OWNERSHIP OVERSIGHT AND BOARD PRACTICES FOR LATIN AMERICAN STATE-OWNED ENTERPRISES

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Introduction

1. This report has been prepared for the 2012 meeting of the Latin American Network on Corporate Governance of State-Owned Enterprises to review current arrangements and trends in SOE ownership oversight and the nomination, training and evaluation of boards of directors in Argentina, Brazil, Chile, Colombia, Ecuador, Mexico and Peru. Information and data were collected from an OECD questionnaire completed by representatives of participating countries, various academic papers published by regional experts and presentations made by Network participants at the 2011 Network meeting in Bogota, Colombia. The OECD questionnaire was circulated in order to provide an overall context for discussions of the Network Meeting. Country practices are compared to the *OECD Guidelines on Corporate Governance of State-Owned Enterprises*, an international benchmark which facilitates assessment of SOE corporate governance policies and practices. The Guidelines are a set of non-binding best practices which take the unique perspective of the State as owner, with the goal of creating a framework of experience from which to learn and compare strategies for effective governance of state-owned companies. This paper is divided into two parts which provide complementary analysis of two important areas of corporate governance to be considered at the Network's 2012 meeting in Lima: ownership oversight and board practices.

Main Findings:

Ownership Oversight Structures: Two Latin American countries, Chile and Peru, use ownership models that are closely aligned with the OECD definition of a "centralised model." Brazil and Ecuador also feature strong co-ordination mechanisms, fitting more closely with a dual model involving both sectoral ministry representation on the board of directors and shared central co-ordination. Argentina, Colombia and Mexico have developed SOE ownership strategies aligned with the OECD's definition of a "decentralised model," with somewhat more limited central co-ordination and sectoral ministries playing a strong role.

Board Practices: Unlike the three ownership models summarized by the OECD, there is no simple classification for types of strategies for nominating, training and guiding Boards of Directors of SOEs. Board practices are quite variable throughout Latin America. Compared to ownership models, consideration of international standards for board practices are relatively new to the region, and therefore subject to less and more recent regulation. Countries with a coordinating entity responsible for SOE oversight (Brazil, Chile, Ecuador and Peru) tend to have more formalized and coherent policies for board nomination and guidance. In these cases, policies apply to the companies or board nominees who fall under the jurisdiction of the coordinating entity.

PART 1: OWNERSHIP OVERSIGHT STRUCTURES

2. State-owned enterprises have an important role in the economy, both in Latin America and elsewhere, especially in strategic sectors such as energy, utilities, mining and infrastructure. Still, they are prone to certain governance challenges. The *OECD Guidelines* highlight some of the main challenges affecting SOEs: limited autonomy due to political interference; SOEs are often protected from two major threats, takeover and bankruptcy, diluting accountability and undermining SOE financial discipline as losses may be absorbed by the state. Accountability can be further diluted by the complex chain of government ownership which can be exercised through many different governmental entities with differing priorities, such as Parliamentary review committees, the President's office, Ministry of Finance, sectoral ministries and state audit agencies. Apart from a small number of majority-state-owned enterprises listed on national stock markets, most SOEs also lack the scrutiny of capital markets and shareholders, which may reduce pressures for financial discipline and efficiency. Another important challenge is maintaining a level playing field between private sector companies and SOEs and ensuring that governments do not distort competition by using their regulatory or supervisory powers.

3. The *OECD Guidelines* offer an international benchmark to help governments overcome these challenges. The Guidelines suggest that the state's ownership rights should be clearly identified, and that this may be facilitated by setting up a co-ordinating entity, or more appropriately, by the centralisation of the ownership function. While the OECD has noted a trend among its members to move towards more centralised ownership models, it also accepts that there is no particular ownership structure that fits the needs of all countries. Differing political and economic contexts make it necessary for every country to adapt its SOE ownership model to meet its specific needs.

Three Ownership Models:

4. The OECD Survey of Corporate Governance of SOEs characterized governments as having three main types of ownership models for SOEs: the decentralized or sector model, the dual model and the centralized model.

5. In the **dual model** responsibility is shared between the sector Ministry and a "central" ministry or entity (usually the Finance Ministry or Treasury). The dual model in most cases resulted from the growing power of the Ministry of Finance (Vagliasindi, World Bank). It is potentially advantageous in that the government's two roles of owner and regulator are divided into two constituencies, which are likely to subject corporate policy to more rigorous checks and balances than would a single ministry. A variation of this model found in a number of Latin American countries provides for shared co-ordination between the the Ministry of Finance and other centralized entities on the one hand, and the relevant sectoral ministry on the other (e.g. Brazil and Ecuador). This type of shared ownership model also facilitates simultaneous technical and fiscal oversight. Still, disadvantages exist in the potential blurring of responsibilities between ministries, and the potential of the SOE to view this as double (or triple) oversight, which may infringe on management and operational productivity.

6. The **centralized model** has been highlighted as a way to streamline oversight and transparency in SOE governance. The centralized model in many cases resulted from a trend towards privatization. Advantages include a clear line of accountability from the SOE to the government, close fiscal supervision, the ability to form coherent SOE policy, and efficient allocation of limited human resources among civil servants. Peru and Chile are the leading examples of this approach among Latin American countries. One challenge associated with this oversight model is to ensure sufficient sectoral expertise that would normally come from a sectoral ministry.

7. In the **decentralized or sector model,** the traditional model for SOE governance, SOE oversight is dispersed among a large number of ministries with only limited co-ordination at the center. This option has the advantage of allowing the most sector expertise, as SOEs are usually assigned to oversight by a ministry based on its sector of operation, allowing for specialization in ownership strategies. While this is the most common ownership oversight model in Latin America, a number of countries have taken steps within such a model to strengthen their co-ordinating capacities. The main responsibilities for oversight, including rights to appoint board members, may rest with the sectoral ministry, but a co-ordinating entity may play a role in advising on overall government ownership policies and corporate governance measures. Challenges associated with a decentralized system include the less clear separation of the ownership from the regulatory role when regulation is handled by the same ministry that exercises the ownership function, and the potentially higher risk of government interference in everyday operations. It also complicates the goal of transparent and consistent aggregate reporting, as recommended in OECD Guideline 5.

