



Asia Network on Corporate Governance of State-Owned Enterprises

Priorities and Recommendations

DRAFT FOR DISCUSSION

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Draft for discussion

Background and Action Required: *The priorities and recommendations in this draft reflect discussion held during the first, second and third meetings of the Asia Network on Corporate Governance of SOEs, which took place in Singapore in May 2006, in Cebu, the Philippines, in April 2007 and in New Delhi, India, in June 2008. These recommendations aim at identifying main priorities for reform in the area of SOE governance in Asian economies and do not necessarily cover all the specific guidelines.*

The final report will be a consensus document reflecting commitments by Network participants. These commitments will be formulated as priorities and recommendations for reform. The purpose is to support national reform efforts and establish a benchmark against which progress can be monitored.

The draft is submitted to the Working Group for discussion.

Next steps:

1) Finalisation of the document

The following sections are still to be added: : a) a preamble highlighting the significance of SOEs for Asian economies and acknowledging the importance of recent reforms regarding the corporate governance of SOEs; b) the insertion of specific examples of good practices from Asian economies.

2) Future work of the Network.

This document forms an important basis for the Networks' future work.

Using this document and the SOE Guidelines for State Owned Enterprises, the Network will focus on implementation of the reform priorities that have been identified. This will be done through analysis of viable policy options and concrete case studies describing how different reform efforts have succeeded or failed. Using the document, the Network will also be able to monitoring progress at country level.

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CHAPTER I: ENSURING AN EFFECTIVE LEGAL AND REGULATORY FRAMEWORK FOR STATE-OWNED ENTERPRISES

Recommendation I.1: Complete the corporatisation process and harmonize SOEs' legal status within each economy.

1. In many Asian countries SOE still have specific legal forms, different from the other companies. There is often a combination of SOEs established under the relevant company law and some with special status. In some countries, some departmental/ministerial entities are even still considered as SOEs. Moreover, in a few countries, the corporatisation process is not yet completed, i.e. the vast majority of SOEs are not yet incorporated as legal entities.

2. The OECD Guidelines recommend governments to “*strive to simplify and streamline the operational practices and the legal form under which SOEs operate*” (Guideline I.B.). This harmonization of legal status would allow “*levelling the playing field with private competitors in increasingly deregulated and competitive markets.*” It would do so by “*making those means and instruments usually available to private owners, also available to the state as an owner*”, by “*enhance(ing) transparency and facilitate(ing) oversight through benchmarking*” (Annotations to Guideline I.B., p. 20).

3. Governments in Asia should first complete the corporatisation process of state-owned enterprises or government-linked corporations.

4. Governments in Asia should then strive to transform previously statutory corporations into regular limited liability companies registered under the company law. The harmonization of SOEs' legal status within one economy is particularly relevant in Asian countries given the number of current reforms aiming at improving the corporate governance of companies, including through amendments to the relevant company law. SOEs would therefore benefit from the overall improvement in the legal and regulatory framework regarding corporate governance.

5. The harmonization, or rationalization, should target firstly SOEs having a commercial activity and active in competitive markets. It should also focus its priority on transparency and disclosure obligations and on the role and authority of the company's organs.

6. A second best solution is to make some specific regulations more inclusive, particularly concerning disclosure obligations, i.e. extending their coverage to SOEs with specific legal forms. This will allow some recent improvements in the legal and regulatory frameworks regarding corporate governance to apply also to statutory corporations.

7. Finally, remaining discrepancies between the legal status of SOEs and regular companies registered under the Company Law should be clearly disclosed. This would clarify the legal environment for any potential investor and pave the way for future reforms.

Recommendation I.2: Clarify and ensure effective separation between the ownership function and regulation.

8. The separation of the ownership function from other state functions is far from fully realised in a number of Asian economies. In many cases, important reforms are still pending to ensure an effective separation between the ownership function and regulation. In this regard, the situation varies from one country to another, and the effectiveness of separation varies across different sectors. In some cases, SOEs themselves have still regulatory powers. Finally, even when independent regulatory authorities are put in

place, there are often doubts regarding their effective independence and their relative power vis-à-vis line ministries.

9. Asian governments should strive to ensure an effective separation between the ownership function and other state functions vis-à-vis SOEs. A clear separation is indeed a “fundamental prerequisite” for ensuring a level-playing field with the private sector and for avoiding competitive distortions. This is the first Guideline in Chapter I of the *OECD Guidelines* and is also advocated by the *OECD Principles of Regulatory Reforms*.

10. Clear laws and regulations should be developed to protect the independence of the regulators, especially vis-à-vis line ministers. Nominal independence is not enough. Operational independence might be jeopardized by a narrowly based fee structure, for example, or by a lack of control over one’s budget. Appropriate financial and human resources should thus be provided to allow regulators to function adequately with the right level of operational independence.

Recommendation I.3: Make specific obligations and related costs transparent

11. There are only a few countries in Asia where specific obligations (i.e. non-commercial) of SOEs are clearly identified. The Guidelines do not preclude such non-commercial objectives but mandate clear disclosure of these objectives, combined with adequate costing and funding. This disclosure, costing and funding is indeed critical both for ensuring the level-playing field with the private sector and for ensuring adequate transparency on the overall performance of SOEs. The Guidelines state that any obligations or responsibilities “beyond the generally accepted norm” should be “disclosed to the general public and related costs should be covered in a transparent manner” (Guidelines I.C., p.10).

