

# Strengthening the Governance and Performance of State-Owned Financial Institutions

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## Abstract

Corporate governance arrangements define the responsibilities, authorities and accountabilities of owners, boards of directors, and executive managers of a company. Good corporate governance is as important for state financial institutions as for private sector companies. Many of the problems that commonly afflict state financial institutions can be associated with, if not attributed directly to, weaknesses in corporate governance. This note draws on guidelines recently published by the OECD and the Basel Committee

for Banking Supervision to compile a comprehensive corporate governance evaluation framework relevant to state-owned commercial and development finance institutions. It highlights aspects of this framework that are considered to be of particular importance to state financial institutions by citing innovative practices in a number of countries. Finally, it presents a detailed case study of the governance arrangements in place at the Development Bank of Southern Africa.

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This paper—a product of the Financial Systems Department, Financial and Private Sector Development Vice Presidency—is part of a larger effort in the department to strengthen financial systems by improving the quality and effectiveness of state interventions in finance. Policy Research Working Papers are also posted on the Web at <http://econ.worldbank.org>. The author may be contacted at [dscott@worldbank.org](mailto:dscott@worldbank.org).

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# **Strengthening the Governance and Performance of State-Owned Financial Institutions**

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## ***I. Introduction***

### **Purpose and Scope**

This note describes good corporate governance arrangements and practices for state-owned financial institutions. Good corporate governance is as important to state-owned institutions as to private sector institutions such as listed companies. Better corporate governance can improve the performance of state financial institutions and can help avoid some of the problems they commonly experience.

*Corporate governance arrangements* serve to define the responsibilities, authorities and accountabilities of owners, boards of directors, and executive managers, as they affect the control a company. Put another way, “corporate governance refers to the process and structure for overseeing the direction and management of a corporation so that it carries out its mandate and objectives effectively.”<sup>1</sup> And corporate governance “provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring.”<sup>2</sup>

This note addresses corporate governance practices in wholly state-owned financial institutions.<sup>3</sup> State-owned financial institutions can be distinguished as between deposit-takers and non-deposit-takers, and as between development institutions (i.e., with public policy mandates) and commercial institutions (with no explicit public policy mandate). In this note the term *state commercial bank* (SCB) is used to refer to profit (or value) maximizing deposit-takers that do not have a mandate to pursue public policy objectives. Such banks exist in many countries, often a legacy of central planning.<sup>4</sup> The term *state development bank* (SDB) refers to institutions that have explicit policy mandates and are funded primarily by deposits.<sup>5</sup> Thus both SCB and SDB in this note are presumed to take deposits from the general public and for that reason are subject to (or at least should be subject to) the full scope of regulation and supervision applied to other deposit-taking institutions.<sup>6</sup> The term *development financial institution* (DFI) refers to institutions that are presumed to be financed mainly by non-deposit resources, such as loans from the state, long term loans from multilateral institutions, and bonds issued in local and international capital markets. Like SDB, DFI are presumed to have an explicit policy

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<sup>1</sup> Report of the Auditor General of Canada, February 2005, Chapter 7.

<sup>2</sup> OECD Principles of Corporate Governance, 2004, page 11.

<sup>3</sup> Subsequent work will address additional corporate governance practices relevant to financial institutions partially owned by the state.

<sup>4</sup> Examples are the four large SCBs in China and the three large SCBs in Egypt. All have been explicitly relieved by the government from any public policy mandate. In many cases, such as these, SCBs are being partially or fully privatized. Three of China’s have raised private equity, and one of Egypt’s SCBs has recently been privatized.

<sup>5</sup> Thus the terminology used in this note differs from common usage, since many institutions called *development banks* in practice take no or only limited deposits.

<sup>6</sup> The term “bank” in this note therefore is synonymous with “deposit-taker.” Deposit-taking is seen by the international bank supervisory community as the principal rationale for *prudential* regulation and supervision.

mandate. In this note, all three types of institution (SCB, SDB, DFI) are referred to collectively as *state financial institutions* (SFI), a class of state-owned enterprise (SOE).

