

POLICY BRIEF ON CORPORATE GOVERNANCE OF STATE-OWNED ENTERPRISES IN ASIA

RECOMMENDATIONS FOR REFORM

NETWORK ON CORPORATE GOVERNANCE OF STATE-OWNED ENTERPRISES IN ASIA



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Introduction

The scale and scope of state-owned enterprises in many Asian economies calls for specific attention to be given to their corporate governance. Even if their economic significance varies greatly from country to country, they still represent a major, if not dominant, part of the economy in some countries (around 30% of GDP in China and 38% in Vietnam). SOEs remain significant in many other large and/or key Asian economies. In India and Thailand they roughly contribute 25% of the GDP, in Malaysia and Singapore close to 15%. SOEs might also represent a not insignificant part of total employment (15% in China, 5% in Malaysia) or of fiscal revenues (25-30% in Vietnam).

As in the OECD countries, SOEs remain prominent in energy and network industries such as air and rail transport, electricity, gas and water supply, natural resource extraction and telecommunications. They are often predominant in the financial sector, particularly in the banking and insurance sectors. In addition, in a number of Asian economies SOEs are also prevalent or still important in a wide variety of manufacturing or service industries such as aerospace, auto-manufacturing, shipbuilding, shoes and textiles, steel, tourism and leisure.

Finally, a considerable and increasing number of SOEs are listed on the national stock exchanges. They represent a significant part of the total stock market capitalisation (from around 20 % in Singapore, one fourth in India and Thailand, around one third in Indonesia and Pakistan, to around 50 % in Malaysia and close to 60% in China). In any event it is in the interest of every country to ensure that state-owned assets are well managed; good SOE corporate governance is a key part of that.

The financial crisis might even lead, as in a number of OECD countries, to a temporary increase in the importance of the state-owned sector, particularly in the financial sector. However, in the medium term, privatisation programmes will most probably decrease the relative importance of SOEs in a number of countries. Even so, improving the corporate governance of SOEs will remain necessary in order to facilitate privatisation and to ensure its success in terms of improved economic performance.

The potential impact of SOE reform on Asian economies can thus not be overstated. Improving their corporate governance could potentially lead to significant efficiency gains, improvement in the quality of public services, a decrease in the fiscal burden and public debt, and ultimately contribute to overall growth. Expected benefits will also include better valuation of state assets (for potential future privatisation) and/or easier access to capital, both debt and equity, therefore facilitating and securing their international expansion (when relevant). In addition, it will in many cases improve overall public governance, including through greater transparency. Last but not least, it will ensure more effective competition with the private sector.

Benefits from improving SOE governance are great, but they are difficult to obtain as SOE reforms can be complex and SOEs indeed face specific challenges in terms of governance. They often suffer both from passive ownership by the state and, at the same

time, from undue political interference. They also typically face a soft budget constraint, being largely protected from bankruptcy and takeover threats. Their transparency in many cases leaves a lot to be desired. More generally, they have a complex chain of accountability, with remote and not easily identifiable principals.

Recent reform

Asian governments have been particularly active in reforming SOE governance in recent years. Significant and in many cases remarkable reforms have been undertaken covering most areas of corporate governance. Some of these reforms will be briefly described as examples to illustrate the recommendations developed in this document. To mention just a few in different areas: three former planned economies have set up centralised ownership entities, i.e. the SASAC in China in 2003, the SCIC in Vietnam in 2007 and more recently the Druk Holding and Investments in Bhutan. The Philippines pioneered the development of an SOE governance scorecard in 2006, following the adoption of the OECD Guidelines. It has proven to be a very effective tool to press for further SOE reforms, as witnessed by the adoption in 2007 of a breakthrough Presidential Memorandum mandating important governance reforms. In India, the Ministry of Heavy Industry and Public Enterprises has been active in trying to foster better governance in the state sector by issuing in 2007 specific Guidelines on the Corporate Governance of CPSEs (Central Public Sector Enterprises).

More recently, Pakistan is also in the process of issuing an SOE Code. Meanwhile, in Malaysia, the far reaching and encompassing “Transformation Programme” is beginning to show impressive results. More focused initiatives are also interesting, such as the development of a directors’ pool in Thailand. In the area of transparency, Temasek in Singapore has also taken a significant step forward by publishing an aggregate report since 2004. In addition, significant reforms are also underway in Korea which is now profoundly reorganising the way SOEs are governed and monitored.

But there is still a long way to go to have efficient and transparent SOEs governed by strong boards, active state ownership without undue interference in day-to-day business and fair competition between SOEs and private sector companies. SOE governance reforms need to be supported in the long run to reach sustainable results. They are an important part of the overall corporate governance reforms that are still an “unfinished agenda”, in Asia as well as elsewhere around the world.

Cooperation between OECD and Asian economies

To face this major challenge, the OECD developed specific *Guidelines on the Corporate Governance of State-Owned Enterprises*. Since their adoption in 2005, the OECD has actively disseminated and discussed these Guidelines in both member and non-member countries. The Guidelines have become the international reference in the area of SOE governance and have been used extensively by governments and other stakeholders wanting to reform the governance of the state sector around the world.

The importance of good governance for SOEs was already clearly emphasised in the *White Paper on Corporate Governance in Asia* (the ‘White Paper’) issued in 2003. Priority #1 of this White Paper explicitly stated that both public and private sector institutions should continue raising awareness of the value of good corporate governance (White Paper, # 35). SOEs clearly form part of the public sector institutions and as such should comply, or possibly take a leading role in implementing this priority. Apart from

Priority #1, the White Paper also explicitly stressed the role of the state in promoting good corporate governance. Priority #2 advised that the state should actively exercise its rights as a shareholder and in the best interest of the company (White Paper, #93). Consequently, the 2004 Asian Roundtable on Corporate Governance mandated the OECD Secretariat to establish task forces focusing on specified topics in Asia; the Task Force on the Corporate Governance of SOEs in Asia was one of them. It met in Beijing in 2005 and agreed on developing a more in-depth exercise including most Asian economies.

In order to reach the appropriate audience and to properly deal with the policy challenges ahead, the Network on Corporate Governance of State-Owned Enterprises in Asia (the “Asian SOE Network”) brings together experience and expertise from most Asian economies. This Asian SOE Network was set up under the Chairmanship of Mr John Lim, President of the Singapore Institute of Directors. The objectives of the Network are to raise awareness of all concerned constituencies about the importance and challenges related to the good corporate governance of SOEs and to evaluate the current SOE corporate governance policy frameworks and practices, benchmarking these against international good practice as reflected by the OECD Guidelines. But the Network has also ambitious objectives in terms of effective impact. It seeks to influence policy making by providing a forum in which policy makers, practitioners and experts can share knowledge and experience among themselves and with their OECD peers. It therefore aims to support viable and effective reforms in the area of SOE corporate governance by discussing and analysing policy options, developing relevant recommendations and agreeing on priorities for reforms adapted to the conditions in Asian economies.

