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Discussion paper session 5

Corporate governance priorities and lessons following the financial crisis.

Break-out session 3: The role of the state: state owned enterprises, sovereign wealth funds, nationalised pensions

This discussion paper was prepared by CEF (Center for Financial Stability- Argentina) and will be used as the basis for the discussion in session 5 of the Latin American Corporate Governance Roundtable, on ***The role of the state: state owned enterprises, sovereign wealth funds, nationalised pensions***.

Corporate Governance Issues and Lessons from the Financial Crisis

1. The corporate governance issues and problems identified and relevant lessons from the crisis in terms of the ROLE OF THE STATE (Nationalised pensions, SWFs, SOEs).

During the recent crisis, public pension funds (PPFs) and sovereign wealth funds (SWFs) gained prominence due to their role of accumulating reserves. Certainly, these funds may well help smooth boom-bust cycles. Nevertheless, some principles must be followed by the public sector in order to guarantee good governance. In the case of pension funds, Musalem & Souto (2009) state that the agency problems that plague all financial intermediation activities are exacerbated whenever the pension plan is run by a government agency because: "a) plan members may relax their vigilance on the fund; b) PPFs do not operate under competitive conditions; c) senior managers and directors in government institutions may not be selected on the basis of fit-and-proper criteria; d) PPFs are not subject to the same regulatory framework than private intermediaries and e) the PPF manager may be mandated by the government to further social goals other than the paramount objective of providing adequate old age income support".

Additionally, the global crisis has prompted many states to augment their stakes in private corporations. Some state owned enterprises (SOEs) have been called on to support government stimulus plans through higher spending and job retention. In these circumstances, what must be taken into account is that these companies, controlled by a government agency, far from meeting private sector's performance levels, often deal with multiple or conflicting financial and social objectives. OECD (2005)[1] has identified SOEs´ governance challenges: "a) they may suffer from undue hands-on and politically motivated ownership interference or from totally passive ownership by the state. There may also be a dilution of accountability; b) they are often protected from two major threats (takeover and bankruptcy); and c) accountability for the performance of SOEs involves a complex chain of agents (management, board, ownership entities, ministries, the government), without clearly and easily identifiable principals". Therefore the governance of SOEs is crucial to guarantee efficiency.

2. Peculiarities to the Latin American context.

2.1 National public pensions funds

In Musalem & Souto (2009)[2] we can find a survey of governance and transparency practices of 82 PPFs, that managed assets globally by about USD 4.4 trillion in 2007. PPFs of US and Japan together represented 71% of total assets, while Latin America´s participation was insignificant. The importance of PPFs in local economies is asymmetric not only worldwide but also in Latin America. While in 2007 Trinidad and Tobago's PPF assets accounted for 11% of GDP in Colombia and Mexico they represented less than 0.5% of GDP. PPFs are mostly a source of financing for issuers of fixed securities, notably sovereign bonds worldwide and in Latin America. Colombia is an extreme case, where the PPFs invest only in government securities (100%), Costa Rica (84%), Guatemala (82%). The undersized local capital markets in developing economies may explain the relatively low participation of equity in funds' investment portfolios.

Musalem & Souto (2009) have surveyed the actual **governance structures** of the PPFs. They found that the governing body of the PPF is part of a governmental agency (inside) in almost all the Latin American countries surveyed, exception made for Colombia and Peru where there has been established as a separate body (outside).

Regarding the composition of the decision-making bodies of PPFs, many Latin American funds have the most typical arrangement is that of the so-called tripartite body, where the board has representation from the government, the employers, and the employees. In some cases the representatives are nominated by their respective constituencies, usually a high-ranked government official, business associations, and labor unions (Costa Rica, Honduras). In other countries, the decision-making body is a board constituted solely by government officials (Argentina).

The information on how governments may influence the PPF through the nomination of board members shows that in half of the Latin American funds surveyed the government has legal powers to determine the composition of the majority or the whole of the decision-making body.

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[1] "OECD Guidelines on Corporate Governance of State-owned Enterprises", 2005, OECD Publishing.

[2] Musalem, A.R. and Souto, P. (2009); "Unveiling the Governance of National Public Pension Funds", World Bank (forthcoming).

