The 2007 Asian Roundtable on Corporate Governance

Network on Corporate Governance of State-Owned Enterprises in Asia

Synthesis Note

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Background and objectives of the Asian SOE Network

The Asian Roundtable on Corporate Governance (hereinafter "**ARCG**") has decided to develop, under its auspices, a specific activity on the corporate governance of SOEs to raise awareness and promote the use in Asian economies of the OECD *Guidelines on Corporate Governance of State-Owned Enterprises* (hereinafter "**Guidelines**"). These *Guidelines* were adopted in the spring 2005 and are the first international benchmark in this area.

A preliminary meeting was held in Beijing in May 2005, gathering a limited number of countries to discuss a first list of priority issues regarding corporate governance of SOEs in Asia. This preliminary discussion underlined the significance of SOEs in Asian economies and the complexity of the policy challenges related to their corporate governance. It was decided to develop a specific forum to carry out a focused policy dialogue and investigate in-depth the appropriate policy options to improve the governance of SOEs in Asia. The Asian Network on Corporate Governance of SOEs (hereinafter the "**Asian Network**") was therefore set up. It is planned to meet regularly and develop into a high-level hub for a structured policy dialogue on corporate governance of SOEs in Asia, using the Guidelines as a framework for discussion.

The objectives of the Network are:

- to raise awareness of all concerned constituencies on the importance and challenges related to the good corporate governance of SOEs;
- to evaluate the current SOE corporate governance policy frameworks and practices, and benchmarking these against international good practice as described in the Guidelines;
- to influence policy making by providing a forum in which policy makers, practitioners and experts can share knowledge and experience among themselves and with their OECD peers;
- to support viable and effective reforms in the area of SOE corporate governance, by discussing and analysing policy options, developing relevant recommendations and agreeing on priorities for reforms adapted to the conditions in Asian economies.

The Network is chaired by John Lim, President of the Singapore Institute of Directors. Eleven Asian economies were represented: Bangladesh, China, Chinese Taipei, India, Indonesia, Malaysia, Pakistan, Philippines, Singapore, Thailand and Vietnam. Altogether, the meeting gathered around 45 participants, plus 5 OECD staff, including prominent, active and influential policy makers, practitioners and experts regarding corporate governance of SOEs in the region. The following constituencies were represented: a) ownership entities / ministries in charge; b) SOE management, both CEO and board members; c) members of state audit bodies in charge of auditing SOEs; d) stock exchanges and securities commissions; and, e) institutes of directors, corporate governance institutes, private sector representatives.

Participants to the Network constitute a peer group that can press for legal and regulatory reform in this field. In order to provide the OECD experience and to ensure consistency with the Guidelines, a key feature of this Network is also the active participation of peers from OECD countries, including the Chair of the OECD Working Group on Privatisation and Corporate Governance of State-owned Assets and delegates from Australia and Korea. By actively participating in meetings and the drafting of the Policy Brief, they are expected to provide the OECD experience and ensure consistency with the Guidelines.

The Asian Network is planned meet at least three times over 2006, 2007 and 2008 to cover the six chapters of the Guidelines. Each meeting is dedicated to comparing regional practices with one or two chapters of the Guidelines. The first meeting took place in Singapore in May 2006, hosted by the Singapore Institute of Directors. It focused on the first two chapters of the Guidelines, namely the legal and regulatory framework and the role of the state as an owner. This second meeting focused on two other chapters of the OECD Guidelines, namely the Chapter VI on "The Responsibilities of the Boards of State-Owned Enterprises", and the Chapter IV on "Relations with Stakeholders".

To keep the dialogue focused and to produce tangible outcomes, the Asian Network will progressively develop a Regional **Policy Brief**, providing a set of recommendations and priorities for policy reform in order to improve the corporate governance of SOEs in the economies of Asia. This Policy Brief will be the product of the Network's deliberations and will be a consensus document.