The Asian SOE Network has met four times since its founding (in Singapore in May 2006, hosted by the Singapore Institute of Directors; in Cebu, the Philippines, in April 2007, hosted by the Institute of Corporate Directors, the Office of the President and the Department of Finance; in New Delhi, India, in June 2008, hosted by the Ministry of Heavy Industry and Public Enterprises, the Ministry of Corporate Affairs and the National Foundation for Corporate Governance, and the Standing Conference of Public Enterprises; and in Bangkok, Thailand, in May 2009, hosted by the State Enterprises Policy Office of the Ministry of Finance).

The meetings have gathered around 50 participants, including the most prominent, active and influential policy makers, practitioners and experts regarding corporate governance of SOEs in the region. They constitute a peer group that can press for legal, regulatory or other type of reform in this field. In order to provide OECD experience and represent the community that developed the Guidelines, the Network also includes relevant experts from OECD countries, particularly from the OECD Working Group on Privatisation and Corporate Governance of State Owned Assets. The Network has developed into a high-level forum for a structured policy dialogue on corporate governance of SOEs in Asia, using the Guidelines as a framework for discussion.

The road ahead

To keep the dialogue focused and to produce tangible outcomes, the Asian SOE Network has progressively developed this Policy Brief, providing a set of recommendations for policy reform in order to improve the corporate governance of SOEs in the economies of Asia. This Policy Brief is the product of the Network’s deliberations and thus reflects discussion held during its meetings. It is a consensus document, whose purpose is to identify reform areas, support national reform efforts and establish a benchmark against which progress can be monitored.

This Policy Brief also forms an important basis for the Network's future work. Using this document and the OECD Guidelines on the Corporate Governance of State Owned Enterprises, the Network will focus on identifying reform priorities for individual countries and monitor their implementation. This will be done through analysis of viable policy options and concrete case studies describing how different reform efforts have succeeded or failed. By referencing to the document, the Network will be able to monitor progress at country level.

This Policy Brief is thus the result of the first phase of a policy dialogue that has already borne fruit, but this is only the beginning. The greatest challenges lie ahead of the Network with the implementation of these recommendations. This will require a strong political will, effort and commitment in the long term, as well as the engagement of all the relevant stakeholders.

Chapter I

Ensuring an Effective Legal and Regulatory Framework for state-Owned Enterprises

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

In many Asian countries SOEs 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 separate and distinctive legal entities.

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 harmonisation 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).

Governments in Asia should complete the corporatisation process of state-owned enterprises or state-controlled entities created by special statutes. They should strive to transform previously statutory corporations into regular limited liability companies registered under the company law. The harmonisation 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.

The harmonisation, or rationalisation, should target firstly SOEs having a commercial activity and operating in competitive markets. It should also focus on transparency and disclosure obligations and on the role and authority of the company's governing bodies (examples of recent Malaysian experiences are provided in Box 1).

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.

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.

Box 1. The Malaysian Transformation Programme

Starting in 2004, Malaysia embarked upon a programme to transform its state holding company, Khazanah, into a more active shareholder. The Transformation Programme for GLCs (government linked companies) is part of a broader and long term modernisation programme of the national economy. It is based on benchmarking of performance against foreign experiences. The programme aims to be realistic, performance-focused and highlights governance issues and shareholder value. The implementation of this reform programme is managed, tracked and monitored by the “High-level Committee on Government Linked Corporations High Performance” (“Putrajaya Committee”- PCG), chaired by the deputy Finance Minister, including representatives from all key SOEs and reporting to the Prime Minister. Khazanah serves as a secretariat for this committee and is assisted by external consultants.

The *first phase*, from 2004 to the first half of 2005 included the introduction of Key Performance Indicators (KPIs), performance contracts, performance-linked compensation, as well as changes in board and senior management composition. The work of the PCG culminated in a “Transformation Manual” which was launched in 2005. The manual includes the overall policy guidelines of the PCG to address some of the core challenges facing GLCs. The policy guidelines in the manual have been set out to achieve 5 objectives: to clarify the GLC mandate in the context of national development; to upgrade the effectiveness of boards and reinforce corporate governance of GLCs; to enhance Government-Linked Investment Companies’ (GLICs) capabilities as professional shareholders; to adopt corporate best practices and to implement and enforce the GLC transformation programme.

The *second* “Generate Momentum” *phase* was conducted from the latter half of 2005 up to the end of 2006. In addition to these policy guidelines, 10 initiatives were identified for launch and implementation across all GLCs during 2005-06, with the development of in-house guidelines. The 10 initiatives included; enhance board effectiveness, strengthen directors’ capabilities, enhance GLC monitoring and management functions, improve regulatory environment, clarify social obligations, review and revamp procurement, optimise capital management practices, manage and develop leaders and other human capital, intensify performance management practices and enhance operational management. This second stage provided a series of reference books, such as the Green Book on enhancing the board effectiveness and revamping the board practices and processes initiatives, the Silver Book, which clarifies social obligations, the Red Book to review and revamp procurement, the Yellow and Brown Book about enhancing operational effectiveness, the Purple Book on optimising capital management practices and the Orange Book on managing and developing human capital. Another feature of this period was the introduction and execution of new key policies such as the headline key performance indicators (KPIs).

The *third phase*, from 2007-2010, is the period where tangible results from earlier periods are expected to materialise. During this time, the focus is on long-term strategic planning. The final stage, 2010 and beyond, is when SOEs are expected to be successfully performing in competition with its private counterparts and the fruit of reform and transformation is realised.

New CEOs have been brought in and they now have three-year contracts with remuneration and renewal based on KPIs’ completion. In the view of the Malaysian authorities, the process is beginning to pay off. The 20 largest SOEs outperformed the KLPCI by 2.7% in 2007 and successfully implemented turnaround plans in 2008. Since 2006, GLCs report on their headline KPIs, and this is seen as a very powerful mechanism to trigger changes. In 2009, sectoral benchmarking was also carried out.

In March 2009, near the half way point of the ten year programme that was launched in May 2004, the GLCs presented a Mid-Term Progress Review. Their report concluded that steady progress had been made and that GLCs are now significantly more financially and operationally resilient than before. Since the launch of the Programme, the G-20 (a selection of approximately 20 large GLCs controlled by GLIC constituents of the PCG) has made significant progress on financial and operational improvements, as well as on balance sheet restructuring. In spite of a more challenging economic environment in 2008, the G-20 aggregate earnings were 53% higher than in 2004. Operating cash flows for non-financial G-20 firms grew by 42%. G-20 total shareholder returns have continued to outperform KLCI by a compounded annual growth rate of 4.8% since the launch of the Programme. G-20 return on equity grew from 8.2% in 2004 to 10.4% in 2008, peaking at 14.6% in 2007. Several GLCs have also undertaken sizeable operational turnaround programmes, aiming to enhance their strategic positions, secure regional expansions and undertake strategic divestments.

Notwithstanding the encouraging and substantial achievements to date, much more still needs to be done to achieve the ultimate Programme aspirations. GLCs still underperform relative to top regional sector peers and, given the long-term nature of the Programme, authorities perceive a danger of complacency and of wavering commitment. In addressing immediate financial and economic challenges, GLCs need to adopt a crisis management mode with plans that include being vigilant and prudent in their day-to-day operations. As an integral part of corporate Malaysia, a key priority for GLICs and GLCs in the medium term is seen to be domestic investments, particularly in sectors with a significant multiplier effect, to catalyse growth in the local economy. This is in line with and supports the recently announced Stimulus Package by the Malaysian Government.