Effective corporate governance arrangements for SFIs are built upon sound legal, regulatory and institutional foundations. Relevant laws and regulations can include the company law, securities laws (e.g., governing the issuance and sale of securities to the public), laws governing auditing and accounting, SOEs, and public financial management, as well as institution-specific founding/organic legislation and, in the case of deposit-takers, general commercial banking law and prudential regulation.<sup>7</sup> Relevant institutional foundations include policies and practices governing the state's exercise of ownership in SOEs or SFIs generally. They also include policies and practices applicable to the board and management of each SFI, including as prescribed in its internal statutes (e.g., articles of incorporation or association, charter, by-laws, etc.), and as prescribed by the owner and the board of directors.

This note draws extensively upon several recently published authoritative sources, including the OECD *Principles of Corporate Governance* (2004), the OECD *Guidelines on Corporate Governance of State-owned Enterprises* (2005), and the Basel Committee on Banking Supervision's *Enhancing the Corporate Governance for Banking Organizations* (2006). It cites recent developments in a number of countries, including Australia, Canada, Finland, New Zealand, Norway, South Africa, Sweden. It also draws upon a detailed case study assessment of one SFI considered to be well advanced in its corporate governance practices, the Development Bank of Southern Africa, that was undertaken for the purposes of illustrating the corporate governance arrangement advocated in this note.

The goal of the note is to contribute to work undertaken with the World Bank Group geared toward helping client government's improve the effectiveness of state interventions in finance. Proactive policies to promote financial sector development in the context of overall economic development and growth strategies often involve the direct provision of financial services by the state, and state financial institutions are a means commonly used for this purpose. Improving the performance of such institutions in many dimensions is important to overall financial sector development. This work by the Financial Systems Department is a complement to initiatives focusing more comprehensively on corporate governance matters undertaken within the World Bank Group by the Corporate Governance and Capital Markets Department (CCGDR).

### **Why Does SFI Governance Matter?**

Many of the problems commonly recognized to afflict SFIs can be associated with, if not attributed directly to, weaknesses in corporate governance. Some examples:

- Government officials acting in the capacity of owners (the minister to whom the SFI is accountable, or other individuals) directly intervene in day-to-day operational decisions, such as to whom to lend, on what terms to lend, and when to forgive indebtedness.

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<sup>7</sup> In addition, contract law, labor law, bankruptcy law and tax law may be relevant.

- Executive managers act with near autonomy, pursue unintended objectives, and operate in a manner contrary to sound commercial business and public financial management principles.
- Board members lack the independence, professional skills and experience necessary to properly undertake their duties.
- Internal and external financial and non-financial reporting is incomplete and inaccurate, does not provide an adequate basis for decision-making by boards and executive managers, and misleads government owners, legislatures and the public.

The consequence of the types of problems cited above can be not only loss-making, inefficient and/or ineffective SFIs, but also a weakened financial system. Poor governance can lead SFIs to under-price risks and otherwise engage in business practices that displace the provision of commercial financial services by the private sector, impede new private entry, and undermine competition. The result can be to retard financial market development, to diminish access to financial services, and to weaken the stability of the financial system, often the opposite of the stated rationale for government ownership of financial institutions in the first place.

In contrast, good corporate governance can help to ensure that SFIs are conceived and managed within a clear vision of how they will overcome existing weaknesses or problems in the provision of needed financial services without becoming part of the problem themselves. It can ensure that SFIs pursue the objectives for which they were established, preventing mission creep and an institutional tendency to continue to grow in size and expand in scope. It can increase the confidence of clients and business partners, and lower SFIs' cost of funds. It can facilitate the ability of the government to attract private capital for eventual ownership diversification and perhaps even privatization.

Yet this note will demonstrate that putting in place and maintaining the corporate governance arrangements necessary to adequately guide and control SFIs is not simple or inexpensive. The governance of any SOE can be more challenging than in private companies. In part this is because the structure of SOE ownership is more complex, involving the legislature, the government, and one or more ministries, such that organizing and exercising the ownership function itself is a challenge. In addition SOEs are at risk to ad hoc political interventions in the guise of exercising ownership. On the other hand, SOEs usually are not at risk to two sources of incentives for sound governance and management, specifically, bankruptcy and takeover.