Synthesis of discussion

The meeting in Cebu was gracefully introduced by Hon. Gwendolyn Garcia, Governor of the Province of Cebu, who underlined the importance of SOE reforms in achieving the President Arroyo's 10 priorities for economic development in the Philippines. She also welcomed all participants by presenting keys of the Cebu province both to the Network Chair, Mr John Lim**,** President of the Singapore Institute of Directors, and to Mr. Lars-Johan Cederlund, Senior Advisor at the Division of State Enterprises, Ministry of Industry, Employment and Communications in Sweden and Chair of the OECD Working Group on Privatisation and the Corporate Governance of SOEs.

Mr. Lim then noted in his **introductory remarks** that it is very timely to discuss corporate governance of SOEs in Asia as there are a number of reforms high on the agenda or initiatives being developed in the region. Mr Cederlund noted that Asia has been the most active and advanced region in discussing the Guidelines implementation and this meeting provides an important opportunity for OECD member countries to better understand and fully appreciate the depth and scope of Asian reforms in corporate governance of SOEs. Both speakers also underlined the importance and complexity of reforming SOE governance. While the benefits are obvious, practicing corporate governance of state-owned enterprises is a complex undertaking. Strengthening SOE boards is at the core of CG improvements in SOEs and a critical challenge is to nominate competent boards, grant them full responsibility and then to refrain from interfering in day-to-day management.

Hon. Eduardo Ermita, Executive Secretary of the Office of the President in the Philippines then made a **keynote statement** presenting a memorandum from the President Arroyo, signed on April 10 2007, on "Furthering good governance in GOCCs and GFIs". This memorandum calls for a systematic annual evaluation of SOE boards, training for board members and setting up of board committees, three elements which are clearly advocated for in the OECD Guidelines. This memorandum demonstrates the high level political commitment in the Philippines to SOE governance reforms.

Significant reforms are being implemented in Asia regarding the corporate governance of SOEs

The **landscape session** demonstrated the significance of current reforms and the potential impact of the Network discussions in supporting reform agendas in the region. Four countries presented recent and current policy reforms and main challenges regarding corporate governance of SOEs.

- These reforms are broad and comprehensive in some countries, covering all the different aspects of SOE governance. This is the case in **Malaysia**, where a long term reform program of the overall SOE framework has been launched and actively pursued (the Government Linked Companies transformation programme). One main pillar of this program is to upgrade SOE boards' effectiveness and corporate governance in general. Ten major initiatives are being implemented, covering a wide range of issues, including enhancing board effectiveness, achieving value through social responsibility, strengthening directors' capabilities, enhancing SOEs monitoring and management functions, revamping procurement practices, etc.

- Reforms might concern more directly the organization of the ownership function, such as in **Vietnam**, where the recently established ownership entity (the State Capital Investment Corporation) plans to play the role of a dynamic and strategic investor in all SOEs, including through the introduction of good governance practices.

- Current reforms often focus or at least encompass board issues, such as in **China** where a major pilot project to set up boards in central SOEs is currently being undertaken. One main challenge of SOE corporate governance reforms in Asia remains the appointment of competent and independent boards. In China, SOE boards lack decision power, especially regarding appointment of senior management, as well as independence from the controlling shareholder. In **India**, one main challenge regarding SOE board remains the appointment of truly independent directors, which is not the case for nominee directors of financial institutions.

- Some specific tools for furthering reforms are being developed, such as SOE corporate governance codes. In **India**, new Guidelines on Corporate Governance for Central Public Sector Undertakings have been recently approved in March 2007, covering non-listed SOEs. These Guidelines include a number of recommendations in line with the OECD Guidelines, including concerning the composition and functioning of the board, such as having at least one third of independent board members, being properly informed, limiting the number of board seats, setting specialized committees, etc. In addition to these new Guidelines, the J. J. Irani Expert Committee on Company Law calls for a level-playing field between SOEs and private sector companies, including through disclosure and adequate coverage of costs related to non-commercial and social responsibilities of SOEs.

- Finally, there are interesting success stories of SOEs being revamped, due *inter alia* to corporate governance reforms. The recent amazing turnaround of the Indian Railways was presented as an interesting example of the impact of corporate governance reforms on SOE profitability.