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Country Reports:

Aggregate SOE data

- **Argentina** has 112 SOEs, 40 of which are commercial;
  only 23 are fully owned and 17 are listed.
- **Brazil** has 147 SOEs, of which 119 are commercial, 8 listed and 38 fully owned;
  SOE revenues make up 5.65% of GDP and 0.7% of employment.
- In **Chile**, all 33 SOEs are commercial companies and the majority, 30 of 33, are non-listed and fully owned by the government. The remaining 3 are majority owned. SOEs account for 13% of GDP and 0.7% of employment. 10 SOEs are considered large and belong to the following sectors: service/retail, transportation, media, mining, oil and gas and banking.
- **Colombia** has 105 SOEs, all classified as commercially-oriented. Three of these are listed. These SOEs' total assets represent a 16.7% share of GDP and 0.12% of total employment. The state has a minority ownership interest in 36 of these SOEs, 51 are majority-owned by the state, and 18 are 100 per cent state-owned, with the most represented sectors being energy (20 SOEs), information technology and communications (8), agriculture and development (7) and social protection (7).
- **Ecuador** has 24 SOEs, 21 of which are fully owned and none are listed on the stock exchange. SOEs make up 29% of total GDP and 1% of total employment.
- 90 of **Mexico**'s 110 SOEs are commercial and none of them are listed on a stock exchange. Pemex, the largest SOE, represents 8.77% of Mexico's GDP with annual revenue of $119,879 million USD.
- **Peru's** ownership entity, FONAFE, oversees 31 SOEs, nine of which are listed on the Lima Stock Exchange. Revenues from these SOEs account for 2.99% of GDP, and 0.15% of total employment. The Ministry of Economy and Finance has responsibility for one national SOE, Perupetro, and more than 100 municipal water, sanitation and savings banks.

8. Each country in Latin America has developed its own method of overseeing its state-owned enterprises. A country's chosen model is often tied to historical context, like trends of privatization or financial crises, and based on each country's specific experience. The OECD has created a broad set of guidelines designed to help facilitate good governance regardless of a country's chosen model. In order to understand and apply these guidelines to current practices, it is important to have a working knowledge of

the ownership structures that are currently in place throughout the region. This section of this report provides a summary of the ownership strategies currently used in Argentina, Brazil, Chile, Colombia, Ecuador, Mexico and Peru. It is heavily based on responses from the OECD questionnaire and presentations made at the 2011 Network Meeting.

9. Chile and Peru use centralised ownership models. Most SOEs in these two countries are overseen by a singular agency— SEP in Chile and FONAFE in Peru. Below is a detailed description of both ownership models.

Chile

10. Most SOEs in Chile fall under the supervision of the Public Enterprise System (SEP), which is the main ownership entity of the government responsible for overseeing SOE governance. Still, SEP exercises this role for only 22 of the country's 33 SOEs. Two of Chile's most important SOEs fall outside of SEP jurisdiction—Codelco, the world's largest copper producer, and ENAP, an oil exploration company. The 11 exceptions have their own supervisory structures but are still responsible to a separate government agency: Codelco, ENAP and ENAMI to the Ministry of Energy and Mining, TVN to the Ministry of the Secretary-General of Government, Corfo and Banco del Estado to the Ministry of Treasury, and the 3 defence SOEs to the Ministry of Defence. All 33 SOEs are accountable to Congress, the President and the General Comptroller Office. In accordance with OECD Guideline 5C, all SOEs (whether under SEPs authority or not) are subject to an external independent audit with resulting information made publicly available. Each SOE under SEP must have an internal audit committee, as recommended in OECD Guideline 5B. A draft law has been prepared to increase the number of SOEs under the control of SEP and to remove ministers from the boards of the only two remaining SOEs where Ministers are allowed to serve on Boards (Chile questionnaire response).

11. Although they are not subject to SEP corporate governance standards, a few of the companies outside of SEP have also been the subject of legislative reforms. Codelco's reforms, based upon a 2009 law, removed all ministers from its board of directors and made several other improvements to its board nomination process and practices, which will be addressed in the second part of this paper. Jorge Bande, a Codelco independent board member, emphasises that Codelco is a state-owned rather than "government-owned" corporation, which helps to insulate the company from the possible volatility of the political cycle (Bande 2011). Codelco's reform created a new code of corporate governance and code of ethics, a renewal process for senior management, defined a long-term development plan and aligned executive salaries with market practices. The legislation also included corporate restructuring and improvement on the issues of security and environmental and social responsibility (CAF White Paper 2012). Such issues have also been prioritised by Chile's ownership entity, SEP, in their recently published Code of Conduct Guide and People Management Guide.

12. SEP issued its People Management Guide in 2012 to highlight how the state develops its employment relationships and practices and provide SOEs with a long-term vision for these issues. This guide is part of a recent trend to utilise "soft techniques" to achieve "hard results" such as profitability and client satisfaction (SEP 2012). Key considerations include workplace climate, the role of management, maintaining key indicators for employee assessment and tools for management. A main priority is ensuring external competitiveness, or private sector comparability. SEP's Code of Conduct Guide establishes a set of rules for all SOE employees and stakeholders. It is a document meant to promote ethical behaviour and demonstrate management's commitment to integrity and effective communication. This involves periodic employee training and establishing clear company objectives, as recommended in the OECD Guidelines. Key considerations include the board's role as the driver of the company, fraud prevention, a sanctions and sanctions complaints channel, ethical principles, handling strategic and/or insider information, conflicts of

interest and the appropriate use of goods and relationships between stakeholders (SEP 2012). SEP invites its SOEs to focus on such issues so that they may be role models for the rest of the country.