SFI governance arrangements can be even more challenging to put in place than SOEs generally. Like most financial institutions, SFIs often are highly leveraged (high debt relative to equity) and thus have the potential to create significant contingent fiscal liabilities. For that reason, public financial management considerations are particularly important for SFIs, implying a routine role for finance ministries in governance. SCB and SDB, as deposit-taking institutions, should be subject to the regulatory regime applicable to other deposit-takers, which typically includes extensive prescriptions regarding governance arrangements, as well as the supervision of such arrangements by the central bank or other bank supervisory authority. SDB and DFI, which have public policy mandates, present further governance challenges, notably with respect to managing the tradeoffs inherent in conflicting objectives (e.g., offering concessionary

finance to certain customers while adhering to commercial business practices and maintaining financial sustainability).<sup>8</sup>

In practice, putting in place sound governance arrangements for SFIs requires a significant investment in people, processes and technology, with substantial up-front and ongoing costs. When considered in the context of the government's objectives for SFIs and the problems they are expected to solve, the costs often may not be justified or affordable. In such circumstances the answer is not to shortchange corporate governance, but rather to design alternative, more economical and efficient means for government intervention.

Finally, it is important to be realistic about the potential for positive outcomes from concerted efforts to upgrade SFI governance arrangements. Good governance put in place on paper, but not implemented or respected in practice, will have little effect. Failure to ensure accurate accounting and reporting and to promote transparency at all levels will undermine other improvements. Even if a serious and comprehensive governance reform is implemented, sustaining those reforms through successive government administrations will present challenges. And, in any case, upgrading governance will not solve all problems. But doing so will help professionalize ownership, boards, and management, and can be a first step along the path toward further enhancing performance by means of partial or even full privatization.

## ***Section II. Key SFI Governance Arrangements and Practices***

### **Overview**

As noted, corporate governance practices should serve to clarify the respective responsibilities, authorities and accountabilities of owners, boards of directors, and executive managers. For any SFI, two overarching objectives for which boards and executive managers must be held accountable are:

- To ensure the institution's long-run financial sustainability (i.e., ensure that it continues as a going concern, without need for extraordinary financial support from the state).
- To achieve certain financial performance objectives (which may be defined in terms of return on equity and dividend payment targets, for example).

For SFI with a mandate to pursue public policy objectives (i.e., SDB and DFI), an *additional* overarching objective is the achievement of those policy objectives. (Section III of this note addresses the special governance challenges associated with SDB/DFI.)

To be able to hold owners, boards and executive managers accountable, objectives and expectations must be explicit and clear.<sup>9</sup> To function effectively, owners, boards and executive managers must have access to accurate, timely and relevant information upon which to base decisions and assess performance. Key underpinnings for accountability,

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<sup>8</sup> This is not to say that SCB (or private commercial banks for that matter) face no conflicts in their objectives. For such institutions, profit/value maximization requires balancing potentially conflicting objectives with respect to different sets of stakeholders. Also, this is not to suggest that SCB or private commercial banks cannot produce valuable public policy outcomes.

<sup>9</sup> Government owners are held accountable by legislatures, and in principle by the public.

therefore, are clarity and transparency regarding objectives, expectations, actions taken, results achieved, and costs incurred.

This Section highlights corporate governance arrangements and practices drawn from OECD guidelines that are advocated here as being critical to effective SFI performance, and as being matters on which SFIs often fall short. It addresses i) state exercise of ownership, ii) the role and functioning of the board of directors, and iii) the supporting information, reporting, disclosure and transparency regime. A more comprehensive compilation of good corporate governance practices is presented in Section IV in the form of an evaluation framework and case study using that framework.

## **State Exercise of Ownership**

With ownership of a company comes the right to influence the company, to obtain information from the company, and to participate in the profits of the company. The principal tasks associated with ownership include: i) to participate in shareholders' meetings and to vote upon matters that, by law and/or internal company statute,<sup>10</sup> must be decided upon by the shareholders;<sup>11</sup> ii) to elect/appoint and, if necessary, to remove members of the board of directors; and iii) to obtain and assess information from the company and from others that is necessary to monitor and evaluate the performance of the board, executive management and the company itself.

### ***Organizing the State Ownership Function***

- **State Ownership Policy**

The manner in which the state organizes the tasks inherent in SFI ownership serves as the foundation for overall corporate governance. As noted in Section I, the ownership arrangements will be shaped by laws and regulations and by state policy. Taken together, the applicable legal and policy regime should provide a consistent and comprehensive framework for the organization and exercise of state ownership.

One means to help promote a consistent, comprehensive framework for state ownership is to articulate a formal **ownership policy**. The ownership policy would define the state's overall ownership objectives, prescribe legal forms for SFIs,<sup>12</sup> define the state's role in governance, and set out how that role and its overall ownership policy will be implemented. The ownership policy would be published, and would not be subject to frequent change.