12. Asian governments should strive to make SOEs’ specific obligations and their related costs transparent. To this aim, they need to clarify SOEs’ mandates, articulate clearly their commercial and non-commercial objectives and identify the costs associated with fulfilling special obligations. Such a process will clarify the financial implications for both the SOEs themselves and for the state budget of meeting these obligations. It will also help clarify the trade-offs to be made between social or regional development and value creation. It could thus trigger discussion on the continuing merits of particular obligations or alternative ways to finance and/or provide/fulfil these specific obligations.

13. Given the large scale and scope of non-commercial objectives of SOEs in a number of Asian economies, this transparent costing and funding could be a politically sensitive issue and a complex task to implement. It will most probably require in-depth reforms both in the accounting of SOEs and in budget processes.

Recommendation I.4: Ensure arm’s length relationships between SOEs, state-owned banks and financial institutions

14. In a number of Asian economies, the state sector still includes a significant share of the banking sector as well as other major financial institutions, including development finance institutions. Moreover, state-owned banks and financial institutions are in many cases the main creditors of SOEs. In addition, whether state-owned or not, banks tend to consider that SOEs’ debts are implicitly guaranteed by the state. This often leads to excessive indebtedness for SOEs and bad loans for state-owned banks. It creates market distortions and shelters SOEs from an important source of market monitoring and pressure.

15. State-owned banks and financial institutions should grant credit to SOEs on commercial grounds, i.e. on the same terms and conditions as to the private sector. Relevant regulations should be adopted, reinforced and implemented, and supervision of the banking sector enhanced, particularly regarding the

control of non-commercial or non viable related party transactions. Interference from the state on lending decision should be strictly prohibited.

16. More generally, appropriate credit allocation processes should be developed and SOEs should also be encouraged to seek financing from capital markets. Where there are implicit or explicit government guarantees, Governments could mitigate the problems of private sector debt being provided at below market rates by implementing explicit debt guarantee fees¹. This would lead to more appropriate capital financing decisions and reduce the incentive for SOEs to seek to retain their government guarantee.

17. Additional mechanisms could be developed to limit conflicts of interest, such as limiting strictly cross board membership among state-owned banks and SOEs. In many Asian countries, the state as an owner appoints state-owned banks representatives in SOE boards, particularly from development finance institutions. The boards of state-owned banks should themselves develop policies in this regard.

Recommendation I.5: Make the corporate governance of SOEs a public debate

18. SOE governance reform will require courageous political decisions and consistent political commitment in the long term. It will also require adequate consultation with stakeholders for the reform to be acceptable and successfully implemented. Political commitment in turn requires constant pressure from the public. It is thus crucial to make the SOE governance issue a public debate and to encourage NGOs to participate in this debate.

19. In the absence of major scandals, it might be relevant to spark off the debate and arouse public interest by making clear current SOE performance, benchmarking it against either private sector or foreign peers. Scorecard exercises might be instrumental in getting the public attention and pushing for reforms.

20. To get and sustain public support and therefore political commitment in the long term, it is also important to demonstrate potentially significant impact of SOE governance reform. This could be done for example by estimating the potential for value creation and subsequent impact on market capitalization, or by communicating about governance reform champions.

21. Benefits from SOE governance reform for all different stakeholders should also be clearly articulated.

22. The role of an educated media is crucial in raising the public interest and in educating the public about what is at stake with SOE governance reform.

¹ Such fees would be paid to the state to reflect the difference between concessional interest rates offered to the SOE and the market rates that would be available in the absence of a Government guarantee or support.

CHAPTER II: THE STATE ACTING AS AN OWNER

Recommendation II.1: Rationalize the state owned sector

23. Asian governments should strive to define clearly in which sectors they want to retain state ownership, the reasons why they want to do so and which forms of state ownership are more adequate. Based on this, some governments might define and implement a privatisation program which would allow appropriate decrease in the state sector or more relevant focus in terms of sectors. Reducing the scale and scope of the state sector will allow focusing governance reforms and advocacy efforts.

Recommendation II.2: Asian governments should develop and disclose an ownership policy

24. Few Asian governments have developed a clear ownership policy as such, much less a published one. When it exists, the ownership policy is often laid down in very general terms, mentioning the overall objectives of SOEs in general, i.e. often combining seeking profit, providing general service to the population and supporting the development of the national economy. There are three typical catalysts that will prompt the development of such a policy, namely a general fiscal crisis, a major corporate scandal or a broader government reform. Asian governments should not wait for such events to clarify and centralise under one high level document the main principles which should drive the exercise by the state of its ownership function.

25. One primary task of the state as an owner of SOEs is to develop an ownership policy, defining “the overall objectives of state ownership, the state’s role in the corporate governance of SOES, and how it will implement its ownership policy” (Guidelines II.A., p. 11). Ownership policy should define clearly the reasons for state ownership, thus defining in broad terms the purpose of state ownership. The ownership policy should also express clearly the main objectives of such state ownership. The tendency is to focus increasingly, at least in principle, on sustainable value creation. Most importantly, the ownership policy should define how the state should behave as an owner. Clear and published ownership policies thus provide a framework for prioritizing SOEs’ objectives and are instrumental in limiting the dual pitfalls of passive ownership or excessive intervention in SOE’s management.