A **Transparency and Governance Index** (TGI) was calculated for the PPFs of the sample. The TGI is composed by two sub-indices, the Transparency Index (includes website, annual report, communication, information completeness, and name of responsible) and the Governance Index (governing body, selection and appointment, external control, investment committee, market experts and code of conduct). The range of values for the TGI for the whole sample is between 0 and 33. For Latin American funds the highest TGI was obtained by the Mexican fund (22.0 points), followed by the fund of Costa Rica (21.9 points). On the other extreme, the lowest value was for Argentina's fund (4.0).

2.2 Sovereign Wealth Funds

According to the SWF Institute (SWFI)[3], the assets managed by the 51 SWFs it compiles reached USD 3.8 trillion in October 2009, of which Latin America represented only 0.9%.

The most relevant country of the Latin American SWFI´s sample is Chile. In 2006, the Chilean government created two sovereign wealth funds: the Pension Reserve Fund (PRF) and the Economic and Social Stabilization Fund (ESSF). These funds assets amount USD 21.8 billion. The PRF is a saving fund, that receives between 0.2% and 0.5% of GDP subject to the size of overall budget surplus each year. The ESSF that came into existence after the closure of the original Copper Stabilization Fund accumulates excess copper revenues when the price of copper is high in order to channel revenues into the budget when the price of copper is low. The Funds are invested in low-risk asset classes (67% in sovereign bonds). The funds stand out in corporate governance issues. There is a Financial Committee whose members are appointed by an independent central bank reports to the Finance Minister. Its revenues are approved by the legislative in the overall budget.

The Heritage and Stabilization Fund of Trinidad & Tobago holds assets for USD 2.9 billion. Created in 2007 to replace the Interim Revenue Stabilization Fund, receives petroleum revenues and is used to help stabilize budget shortfalls. Its objective is to generate saving and investment income for future generations. The fund has initiated a corporate governance structure.

In Venezuela the Macroeconomic Stabilization Fund of Venezuela (FIEM) was established in 1998 in response to an advice from the IMF. The fund, with USD 0.8 billion, serves to hedge the fluctuation of income generated by crude oil. It receives revenues above a reference price. If oil prices drop below the reference price, the fund transfers revenues to the treasury. The FIEM is regulated by the Board of the Central Bank of Venezuela.

The Sovereign Fund of Brazil was recently created with USD 8.6 billion as a tool to deal with future financial crises and assist the export sector. The fund will focus on corporate debt instruments.

According to the **SWF Institute Transparency Index**[4] Chile´s fund has the highest score (10), followed by Trinidad and Tobago´s fund (5). Venezuela´s score is the lowest (1).

2.3 State Owned Enterprises (SOEs)

Amid the wave of privatization across developing countries in the eighties and nineties, Latin America currently assists a wave of interventions in many countries, some due to the financial crisis and some that preceded it. The latter refers to countries that had previously expropriated private entities (Venezuela and Bolivia) and that found a perfect scenario to continue doing so. In a less aggressive mood, this attitude was followed Ecuador[5].

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[3] http://www.swfinstitute.org/

[4] This Index compiles information related to: a) fund provides history including reason for creation, origins of wealth, and government ownership structure; b) up-to-date independently audited annual reports; c) ownership percentage of company holdings, and geographic locations of holdings; d) total portfolio market value, returns, and management compensation; e) guidelines in reference to ethical standards, investment policies, and enforcer of guidelines; f) clear strategies and objectives; g) If applicable, the fund clearly identifies subsidiaries and contact information; h) If applicable, the fund identifies external managers; i) manages its own web site; and j) main office location address and contact information such as telephone and fax.

[5] Just to mention recent expropriations, with the aim of having the major control of private companies of the cement sector, the Venezuelan government nationalized the *Holcim*, a Swiss cement group, and *LaFarge*, a French building materials group, in 2008. In 2009 the government took control the *Banco de Venezuela*, one of the country´s largest banks, which had been owned by Spain's *Grupo Santander*. The government mobilized troops to assist Venezuela's state-owned oil company, PDVSA, to seize the assets of sixty oil service companies. In Bolivia, a new constitution was adopted at the beginning of 2009 forbidding foreign companies from repatriating profits or seeking international arbitration to resolve disputes with the government. The government announced a decree to take over Air BP, a division of British oil giant BP, and instructed troops and