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

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 in relation to line ministries.

Asian governments should strive to ensure an effective separation as regards SOEs between the ownership function and other state functions. 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*.

Clear laws and regulations should be developed to protect the independence of the regulators, especially in relation to line ministers. Nominal independence is not enough. Operational independence might be jeopardised 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

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 about 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).

Asian governments should strive to make SOEs’ specific obligations and their related costs transparent. To this end, 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 to meet 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.

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. However, countries might start by clarifying their policy objectives and developing reasonable estimates of costs and monitor these estimates over time.

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

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.

State-owned banks and financial institutions should grant credit to SOEs on commercial grounds, i.e. on the same terms and conditions as for 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 abusive related party transactions¹. Interference from the state on individual lending decisions should be strictly prohibited.

More generally, appropriate credit allocation processes should be developed and SOEs are 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 exacting a market-based fee for debt guarantees to SOEs². This would lead to a more appropriate capital allocation and reduce the incentive for SOEs to seek to retain their government guarantee.

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 bank representatives to SOE boards, particularly from development finance institutions. The boards of state-owned banks should themselves, subject to the policy frameworks established by governments, develop policies in this regard in consultation with the government ownership entity.

¹ The publication OECD (2009), *Guide on Fighting Abusive Related Party Transactions in Asia* provides important insights and recommendations on this topic.

² 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.

Box 2. The SOE Corporate Governance Scorecard in the Philippines

In 2005, the Institute of Corporate Directors (ICD) launched the first results of its Corporate Governance Scorecard for Publicly-Listed Companies to evaluate the corporate governance practices of Philippine companies. Given the success of the PLCs and prompted by the need for a similar scorecard for Government Owned and Controlled Corporations (GOCCs), the ICD developed a Corporate Governance Scorecard for State-owned Enterprises in the Philippines. The CG Scorecard was inspired by the Asian Roundtable Meeting in September 2005 at Bali Indonesia where the OECD Guidelines on Corporate Governance of State-Owned Enterprises was released. The objective was to develop a CG benchmark using a scorecard for key SOEs that would establish the level of appreciation and practice of corporate governance in the Philippines. It was also to identify areas for improvement and raise awareness on corporate governance issues among Philippine SOEs.

The Department of Finance (DOF), the Office of the President (OP) and ICD jointly selected 31 GOCCs to compose the initial group for the project. They were chosen according to their substantial stake in the Philippine economy. The group included the 16 GOCCs specially-monitored by the OP and the DOF.

ICD organised a working session on a CG Scorecard for GOCCs and Government Financial Institutions (GFIs) in November 2005. It was attended by key regulators, representatives from various GOCCs, and ICD Fellows. The questionnaire was carefully deliberated at the November 2005 Working Session. From an extensive document, it was further divided into a “micro” and a “macro” questionnaire. Both questionnaires were contextualised versions of the Philippine experience of the OECD Guidelines on CG for SOEs. The ICD has further developed Notes on Corporate Governance on GOCCs and GFIs in the Philippines.

ICD collaborated with the Office of the Government Corporate Counsel in identifying the laws and issuances pertaining to GOCCs. They also worked with university students in compiling 31 folios that contained: a) charters, annual reports and audit reports of each GOCC; b) other relevant documents made public by the GOCCs; c) print outs of the websites of the GOCCs; and d) the Survey on Corporate Governance answered by top officials of the GOCCs.

ICD solicited the assistance of the Philippine Institute of Internal Auditors (2 rating runs). A third run was made by ICD Fellows to consolidate the results of the first two runs. Each answer to the questionnaire was justified by a specific information source or evidence from the compiled folio.

Since then, through the Network on Corporate Governance of SOEs in Asia, there has been a growing interest in such a CG Scorecard for SOEs. Hence the 2009 CG Scorecard for GOCCs/GFIs was again undertaken as a follow-up to the initial CG Scorecard launched in 2005. This time, the CG Scorecard guideline was improved and made more extensive as a result of ICD’s Annual Working Session in an effort to improve corporate governance of Philippine SOEs.

On the occasion of the OECD Asian Roundtable on Corporate Governance held in Manila on 9-10 September 2009, the 2009 results were released and commitments were made for the CG Scorecard to GOCCs/GFIs to be sustained on an annual basis until such time – some 4 to 5 years down the track– as enough data has been collected to allow for econometric analysis of the scores. This has been done in the CG Scorecard for publicly listed corporations, wherein the 4-year CG Scorecard results has been subjected to an independent, outside econometric study. The 2009 results revealed that standards of compliance with good corporate governance practices have risen in the Philippines.

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

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, among other things, NGOs to participate in this debate.

To underpin and promote the debate and arouse public interest, it would be best to highlight current SOE performance, benchmarking it against either private sector or foreign peers. Corporate governance assessment exercises might be instrumental in getting the public attention and pushing for reforms (the Philippine approach is described in Box 2).

To obtain and sustain public support and therefore political commitment in the long term, it is also important to demonstrate the potentially significant economic impact of SOE governance reform. This could be done for example by estimating the potential for value creation and subsequent impact on market capitalisation, better services and lower costs for the general public, and by communicating about governance reform champions.

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

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

Chapter II

The State Acting as an Owner

Recommendation II.1: Rationalise the state owned sector

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 most suitable. Based on this, some governments might define and implement a privatisation programme which would allow for an 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 a greater focusing on governance reform efforts and oversight.

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

Few Asian governments have developed a clear ownership policy as such, much less a published one. Where 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.

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). The ownership policy should define clearly the overall rationale for state ownership. It should also express clearly the main objectives to which this rationale gives rise. 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 prioritising SOEs’ objectives and are instrumental in limiting the dual pitfalls of passive ownership or excessive intervention in SOEs’ management (examples of ownership policies or guidelines in India and Thailand are provided in Boxes 3 and 4).

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 state’s objectives and a sense of predictability of the state’s behaviour as an owner. Such a high level principle document will thus help in making policies consistent across sectors and across time.

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

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, during a given period, the ownership policy has been implemented.

Box 3. The Guidelines for the Corporate Governance of CPSEs in India

In order to improve public accountability in SOEs, in June 2007 the Department of Public Enterprises brought out comprehensive “Guidelines on Corporate Governance for Central Public Sector Enterprises”. India is one of the few countries having adopted such guidelines following discussion with all relevant stakeholders and consideration of all relevant laws and regulations.

The most significant aspect of the guidelines is that they are applicable to both listed as well as un-listed Central Public Sector Enterprises (CPSEs). The DPE guidelines are mostly in line with the Clause-49 of the listing agreement with stock exchanges issued by the Securities and Exchange Board of India (SEBI). The guidelines also carry a model code of business conduct and ethics for board members. As the Office Memorandum (No.18 (8)/2005-GM dated 22nd June 2007) enclosing the guidelines states *“These guidelines though voluntary in nature should be followed by all CPSEs as proper implementation of these guidelines would protect the interests of shareholders and relevant stakeholders. The compliance with these guidelines requires to be reflected in the Directors’ report, Annual Report and Chairman’s speech in the Annual General Meeting. This Department would also grade the CPSEs on the basis of their compliance of the corporate governance guidelines”*. It is expected that the DPE will allow sufficient time for the CPSEs to conform to these guidelines and undertake appropriate studies for assessment and grading of the CPSEs, in the course of time.