26. These ownership policies should also be consistent and not be modified too often, in order to provide SOEs, the market and the general public with a clear view and understanding of the states’ objectives and a sense of predictability of the state’s behaviour as an owner. Such high level principle documents will thus help in making policies consistent across sectors and across time.

27. To be credible, ownership policies should be high level, transparent and enjoy strong political support. This way they will also be instrumental in raising awareness on the SOE governance issue and in rooting this issue in the public debate.

28. It is necessary to ring fence the ownership policy and ensure its effective implementation. The state should not be able to exempt itself from applying it. One effective measure is for the state and the ownership entity to report regularly on how the ownership policy has been implemented.

Recommendation II.3: Ensure visibility, strength and consistency in the exercise of the ownership function, through centralization or effective coordination between the different ownership entities

29. The exercise of the ownership function is carried out in very different manners in Asian economies. Some countries have already centralized the ownership function under one Ministry or one holding company. A number of countries have a dual model where two ministers share the different

ownership rights over SOEs, or decentralized models where the ownership rights are exercised by sector ministries over their sector SOEs.

30. The Guidelines recommend the centralization of the ownership function or, at the least, efficient coordination among the different entities in charge of the ownership function. Centralization here does not refer to the central/regional or federal/state organization of the government, but, at any given level of government, to the grouping of ownership responsibilities over different SOEs into one single entity or under one single Ministry. Centralization ensures clarification of functions through effective separation between the ownership function and other state functions vis-à-vis SOEs. It also makes the ownership function more visible and identifiable and might facilitate the strengthening of competencies by centralizing financial and human resources. It thus helps to sharpen the ownership function per se. Finally, it could be instrumental in decreasing political interference in SOEs and in transferring clearer responsibilities to SOE boards.

31. There are costs and challenges in carrying out such centralization. The most serious one is to overcome resistance from other ministries which would lose significant power and rent seeking opportunities. Governments should carefully consider these obstacles before deciding on reforms, develop effective reform paths and mechanisms, and build up appropriate political support to overcome them.

32. In some cases, centralization might not be advisable given the size of the state-owned sector. Centralization could lead to excessive power concentration, and a centralized entity might not necessarily be able to gather more competencies than technical ministries. In this case, it is nevertheless necessary to set up an efficient co-coordinating entity, whose main functions are to develop the general ownership policy, to ensure consistency among different ministries on the way they exercise their ownership function and to report in an aggregate manner on the overall state sector.

Recommendation II.4: Avoid interference in SOE management

33. A major danger and actual weakness in SOE governance in Asia is direct or indirect political and/or bureaucratic interference in SOE management.

34. As an owner, the state should clarify SOEs' mandates and objectives, empower boards and then refrain from interfering in SOE management. This is clearly set out in the Guidelines: "*The government should not be involved in the day-to-day management of SOEs and allow them full operational autonomy to achieve their defined objectives*" (Guideline II.B.). This is valid both for the ownership entity and the technical or branch ministries. The ownership entity's ability to give direction to SOEs and their boards should be limited to strategic directions and policies.

35. To limit direct and indirect interference or pressure on SOE management, boards should be reinforced, with management being clearly accountable to, and under the supervision of, boards. SOE boards should also be given clear directions on the overall SOE objectives and should be held responsible for their achievement. Once clear objectives have been set, the government should let the boards carry out their responsibilities. This would also limit potential pressure from informal institutions.

36. Strict limits should be defined for any other government body to give instructions to, or interfere in, day-to-day SOE operations. The relationship between the government and SOE boards should be reinforced, but transparent. Any specific directive received directly from the government, apart from the overall SOE objectives, should be clearly disclosed.

Recommendation II.5: Develop structured and transparent board nomination process for SOE boards

37. A major challenge in most Asian economies remains on how to avoid political appointees on SOE boards and to move away from the general culture of complacent boards. A number of SOE boards are staffed with an excessive number of state representatives and political appointees without appropriate qualifications or experience to contribute adequately to the boards' work.

38. One of the fundamental roles of the ownership entities, in exercising the state's ownership rights, is to nominate competent SOE boards, and let them exercise their responsibilities (Guideline II.C.). It is fundamental that ownership entities establish "*well structured and transparent board nomination processes*" (Guideline II. F.2.).

39. Nomination processes should require each board to define clear and specific profiles for new board appointments. The definition of these profiles should be based on the appropriate mix of competencies and experience required for the board to fulfill its mission. It should thus be based on the evaluation of the existing board and consideration of the company's strategy, thus on resulting gaps in the current mix of experiences.

40. The nomination process should involve the boards themselves and their Chairs, particularly in defining the new appointments' necessary profiles. It gives them the opportunity to reflect on their composition, to better understand their responsibilities and to improve their collective functioning.

41. Once the profiles have been defined, it is advisable that they are openly advertised. An independent body could also be in charge of screening the applicants and do a short list of qualified candidates. In addition to competency and experience, the screening process should take into consideration candidates' commitment and time availability.

42. Another useful mechanism to help ownership entities to nominate competent boards is for them to develop or get access to databases of qualified candidates. These databases should be developed through competitive process and open advertisement to encourage broadening of the pool of qualified candidates. Specialised screening or search committees could also be set up to proactively look for suitable candidates, with a formal process for their identification.