13. The SEP council has 9 members: 3 appointed by the President, 2 appointed by the Ministry of Treasury, 1 appointed by the Ministry of Economy and 3 appointed by the Vice President. The goal of SEP is to represent the state's interests as owner and add a collective vision to SOE oversight beyond the individual vision of each specific SOE (Caneo 2011). SEP centralises the monitoring, ownership guidance and reporting duties of SOEs. Advantages of this centralized model come from the ability to use a pool of past experience to improve management styles and benefit from economies of scale (for example, in the case of the 10 harbour companies under SEP). SEP promotes transparency by appointing external auditors and requiring the disclosure of financial and regulatory information on company websites (Caneo 2011).

14. The creation of SEP has brought several measures to ensure the separation of owner and regulator within SOE governance. In accordance with OECD Guideline 2A, the Chilean government has developed a written **ownership policy** regarding all SOEs under SEP, outlining its role and objectives in SOE governance.

15. Like Chile, **Peru** provides another example of a centralized ownership model. FONAFE (National Funding for the Financing of the Peruvian State's Business Activities) was established in 1999 as a centralized entity to oversee Peru's SOEs. It currently has responsibility for 31 SOEs. Before its creation, Peru's SOEs suffered from high volatility in size and structure with each change in government (Gonzales 2011). FONAFE's main functions are to exercise ownership rights of the state, approve the consolidated budget and management procedures, and appoint its representatives to the Annual General Shareholders Meeting, for the companies in which it is a majority shareholder. FONAFE's mission is to align its own interests with those of the SOEs and the state, and to present them in a homogenous way to facilitate transparency. Peruvian authorities consider that a centralized ownership model can streamline oversight and transparency and minimize meddling in SOEs day-to-day operations.

16. Peru has sought to address the standard disadvantage of a centralized model, the lack of individual sector expertise, through specialization—FONAFE has incorporated representatives of five Ministries on its Board of Directors: the Minister of Economy and Finance Chairs the FONAFE Board which also includes the Ministers of Energy and Mines, Housing, Construction and Sanitation, Transportation and Communication, and the President of the Minister's Council. Ministerial participation in the board and the support of their staff's input between meetings allows for a more comprehensive management of state property supported by sectoral specialization. FONAFE is working on further improvements, including a framework for the appointment of independent directors and increased use of private capital to benefit from market discipline. Other challenges include balancing the needs of many different companies and the expectations of their various stakeholders.

17. Still, FONAFE benefits from a strategic role as a coordinated entity. It maintains the ability to establish corporate governance best practices as minimum requirements for the SOEs under its control. Policies are clearly defined and allow for streamlined regulation and enforcement. Specifically, FONAFE has implemented framework guidelines through the "Guidelines for the performance of the State as owner and the Framework Code of Corporate Governance" (CAF White Paper 2012).

18. Like Chile and Peru, **Brazil** also has a government entity specifically responsible for SOE ownership -- the Department of Co-ordination and Corporate Governance of State Enterprises (DEST) within the Ministry of Planning, Budget and Management. However, Brazil differs from the before mentioned countries because SOEs are also overseen by two additional ministries: the Ministry of Finance and a sectoral Ministry. Below is a description of Brazil's ownership model.

19. In **Brazil**, the state ownership function of SOEs comes from three different sources: DEST (Ministry of Planning, Budget and Management), the Ministry of Finance and the sector Ministry in which the SOE is involved. Though Brazil's ownership structure is certainly decentralised, it comes closest to fitting the dual model, with the addition of a specific coordinating ministry as well—DEST. Due to the specific rules of the accounting system, particularly those aimed at federal banks and financial institutions, SOEs are categorized into two separate groups.

20. The state productive sector (SPE) includes federal enterprises producing goods and services such as basic inputs, distribution and transportation. The second category includes federal financial institutions (mostly banks) whose activities are governed under a different law. Investment in SOEs is nearly half of the total fiscal budget. Revenue from Banco de Brazil and Caixa Economica Federal alone make the financial sector the country's most profitable sector for government-owned companies. SOEs are given the status of a legal entity, as well as administrative, budgetary and financial autonomy so that they may fulfil their social function and corporate purpose (Barella 2011). Companies with more financial independence receive more autonomy. Still, this autonomy does not prohibit state control. SOEs are ruled by the same laws as private sector companies under the Brazilian Law of Corporations; state-owned publicly listed banks are also subject to the laws of the Central Bank, the Securities and Exchange Commission of Brazil (CMV) and BOVESPA. As entities with their own legal identity, SOEs are a category of **indirect administration;** activities are developed in a **decentralized** way and companies are generally linked to a corresponding sector Ministry (Higa). For example, Petrobras and Electrobras are linked to the Ministry of Mining and Energy.

21. For the exercise of ownership responsibilities, **DEST** is responsible for establishing corporate governance guidelines, approving the allocation of income, fixing board member remuneration, appointing one board member and approving bylaws and capital increases. The Ministry of Finance approves financial statements, appoints one Fiscal Council member (who carries out responsibilities similar to an audit committee), represents the State at shareholder meetings and authorizes issues of debt and securities. And finally, the sector Ministry appoints the majority of non-executive board members and sets out the strategy of the board of directors and for investment (Barella 2011).

22. The Interministerial Corporate Governance and Federal Government Management of Participation Commission **(CGPAR)** provides an additional co-ordination mechanism to decide and control the execution of proposed guidelines for managing SOEs. Members include the Minister of DEST, the Minister of Finance, Chief of the Presidential Staff Office, and other ministers of state. CGPAR has many guidelines related to corporate governance, including separating the chair from the CEO, and activities regarding the internal audit procedure (Barella 2011). OECD Guideline 1A advises that "there should be a clear separation between the state's ownership function and other state functions that may influence the conditions for state-owned enterprises, particularly with regard to market regulation." To address this issue, Brazil has established independent government agencies to regulate some sectors of the market.