The guidelines cover issues such as the composition of the boards of directors, the role and power of the audit committee, required disclosure, as well as details on how to implement these guidelines. Important features include the fact that risk management is clearly put under the board’s responsibility. The guidelines also have an annex of *“Model Code of Business Conduct and Ethics for Board Members and Senior Management”*. They include a whole chapter on disclosure, with the requirements to have a separate section in the annual report on corporate governance with details on compliance with these guidelines.

The SOEs are required to also get a certificate from either their auditors or the company secretary on compliance with these Guidelines. The DPE also decided to grade CPSEs based on their implementation of these guidelines.

There is an explicit recommendation in these guidelines, as well as in other relevant policy statements, for all unlisted companies to progressively move towards meeting the guidelines and list on the stock exchanges. The Prime Minister, Dr. Manmohan Singh, said in his address to the Conference of Chief Executives of CPSEs in March 2007 that *“it may be useful for more public enterprises to be listed on the Stock Exchange, as this would enhance professionalisation of the Board of Directors and empower Independent Directors. Induction of Independent Directors on the Board of PSEs would, I believe, ensure greater efficiency and effectiveness in decision making processes as well”*. Further, the Finance Minister stated in his address in June 2007 on the occasion of releasing these comprehensive guidelines that *“The ultimate unlocking of value for PSEs is only by listing in a Stock Exchange. That does not make it any lesser a public enterprise or dilute the character of PSE..... there is need to reassess the role of Public Sector in a growing global market. The market is the world, not just India. Fundamental to success of any corporate set up is to achieve global benchmarks”*. The initiative of the DPE and the policy direction given by the government through such statements are indeed unique and promote conformance to the international standards of corporate governance, while encouraging progressive dilution of governments’ shareholding in favour of the general public and private enterprise at large.

Box 4. Thailand: The SEPO Guidelines on Corporate Governance of State-Owned Enterprises

The State Enterprise Policy Office (SEPO) of the Ministry of Finance has developed Guidelines on Corporate Governance of State-Owned Enterprises that set out a main framework for SOEs' operations in Thailand. The Guidelines stipulate:

The State Acting as an Owner. The government should develop and issue a Statement of Directions in addition to disclosing a Statement of Corporate Intent to the general public.

Rights and Equitable Treatment of Shareholders. Shareholders should exercise their ownership rights through well structured and transparent board nomination processes by appointing the board of directors to act as their representatives.

The Responsibilities of the Boards. SOE boards should actively formulate, monitor and review corporate strategy, subject to the objectives set by the government and the ownership entity.

Role of Stakeholders. Stakeholders should be treated fairly in accordance with their legal rights as specified in relevant laws. In addition, SOE boards should set clear policies on environmental and social issues.

Disclosure and Transparency. SOEs should ensure that material information, both financial and non-financial, is disclosed correctly, accurately, on a timely basis, and transparently in accordance with relevant laws and regulations.

Code of Conduct. SOEs should develop, disclose and implement internal codes of ethics providing clear and detailed guidance as to the expected conduct of all employees.

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

The exercise of the ownership function is carried out in very different manners in Asian economies. Some countries have already centralised 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 decentralised models where the ownership rights are exercised by sector ministries over their sector SOEs.

The Guidelines recommend the centralisation of the ownership function or, at the least, efficient coordination among the different entities in charge of the ownership function. Centralisation here does not refer to the central/regional or federal/state organisation 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. Centralisation ensures clarification of functions through effective separation between the ownership function and other state functions in relation to SOEs. It also makes the ownership function more visible and identifiable and may help facilitate the strengthening of competencies by centralising financial and human resources. It thus helps to sharpen the ownership function per se. Finally, it can be instrumental in decreasing political interference in SOEs and in transferring clearer responsibilities to SOE boards. (Examples of recent change toward more centralised ownership functions in China, Vietnam and Bhutan are provided in Boxes 5, 6 and 7.)

There are costs and challenges in carrying out such centralisation. 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.

In some cases, centralisation might not be advisable given the size of the state-owned sector. It could lead to excessive power concentration, and a centralised 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.

Box 5. The establishment of SASAC in China

In March of 2003, the SASAC (the State-owned Assets Supervision and Administration Commission) was established by the National People's Congress of China, by approving a reform proposal submitted by the State Council on establishing a new State Owned Assets Administration System. The SASAC performs investors' responsibilities in accordance with the Interim Regulation on Supervision and Management of State-owned Assets, released in May of 2003 by the State Council based on drafting done by the SASAC and Legal Affairs Office of the State Council. Along with the SASAC, local supervisory bodies have been established to oversee the locally-owned SOEs.

According to the Interim Regulation, SASAC exercises ownership rights in a centralised and unified manner, while complying with the Company Law which was released in 1993 and revised in October 2005. The Interim Regulation also prescribed that SASAC is responsible for non-ownership affairs, such as instructing and advancing enterprises reform and increasing the controlling power in certain sectors related with national security. Since its establishment SASAC has in practice focused on the ownership function. Thus, the objective of the state supervision has shifted from direct intervention in enterprise management to capital oversight.

In October of 2008, the "People's Republic of China State-Owned Asset Law" was examined and adopted in the fifth meeting of the Eleventh National People's Congress, and was put into effect from 1 May 2009. The law provides a legal framework for monitoring SOEs, state investment and withdrawal, and management issues pertaining to SOEs. Most importantly, the law pulled back SASAC's position from non-ownership functions, and clarified SASAC's position as to fulfil investor's responsibilities. The law also requires the SASAC to exercise its ownership according to the legal types of state owned companies.

Box 6. The establishment of SCIC in Vietnam

In Vietnam, the government has established the "State Capital Investment Corporation (SCIC)" whose role is to represent the state shareholdings in the enterprises, in other words, to centralise or integrate the ownership function and clearly separate it from (other) regulatory and policy functions carried out by line ministries.

SCIC is a special economic organisation of the state, operating under the Law on State Enterprises and other relevant laws. It was established in 2005, having functions and responsibility mandated in law, and commenced operations on 1 August 2006. It is entirely owned by the state and is chaired by the former Vice Minister of Finance. It is organised as a financial holding company. The SCIC receives and represents state equity ownership in enterprises where the state owns shares.

The objectives were to speed up the SOE privatisation and reform, to split regulatory functions from business functions, to enhance effectiveness of the management and investment of State assets and capital, and to promote the introduction of the best practices of corporate governance.

Box 7. The Establishment of Druk Holding and Investments in Bhutan

Druk Holding and Investments (DHI) was created through a Royal Charter and incorporated under the Companies Act in November 2007 as the holding company of the Government for five fully state owned companies. It also holds between 13% and 80% of the shares in seven other companies. These companies are all commercially oriented and operate in the power, telecommunications, aviation, banking, manufacturing and industrial sectors. The Government has retained companies with larger social mandates within its direct control. The Ministry of Finance (MOF) is DHI's sole shareholder and receives agreed-upon dividends from DHI. An independent "Blue Ribbon Panel", consisting of eminent persons, has been set up to select the board directors of DHI. DHI has two primary mandates: improving the performance of its companies and making new investments as the commercial arm of the government.