43. Ownership entities could also use professional head hunters to enhance the quality of the search process.

44. Once SOE boards are appointed, it is necessary to disclose all directors' qualifications as well as the number of directorship they have. This number should be strictly limited.

Recommendation II.6: Ensure appropriate accountability of the ownership function

45. It is important to ensure adequate accountability of the ownership function as well as of the SOEs themselves. The existence of effective controls has the positive effect of enhancing public confidence. Their accountability "*should be, directly or indirectly, to bodies representing the interests of the general public, such as the Parliament*" (Annotations to Guideline II.E.).

46. Proper accountability requires firstly that objectives are clearly set. The accountability should cover how the ownership entities have performed in exercising state ownership and in achieving state objectives in this regard. It should also provide reliable information to demonstrate how the SOEs are managed in the interests of their owners.

47. Reporting to Parliament implies a process of compiling and checking information and includes a large number of parties. This interaction among the ownership, the SOEs, ministries, parliamentarians, the media and in fine the general public creates a disclosure dynamic.

48. To ensure appropriate accountability towards Parliaments, the ownership entity(ies) should provide them with structured, relevant and concise information. Reports should include aggregate data about the overall performance of the state sector. Discussion within specialized committees could be encouraged to allow for more in-depth discussion and to flag key issues to be discussed in plenary sessions. A specific discussion on the SOE performance, separate from the general budget discussion, could be organised in the plenary session.

49. However, in order to ensure a level-playing field with the private sector, it is important to achieve a right balance and focus accountability mechanisms on critical controls. SOEs and ownership entities should not be overburdened with redundant, excessively detailed and non strategic controls. Excessive and non-focused controls might lead to demobilization and risk minimizing instead of performance maximizing behaviors. It could also be an avenue for undue political interference.

50. Reports to Parliaments as well as minutes of discussion within the Parliament should in principle be publicly disclosed. However, adequate safeguards should also be developed to deal with confidentiality issue, especially whenever SOEs active in competitive sectors themselves are called in front of the Parliament for ad hoc reporting or special hearings. Meetings in these cases could be heard 'in camera', and information received treated as 'commercial in confidence'.

51. Another critical element of accountability for the ownership entity might be the publication of an aggregate report on the whole state sector. Such reports are a key communication tool for the state as an owner. They allow to build trust and to generate genuine public debate. They are also instrumental in improving internal reporting systems, making information consistent and building consensus within the government on ownership practices.

CHAPTER III: EQUITABLE TREATMENT OF SHAREHOLDERS

Recommendation III.1: Reinforce provisions protecting the rights of minority shareholders in relevant laws and regulations

52. The protection of minority interests is a corner stone to the further development of Asian capital markets. This has been identified as a priority in the Asia White Paper on Corporate Governance. In many Asian economies, listed SOEs represent a significant share of market capitalization. Moreover, a growing number of SOEs are to be listed on the markets. In such circumstances, an effective system is needed to protect effectively, easily and conveniently against abuses by majority shareholders. This is crucial for Asian states as owners to be credible in ensuring an equitable treatment of all shareholders and equal access to corporate information. The state's reputation in this regard will have a significant impact on its capacity to attract further funding and thus to list additional SOEs, as well as on the valuation of the SOEs concerned.

53. Ownership entities should review the legal and regulatory framework and ensure that they include sufficient provisions with regard to the protection of minority shareholders. These provisions should allow minority shareholders to have a more effective participation in the decision making. They relate firstly to SOE boards' independence and nomination. They also should require pre-emptive rights and qualified majorities for certain shareholder decisions. Finally, it is crucial that there are provisions relating to the rules for reviewing and approving related party transactions, as well as disclosure requirements in this regard. In the case of SOEs, related parties are particularly difficult to define, as there are many explicit and implicit ones.

54. Efforts have been made recently to address these issues, introducing more deterrent provisions particularly through the revision of the company laws. However, relevant provisions could still be tightened in a number of Asian jurisdictions.

Recommendation III.2: Increase the independence of SOE boards and improve the transparency of their nomination process.

55. One of the most effective tools to protect minority shareholders remains the appointment of independent directors. What is needed is empowered SOE boards with a sufficient number of genuinely independent directors who are truly independently appointed.

56. A number of Asian SOEs still don't have an adequate level of independent directors or no independent directors at all. Moreover, in some cases, the public perception is that the independent directors are not really independent and that there is political interference in their nomination process.

57. Independence of SOE boards should be reinforced. Minority shareholders should be able to exert influence on their elections through the possibility of nominating candidates and through cumulative voting processes. There should also be a clearly established duty of loyalty for board members. Finally, further needs to be done, and seen to be done, in improving the transparency in the appointment process of SOEs' independent directors.

Recommendation III.3: Reinforce minority shareholders' capacity to obtain effective redress for the violation of their rights.

58. Even if an appropriate legal and regulatory framework seems to be in place in a number of Asian economies with regards to the protection of minority shareholders, effective enforcement is often lagging. This reflects a general situation in much of Asia where one could say that there is a weak implementation of laws and regulations in the area of corporate governance.

59. Enforcement has nevertheless improved recently in some countries and, as importantly, in some cases has become more timely. Enforcement has evolved towards using more civil action than criminal suits and in some jurisdictions provisions now exist for the securities regulator to take derivative action. But there is still a long way to go.