23. The main source of aggregated information on Brazil's SOE sector is IBGE, a government institution that provides economic data. The last available Public Finance study was published in 2003. Other than this, most federal SOE data comes from DEST. The main SOEs in Brazil are federal, such as Petrobras, Electrobras, BNDES (Brazilian Development Bank), Caixa Economica Federal and Banco de Brazil. In fact, federal SOEs accounted for 90% of total SOE revenue in 2005. Banco de Brazil and Caixa Economica Federal are ranked in the top five Brazilian banks by total assets and are responsible for a third of the assets. The financial sector accounts for nearly 40% of total SOE employment, representing the most important source of SOE human capital. The communications sector is the second most important for employment and third is the Oil and Derivatives sector, with 13.5% of federal SOE employment (with Petrobras as the most important company) (Higa).

24. **Ecuador** has a unique tripartite structure of ownership oversight with a strong co-ordinating role played by the National Secretary for Planning and Development (SENPLADES). SENPLADES appoints one board member to each SOE and is responsible for issuing the government's national development plan, "Plan Nacional del Buen Vivir" which serves as a basis for the government's overall ownership objectives along with the Constitution. The President of the Republic also has the right to appoint one board member, and the responsible sectoral ministry appoints the third board member. All but four of Ecuador's 24 SOEs have 3 board members. Four SOEs under the responsibility of the Ministry of Defense are an exception with five board members, and SOE subsidiaries may have up to seven members.

25. **Argentina** uses a "decentralized corporate" SOE administration. Corporate governance is achieved through an audit committee (AGN), monitoring committee and the General Trustee of the Nation (SIGEN). All three sources fall under the executive branch but form separate entities that all SOEs must answer to. Internal and SOE performance control is exercised by SIGEN, reporting to the President, while external control is exercised by AGN, reporting to the Parliament.

26. Companies that are wholly or majority-owned by the state (about half of all companies with government involvement) operate under a decentralized structure and are controlled by corresponding ministries. The Ministry of Federal Planning, Public Investment and Services is responsible for oversight of the highest number of SOEs (11), followed by the Interior and Transportation Ministry (9) and the Ministry of Economy and Public Finances (6). The government does not have a written ownership policy for SOEs. According to Argentina's questionnaire response, the most pressing corporate governance challenges facing SOEs in Argentina are mandating a director nomination process, defining common criteria for reporting financial statements and audit reports, and avoiding interference with the day-to-day operation of SOEs (in particular non-commercial SOEs which often have more corporate governance obstacles).

27. An additional corporate governance issue in Argentina relates to the role and exercise of state ownership rights through the national pension fund, ANSES, in listed Argentinian companies. According to June, 2012 data received from ANSES, ANSES has positions ranging from 0.14 per cent to 30 per cent in 44 of Argentina's 50 largest listed companies. Such companies are not considered to be state-owned enterprises but nevertheless ANSES, as a state-owned pension fund, has minority share ownership in some cases large enough to appoint board members to some of these companies. The Latin American Corporate Governance Roundtable's Related Party Transactions Task Force has reviewed this situation and noted the potential concern within the market related to the risk of abuse of related party transactions between the state and private companies, making it important to establish clear policies for transparent reporting and approval processes for such transactions.

28. **Colombia.** State-owned enterprises are split into two categories in Colombia: those that are 100% state-owned (Empresas Industriales y Comerciales del Estado) and those that have both public and private capital (Sociedades de Economia Mixta). Empresas Industriales y Comerciales del Estado are involved in commercial business under private law but has some intrinsic incompatibility or conflict of interest with the private sector, which is why the state has chosen a 100% ownership policy (technically SOEs with state-ownership greater than 90% also fit in this category). These SOEs maintain financial and administrative autonomy. Sociedades de Economia Mixta have both state ownership and private capital (Guillermo 2011).

29. While the Ministry of Finance and Public Credit (MFPC) plays an important role in the ownership oversight of Colombian SOEs, particularly in relation to budgetary oversight, Colombia essentially functions under a decentralized ownership model that divides ownership responsibilities across the government, involving also CONFIS (Consejo Superior de Politica Fiscal) and corresponding sectoral ministries. The Ministry of Finance and Public Credit oversees SOEs in the financial sector and electricity

SOEs that are owned by the Ministry of Mines and Energy, as well as other public services. It is also responsible for monitoring the financial position of companies to mitigate financial risks. CONFIS sets out policies regarding dividends, debt and equity structuring, and defines investment plans. The Defense Ministry also has a significant number of SOEs under its authority, while other sectoral ministries maintain ownership responsibilities for SOEs within their sectors. Another government agency, La Superintendencia de Sociedades, is responsible for the supervision of Sociedades de Economia Mixta. One challenge emerging from Colombia's SOE structure is the tendency to manage SOEs on budgetary grounds as opposed to strategic grounds; this issue is likely exacerbated by the strong role that the Ministry of Finance plays in SOE oversight (Mac Master 2011). Another challenge cited in Colombia's questionnaire response is the impact of political influence on SOEs.

30. Commercial and industrial SOEs competing on the market are regulated by law 489 of 1998 which stipulates their functioning and organization, including that these companies must follow the same requirements as private companies with no advantages. Listed SOEs with mixed ownership must follow the same requirements as other publicly listed companies to address minority shareholders rights. However, as explained above, not all SOEs are grouped under the same legal form. Some sectors are subject to special laws, although more specific information was not immediately available. Consultation with stakeholders is mandatory only for public utility companies (Guillermo 2011).

31. In **Mexico's** decentralized ownership model, each SOE is overseen by the ministry corresponding to its sector of operation. For example, development banks are supervised by the Ministry of Finance. These ministries are responsible for dictating company policies and the minister serves as chairman of the board. Each ministry is accountable to the President and to Parliament. The SFP (Ministry of Public Function) and the ASF (Congress Federal Audit Office) supervise all state-owned companies regarding audit and control functions. The SFP represents the Presidency while the ASF is situated within the Legislative branch. While SOEs with minority private ownership are operated similarly to private firms, SOEs fully owned by the government are different in that their revenue can be complemented by state subsidies.