As the first step towards improving performance in its companies, annual compacts were introduced and signed. These compacts set out targets in five areas: capital formation in infrastructure, operational efficiency, profitability, customer service and corporate governance. While Government plans and programmes are also taken into consideration in finalising the compacts, the government provides subsidies for socially oriented activities like rural electrification and rural telecommunication so that these do not adversely affect the performance of the DHI companies.

Governance improvements within the SOEs have included an increase in board competence and independence through a criteria-based selection process, inclusion of private sector individuals in the boards, provision of training, development of specific board guidelines and board empowerment to hire and fire CEOs. All companies have become more performance oriented and are expected to establish performance management systems with incentives at the corporate, group and individual levels shortly.

A strong champion has been the key to the success in establishing DHI. A very clear vision for DHI, continuous engagement with stakeholders, inclusion of key stakeholders in the decision making process, a concrete plan of action, and early wins through quick improvement in services being provided by the companies under DHI have also helped in generating support and acceptance of DHI.

Recommendation II.4: Avoid interference in SOE management

A major danger and actual weakness in SOE governance in Asia is direct or indirect political and/or bureaucratic interference in SOE management. Establishing an "arms length" relationship between the government's shareholder entity and the SOE is a key component in overcoming this, but not necessarily in itself sufficient.

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 consistent with their levels of ownership.

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.

(Recent Indian efforts to enhance the autonomy of some categories of SOEs are described in Box 8.)

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

Box 8. The Navratna and Miniratna Status in India

In 1997, the Indian government decided to strengthen the CPSEs to become global giants and thus planned to improve the autonomy and delegation of powers to a select group of CPSEs called “Navratnas” and subsequently, another category called “Miniratnas”. The policy enunciated by the Department of Public Enterprises (DPE) made it obligatory for this select group of companies to restructure the boards to be able to exercise the enhanced autonomy and authority.

In the first instance, the CPSEs were required to induct at least four independent directors (termed as “non-official part time directors) with demonstrated experience and professional standing. It further advised that such members of the board should reach at least 1/3 of the total strength within six months. The selection of such independent directors was required to be done by a high-powered Search Committee comprising of the Chairman – Public Enterprises Selection Board, the Secretary – Department of Public Enterprises, the Secretary of the concerned administrative ministry and one or more eminent persons to be nominated by the Industry Minister. Thus, board restructuring became an important condition for greater autonomy and fostered improved corporate governance. Subsequently, all the listed CPSEs were required to meet Clause-49 of the listing agreement with the stock exchanges as directed by the SEBI, which has strict requirements relating to independent directors, audit committees, reporting and disclosure standards.

The lists of Navratna and Miniratna companies have since been enlarged and there is now a fresh move by the Ministry to have a new category called “Maharatnas” comprising of select large profit making CPSE’s that have significant global potential.

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

A major challenge in most Asian economies remains how to avoid political appointees on SOE boards and to move away from a 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.

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.).

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 fulfil its mission. It should be based on the evaluation of the existing board and consideration of the company’s strategy and thus on resulting gaps in the current mix of experiences.

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

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 compiling a short list of qualified candidates. In addition to competency and experience, the screening process should take into consideration candidates' commitment and time availability.

Another useful mechanism to help ownership entities to nominate competent boards is for them to develop or get access to databases of qualified candidates (an example from Thailand is provided in Box 9). These databases should be developed through a 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.

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

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.

Box 9. The Directors' Pool in Thailand

Current reforms in Thailand focus on SOE boards. The main problem lies in the transparency of the nomination process and continuity of board members. SOEs are usually established by specific laws, with sector Ministries in charge of appointing board members. When governments change, board members change also.

To improve the situation, the Act on Qualification of Board has been revised. Candidates must now be under 65, have no political affiliation and no conflicts of interest.

In June 2008, a law was adopted to create a pool of credible and competent SOE directors. The selection committee for this pool comprises of persons known to be non-political, independent-minded and with a track record of credibility. The pool comprises of 50 people so far and the objective is to find an additional 200 candidates with expertise in different areas and sectors. Applications to enter this pool can be received from the public, from head hunters, or from the members of the selection committee. All candidates are then scrutinised by the selection committee to ensure their competence and credibility.

According to the law, one third of the board members will have to come from this Directors Pool, eventually the experts for specialised committees. No matter the changes in the government, the directors coming from this pool should not be changed. However the selection process is not currently required by law. .

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

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.).

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.

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

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

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 de-motivation and “box ticking” instead of performance-enhancing behaviour. It could also be an avenue for undue political interference.

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 issues, 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’.

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 the building of trust and generate 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

The protection of minority interests is a cornerstone to the further development of Asian capital markets. This was identified as a priority in the Asia White Paper on Corporate Governance. In many Asian economies, listed SOEs represent a significant share of market capitalisation. 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, to the greatest extent possible, 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.

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 effective participation in some 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 ones³.

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.

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.

³ Refer again to OECD's 2009 guidance on related-party transactions in Asia, *op. cit.*

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.

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, high standards of transparency must be established for the appointment process of independent directors.

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

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 and timely enforcement is often lagging. This reflects a general situation in much of Asia where, arguably, there is a weak implementation of laws and regulations in areas of corporate governance.

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 law 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.

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

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.

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. (An example from Malaysia is provided in Box 10.) It is important to encourage such institutions as a good prevention against abuses.

Box 10. The role of MSWG in Malaysia

The Minority Shareholder Watchdog Group (MSWG) was established in 2000, sponsored by the capital markets regulator. Its basic role is to enhance shareholder activism and the protection of the minority interests. Its mission is to lead in the development of knowledgeable as well as vibrant minority shareholders, thereby contributing to the development of the capital market.

The Watchdog's more concrete objectives are: (1) to become the forum on minority shareholders' experiences in the context of the Malaysian Code on Corporate Governance and the Securities Commission's Disclosure Based Regime and the Capital Market Masterplan; (2) to become the think-tank and resource centre for minority interest and corporate governance matters in Malaysia; (3) to develop and disseminate the educational aspects of corporate governance; (4) to become the platform to initiate collective shareholder activism on unethical or questionable practices by management of the public listed companies; (5) to influence the decision making process in public listed companies as the leader for minority shareholders' legitimate rights and interests; (6) to monitor for breaches and non-compliance in corporate governance practices by public listed companies; and (7) to initiate, where appropriate, reports to regulatory authorities and transforming MSWG into an effective deterrent of such events or activities that can be against the interest of the minority shareholders.

Each year, the MSWG publishes a Company Meeting Survey, a Dividend Survey and a Corporate Governance Survey. Its main actions are to participate in AGMs and EGMs.

Chapter IV

Relations with Stakeholders

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

The Guidelines emphasise 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 recognise 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.

In many SOEs there are numerous stakeholders and relations with them are complex. Specific proactive strategies for addressing key stakeholders might have to be developed. 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. On the other hand, the main challenge in many SOEs is to fight stakeholder capture and regain discretion to take strategic action as regards 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 recognise their existing and evolving rights, powers and levels of interests in the firm's activity.