60. To improve further implementation and enforcement of minority shareholders rights, the priority is to further reinforce the capacity of relevant regulators. This entails providing them with adequate financial and human resources and granting them effective independence.

Recommendation III.4: Support the development of minority shareholders associations

61. Shareholders should raise their voice and be active. To do so, they must know their rights and be better informed. In some Asian SOEs, minority shareholders are banks and financial institutions which tend to remain dormant shareholders even though they have nominee directors. Awareness amongst the retail shareholders is also at minimum.

62. In many Asian countries there is a need to develop credible shareholder activist institutions. Minority shareholders' associations are instrumental in enhancing shareholder activism. They also help in educating shareholders about their rights and raising awareness in the business community, and the public in general, about shareholders' rights. It is important to encourage such institutions as a good prevention against abuses.

CHAPTER IV: RELATIONS WITH STAKEHOLDERS

Recommendation IV.1: SOEs should reassess their stakeholder engagements and develop a strategic approach vis-à-vis stakeholder relations

63. The Guidelines emphasize the fact that 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, the Guidelines also emphasise that 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 stakeholder 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 that SOEs should 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 should be explicit.

64. In many SOEs there are numerous stakeholders and relations with them are complex. In many countries SOEs are perceived as champions of stakeholder relations and win awards on their stakeholder reports. However, this should not prevent them from reassessing their practices and develop strategic policies in this regard. 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. A pre-requisite for SOEs to deal appropriately with these stakeholders' relations is thus to map them, i.e. to recognize their existing and evolving rights, powers and levels of interests in the firm's activity.

65. Depending on this mapping exercise and evaluation, SOEs could decide to inform, consult, involve or partner with respective stakeholders. They should structure their efforts and move from social obligations to voluntary contributions. In other words, SOEs should adopt a strategic approach towards stakeholders' relations. The role of boards is key to defining the SOEs' stakeholder policy and in ensuring adequate reporting on stakeholders' relations.

Recommendation IV.2: Mechanisms could be developed to allow and encourage stakeholders to exercise their voice.

66. An active dialogue with relevant stakeholders could be encouraged both by the ownership entities and by SOE boards. This could be facilitated by developing specific mechanisms allowing stakeholders to exercise their voice and engage with SOEs in a constructive and forward looking manner.

Recommendation IV.3: Ownership entities should encourage SOEs to report on stakeholder relations.

67. The Guidelines recommend reporting on stakeholder issues particularly for listed and large SOEs, as well as for SOEs pursuing important policy objectives or having general services obligations, with due consideration for the costs involved. They refer to existing best practices and recently developed guidelines on social and environment responsibility disclosure. They also call for an independent scrutiny of this reporting to reinforce its credibility. Finally, the state as an owner could report itself at the aggregate level on stakeholder relations, setting good example and indicating clearly its policy in this regard.

68. The ownership entities in Asia should clearly require SOEs to report on their stakeholder relations, either within their annual report or in a specific stakeholder report. They could encourage SOEs to do so for example by organising awards on stakeholder reporting or encourage SOEs to compete in

existing relevant awards. Ownership entities could also provide guidance and indicate clearly what should be the main content of stakeholder reporting, choosing a specific reference for doing so, such as the GRI Guidelines. They should set a clear threshold and criteria to determine which SOEs are concerned.

69. SOE boards should be aware of their responsibilities regarding stakeholder issues and effectively oversee stakeholder reporting. They are responsible for the accuracy of stakeholder reports' contents. This responsibility implies at least an annual discussion on stakeholder issue, an effective discussion on the stakeholder report and its formal approval. This could be done through a specialised committee if deemed necessary, i.e. when stakeholder relations are considered as strategic, when they infer significant costs or risks.

70. Stakeholder reports could be audited to increase their credibility.

71. Finally, the state as an owner should clarify its own policy on stakeholder relationships and report on them at the aggregate level.

CHAPTER V: TRANSPARENCY AND DISCLOSURE

Recommendation V.1: Clarify SOE objectives and make non-commercial ones explicit.

72. A number of SOEs in Asia have significant non-commercial objectives which are often implicit. In some cases these objectives are part of a long term development plan. They can also be legacies from a planned economic regime and/or a convenient way to finance public services off the public budgets. Whatever their *raison d'être*, these objectives have a non-trivial impact on SOE performance. Any serious attempt at monitoring SOE performance and at ensuring a level-playing field between SOEs and the private sector would require these non-commercial objectives to be made explicit, together with their related costs.

73. To clearly define SOE non-commercial objectives, a crucial step is for the Asian governments to identify the existing ones and their related costs, using a consistent methodology. This is both a complex and political sensitive process that will in many cases involve negotiation between the ownership entities, the SOE concerned and relevant stakeholders. But it is at the cornerstone of the clarification of SOE objectives, and thus of setting up proper performance monitoring systems. This mapping exercise will allow a strategic discussion on their relevance and effective costs, thus on their budgetary impacts and distributional consequences. Non-commercial obligations must become the result of a well thought out and political discussion process, rather than a historic liability.

74. In some Asian economies, it might be necessary to review SOE mandates, updating them to take into consideration the evolution in their non-commercial objectives, their industry and in global markets. These mandate reviews will also be an opportunity to debate, clarify and amend the high-level objectives and missions of the most important SOEs.