Formulating, adopting and publicly disseminating an ownership policy along these lines can help clarify and reinforce the authorities and responsibilities of the owner, and can provide more clear guidance to the board. Minimizing changes to the policy will help provide a predictable basis for governance and management. An increasing number of

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<sup>10</sup> Such as the company's constitution, articles of incorporation or association, charter, by-laws, or similar governing documents.

<sup>11</sup> For SFIs and other SOEs, these will generally include dividend policies, authorization of major acquisitions or divestitures, significant change in scope of business, and the like.

<sup>12</sup> For example, whether the institution should be incorporated under the company law and made fully subject to that law. Also relevant in this context is the consideration of whether an incorporated financial institution is the most effective means of state intervention, as compared to, for example, a perhaps more economical institutional arrangement such as a specialized government department or unit.



countries are adopting formal ownership policies, including Sweden, Finland, France, and Poland. See **Box A** for a brief description of the ownership policy in Sweden.

### **Box A – Sweden’s Ownership Policy**

The Swedish government administers ownership of 41 wholly-owned and 14 partly-owned companies and groups with a total value of approximately SEK 500 billion (US\$ 70 billion). The government has published an *Ownership Policy* defining the manner in which it administers ownership in all SOEs.

The policy highlights the constitutional basis for the administration of state property, and describes and differentiates the roles of the government administration and those of the legislature. The government’s mandate is explicit (“actively monitor and manage the state’s assets in order to achieve the best long-term development of value (and, in those cases where it is applicable – to comply with the special societal interests). SOEs in Sweden are explicitly subject to the same legislation as privately-owned companies.

The Swedish Code for Corporate Control, published in 2004, developed by an expert group of representatives of the Swedish business community, and applicable to all listed firms, serves as the principal basis for the conduct of state ownership. The Ownership Policy makes clear where it varies from prescriptions in the Code. The Code’s Rules for Corporate Governance are annexed to the Ownership Policy.

The Ownership Policy sets out principles for the administration of SOEs that address, among other matters, legislative and public participation in annual shareholders meetings, board member qualifications, board composition, board size, board member tenure, participation of government officials as board members, the board appointment process, and the disclosure of fees paid to board members. The policy prohibits managing directors (CEOs) of state companies from serving on the board (citing the appointment and dismissal of the managing director as one the board’s most important tasks). The policy prescribes the manner in which the external auditor is to be appointed, placing ultimate responsibility on the owner representative for auditor selection.

The policy requires that SOEs be at least as transparent as listed companies, and places responsibility on the board to ensure that specific standards are met as the basis for reporting. The board is required to disclose in the annual report its application of the government’s Ownership Policy and guidelines (including those governing external financial reporting). The government, in turn, submits an official annual report on the administration of SOEs to the legislature and annually publishes a report oriented toward the public, media, trade unions and other stakeholders.

See: [http://www.ud.se/sb/d/2106/a/19792.jsessionid=aJ4JprhavBo\\_](http://www.ud.se/sb/d/2106/a/19792.jsessionid=aJ4JprhavBo_)

### • **Shareholder Representatives**

Two critical elements in organizing the state’s ownership function are to make clear who is responsible and accountable for functioning as the state’s shareholder representative (i.e., acting as owner on behalf of the state), and to define the shareholder representative’s role and accountabilities.

In many countries, SFIs (and SOEs generally) fall within the administrative portfolio of individual ministers, such that, for example, the minister of agriculture serves as the state’s shareholder representative for the national agricultural development bank. In some countries it is required that two or more ministers share this responsibility, such as in New Zealand, where shares in most SOEs are held in equal amounts by a “Responsible Minister” and the Minister of Finance, who together comprise the “Shareholding Ministers.” In other countries, such as Canada and South Africa, while a single minister serves a shareholder representative, the Minister of Finance plays an explicit role in overseeing and authorizing the shareholding minister’s actions by virtue of responsibilities and authorities set out in public sector financial management legislation.