Enhancing board effectiveness is a long and complex process, but a crucial element of SOE governance reforms

Session one focused on SOE board mandates and functions. SOE boards in Asia are not always entrusted with the full range of board responsibilities, i.e. providing strategic guidance, monitoring management and controlling disclosure. They see their roles and responsibilities encroached by the ownership entities and the management, being by-passed in some cases by ministries giving direct instructions to the management. In some other cases, their functions are duplicated by specific state regulatory bodies. Accordingly, responsibilities and liabilities of SOE board members should be the same as those in the private sector. It might however be necessary to clarify the respective personal and state liability in cases state officials are appointed on SOE boards.

The presentation by Mr. Qin Yongfa, Deputy Head of Board Pilot Project Office in the SASAC (State-owned Assets Supervision and Administration Commission of the State Council) showed progresses and challenges in setting boards in central SOEs in China. One main objective is to entrust boards with their full responsibilities, including strategic guidance and management monitoring. As in a number of Asian economies, SOE boards do not have the legitimacy or authority to monitor management. In the Chinese context, it is crucial to prevent senior executives from managing themselves by increasing the number of independent, or at least external, board members. The pilot project allowed a significant improvement in this regard as external directors account for more than half of board members in 14 pilot boards and audit and remuneration committees are only composed of non-executive directors. Difficulties remain regarding board functioning, especially due to the information asymmetry between external directors and senior management and to the interaction amongst them. Challenges also remain with regards to board evaluation and remuneration. The SASAC was complimented for its bold reforms and the 17 pilot SOEs were characterized as ahead of Chinese private sector companies with regard the quality of their boards. However, more external directors should be brought from the private sector, as they are currently 2/3 from other SOEs or retired officials. To fully exercise their monitoring function, boards should also be able to appoint and dismiss CEOs.

More general discussion focused to how to ensure that boards are entrusted with their full range of responsibilities. Some important avenues to achieve this were mentioned, particularly to allow boards to monitor management. These include separating Chairman from CEOs, letting boards nominate CEOs; and setting specialised committees composed of independent directors. Another barrier to board effectiveness is the role of state auditors, which in some Asian economies might deprive the boards from some of their authority.

Discussion also covered the progressive separation between the ownership and management function. It was noted that in some cases this separation has not yet been achieved. However, this does not mean that there should be a divorce between the ownership entity and SOE boards. To the contrary, the importance of the relationship between the board and the ownership entity was reminded. One important aspect of this relationship is the clarification of expectations that must be done by the ownership entities.

Session II focused on board nomination, competence and functioning. A prerequisite to empowering SOE boards is to improve their quality and functioning so that they can effectively exercise objective and independent judgment and fulfil their responsibilities. A key element to improve the quality of boards and to protect them form undue political interference is thus to put in place a well-structured and transparent nomination process, based on competencies and experience. A good nomination process is also instrumental in improving the composition of SOE boards, which should include a limited number of state representatives and as much as possible experts with business experience.

Mr. Abdullah Abdul Hamid, Executive Director of Investment in Khazanah Nasional Berhad, presented the main content of a "Green Book" of the Putrajaya Committee on *"Enhancing board Effectiveness".* The presentation highlighted key areas for improving boards' effectiveness including their composition, but also their processes and practices, as well as interactions. It provided best practices guidelines to structure high-performing boards, to ensure effective operations and interactions and to fulfil the board's fundamental roles and responsibilities.

Discussion focused on the difficulties to put in place transparent and structured nomination processes, with the continuing pervasiveness of political appointments in a number of Asian economies. SOE boards include "civil servants who lack the authority, background or interest to perform their roles", or are appointed "as perks or as a form of early retirement". These persons might "be pressured to use their position to pursue political or social objectives of the government at the expense of the company" (OECD White Paper on Corporate Governance in Asia, par. 97-98). Practices in this area can only evolve slowly. In addition to the nomination of candidates by the ownership entities, boards themselves might be involved in proposing names for new directors. There should be informal dialogue on this issue between the boards and the ownership entities. Other useful avenues to support adequate nomination process were mentioned, including seeking advice from head-hunters in order to broaden the pool of potential board members.