75. Asian governments could review the existing processes to agree on SOE objectives, ensuring that such processes exist, are properly documented and effectively implemented. They should also allow for a balance discussion between the ownership entities and the SOEs concerned, leading to a clear understanding of, and genuine agreement on, SOE objectives.

76. More generally, in a number of Asian economies, SOEs objectives are not always enunciated clearly in a specific document. It is necessary to clearly articulate and communicate on both the commercial and non-commercial objectives. SOE objectives have to be described in a specific document, such as a Memorandum of Understanding, and agreed on by both the ownership entities and the SOE boards concerned. These objectives documents will serve as a reference and will allow communicating clearly, formally and publicly on the governments' expectations from SOEs. This will allow for an informed debate about their relevance and will be instrumental in encouraging proper monitoring of their effective performance, including by the general public.

77. Ownership entities and/or the SOEs themselves should disclose their main objectives, by making their objectives documents, or relevant summaries of them, publicly available.

Recommendation V.2: Cover the costs of non-commercial objectives by the state budget

78. In a number of Asian economies, SOEs are still heavily burdened by the costs related to the fulfilment of their non-commercial objectives. Any serious discussion and effort at improving the financial performance of SOEs is impaired by these hidden costs.

79. Once these objectives are made explicit, it is necessary for the ownership entities, together with the SOEs concerned, to evaluate their related costs. The evaluation could be based on “avoidable costs”, as a practical and achievable approximation for marginal costs, or any other relevant and agreed upon methodology. The choice of methodology should allow for a fair appraisal of SOEs’ financial performance and for a level-playing field with their competitors from the private sector.

80. Covering related costs through the state budget can be achieved through different methods, from direct funding, the most simple and transparent approach, to levies on users, voucher systems etc. All present different pros and cons in terms of transparency, accountability and redistribution. This should also lead the governments to consider alternative mechanisms to achieve these objectives, mechanisms that might be more effective, less costly and/or leading to less market distortion.

Recommendation V.3: Build up and publish relevant performance indicators.

81. To more actively monitor SOE performance and to allow for a public debate about it, hence putting pressure for performance, it is instrumental for SOEs to have a limited set of simple but relevant performance indicators that will reflect their main objectives as agreed with the ownership entity.

82. These key performance indicators would reflect the desired balance between commercial and non-commercial objectives. They will include financial ones allowing measuring, following and assessing SOEs’ profitability, efficiency and risk level. They could also include dividend targets. Some structural objectives and related performance indicators could be added, covering for example the quality of the corporate governance or the human resource policy according to strategic success factors.

83. It is instrumental to disclose key performance indicators for each SOE. This could be done both by the SOE concerned on its website and by the ownership entity on its own website. The ownership entities could also communicate regularly on the evolution of these performance indicators in comparison with the set targets for their whole portfolio.

Recommendation V.4: Require large SOEs to be as transparent as listed companies.

84. In a number of Asian economies SOEs are not subject to the same requirements as listed companies in terms of transparency and disclosure, except obviously for the largest ones when they are listed. As an example, they are not even required in some countries to publish annual reports. It is crucial that SOEs publish enough information to allow for the ownership entities to properly monitor their performance, for the Parliaments to play their supervisory roles, and for the media and the general public to get a clear picture on SOE performance and its evolution.

85. The ownership entities should review the legal and regulatory framework for SOEs and identify main discrepancies in terms of transparency and disclosure requirements when compared to listed companies. In addition, effective practices of SOEs will have to be reviewed to assess weak areas, i.e. where SOEs do not comply with the existing requirements.

86. On this basis, the ownership entities could engage in a revision of this framework, in reinforcing the effective implementation of this framework by SOEs when necessary, and in developing a specific disclosure policy for SOEs. The ownership policy would identify and define clearly what information should be disclosed by SOEs, how it should be disclosed and the processes to be put in place to ensure an appropriate quality of this information. Specific guidelines on disclosure for SOEs could also mandate and/or encourage higher disclosure standards than the ones mandated by the existing legal and regulatory framework.

87. In developing a disclosure policy or specific guidelines for SOEs, it is important to consult adequately with the SOEs themselves and other relevant stakeholders, such as regulators and professional organisations of accountants, board secretaries, etc. to avoid unnecessary and excessive requirements that would put SOEs on an unequal footing with their private sector competitors.

88. Ownership entities could also be proactive in monitoring effective implementation and in encouraging good practices with regard to disclosure and transparency by SOEs. This would include proper communication with the SOEs concerned about the requirements and good practices, the development of specific guidance whenever necessary, the organisation of focused training if needed, and the distribution of awards for excellence in disclosure and transparency.

Recommendation V.5: Ensure that SOEs are subject to a robust audit system

89. SOEs in Asia are often subject to different audits, including external audits and state audits, of which respective roles are not always clearly defined and which in some case duplicate each others. It could also happen that state audits are focusing on minor issues, are excessively intrusive and even impair SOE boards and management to fulfil their missions. These processes are often too long, with their findings being neither timely nor always acted upon.

90. Ownership entities should ensure that the audit system for SOEs is robust and grants sufficient credibility to their financial statements. This might require a reconsideration of the respective roles and focus of internal, state and external audits.