32. OECD Guideline 1A recommends a clear separation between the state's ownership function and other state functions, especially with regard to market regulation. Mexico has reported that for its largest SOEs within the energy sector, two autonomous regulatory organizations were created to provide technical opinions to the Ministry in charge of regulating this sector. This is a movement towards transparency and it may be helpful to track the progress of these organizations. Mexico does not report the use of an ownership policy. Rather, each new government issues a National Development Plan which states the priorities of the administration for its 6 year term, which indirectly defines the role and objectives of SOEs as executors of public policy.

33. As far as improving corporate governance practices, Mexico has prioritized Pemex as a target SOE due to its size and economic importance. In 2008 legal reforms were enacted to include independent directors, proposed by the President and approved by the Senate. This has increased firm oversight. However, according to Mexico's questionnaire response, it is common belief that the board is subject to bureaucratic decision-making which often interferes with management of the company, and that Pemex's board has been accused of trying to micromanage the firm.

Classification of SOEs

34. The market structure and regulatory framework under which an SOE operates is paramount to corporate governance strategies. For example, SOEs may be classified according to the degree or type of

market competition that exists within its particular sector. It is also helpful to distinguish among SOEs by their individual objectives. SOEs generally have public policy goals, which may range from producing services for the public to generating revenue for the state, and often includes both. OECD guideline II.A "The State Acting as an Owner" states that the government should issue an ownership policy that defines the overall objectives of state ownership of SOEs and the state's role in SOE governance. Governments must communicate their objectives to stakeholders and to the public. Because these objectives are not always clear, it may be helpful to use specific economic, social and political indicators to better clarify the role of each SOE. CAF has set out possible considerations for classifying SOEs. These indicators include:

- SOEs created for the purpose of achieving public policy objectives;
- SOEs responsible for producing public utilities or services like water, electricity and gas;
- SOEs which provide exclusively goods or services required by the State, such as military suppliers;
- SOEs responsible to produce revenue for the state and compete competitively with private sector standards (profit maximizing);

35. An SOE classification may help to determine how an SOE's governance may be structured to best serve the State's objective (CAF White Paper 2012). Of course, SOEs may fall into multiple categories. Bruce Mac Master, formerly Vice minister of Finance and Public Credit in Colombia (and now Director of Colombia's Department of Social Property), identifies four reasons for SOEs to exist: to provide services to the public, to increase fiscal income, to carry out public policy objectives and for the provision of services to the state (Mac Master 2011). A company may be state-owned for any of these motivations, though they often overlap. Understanding the motivation for state-ownership is important to ensure clear disclosure of SOE objectives. Often, the most appropriate and efficient ownership structure for an SOE will depend on the type of service it performs.

Norway's SOE classification system

36. Some countries have created their own SOE categorisations based on ownership objectives. Norway has a useful classification of SOE ownership objectives based on each SOE's orientation. This is an efficient way to clarify objectives in a transparent manner. The Norwegian government has stated a commitment to clarify SOE objectives because they serve as the basis for active, value-creating ownership. Norway has divided its ownership into two main categories: companies with commercial objectives (further sub-divided into 3 categories) and companies with sector policy objectives. Commercially oriented SOEs include, firstly, companies with commercial objectives that are not strictly a Norwegian SOE, but along with the governments of Denmark and Sweden the state holds a dominant influence in the company (SAS AB airline); secondly, companies with commercial objectives that must maintain headquarters in Norway (Telenor ASA telecommunications); and thirdly, companies with commercial objectives as well as other specific objectives (Posten Norge AS postal service).

37. **Mexico** also uses a classification system to differentiate among state-owned enterprises. For-profit SOEs are categorized into three groups: non-equity, majority-owned and public trust funds. Non-equity SOEs, like Pemex, are governed by Boards and focus on developing priority sectors and public services. Majority-owned SOEs, like development banks, are governed by Boards that observe minority rights and focus on facilitating market development. Public Trust Funds, like infrastructure funds, are governed by technical committees and focus on procedures to disburse credit or non-refundable grants. Because ownership and regulation of SOEs is not centralized, there is an established "pecking order" to determine which laws are first applicable. The corporate governance framework is complex, but most

aspects are covered by the following mix of regulation: an SOE will first be subject to its own individual regulatory framework; next the public administration and SOE general laws; and finally Commercial Company Laws (Dario Luna 2011). These detailed classification systems show that preferred ownership oversight arrangements may vary based on an SOE's classification. In particular, certain types of SOEs may be subject to differing legislation based on which classification they fall into. In addition to sectoral classifications, SOEs can also be distinguished based on levels of private sector or market involvement.

38. Peru has divided its SOEs into commercial and non-commercial enterprises, but notes that SOEs in both of these categories are involved in commercially-oriented production of goods and services and does not imply different standards or requirements for the SOEs in different categories. FONAFE is currently considering moving to a sectoral-based classification system that would divide SOEs based on their particular undertakings, such as power, financial, hydrocarbons and remediation, sanitation, infrastructure and transportation; and others.