Session III focused on board evaluation. Enhancing SOE boards' quality and professionalism requires putting in place a systematic evaluation process. This practice is for the time being still quite under developed in most Asian economies. It is still underdeveloped even in the private sector, and individual evaluations are just beginning. Such evaluation processes encourage board members to devote time and energy in exercising their functions. They also help in reviewing board size and composition, thus in identifying necessary competencies and required new board profiles.

Discussion underlined the necessity to have a few but clear and specific strategic objectives as yardstick to evaluate the board's performance. It is important for evaluations to be objective, not personalised. Evaluation should focus on the overall board performance as well as on the contribution of individual board members, without damaging the required collegiality of board work. Evaluation could include self-evaluations and peer evaluations, which must remain strictly confidential. The use of an external and independent facilitator might be useful in this regard. The Chairman's evaluation is particularly sensitive, while the effectiveness of the Chairman is critical for the board's overall effectiveness. Finally, evaluation should be perceived as a tool for improvement. The Chairs should have informal discussions with individual board members in order to voice criticisms. These discussions must be handled with subtlety.

In summary, enhancing board effectiveness is at the centre of SOE reform. The three sessions covering board issues in SOEs showed how strengthening boards' independence and developing further an adequate board culture is a long and complex process. A key element of strengthening boards in the Asian context is to put in place structured nomination processes which would limit political appointments, increase the number of independent directors as well as private sector expertise within boards. There is still a long way to go to improve SOE board composition in most Asian economies. Nevertheless, reforms should not focus only on boards' "conformance", i.e. their composition. They must also turn to more performance-related aspects and focus on board practices, processes and interactions. The overall objective of these reform efforts should be to avoid having boards "randomly selected, never evaluated and rarely accountable".

Employee representatives in board could have a positive contribution provided that they think independently, serve the interests of the company and are appropriately trained.

Session IV focused on specific rights of employees in SOEs and the role of their representatives in boards. In a number of Asian economies, stakeholders and particularly employees are granted some specific rights in SOEs, including board representation and other consultation/decision making rights. These rights might have a critical impact on the overall governance of SOEs and in particular on the functioning of the board. The OECD Guidelines recommend, whenever employee representation on boards is mandated, to develop specific mechanisms to ensure that it contributes to the enhancement of the board skills, information and independence.

Discussion focused on issues that might arise, for example regarding confidentiality and conflicts of interests. The question of confidentiality was not considered more acute with employee representatives than with other board members. Examples of positive contribution and "good partnerships" were provided where employee representatives do not promote their own specific interests, both in OECD and Asia. It was considered that it is in general in the interest of the company and its shareholders to have employee representatives within boards. The contribution might depend on how employee representatives are elected on boards, i.e. whether these are trade-union representatives, from in-house or country level trade-unions. What is crucial is that employee representatives think independently, contribute to value creation and do not damage the collegiality of the board. Their primary duty is to the corporation. The importance of training was underlined to familiarise employee representatives with their responsibilities as board members. Finally, it was also mentioned that effective contribution also requires acceptance by the other board members and management**.**

SOEs should reassess their stakeholder engagements and develop a strategic approach vis-à-vis stakeholder relations

Session V focused on effective co-operation and communication with stakeholders. Stakeholder relations might be particularly important for SOEs for building sustainable and financially sound enterprises, for improving or protecting their reputation and for fulfilling the general service obligations that a number of them have. In addition, there is an increasing risk of litigation linked to stakeholder issues. Societal concerns, if not properly addressed, can lead to potential disruption to the sustainability of a company or industry. The OECD Guidelines thus recommend SOEs to respect stakeholders rights established by law or through mutual agreements and to fully recognize stakeholders' contribution. They also encourage active and wealth-creating cooperation with them. This implies for SOEs to report on their policies and effective relations with stakeholders. This said, the Guidelines also recommend that stakeholders rights or influence on the decision making process are explicit.