91. It is critical for SOEs to have appropriate procedures for internal audits. The ownership entities should encourage internal auditors to focus not only on compliance audits but also on risk management. They could require, for example, that SOEs' annual reports comprise a report on internal audit describing procedures for financial reporting and the internal control structure.

92. SOEs should be subject to an annual external audit by an independent and qualified auditor, using the usual criteria for independence, whether or not state audits are also performed.

93. The scope of state audits could often be more defined. State auditors could focus on performance, leaving financial audits as the exclusive preserve of external auditors.

94. SOEs' audit committees should be given a primary role in supporting, overseeing and coordinating the different types of audits. SOE boards could also discuss audit results with the ownership entities and even disclose main findings to the public, with proper consideration for the protection of commercially sensitive information.

Recommendation V.6: Actively monitor and benchmark SOE performance

95. It is a prime responsibility of the ownership entities to actively monitor SOE performance. To be an active and informed owner, ownership entities need to have a clear, correct and up-to-date vision on the evolution of SOE performance. They should be able to identify early underperformance and react promptly on it.

96. To do so, ownership entities must ensure that they have access to relevant, accurate and timely information from SOEs and set up appropriate process to monitor it on an on-going basis. These processes might include various mechanisms, both formal and informal, including reporting per se, representatives on SOE boards, meetings with SOE boards to discuss performance, etc.

97. An important element of performance monitoring is benchmarking. It allows identifying gaps and areas for improvement. This is still a quite under-developed practice in many Asian economies and remains a difficult exercise. But ownership entities should strive to benchmark SOE performance with appropriate peers, domestic or foreign.

98. Ownership entities should also carry out in-depth annual performance reviews, assessing results against key performance indicators. This performance review would include an in-depth discussion between the SOE board and the ownership entities. Specific mechanisms could be developed to support the ownership entity in this demanding exercise, but special care should be given to avoid burdening SOEs with excessive information requirements in this regard. The result of annual reviews could be disclosed in a summarized form by the ownership entity.

Recommendation V.7: Publish aggregate reports on state ownership

99. Very few countries in Asia have developed aggregate reports on state ownership, and the existing ones tend to be lengthy reports, the main purpose of which is to inform Parliaments within the framework of the budget process. However, a number of countries are trying to develop such reports or to simplify their existing reports to the Parliaments.

100. Aggregate reports should provide an overall picture of the performance of SOEs and the evolution of the state sector, and inform the general public on how the state exercises its ownership function. One main interest in developing such aggregate reports for the ownership entities lies also in the process itself. It helps in clarifying policies, internally to the ownership entity, with the SOEs and with other government departments concerned, and helps build consensus on sensitive issues. It also helps in improving the reporting system and in making the information from various SOEs consistent.

101. Publishing aggregate reports on state ownership would be instrumental in the Asian context to raise awareness of the media and the general public about the importance of the state sector and the performance of SOEs. It would thus help the ownership entity in communicating about its activities and, more importantly, in pushing for reforms.

CHAPTER VI: THE RESPONSIBILITIES OF BOARDS OF SOES

102. The overall objective of reform efforts regarding SOE boards should be to avoid having boards “randomly selected, never evaluated and rarely accountable”. In other words, the processes and mechanisms put in place should promote the appointment of competent boards, make them duly accountable for the SOE performance, and evaluate them appropriately to ensure that they effectively perform their functions.

Recommendation VI.1: Clarify and reinforce SOE board mandates and functions.

103. 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, or weakened by the role and authority of state audits, for example in the case when state auditors have extensive power to sanction strategic decisions ex post.

104. Government should entrust SOE boards with their full responsibilities and make sure they have the legitimacy and authority to monitor management. To do so, in some countries, it might be necessary to clarify and reinforce their fiduciary duties. SOE boards should have the same responsibilities, and thus liabilities, as those in the private sector. It might also be necessary to clarify the respective personal and state liability in cases where state officials are appointed on SOE boards.

105. To increase SOE boards’ capacity to monitor management, it is firstly required that the Chairman of the board is separating from the CEO and that the board is entrusted with the responsibility to hire and fire the CEO.

106. It is also necessary to increase the number of independent directors and to set up specialised committees composed of a majority of independent directors. Such specialised committees support the full boards in performing their functions, particularly in respect to audit, risk management, remuneration and corporate governance (as recommended in Guideline VI.E.).¹⁰⁷ The role of state auditors *vis-à-vis* SOE should also be clearly defined. It should not lead to depriving SOE boards of some of their functions or authority.

Recommendation VI.2: Ensure that SOE boards are actively engaged in shaping the strategy.

108. One of the key functions of SOE boards which is often not fully fulfilled is to provide strategic guidance to the management. As SOE boards receive from the ownership entity strategic orientations and overall objectives, they often consider that their role in defining the strategy is reduced. However, this should not make SOEs different from private sector companies which also receive strategic orientation from their significant owners.

109. To ensure that SOE boards do fulfill their role in terms of strategic guidance, at least one meeting of the board should be devoted to strategic issues every year. An even better option to ensure that the board is actively engaged in shaping the strategy is for every board meeting to include a strategic item on its agenda.

Recommendation VI.3: Require SOE boards to have nomination committees

110. A key element to improve the quality of boards and to protect them from undue political interference is to put in place a well-structured and transparent nomination process, based on competencies and experience (as described above in recommendation II.5).