Arrangements involving two ministers offer the potential advantage of better balancing the interests and goals of sectoral ministers (e.g. agriculture, housing) with those of the ministers responsible for public sector finance, performance and efficiency, and

mitigating the potential for unilateral action by a single minister that runs contrary to good corporate governance. These advantages are particularly relevant with respect to deposit-taking SFIs, where poor performance can create potentially unrecognized contingent fiscal liabilities arising from the protection of depositors, and by virtue of which the minister of finance should have an important governance role.<sup>13</sup>

In any case, to preserve individual accountability, when two or more ministers share responsibility, it is important that respective duties and authorities be clearly differentiated. See **Box B** for a description of how several countries have provided for clarity as to shareholder representative responsibilities and authorities as well as checks and balances on such authority.

### **Box B – Strengthening the Shareholder Representative Function**

SFI under the control of a single minister, in an environment where the state’s expectations regarding the responsibilities and accountabilities of the shareholder representative are not well defined, is likely a key source of poor SFI performance. Ensuring clarity regarding the role of a shareholder representative, and putting in place appropriate checks and balances, can lay a better foundation for good governance.

In New Zealand, SOE shares generally are held in equal amounts by the Responsible Minister and the Minister of Finance (together comprising the Shareholding Ministers). The functions of Shareholding Ministers are set out in the Companies Act, the SOE Act and in company-specific legislation. Shareholding Ministers are accountable to the House of Representatives for the performance of those functions.

In South Africa, under the Public Finance Management Act (PFMA), each SOE is accountable both to a minister (the shareholder representative, referred to as the “executive authority” in the Act), and to the Minister of Finance, in his capacity as the head of the National Treasury. (In only one SFI, the Development Bank of Southern Africa, does the Minister of Finance at the same time serve as the executive authority for the SFI.) The shareholder representative is accountable to Parliament for the performance of the SOE. The PFMA and institution-specific legislation set out the responsibilities and authorities for shareholder representatives and for the Minister of Finance with respect to SOEs, as well as detailed reporting responsibilities for SOE boards.

In Canada, the Financial Administration Act sets out the legislative basis for the governance and accountability framework for SOEs. It sets out the authorities and responsibilities of the minister functioning as shareholder representative, and assigns specific tasks for shareholder representative oversight to the Minister of Finance as well as other bodies in the executive branch. The shareholding minister is accountable to Parliament for the performance of the SOE.

In recent years, there has been a centralization of responsibility for SOE ownership functions in countries such as Sweden, Singapore, Poland and Chile, where a single minister now is responsible for functioning as the state’s shareholder representative in all or most SOEs, including SFIs. Carrying this trend a step farther, Norway and Finland have set up specialized ownership units within ministries for this purpose. In Norway, for example, in 2002 the Department of Ownership was established as a separate department within the Ministry of Trade and Industry responsible for managing the state ownership in 20 companies, coordinating the activities of all other ministries involved in state ownership, and preparing the State Ownership Report, an annual report on the administration of the ownership within all the ministries.

The case study in Section IV of this note sets out more detailed guidelines regarding the responsibilities, authorities and accountabilities of SFI shareholder representatives.

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<sup>13</sup> The state’s contingent liability for non-deposit-taking SFIs are likely to be better identified and controlled within normal public financial management arrangements, in contrast to contingent liabilities for repaying deposits.

- **Professional Support to Shareholder Representatives**

Ministers functioning as shareholder representatives have critical roles to play. To function effectively, they should be supported by a professional staff with relevant skills and expertise. An increasing number of countries are establishing specialized bodies tasked with providing expert support to ministers functioning as shareholder representative. Examples include in New Zealand the Crown Company Monitoring Advisory Unit, a semi-autonomous unit attached to the Treasury, in Australia the Office of Government owned corporations (Queensland), in the United Kingdom the Shareholder Executive within the Department of Trade and Industry, in France the French Government Shareholding Agency in the Ministry of Finance, and in Canada the Crown Agencies Secretariat within the Ministry of Finance, British Columbia. **Box C** describes the Crown Company Monitoring and Advisory Unit in New Zealand, as an example.

**Box C – Professional Support to Shareholder Representatives in New Zealand**

In New Zealand, the administration of state ownership is supported by the Crown Company Monitoring and Advisory Unit (CCMAU). The unit was established in 1993 to advise shareholding ministers on SOE performance and to recommend qualified persons to sit on SOE boards. CCMAU is situated administratively within the Treasury, but is independent in operational and financial terms. Funding is provided by SOEs and other state entities.