The presentation by Dr. YRK Reddy, Chairman of Yaga Consulting Pvt Ltd & Academy of Corporate Governance in Hyderabad, underlined the complexity of stakeholders' relationships in the case of SOEs. It is necessary to map stakeholders, i.e. to recognize their existing and evolving rights, powers and levels of interests in the firm's activity. Depending on this evaluation, the company could decide to inform, consult, involve or partner with respective stakeholders. The main challenge in many SOEs is to fight stakeholder capture and regain discretion to take strategic action vis-à-vis stakeholder relations. In most case stakeholder engagements need to be reassessed.

Mr Affan Mohd Nawi from the Transformation Management Office in the Khazanah Nasional Berhad in Malaysia presented the Silver Book of the Putrajaya Committee on *"Achieving value through social responsibility".* The book, as one of the 10 initiative of the overall SOE transformation program, advises SOEs to take a strategic approach towards stakeholders' relations and to move from social obligations to voluntary contributions.

Discussion focused on the role of the board in defining the stakeholder policy, the necessity to structure efforts and the importance of adequate reporting on stakeholders' relations. In many countries SOEs are perceived as champions of stakeholder relations and win awards on their stakeholder reports. However, this should not prevent them form reassessing their practices and develop strategic policies in this regard.

Reform efforts need high-level political commitment. Specific tools such as corporate governance scorecards might be instrumental in raising awareness and monitoring progress.

A specific session discussed **recent developments in the Philippines** regarding the corporate governance of SOEs and updated the participants on the SOE Corporate Governance Scorecard and the Presidential Memorandum on *"Furthering Good Corporate Governance in Government-Owned or Controlled Corporations & Government Financial Institutions (GOCCs & GFIs)"*. The main results of the scorecard exercise were presented as well as how to frame and use such an exercise to raise awareness, trigger political commitment and monitor progress.

Discussion focused on how to support reforms and ensure effective implementation of the Presidential Memorandum. The role of NGOs and the media was mentioned, as well as the interest of including the private sector in the discussion.

Development of a Regional Policy Brief

A **drafting session** allowed discussion of the two draft chapters the Regional Policy Brief which was circulated to all the Network participants ahead of the meeting. Participants agreed on the general tone and content of the current draft, considering that it reflected the discussion held in Singapore. They provided the OECD Secretariat with useful comments and suggestions to improve the current draft.

Two new chapters of the Regional Policy Draft will be drafted based on the Cebu meeting discussion. These two new draft chapters will be discussed in the next meeting of the Network. Participants also agreed on main issues which will be covered in these two chapters, including: a proper board nomination process; performance evaluation; effective training for new board members; one yearly meeting of the board to discuss strategic issues; the use of specialised committees as in the private sector; the creation of a nomination committee headed by an independent director; awareness of fiduciary duties and a review and balancing of stakeholder commitments.

Evaluation and future steps

Evaluation of the meeting by participants was very positive. Participants consider that issues or topic covered are of great importance, that there was active participation in discussion and that the meeting was properly structured, allowing useful exchanges of experience and networking. Some participants however call for presentations to be more focused and to answer more effectively to the specific questions set for in the agenda. They also call for moderators to be more proactive in framing the discussion. Participants suggested to invite more CEOs, Chairs and board members of large SOEs to the next meetings and to extend the drafting session to half-a-day. They also called for the discussion of specific success stories and case studies.

Topics to be covered in the next meetings, besides the remaining two chapters of the OECD Guidelines (namely transparency and disclosure and the equitable treatment of shareholders) could also include enforcement and implementation aspects.

The Network Chair, Mr John Lim, will report on the main findings and progress in developing the Regional Policy Draft in the next meeting of the Asia Roundtable on Corporate Governance to be held end of June 2007 in Singapore.

The next meeting of the Network will take place in the spring 2008, most probably in India.