111. Boards themselves could be involved in proposing names for new directors. There should be informal dialogue on this issue between the boards and the ownership entities. This could be facilitated by setting up nomination committees within SOE boards. These committees would work with the ownership entities to define specific profiles required for new board members, propose candidates to include in a short list, as well as participate in the interviews. It would be instrumental in improving the composition of SOE boards by including more experts with business experience.

Recommendation VI.4: Enhance SOE boards' role in talent management and in setting remuneration.

112. Attracting the relevant talents is a key success factor to improve SOE performance. Talent management is thus crucial and SOE boards should ensure that this is done proactively. Boards should review and discuss the human resources policy at least once a year.

113. One important condition to attract talents is to be able to offer competitive remuneration. The possibility for SOE boards to define the remuneration of SOE management and to de-link it from the civil service pay scale is thus critical. Setting up a remuneration committee should be seriously considered, if not mandatory. These committees should benchmark management compensation against competition and make sure that management remuneration is appropriately linked to performance.

Recommendation VI.5: Increase competencies in SOE boards

114. SOE boards are crucial in ensuring that SOEs will be properly governed and held accountable. Boards need first and foremost to comprise an appropriate mix of competencies to be able to fulfil their responsibilities. Appointing appropriate and competent directors is a prerequisite to ensuring appropriate governance.

115. Many SOE boards in Asia 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 but a key improvement would be to decrease progressively but significantly the number of government nominees on SOE boards. In choosing such nominees, the government should also look in priority for competency. 116. Another face of the same coin is to increase systematically the number of directors with experience from the private sector. Such directors could also come from abroad whenever the domestic pool of experienced and competent directors is too limited.

117. The ownership entities could also require SOE board members to pass a “fit and proper” test, especially in the banking and financial sector.

118. To support boards in fulfilling their duties, it is also necessary to allow them access to independent expert opinion and set aside specific budget for this.

119. The priority in order to improve SOE boards' competencies remains for the ownership entities to put in place a structured nomination process, as recommended above in recommendation II.5.

In addition to being competent, SOE boards should also include a sufficient number of independent non-executive directors, i.e. directors having the capacity and character to think and act independently, free of conflicts of interests and not receiving directions regarding issues to be decided by the board.

Recommendation VI.6: Provide proper training for SOE board members, including induction training

120. To improve SOE boards' competencies and practices, it is necessary to develop training for board members, including induction training. This requires that SOE boards have adequate resources.

121. It could be IODs have a critical role in offering adequate and specific training to SOE boards. Such training should cover their roles and responsibilities, as well as specific training on relevant technical aspects, related for example to financial and non-financial disclosure.

Recommendation VI.7: Develop performance evaluation for SOE boards

122. 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. Enhancing SOE boards' quality and professionalism requires putting in place a systematic evaluation process. Annual evaluation of boards is recommended in the OECD Guideline VI.F. Such evaluation processes encourage board members to devote time and energy in exercising their functions. They are a tool for improvement. They also help in reviewing board size and composition, thus in identifying necessary competencies and required new board profiles.

123. The practice of evaluating board members is for the time being still quite under developed in most Asian economies. Board evaluations tend to be not effective as people are culturally inclined not to say things too negative. It is the case even in the private sector, and individual evaluations are just beginning to develop.

124. Evaluation should first focus on the overall board performance. Evaluation of whole boards is less sensitive and can address some of the main weaknesses of the SOE boards in Asia. However, the assessment should not be a "conformance" evaluation, but be carried out against key objectives and compliance with accountability, including reporting requirements.

125. The conduct of evaluation might vary a lot. It should always include a self-assessment process. It could for example be carried out mainly by the Chair on the basis of a tailored made questionnaire. Such questionnaire should cover, *inter alia*, the quality of communication with management, the internal interaction among board members and the working climate (absence of rivalry, quality of dialogue) , the organisation and structure of board meetings, the coverage of all expertise areas, the quality of induction and training, etc.

126. The use of an external and independent evaluator might also be instrumental in helping the board to reflect on its own functioning and practices. However, the use of an outside expert might create trust issues.

127. Evaluation could also progressively cover the contribution of individual board member, without damaging the desired and necessary collegiality of board work. Individual evaluation could be based both on self-evaluations and peer evaluations, which must remain strictly confidential. It is important for evaluations to be objective, not personalised. These evaluations should cover attendance, quality of contribution, team spirit, good judgment and commitment. It should also cover knowledge of the company's operations, understanding of the sector, as well as personal contacts. The Chairs should have informal discussions with individual board members in order to voice criticisms. These discussions must be handled with subtlety.

128. The Chairman's evaluation is particularly sensitive, while the effectiveness of the Chairman is critical for the board's overall effectiveness. Such evaluation should cover the Chair's leadership, strategic planning, external communications, relations with the board, etc.

129. Each board should reflect and establish its own evaluation system. Alternatively, the ownership entities could also develop specific guidance regarding board evaluation. It could for example develop questionnaires for collective, individual and Chairman evaluations.

130. Whatever the form of the evaluation, the final result should identify areas of strengths and weaknesses, and set up goals for improvements. It is also important that its results are acted upon, either by modifying the functioning of the board or when discussing the appointment of new directors. Evaluation could be useful for the internal dynamic of the board if done properly and with the right guidance. Otherwise there is a risk of creating tensions, opening the Pandora box for nothing.