Listed SOEs

39. State-owned enterprises in Latin America are generally not listed on a stock exchange. Rather, SOEs are usually 100% government-owned. Brazil and Colombia are the two most visible exceptions because of the large SOEs listed on their national stock markets. In Brazil, SOEs currently account for 24.8% of total market capitalization on Brazil's stock exchange, BM&F BOVESPA; Petrobras alone makes up 16.6% while Petrobras along with Banco de Brazil and Electrobras make up 21.2%. Of the 25 SOEs listed on BM&F BOVESPA, 17 are controlled by states and 8 by the federal government (Higa). Still, since the 90's, privatisation has diminished the importance of SOEs on BM&F BOVESPA's performance. Although only 8 of Brazil's 147 federal SOEs are listed on the stock exchange, these 8 companies make up nearly 15% of market capitalization. These strategic SOEs include Electrobras and 3 state banks: Banco de Amazonia S.A. (BASA), Banco de Brazil S.A. (BB), Banco de Nordeste de Brazil S.A. (BNB) and the Brazilian Development Bank (BNDES). These facts are provided by DEST and follow the Brazilian government's official definition of state-owned enterprises which only includes companies with 50% or greater state ownership. Similarly, although only 3 of Colombia's 105 SOEs are listed, these three companies (Ecopetrol, ISAGEN and ISA) constitute 52% of national market capitalization and 70% of the total value of SOEs (Colombia OECD questionnaire response). A substantial 19 of Argentina's 112 SOEs are listed, and Peru has 9 of FONAFE's 31 SOEs listed on the Lima Stock Exchange, though in most cases the state has maintained 100 per cent of the shares. Finally, Chile also has three listed SOEs, while Ecuador and Mexico have so far chosen not to list any SOEs.

40. Recommending a preferred ownership structure for listed SOEs is not the purpose of this paper. Still, it is important to provide a general understanding of this group of SOEs, as it often includes companies of major importance to the national economy. Richard Frederick, OECD consultant, has prepared a separate paper on the role of the state in the markets and experience with corporate governance of listed SOEs, as background for Session 5 of the 2012 Network Meeting.

Regional Trends

41. Within the context of individual country ownership structures, it is relevant to examine regional trends that have affected governments throughout Latin America.

42. Such trends can be influenced by the sectors in which SOEs operate. SOEs are prevalent in utilities and infrastructure industries, such as energy, transport and telecommunications, where performance is important to much of the population, and other parts of the business sector, like banking

and financial institutions. Each sector has particular needs which may entail a modified ownership structure or policy.

43. A study done by the Inter-American Development Bank (IDB) investigates the role of government intervention in the form of state ownership in banking. In developing countries, banking regulations and depository insurance systems may be newer or less advanced. Therefore, the study concludes that direct state-ownership of banks may be justified in developing countries as a way to safeguard credit allocation and contribute to consumer confidence by facilitating public trust and investment. In times of financial instability, public banks may be seen as a safer investment than more volatile and variable private investments. Within Latin America, Costa Rica has the most state-owned banks while Ecuador, Chile and Peru have the most privatized financial sector (Peru and Chile have less than 30 and 20% public banks as percentage of total banks). Mexico's banks have seen volatile changes from private to public ownership following political trends (Yeyati, Micco, Panizza 2004).

44. SOEs are generally under state ownership at least in part to address public policy objectives. In addition to this, a company's sector of operation can often justify particular ownership and management strategies as more suitable than others. The World Bank authored a working paper entitled "National Oil Companies and Value Creation" which investigates the corporate governance practices, externally and internally, best suited to this specific type of SOE. The study examined 20 companies worldwide, including Pemex (Mexico), Ecopetrol (Colombia) and Petrobras (Brazil). Econometric analysis found that NOCs (national oil companies) with the largest oil reserves have lower incentive to produce efficiently and create value for the government ("National Oil Companies and Value Creation" World Bank).

45. Countries with the highest dependence on NOC revenue tended to exercise SOE ownership rights directly or indirectly through the Ministry of Finance or another central authority. These countries preferred to adopt a centralized ownership structure where the state maintains most or all voting rights and direct influence over board nomination (or indirect influence, through the external approval of strategic financial decisions). They were also more likely to grant special privileges to their NOCs, like exclusive rights. On the other hand, NOCs that earned part of their income externally (without state involvement) tended to adopt more flexible methods of decision making ("National Oil Companies and Value Creation" World Bank).

46. A centralized ownership structure does not always imply centralized ownership of assets. In another World Bank study, "An Overview of State-Ownership on the Global Minerals Industry," it is argued that this strategic sector of operations actually benefits from decentralized ownership, in the sense that additional stakeholders should be incorporated to complement that of the national government. SOEs in sectors that have experienced rapid technical change or that have a high investment risk benefit particularly from partial private sector participation. Oil, gas, coal and mining (minerals) compose a unique sector as it takes several years to develop a mine or well. These are very capital-intensive industries with high geological and market risks. They require re-investment in exploration and development to provide reserves for future production. For this reason, joint stock companies may be a more successful strategy than 100% state ownership as they allow for risk sharing ("Overview of State Ownership on the Global Minerals Industry" 2011).

47. For this sector, it is also advised that internal corporate governance should be given particular attention. Governance of Boards and company management has a tendency to be overlooked more often than ownership structures. This paper will closely examine such internal corporate governance structures, like board nomination and training, in part two. Latin American companies examined in the study include the Bolivian tin company, Vinto, and Chilean copper mining company, Codelco. The Bolivian government nationalized the tin company Vinto, formerly Glencore, in 2007 after alleged corruption, with a plan to create multiple SOEs to develop large iron depositories. Codelco is one of the few Chilean SOEs that does

not fall under the jurisdiction of Chile’s centralized SOE ownership entity, SEP, yet it has enacted its own corporate governance reforms, and its profits have served as a major and steady source of revenue for the Chilean government.

PART 2: ACHIEVING EFFECTIVE SOE BOARDS IN LATIN AMERICA

48. The state has a responsibility as owner to ensure that sound corporate governance practices are advocated in its ownership policy for state companies. But, it is also important to ensure that the boards of directors in state enterprises are able to carry out their responsibility of strategic guidance and monitoring of management.

49. Chapter 6 of the OECD Guidelines on Corporate Governance of SOEs specifically addresses the responsibilities of boards of directors— “the boards of state-owned enterprises 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.” Specifically, the OECD recommends that boards be assigned a clear mandate, have the power to appoint and remove the CEO, the Chair should be separate from the CEO, performance committees should be established to monitor board performance, and boards should carry out an annual evaluation. The second part of this paper reviews board nomination processes and other practices aimed at achieving SOE board effectiveness throughout Latin America. An overall trend is yet to be established for these aspects of corporate governance. Overall, there appears to have been more reform activity in Latin America around ownership oversight structures than in relation to board nomination and practices.