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 engagement. 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.

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.

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 to 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 a good example and indicating clearly its policy in this regard.

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.

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.

Stakeholder reports could be audited to increase their credibility.

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.

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 significant impact on SOE performance. Any serious attempt at monitoring SOE governance and 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. (This issue is closely related to the observations made earlier in Recommendation I.3.)

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.

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. (Recent Indian experiences are described in Box 11.)

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 balanced discussion between the ownership entities and the SOEs concerned, leading to a clear understanding of, and genuine agreement on, SOE objectives.

More generally, in a number of Asian economies, SOEs commercial and non-commercial objectives are not always enunciated clearly in a specific document. 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. Such documents will serve as a reference and will allow clear communication, both formally and publicly, on the government’s expectations of SOEs. This informed debate about their relevance will be instrumental in encouraging proper monitoring of their effective performance, including by the general public.

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

Box 11. Task Force on SOE Objectives and Performance in India

In addition to the quarterly evaluation done by line ministries, annual reviews are carried out with the help of the Department of Public Enterprises. A special Task Force discusses SOE targets with both the CEO and line ministry concerned. Yearly performances are first evaluated by the SOEs themselves, then sent to the DPE, before being placed before the Task Force and evaluated on a scale of 1 to 5. The performance of CEOs and board members will be linked to this score, and in some cases it is linked with performance based remuneration. In the case of Navratna companies, an inter-ministerial committee with the Secretary of the DPE, representatives from the Planning Commission and Ministry of Finance, reviews annually their performance and assesses whether or not they should be granted more autonomy. In addition, a “High-Power Committee” headed by the Cabinet Secretary of India reviews Navratnas’ performance every three years.

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

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.

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.

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.

To more actively monitor SOE performance and to allow for a public debate about it, hence putting on pressure for performance, it is essential 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.

These key performance indicators would reflect the desired balance between commercial and non-commercial objectives. They will include financial ones allowing

measurement, monitoring and assessment of 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.

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.

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 in the case where the SOEs themselves are listed. As an example, in some countries they are not even required to publish annual reports. Ownership entities and parliaments may or may not receive sufficient unpublished information to play their monitoring and oversight roles, but the whole process of public accountability works much better when the media and the general public get a clear picture of SOE performance and prospects.

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.

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.

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, and board secretaries to avoid unnecessary and excessive requirements that would put SOEs on an unequal footing with their private sector competitors.

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

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 cases

duplicate each other. It could also happen that state audits focus 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.

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.

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.

SOEs should be subject to an annual external audit by an independent and qualified auditor, using the usual criteria for independence and taking into account agreed standards such as the International Standards on Auditing, whether or not state audits are also performed.

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.

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

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.

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 ongoing 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.

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 (an example of early progress in Malaysia is provided in Box 12). But ownership entities should strive to benchmark SOE performance with appropriate peers, domestic or foreign.

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 summarised form by the ownership entity.

Box 12. Blue Book in Malaysia

In Malaysia, performance management, involving KPIs and performance linked compensation (PLC) and performance contracts were among the key GLC measures launched by the Transformation Programme.

The PCG conducted an audit on the implementation of the KPIs and PCI Guidelines. On the basis of that audit, PCG recommended that personal performance reviews should be on a semi-annual basis where each manager's performance is reviewed against targets, resulting in differentiated evaluations with meaningful personal feedback, rewards and consequences. It also recommends that the base pay should be comparable to industry peers and that GLCs should offer meaningful performance bonuses that vary significantly with individual performance. Promotion, recognition and other non-financial rewards should be based on merit and highly correlated with performance.

The PCG launched the "Blue Book: Guidelines on Announcement of Headlines KPIs and Economic Profit" in 2006. They provide a comprehensive reference to GLCs to ensure uniformity and consistency in their reporting. Headline KPIs align expectations and interest at all levels, promote a results driven culture, and progress reporting serves as an opportunity to take stock. The announcement of headline KPIs also enables stakeholders to have better insight into the performance of the company.

Each GLC should have 5 to 8 KPIs with targets along financial, customer, operational and organisational dimensions that are tightly linked to its specific strategy. The targets of each KPI should be benchmarked against comparable international peers. The CEO should be responsible for the implementation of quality KPIs and for reporting them to the market. Business performance reviews should be conducted every quarter resulting in order to understand any major variances and to chalk out action plans to further improve performance.

The Blue Book also provides guidance on Economic Profit reporting, on how to deliver Headline KPI results and provides a communication checklist for GLCs. It also gives advice on how to manage poor or missed results.

The Blue Book Implementation Assessment shows that, for the majority of GLCs, corporate scorecards are in place, KPIs have been formally set for CEOs and senior management and Headline KPIs are being monitored. To enhance performance and to promote results-orientation, GLCs have been announcing their Headline Key Performance Indicators ("HL KPIs") annually and have been showing overall improvements. The number of HL KPIs met increased from 72% in FY2006 to 76% in FY2007. However, the present harsh economic environment has reduced number of HL KPIs met in FY2008 to 54%. Nevertheless, recognising that it is critical to stay performance focused despite the economic turbulence, the G-20* continue to publicly announce their forward looking HL KPIs, which are documented in the "GLC Transformation Programme Mid-Term Progress Review" report.

Recommendation V.7: Publish aggregate reports on state ownership

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.

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. (Examples of aggregate reporting in Singapore and India are provided in Boxes 13 and 14.) 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.

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.

Box 13. Temasek aggregate report in Singapore

Temasek has published an annual review since 2005. This differs from the annual report which is provided to the shareholders in that it does not include, among other things, the auditor's report. It is however quite detailed and provides an overview of the performance as an investment house. It describes the portfolio with key investments and effective shareholdings. It provides the net portfolio value by country/region, industry and type of liquidity. It explains the wealth added and the total shareholders' return. It includes a "message from the Chairman", and other more qualitative information, including concerning boards, corporate governance, risk management and major investments. In addition, Temasek-invested companies publish their own annual reports.

Box 14. The DPE's Overview on the Performance of CPSEs in India

The Department of Public Enterprises (DPE) publishes every year, a "Public Enterprises Survey – Annual Report on the Performance of Central Public Enterprises", which presents to all the stakeholders and general public a detailed analysis and reporting of the performance of the CPSEs. The first aggregate report was published in 1961, covering all government companies (i.e. in which the Government owns 51% or more of equity) and statutory corporations.

As per the Survey 2007-2008, 160 out of the 242 CPSEs are profit making, while 53 are loss-making. The Survey gives detailed information, inter alia, relating to an overview of policy and performance, financial indicators, employment, productivity, investment, disinvestment & privatisation, revival strategies for sick-units, international operations of CPSEs, performance in relation to the Memorandum of Understanding, Board structures & their professionalisation and corporate governance. This report is scrutinised by the Committee on Public Undertakings of the Parliament.

The DPE has also conducted a survey of the state-level public enterprises which is now available on a consolidated basis for the country, for public information and policy debate.

Chapter VI

The Responsibilities of Boards of SOEs

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.

Many of the recommendations in this chapter necessarily dovetail with those concerning the state’s role as an owner in Chapter II. The essential difference is, the recommendations in Chapter II are addressed largely to the state; those in the present chapter concern the responsibilities of boards and board members.