The CCMAU provides advice in the areas of monitoring (reporting on company business plans, performance against targets), ownership functions (advising on strategic issues, investment and diversification opportunities, and the impact of government policy), identifying and screening potential directors, managing the board appointments process, and promoting corporate governance best practices.

The Treasury and CCMAU have joint responsibilities in the area of state ownership administration. Their roles are complementary. CCMAU primarily focuses on performance, commercial aspects and risks at the company level. CCMAU also advises on board composition and performance. The Treasury focuses mainly on broader issues relating to SOE's overall balance sheet and fiscal position.

The CCMAU has published a number of documents which articulate the legal, regulatory and policy framework applicable to SOEs in New Zealand, and helps shareholding ministers and board members understand their responsibilities and accountabilities. A key document is the 2002 Owners Expectation Manual, which outlines shareholding ministers' expectations of SOE boards.

See: <http://www.ccm.au.govt.nz/about-ccmau.html>

- **Separation of Ownership from Regulation and Supervision**

It is an accepted principle of SOE ownership that there be a clear separation of responsibility within government for exercising ownership, on the one hand, and for exercising regulatory and supervisory responsibilities, on the other. This is of particular importance in the context of deposit-taking SFIs, which are more relatively heavily regulated than other SFIs and most other type of SOEs. Combining both ownership and regulatory/supervisory functions (for example, within the central bank) presents conflicts of interest that likely will undermine the conduct of both functions.

## *Constituting the Board of Directors*<sup>14</sup>

- **The Board Appointment Process**

A key ownership task is to appoint the board of directors. An appropriately constituted, qualified and empowered board of directors is an essential component of good corporate governance. The board appointments process is thus a key governance matter. Too often SFI board member appointments are seen as a form of political patronage, with the result that the board does not collectively possess the necessary skills and experience to do its job. A better approach is for the shareholder representative to use a structured and transparent board appointment process that adheres to explicit policies and procedures and seeks to ensure the ability of the board to exercise its responsibilities in an independent manner, including the use of competence and experience requirements consistent with the strategy and business of the SFI.<sup>15</sup>

A number of countries have taken steps in this direction in recent years. In some countries, legal and regulatory requirements have been modified to mandate use of skill and experience criteria by the shareholder representative or other parties with appointment powers. In some instances, this involves a requirement for a board subcommittee (e.g. a nominations or remuneration committee) to assess the skill requirements of the board, and the capacities of existing board members, and to make recommendations to the shareholder representative. In other cases, specialized units have been created within government to coordinate and advise on the appointments process. Canada is an example of the former, while New Zealand is an example of the latter. See **Box D** for a description of the board and chairperson appointment processes in those two countries.

- **Issues in Board Composition**

Besides ensuring that the board collectively has the proper mix of skills and capacities, two other key questions that arise with respect to board composition are whether public servants should serve on the board of a SFI (or SOE), and whether the Chief Executive Officer (CEO) should be prohibited from also serving as the board chairperson.

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<sup>14</sup> The reference here is to the board responsible for governing the institution and overseeing the executive management. In countries with a unitary board structure, this is the board of directors that normally will include executive and non-executive directors. In countries with a two-tier board structure, the reference is to the supervisory board (on contrast to the management board, which is normally composed entirely of executive directors/managers).

<sup>15</sup> Such a board appointment process might well be applicable to all SOEs.

## **Box D – Board and Chairperson Appointment Processes in Canada and New Zealand**

The Canadian Financial Administration Act provides that the shareholder representative (“responsible minister” in the terms of the Act) appoints directors with the approval of the Governor in Council, following a review of the recommendation by the Prime Minister. In the past, in practice, the qualification criteria employed by ministers, and the extent to which the board or chairperson of the board was consulted in the process, varied considerably.

In March 2004 the Canadian government adopted significant changes to the SOE board and chairperson appointment process. Boards of directors must establish a nominating committee to identify board and chairperson candidates, and are expected to seek the assistance of an executive search firm. The nominating committee must develop a *competency profile* for the board (a description of the experience, attributes and skills that should be possessed by the board as a whole). The profile is to be based on the roles and responsibilities of the board, including considerations relevant to the industry in which the firm operates. In filling board positions, the committee is to assess the skills already on the board, and identify specific competencies required to complete the skills mix. For board chairpersons, the committee is to develop specific selection criteria. The board profile and selection criteria are to be discussed with the responsible minister and well as others in the executive branch. To fill positions, the committee formulates a list of suitable candidates which is submitted to the board, which in turn submits an approved short-list to the responsible minister, who makes the recommendation for appointment.