In Argentina, in 2008, the government sanctioned a law transferring the reserves of the mandatory privately managed funded regime, the main institutional investors, to a single publicly managed pension fund. After the nationalization the State started to appoint board members in the private companies that used to have the private pension funds as investors. Although this has been done according the legal frame in force, concerns whether their mandate responds to transparent criteria came to surface. By the same time, the Brazilian government issued a decree allowing the *Banco do Brasil* and *Caixa Economica Federal* to acquire private banks bankrupted due to the financial crisis. The independence of the SOEs in Brazil are put into doubt considering the fact that the Brazilian Decree 757/1993 that dictates the appointment of the SOEs board is subject to the President´s approval and can be dismissed instantaneously (Filho, 2008)[6]. Usually, SOEs are expected to satisfy public policy demands that go beyond their commercial activities.

According to Maplecroft's **Corporate Governance Index and Business Integrity and Corruption Index** Venezuela, Bolivia and Ecuador are all rated as extreme risk. Both indexes make up part of Maplecroft's Dynamic Political Risk Index, which covers 170 countries, and of which Venezuela is considered extreme risk, Bolivia and Ecuador are both high risk. Argentina and Brazil are viewed as countries of medium risk.

3.Some conclusions and proposals for ways forward with particular focus on Latin America.

A strong commitment of governments with the setting up of a good governance structure for PPFs, SWFs and SOEs is needed. In terms of governance, a number of good practices have been advanced by international organizations, such as the ISSA and OECD. Independence of the governing body from undue political interference is perhaps the most important issue that countries have to deal with. An effective monitoring from outsiders and the proper functioning of accountability requires high levels of transparency.

The analysis of the governance structures of PPFs poses a number of challenges given its simultaneous role as financial intermediary and state-owned entity. They intermediate funds whose ultimate beneficiaries have in most cases no specific proprietary rights over them, expanding the scope for potential conflicts of interest that the governance structures should have to tackle and resolve. Although there are no specific guidelines on which set of information should be disclosed, elements that should be considered as a minimum standard to be met, include: accuracy, timeliness, relevancy, user friendliness, easiness of access and effective contact information. Grounded on these principles, Musalem and Souto (2009), based on ISSA (2004)[7], propose a specific information set that should be disclosed including: "a) legal framework, charters, and bylaws; b) governing body; c) administrative and legal relationship of the governing body with national government; d) investment policy; e) oversight and accountability; and f) disclosure".

Regarding the SWFs, in December 2008, the IMF created an international working group in order to design a frame for SWFs governance and financial statements audit.

Finally, specific guidelines to corporate governance of SOEs are outlined by OECD (2005): "I) ensuring an effective legal and regulatory framework for SOEs where SOEs and private sector companies compete in order to avoid market distortions; II) the State acting an informed and active owner and ensuring that the governance of SOEs is carried out in a transparent and accountable manner, with the necessary degree of professionalism; III) equitable treatment of shareholders and equal access to corporate information; IV) recognition of the SOEs responsibilities towards stakeholders; V) transparency and disclosure; VI) boards of SOEs should have the necessary authority, competencies and objectivity to carry out their function of strategic guidance and monitoring of management. They should act with integrity and be held accountable for their actions".

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the national oil firm, *Yacimientos Petrolíferos Fiscales Bolivianos*, to take control of the company. It confiscated the Chaco Oil Company, another subsidiary of BP, in 2009, as it had done the previous year with the gas distribution network, *Transredes*. Although Ecuador has not demonstrated the same appetite to take over private entities, in 2008 the government nationalized the assets of the Brazilian construction company *Constructora Norberto Odebrecht* and seized control over French oil company *Perenco's* oil fields in the north-eastern Amazon region over a tax dispute in mid 2009 (Skinner, A. , 2009; "Expropitation and Nationalisation Loom Large in Latin America", Maplecroft).

[6] Filho, J. (2008): "*Gobernabilidad Corporativa en Empresas Estatales y el Papel del Consejo de Administración*", *Estado, Gobierno, Gestión Pública. Revista Chilena de Administración Pública*.

[7] ISSA (2004); "Guidelines for the investment of social security funds", Technical Report 13, Study Group on the International Social Security Association.

In sum, PPFs, SWFs and SOEs are relevant players in financial markets. Improving their governance practices, accountability and investment policies will contribute to international financial stability.