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

SOE boards in Asia are not always entrusted with the full range of board responsibilities, i.e. providing strategic guidance, monitoring management and controlling disclosure. They see their roles and responsibilities encroached by the ownership entities and the management, being by-passed in some cases by ministries giving direct instructions to the management. In some other cases, their functions are duplicated by specific state regulatory bodies, 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 after the fact.

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.

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

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.). The role of state auditors in relation to SOEs should also be clearly defined. It should not lead to depriving SOE boards of some of their functions or authority. (Examples of board functions and committees in Indonesia and Pakistan are provided in Boxes 15 and 16.)

Box 15. Decree to set up specialised committees in Indonesia

The Ministry of State Owned Enterprises (MSOE) requires SOEs to set up committees to support boards in performing their functions. The first notion of enforcement was by produced the Ministry Decree 103/2002 on Audit Committees, which established the procedure and structure concerning SOE board audit committees. However, not all SOEs were at this time obligated to establish audit committees. Audit committees were mandated for publicly listed SOEs, SOEs in the financial and banking sector, SOEs which were prepared for privatisation and the SOEs which had assets of more than Rp. 1 Billion.

In 2006, The MSOE refined the Ministry Decree 103/2002 and replaced it by Ministry Decree no 5/2006. The new decree obligates every SOE to have and to structure adequately an audit committee. The new decree also refined the procedures guiding the committee and its duty to support the board performing their function. However on recent evidence, even though the decree gives appropriate guidelines concerning audit committee duties, some committee members still find it difficult to define and separate their duties from those of the internal and external auditors.

Some SOEs, particularly the publicly listed companies, have moreover established and structured specialised board committees in areas such as risk management, remuneration and corporate governance. However, according to SOEs' corporate form, not all enterprises have been able to establish the specialised committees other than audit committees.

Box 16. Board Mandates and Functions in Pakistan

1) Powers of the Governing Boards of Companies Established under the Companies Ordinance 1984

In March 2007 the Government of Pakistan clarified as under:

- i. Government established/owned companies under the Companies Ordinance may use full powers to the extent given in the Companies Ordinance provided their decisions do not impact the Federal Budget in any way.
- ii. In case of organisations, established under specific enactments (other than Companies Ordinance) the BOD will act according to their respective laws. However, in such cases, the agenda for the meeting of BOD may be circulated well ahead of time so that finance division representatives on the boards may consult and get orders of the appropriate authorities and act accordingly in the meeting of BOD.

2) Separation of Chairman and CEO functions/officers

Some SOEs have separated the offices/functions of Chairman of the Board and the CEO (e.g. Pakistan State Oil, Pakistan International Airlines, Oil & Gas Development Corporation, Pakistan Petroleum Limited etc).

3) The role of Independent Non-Executive Directors

Some SOEs have sufficient number of Independent Non-executive Directors on their Boards and Board committees' e.g. State Life Insurance Corporation, Civil Aviation Authority, Employees Old Age Benefit Institution. However, the above initiatives are proposed to be reinforced through the issuance of the SOE Regulations.

The SOE Regulations in Pakistan

The Securities Exchange Commission of Pakistan, the premier regulator of corporate bodies, framed the Draft Public Sector Companies (Corporate Governance) Regulation in November 2007. The draft was vetted by the Pakistan Institute of Corporate Governance in December 2007 who proposed appropriate amendments. The proposals were also peer reviewed by the International Finance Corporation. The final proposals/comments were sent to the Commission in December 2007.

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

One of the key functions of SOE boards which is often not completely fulfilled is to provide strategic guidance to the management. As SOE boards receive strategic orientations and overall objectives from the ownership entity, 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.

To ensure that SOE boards do fulfil 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

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).

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. Such a process 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.

Attracting the relevant talent 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.

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 separate 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

SOE boards are crucial in ensuring that SOEs are properly governed and held accountable. Boards need first and foremost to include an appropriate mix of competencies to be able to fulfil their responsibilities. Appointing appropriate and

competent directors is a prerequisite to ensuring appropriate governance. (The Malaysian experience with enhancing board effectiveness is highlighted in Box 17.)

Box 17. Green Book on Enhancing Board Effectiveness in Malaysia

A review by the Putrajaya Committee on GLC high performance (PCG) in Malaysia found that the current pool of GLC directors was too small and resulted in some directors holding too many mandates. With the evolving strategic, operational and geographic priorities of GLCs, boards now require new types of expertise in marketing, organisational design and change management. While recognising that not every director will individually possess all necessary and relevant knowledge and experience, the objective is to ensure that on a collective basis, every board is balanced and reasonably complete in its pool of skills.

PCG recommends that GLICs and GLCs proactively leverage new sources, namely, professional as well as sector or functional expertise from private sector organisations. GLC CEOs at the early stage of GLC transformation are not permitted to sit on other boards, apart from the boards of their subsidiaries. Exemptions to this rule are given on a case-by-case basis through GLICs by application to the PCG. Additionally, in order to ensure that directors have the time to focus and be effective board members, PCG recommends that the cap on the number of listed boards on which a director of GLC can sit be limited to five.

The Green Book, which had to be implemented by all SOEs by the end of 2006, aims to help SOE boards upgrade their effectiveness. It first provides best practice standards to which all boards should adhere. These include, for example, the following recommendations:

- SOEs have a Nomination Committee consisting of exclusively non-executive directors, a majority of whom should be independent. The Nomination Committee should recommend to the board clear and appropriate criteria for directorships. The recommendations should be based on an annual review of the board's required mix of skills and experiences.
- At least one-third of the entire board, which is preferably no more than 10 board members, should be composed of independent directors (up to 2 members may be from management with a maximum of 30% representation).
- There should be a clear and distinct separation between the roles of the chairperson and CEO, and these boundaries should be reviewed at least every 2-3 years. This separation is designed to ensure a balance of power and authority, such that no one individual has unfettered powers of decision. To reinforce the importance of the chairperson's position, the selection criteria for chairpersons are more stringent than that of normal directors. Further, given that the time and dedication required to effectively fulfil the role of a chairperson is significant, the onus lies on the chairperson and the nominating GLIC to ensure that he or she must have sufficient time and capacity to focus on the task by limiting his or her presence on other boards and responsibilities as appropriate. The board which is formally responsible for determining the roles of the chairperson and CEO should ensure that there is clarity and shared understanding from the very start.

The Green Book also gives practical suggestions on how to raise board effectiveness. For example, it gives a description of the ideal characteristics of an effective director, in terms of knowledge, skills and mindset.

Finally, the Green Book provides guidance on how to conduct an "Effectiveness Assessment" and to develop an "Actionable Development Programme".

As a result of the implementation of the Green Book, by 2008 significant progress has been made in raising board effectiveness and enhancing their composition. 83% of the G-20 had completed their Board Effectiveness Assessment and 67% had developed their Actionable Improvement Programme.

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. Selection of nominees on the basis of competency should be the government’s priority. 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.

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

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.

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

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.

Professional bodies and centres of excellence (such as institutes of directors) could play 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. (Examples of training and certification of SOE directors in India and Malaysia are provided in Boxes 18 and 19.)