50. Azumendi and Andres conducted an empirical study of water and electricity SOEs in Latin America and found very few SOEs with criteria for assessment of Directors. They are evaluated, but on an informal, ad hoc level. Corporate governance practices were generally better at the CEO level than the Board level. Due to the large number of ministry representatives, selection of Board members was more likely to be influenced by politics than capability or experience. Performance orientation and professional management received the worst reviews when compared to corporate governance best practices. Corporate boards were mainly composed of public officials, and executive members and independent directors are not yet common practice in Latin America (Azumendi and Andres 2011).

51. The OECD questionnaire circulated in 2012 provides additional insight as reported directly from ownership entities within Latin American countries. The lack of a uniform trend regarding board practices of SOEs in Latin America makes it important to examine each country on an individual basis. Following is a synopsis of the information collected through the OECD questionnaire. The following country-specific information on board practices is separated into three parts. The first section provides an overview of the existing regulations for Board composition; second, practices for SOE Board Nomination and Evaluation are discussed; lastly, practices for Board Orientation and Training are described.

Board Composition

52. Disproportionately large board sizes can result in excess bureaucracy and a lack of clear direction. The OECD 2005 publication “Corporate Governance of State-Owned Enterprises: A Survey of OECD Countries” highlights a trend of reducing the board sizes of SOEs, usually by enforcing a maximum board size. Based on results from a questionnaire used for the creation of this publication, the optimal board size among OECD member countries is considered to be between 5 and 8 members. In addition to efficiency, cost savings can also be a motivator in reducing the size of boards. Latin American countries

responding to the survey have a tendency to use relatively small boards in the range of 3 to 7 members, although statutorily, Argentina, Colombia and Mexico do not have a maximum limit on the size of their boards.

Regulations for Board Composition and remuneration:

- **Argentina:** no size limits for boards;
  Argentinean nationality required.
- **Brazil:** 6 members with 1 from MPOG (Ministry of Finance)
  Brazilian nationality required;
  Remuneration set to 10% of manager's median salary.
- **Colombia:** at least 3 members with no maximum. No specific policy for remuneration but often set in relation to the size of the SOE's assets.
- **Chile:** 3-7 members with at least one employee representative;
  Member cannot participate in more than 5 company boards;
  No laws for remuneration.
- **Ecuador:** 3 members for most SOEs (one appointed by President, one by sectoral Minister and one by National Planning and Development Ministry); 5 members in SOEs under Defense Ministry oversight and 7 in subsidiaries with shareholders.
- **Mexico:** no size limit for boards.
  Civil servants do not receive remuneration for serving on boards.
- **Peru:** 3-7 members appointed by FONAFE, including at least one nominated by the Minister of Finance and Economy.
  Remuneration determined by FONAFE's Board and is between USD700 and USD 1300 per month for board members with a maximum of USD 5800 per month for board presidents of large SOEs.

Information collected from OECD questionnaire

Board Nomination and Evaluation

53. In countries where a single government co-ordinating entity exists to oversee SOE ownership, this entity is often involved in nominating board members, and guiding or evaluating board practices.

54. In **Chile**, SEP defines the appointment and removal of board members according to the general regulation for SOEs. A formal set of rules exists for this matter—the "Procedure for Selection and Appointment of Company Directors," which lays out specific mechanisms for induction of new directors to SOE boards. Chile reported standards for board member qualifications close to private-sector norms. They should have professional experience in the private sector, a degree and university teaching experience in the economic sector in which the SOE operates, among other characteristics. Nominations are made by SEP's board of directors, meaning that "ministers neither approve nor nominate candidates for board members."

55. SEP performs an annual evaluation of SOE boards which is conducted by nationally known corporate governance centers, specialized companies or auditors. All evaluations are used in board nomination processes. SEP establishes clear goals to be fulfilled by SOEs each year.

56. As previously noted, 11 of Chile's 33 state-owned enterprises are not overseen by SEP. This includes Codelco, a large copper mining company. Still, because of its significant role in the nation's economy, it is important to report on the standards that Codelco has set pertaining to its own board practices (though they are separate from SEP and only apply to Codelco board members). The **Codelco Legislative Reform** was passed in 2009, to improve several aspects of corporate governance. The law eliminated ministers from Codelco's board, increased the number of independent directors to be elected through open, competitive processes, established professional qualifications for board members, and ensured that Codelco and its board are subject to the same requirements as the private sector. The reform also changed board terms from a presidential term to a four-year partially rotated term to prevent huge changes due to political election trends. The Codelco law essentially created a new independent and technical nomination process for the CEO, providing the board with more authority and discretion in this process (CAF White Paper 2012).

57. In **Peru,** FONAFE's Board of Directors, comprised of Ministers, nominates directors to SOE boards, including at least one nominated by the Minister of Finance and Economy, who serves as the Board's Chair. All nominees are then subject to a review process to ensure that they meet established criteria before their appointments may be confirmed. The nominees must state in an affidavit that they have not been fired or terminated from an SOE or other enterprise for an administrative and/or disciplinary offense; are not party to any court proceedings involving the SOE whose board they are nominated to serve on; that they are not a board member of any other enterprise except for exemptions allowed under the law; and that they have no other impediments to be appointed to the board. FONAFE's Executive Director must also review each nominee to ensure that they are not disqualified due to these or other factors such as a criminal history related to business activities, having been removed from a Board of directors, or due to additional criteria established by FONAFE. The Executive Director also reviews the nominees' positive qualifications in relation to educational and professional experience, personal attributes and qualifications, and their potential to further enrich their qualifications through additional training. Nominees are confirmed as "certified fit nominees" for appointment if they receive at least 30 out of 50 points concerning their qualifications, and are not disqualified in relation to the prohibitive criteria described above. Peru has not established a formal evaluation process for SOE board members.