In New Zealand, Shareholding Ministers have the responsibility to appoint directors, chairpersons and deputy chairpersons. CCMAU assists ministers in fulfilling their responsibilities by administering a Cabinet-approved process for identification and appointment of directors. Key tasks performed by CCMAU in this process include: identification and pre-screening of potential candidates; assessing future skill requirements for board vacancies and preparing a position specification in collaboration with company chairpersons and the Shareholding Ministers; matching candidates with skill requirements; and submitting qualified candidates to Shareholding Ministers. Once Shareholding Ministers identify their preferred candidate, CCMAU and the chairperson undertake a due diligence process that further assesses the candidate’s suitability and identifies and evaluates any conflicts of interests that may exist. Where necessary, CCMAU conducts reference and credit checks.

Shareholding Ministers make the final decision, either selecting the preferred candidate or requesting that other candidates be identified. By convention, the Shareholding Ministers’ selection is reviewed by the Cabinet prior to final decision. Ministers are required to certify that they have followed the Cabinet-approved appointment process and have appointed the best qualified candidate, and that there are no unmanageable conflicts of interest issues in the appointment. Selected candidates are provided a written terms of reference describing the Responsible Minister’s expectations for the appointee. CCMAU conducts general induction seminars for groups of confirmed appointees. Company-specific induction is the responsibility of the company’s board chairperson.

In very few countries are public servants (such as a deputy minister reporting to the minister who is the SFI’s shareholder representative) prohibited from serving on the board. Norway is one country where such a prohibition is in place. The concern is that the public servant would be seen by other board members as having inordinate powers, and therefore be in a position to inappropriately influence the decisions and direction of the board. For this reason, in some countries such as Canada there is an ongoing debate about whether to prohibit public servant board appoints.<sup>16</sup> While there certainly is a need for the board to have access to the views of the shareholder, this should be accomplished by structured arrangements for interactions between the shareholder representative, the chairperson of the board, and the board itself (as described below), rather than having a proxy for the shareholder representative sit on the board with a special role in articulating policy. In any case, when public servants are appointed to the board, their number should be limited, they should meet the requisite skill and experience requirements, and they should have the same obligations and roles as any other board member.

The question as to whether the CEO should be prohibited from serving as chairperson of the board is one confronted in many countries in both the private and public sector.

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<sup>16</sup> A reevaluation of the policy permitting public servants to serve as board members was called for by the Auditor General in 2005.

There is a trend toward adopting policies and laws calling for a separation of the two positions. Some countries, such as Finland, Norway, Canada, Australia and New Zealand already have a prohibition in place with respect to SOEs generally. Since an important objective of the corporate governance practices advocated in this note is that the board do a better job in overseeing management, the separation of the two positions seems well advised. This can be a decision taken at the level of an individual SFI by the shareholder representative. This is the case of the DBSA, for example.

### ***Clarifying Shareholder Representative Objectives and Expectations***

- **Setting Financial and Non-financial Performance Objectives**

The state (and thus the shareholder representative) cannot function as a passive shareholder, especially in wholly-owned SFIs, whether the SFI pursues public policy objectives or not. Failure to define clear objectives and performance measures and targets opens the door to a number of problems, including inappropriate political interventions in day-to-day managerial decisions, excessive management autonomy (leading to self-interested activity and mission creep or drift beyond that which was intended), and difficulties in measuring and evaluating the performance of the board, management and institution.

As advocated above, for any SFI two overriding objectives are to ensure the institution's long-run financial sustainability and to meet financial performance objectives specified by the owner. These high-level objectives should be codified in law or regulation, or in the state's ownership policy. Similarly, the public policy objectives of SDB/DFI should be made similarly explicit. (The special challenges faced in defining SDB/DFI policy objectives, balancing policy and financial sustainability objectives, and measuring policy performance, are discussed in Section III.)

The shareholder representative, in consultation with the board, should further specify SFI objectives, and translate them into performance measures and targets. At a minimum, this would include specifying *financial performance targets*, which might include profitability, capitalization and dividend payment targets, as well as *operational targets* designed to ensure the SFI adheres to commercial business practices, operates efficiently, and is funded prudently. The shareholder representative could well specify other objectives. For example, in the case of SCB, despite having no public policy mandate, the shareholder representative might specify objectives designed to ensure that the institution adds value within the context of the existing commercial financial services industry landscape, so that executive management and the board are not simply left to compete only in the same markets as other private financial institutions.