Recommendation VI.7: Develop performance evaluation for SOE boards

Reforms should not focus only on boards’ “conformance” with formal rules, e.g. their composition, but must also take into account 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 and are a tool for improvement. They also help in reviewing board size and composition, thus in identifying necessary competencies and required new board profiles.

Box 18. Certification of SOE directors in India

Arguably, the most notable initiative in promoting corporate governance amongst CPSEs is that of corporate governance certification and conclaves initiated and delivered by the Standing Conference of Public Enterprise (SCOPE, which is a Society and apex body of CPSEs functioning since 1973) and Academy of Corporate Governance (ACG, a think tank and a public trust operating since 2001) - under the aegis of the Department of Public Enterprise, Government of India.

The first Directors' Certification of four days duration and Chief Executives' Conclave of two days duration were conducted in 2005. Since then, three Directors' Certification programmes have been conducted covering nearly 100 Directors and Senior Executives of large CPSEs, including independent directors and government nominee directors, all of whom were administered a three hour examination before certification. In addition, a shorter version titled "Conclave on Corporate Governance for Chief Executives" (Chairman & Directors) has been conducted four times, resulting in a trained pool of about 150 in this stream.

By now, there is a critical mass of 250 top-notch directors and CEOs who have been fully exposed to the essentials, principles, standards, and best practices of corporate governance as relevant to SOEs. It is notable that the Honorable Minister for Heavy Industries and Public Enterprises, Government of India who inaugurated the 4th Conclave observed that "*The need of holding Directors' Conclaves and Certification Programmes lies in its basic objective of sensitising and creating an in-depth understanding of multifaceted dimensions of the role and responsibilities of the directors. These programmes will help the chief executives, directors and potential directors (of CPSEs) to not only gain an insight into the practice of corporate governance but also would enable them to build on their competencies.*"

The programme content, designed and delivered by ACG, has distinct elements that address the issues and dynamics in reforming corporate governance structures among developing countries such as India to converge with the international guidelines.

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, or defer to persons who are considered more senior or more "respected" in the relevant societies. It is the case even in the private sector, and individual evaluations are just beginning to develop. (Examples of board evaluation, and self-evaluation, in the Philippines are provided in Boxes 20 and 21.)

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.

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, among other things, 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.

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.

Box 19. The Directors Academy in Malaysia

One of the main policy thrusts of the GLC Transformation (“GLCT”) Programme is the need to upgrade the effectiveness of GLC Boards through learning, which led to the establishment of the Malaysian Directors Academy. The Malaysian Directors Academy aims to address board performance by equipping directors of GLCs with world class knowledge, skills and mindset to perform to a consistently high standard. To be an effective director, a number of performance criteria are critical. These include understanding the boundaries between the board and management, active problem solving with both the board and key management on strategic issues, whilst leveraging networks and managing multiple stakeholders in a proactive manner.

For new and potential directors, the transition from a management role to a director’s role and all its implications has to be addressed in a holistic manner. With the evolving strategic, operational and geographic priorities of many GLCs, directors that have deep commercial, functional, geographical and/or relevant industry skills, knowledge and experiences are required.

The Malaysian Directors Academy seeks to address this by delivering four integrated functions in a distinctive way, namely: Facilitate sharing of learning through forums, linkages and databases of best practices to build directors’ capabilities; Research and develop Malaysian-related case studies to assist directors in building knowledge on how to handle specific situations; Arrange “on-the-job” learning and coaching which will be customised to an individual director’s needs; and Enhance existing training and development programmes to meet the needs of directors.

The Malaysian Directors Academy recognises the different types of directors and the complexities of their roles and relationships. Therefore the learning interventions to be designed and developed cater for the differing roles and issues relevant to each category. The Academy seeks to provide programmes which are of world-class status. To achieve this, it will collaborate with leading international institutions that specialise in designing and deploying programmes at Director’s level, including the IMD– The International Institute for Management Development - based in Lausanne, Switzerland. IMD is the leading provider of executive education and was ranked 2nd in the world and 1st amongst European business schools for the overall quality of its programmes in the 2006 Financial Times rankings. The Malaysian Directors Academy is also in discussions currently with other local and international institutions to identify potential areas for collaboration.

Box 20. Presidential Memorandum in the Philippines

The Presidential Memorandum issued on April 10, 2007 mandated that:

1. Development of a performance evaluation system to be used in evaluating the yearly performance of the Board of Directors of GOCCs and GFIs, taking into account corporate governance principles and best practices.
2. All Directors of GOCCs and GFIs are required to take an Orientation Seminar on Corporate Governance.
3. All Boards of Directors of GOCCs and GFIs were “enjoined to set up and organise appropriate Board Committees, e.g. Audit Committee and Governance Committee”.

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.

The Chairman's evaluation is particularly sensitive, because 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, and relations with the board.

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. Evaluations should also be extended to board committees.

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.

Box 21. The SOE corporate governance circle in the Philippines

The Mandate of the general Company Circle is to secure the momentum for Corporate Governance Reforms that ICD has already generated and thereby build a legacy that would maintain such momentum into the long-term future. Company officers are invited to join on the basis of their Company's relatively high scores in the Corporate Governance Scorecards.

The objective is: a) to promote greater consistency, clarity, enforceability and practicality in order to attain a higher level and wider base of compliance among the publicly listed corporations (PLCs) in the Philippines; b) to lead in the effort to raise the standards of CG practice in the Philippines by gradually moving away from mere compliance with the letter of CG laws, rules and regulations; c) to bring corporations in the Philippines, through the vanguard group in the Circle, to a level of CG practice that takes into account the spirit behind CG laws, rules and regulations. Such a spirit places emphasis on performance that can be achieved through CG breakthrough results for the benefit of the corporations and their respective constituencies.

A specialised corporate governance circle For GOCCs and GFIs has been set up to lead the effort in raising standards of Corporate Governance within the state sector.. It is a Working Group for that would be in the lead to make a significant difference by observing high standards of corporate governance practice. It brings together the heads and key members of the board of GOCCs (and GFIs) that are open and willing to pursue and further promote improved corporate governance practices. The ten GOCCs that had the highest scores in the first Corporate Governance Scorecard for GOCCs/GFIs formed the initial nucleus for this Circle. (MOA signed last June 11, 2008 with DBP as lead convener). The Institute of Corporate Directors provides technical and secretariat services to the Circle.

The objectives are to continuously work on improving the CG Scorecard by taking the following action:

- a) To review the current CG Scorecard for GOCCs/GFIs questionnaires to better suit local Philippine conditions. In addition, this Circle incorporated selected, relevant questions from the ICD Corporate Governance Scorecard for Publicly Listed Companies into the 2008 version of the Scorecard for GOCCs/GFIs. It took into account the Memorandum Order from the Office of the President with respect to corporate governance for GOCCs/GFIs, as issued on April 10, 2007;
- b) To measure compliance to CG practices by letting the GOCCs/GFIs undergo a self rating system. The final assessment and initial release of the aggregate results was released in November 2008;
- c) To issue final recommendations on further improvement of the CG Scorecard for GOCCs/GFIs so it becomes a prod for them to move up the governance improvement pathway.