and are therefore more dependent on further state support.[5]

While internal controls in private sector companies tend to be organised according to the so-called "three lines of defence" model, it seems that in SOEs these controls are much more scattered and do not allow the identification of SOEs' risks from a holistic perspective.

The most frequently seen internal control function is the internal audit as in 17 (46 per cent) countries all SOEs are required to have such a function. In 27 per cent of countries this requirement only applies to some SOEs.

4 OECD (2019), *Guidelines on Anti-Corruption and Integrity for State-Owned Enterprises*, Paris. Also available at: https://www.oecd.org/fr/gouvernementdentreprise/anti-corruption-integrity-guidelines-for-soes.htm (last accessed 21 December 2020).

5 Chapter 2 of the following: *EBRD (2020), Transition Report 2020-21 – The State Strikes Back*, London. Also available at: https://2020.tr-ebrd.com/ (last accessed 21 December 2020).

In the majority of jurisdictions (54 per cent, 20 countries), SOEs are not required to have codes of ethics or compliance programmes. Compliance with codes of ethics is monitored and enforced in all SOEs only in 12 countries (32 per cent) while in three countries (8 per cent) it applies only to selected SOEs. However, this is not specified in over half of the jurisdictions (51 per cent). In 80 per cent of EBRD economies, SOEs are not required to have a unit dealing with compliance issues.

SOEs also seem to conduct very little risk analysis. SOE strategies are rarely assessed from the risk perspective, while specific risks are unlikely to be addressed in strategies and mitigating measures in budgets. Most have no risk department, thus no organisational framework to act on (external) risk analysis.

CONCLUSION

There is little doubt that the economic needs on the one hand and the decreasing room for state spending on the other will require SOEs to run successfully without relying (as) much on the state budget for years to come. This will require adjustments from both the state and the SOEs themselves. Starting with the state, this current situation will provide an excellent opportunity for many governments to re-assess their ownership rationales and define more clearly (preferably within the framework of state ownership policies) in which cases state ownership is necessary.

Hopefully this will mean that they will also be more incentivised to set clearer expectations, not just in terms of public service obligations and financial performance, but also with respect to environmental, social and governance issues that are relevant for particular SOEs. This will mean that many jurisdictions will need to strengthen their own capacity in order to follow up as to how objectives that have been set for SOEs are being implemented and hold boards and management to account in cases of poor performance.

On the SOEs level, the greater clarity to be provided by the state should be reciprocated with an improved intelligibility on what an SOE can realistically achieve and the risks (and opportunities) it may face on this journey. This requires improved strategic planning, risk analysis and budgeting processes as well as diligent oversight and controls in implementation, which – as is usually the case in corporate governance – can be built with the help of a professional and empowered board and a management team that is capable, motivated and accountable.