58. **Brazil** generally provides for most board appointments to be made by the responsible sectoral ministry, with one place reserved for a nominee from the Ministry of Finance. On the other hand, Brazil uses a singular government entity (similar to SEP and FONAFE), the Department of Co-ordination and Corporate Governance of State Enterprises (DEST) within the Ministry of Planning, Budget and Management, to coordinate SOEs on governance matters. In association with its written policies for SOE governance, DEST has published a guide for SOE board members which applies to all SOE boards in Brazil and is based in part on the OECD Guidelines on Corporate Governance of SOEs. A resolution was recently implemented requiring all SOEs to carry out board and manager evaluations through a questionnaire and self-evaluation. Audit bodies do not participate in this evaluation. Board and manager evaluations are sent to MPOG (Ministry of Finance) for the process of fixing remuneration. It is asked that evaluations be considered in the remuneration process. This new practice is in its early stage and at the time of this questionnaire it had not yet been evaluated.

59. **Ecuador,** as noted earlier in this report, has established a unique tripartite system of nominating and appointing its board of directors, with one member each appointed by the President of the Republic, the National Secretary for Planning and Development, and the responsible sectoral ministry. Exceptions are made in the case of three SOE subsidiaries that have private shareholders, where seven board members

are appointed, and in the four SOEs under the responsibility of the Ministry of Defense, which have five board members. SOE boards are evaluated by the President of the Republic, other ministers, and by the organisms of state control, based on indicators of efficiency and social benefits.

60. In countries with decentralised ownership structures and without a specific government entity dedicated to SOE oversight (including Mexico, Argentina and Colombia) broad regulation for board practices generally does not exist. Rather, board practices are addressed by each SOE on an individual basis.

61. For example, in **Mexico**, differing bylaws exist for each SOE, making it difficult to provide comprehensive responses on the board practices in place for the entire SOE sector. In this decentralized ownership structure, all SOEs are audited by their individual, internal monitoring body, which has the responsibility for overall performance evaluation of the SOE. Though there is no required annual evaluation, this occurs on an ad hoc basis. The board president is usually the head of the relevant Ministry in charge of the public programme related to each SOE. Board members are directly appointed by the head of each Ministry that has a seat on the board (except in the case of credit institutions where there is a special procedure to appoint "independent" board members- so some appointments are made by the Minister responsible for the sector and some are made by the Board). Each board will also include a representative of the Secretariat of Finance and Public Credit, representatives of the Secretariat in charge of regulation of the SOE, and representatives from the private and public sectors that are linked by experience to the SOE's sector of production. Members from the private sector will constitute a minority on the board. Board members cannot be members of Congress.

62. In **Argentina**, SOE board directors are appointed in shareholder meetings. Nomination committees are only used for SOEs that list on the capital market (17 of 112 SOEs). There are no written criteria for board members. Politicians are sometimes appointed. Recently, a trend has emerged of union representatives being appointed to boards. An exception exists for Energia Argentina in that its bylaws require at least one director to be well experienced with capital market business, as this enterprise must list shares on the market. Board vacancies are not advertised to the public.

63. In **Colombia,** there is no uniform policy for the appointment of board members, which are either made by the President or by the responsible Ministries. In the case of listed companies with minority shareholders, minority shareholder rights have the same voting rights as they do in other listed companies. No formal criteria have been established for ensuring the qualifications of board appointees, and no evaluation system has been established.

Board Training and Orientation

64. Providing organized orientation training for new board members, as well as periodic training sessions for existing members, is not yet common practice in Latin America. The main exceptions are in Brazil, Chile and Peru.

65. **Chile** has in place an organised system of board training for the 22 of 33 SOEs that are controlled by SEP. SEP holds seminars at least annually and other events where directors receive information about company objectives and/or board requirements. Additionally, board members have one-on-one meetings with the board chairman and with audit committees. Questionnaire responses did not differentiate between board induction/orientation and board education/training. All references are made to the initial induction training phase (as opposed to an ongoing education process).

66. Similar to Chile, **Brazil** has designated its own government entity specific to SOE oversight, DEST, with the responsibility of providing orientation training to its own representatives serving on boards (since each SOE board must include 1 person from DEST). DEST is not responsible for providing orientation training to representatives of the sector Ministry, minority shareholders, employees, or other board members. Brazil also noted that holding companies are responsible for providing training to board members of its subsidiary companies. In June 2012, DEST organized a one-time orientation seminar for its directors with the partnership of the OECD, the Brazilian Institute of Corporate Governance (IBGG) and the Brazilian Securities and Exchange Commission (CMV).

67. **Peru** offers some induction to its new board members, generally provided by each SOE's General Manager, and in the case of FONAFE's board, through presentations made by FONAFE's executive director on FONAFE's duties, responsibilities and organization, and board members' rights, obligations and prohibitions. Peru does not offer ongoing training to its SOE board members, suggesting that board members are expected to have the necessary qualifications and experience to perform their duties.

68. **Colombia, Ecuador and Mexico** reported that they do not have in place a system of board training or orientation (although Colombia's Ministry of Finance and Public Credit reports that it is in the process of developing an induction programme for new board members in partnership with a private university.

69. **Argentina** also reported that there is no official, ongoing board training. However, they did have a one-time course in 2011 organised by the National Securities Commission, the Ministry of Economy and Public Finances and the Sindicatura General de la Nacion which was held twice a week for three months. Instructors included legal authorities and officers of the National Securities Commission and the Sindicatura General de la Nacion and the course focused on various aspects of the Law of Commercial Organisations and Corporations, such as special bodies, responsibilities, duties, and rights, the Law of State Financial Administration and Internal Control Systems, commercial regulations and commercial practices, like corporate governance.

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