To achieve this in practice, the shareholder representative and the board should enter into written agreements documenting corporate missions, objectives, and strategies, as well as specific financial and non-financial performance targets. In South Africa, for example, regulations issued by the Treasury, under the Public Financial Management Act, requires that the shareholder representative annually conclude a ***Shareholder Compact*** with SOE boards. In the case of the DBSA, the Shareholder Compact is signed by the Minister of Finance (as shareholder representative), the chairperson of the board (on behalf of DBSA), a representative of the Office of the Minister of Finance (on behalf of the

National Treasury), as well as by the CEO and the chairperson of the boards' audit committee. The Shareholder Compact documents the government's policy and strategic objectives as well as key performance measures and indicators to be attained by DBSA. A statutorily mandated **Corporate Plan** is annexed to the Shareholder Compact and elaborates upon agreed objectives, performance indicators and quantitative targets. In practice, the strategic objectives and performance measures and targets generally are proposed by the CEO, executive management and the board, and agreed with the Minister as shareholder representative. They form the basis of reporting by the board on performance against specific financial and non-financial objectives in the Annual Report and in other reports. (See Section III for additional information.)

Another example, representing a somewhat more structured arrangement for specifying and documenting shareholder representative expectations, is that of the State of Queensland in Australia, which recently issued guidance to SOE boards and executive managers for agreeing with shareholder representatives annual **Statements of Corporate Intent**, as well as five-year Corporate Plans. See **Box E** for details.

#### **Box E – Statement of Corporate Intent – The State of Queensland**

The Statement of Corporate Intent (SCI) is a formal annual performance agreement between SOE boards and Shareholding Ministers. It serves as the basis for quarterly reporting to Shareholding Ministers, as well as regular management reports to the board. The SCI is the basis of Shareholding Ministers' assessments of whether and how successfully the SOE achieves its financial and non-financial targets and outcomes, and is thus a principal tool for promoting board accountability. Financial and non-financial performance targets set out in the SCI also are expected to be reflected in the performance contracts of the Chief Executive Officer and other senior executive managers.

In 2006, the Queensland Treasury issued new guidelines for SCIs. SCIs are to be based on the five-year Corporate Plans each SOE must agree with their Shareholding Minister. The Corporate Plan is a forward-looking document that defines, among other matters, the SOE's vision and mission, its business objectives and priorities for the medium and long-term, its strategies for achieving those objectives and priorities, and the anticipated corporate, financial and non-financial outcomes of those strategies.

The 2006 guidelines specify the content and suggested format of SCIs. SCI content is to include a summary of key corporate objectives and strategies, including a statement of the SOE's core business, identification of its corporate and operational objectives and corporate strategies, quantifiable corporate performance objectives (business development, asset/liability structure, cost structure, etc.). By statute, the SCI must include annual financial and non-financial performance targets for the SOE. Financial targets and other financial performance indicators must be identified, and historic and budgeted values provided. Non-financial targets must be identified and presented in the same format. Key assumptions underlying the targets must be provided, including economic assumptions, and business-specific financial and operating assumptions. The SCI must include historic and budgeted balance sheets, income statements and cash flow statements, both on a consolidated basis and for major legal entities (parent, subsidiaries). The contribution to corporate targets of major business lines should be specified. The SCI also is to include statements regarding financial control, risk management and corporate governance practices, among other matters, and details on remuneration agreements for board members, the CEO and other key executive managers. The SCI must be signed by the board, or by the chairperson on behalf of the board.

See: <http://www.ogoc.qld.gov.au/goc-policies/index.shtml>

- **Periodic Mandate Reviews**

Over time, SFI can come to be engaged in activities and pursuing objectives that were never envisioned by the state or the shareholder representative. Even where a SFI remains focused on a clear and specific mandate, the evolution of markets, client needs, and public policy objectives may render the mandate no longer valid or appropriate.

One mechanism governments can adopt to mitigate the risk that mandates become outdated is periodic **mandate reviews**. Some countries are beginning to adopt policies requiring such reviews. The Auditor General of Canada, for example, in a December 2000 report, cited the need for more systematic reviews of SOE corporate mandates. The report suggested that the government adopt guidelines for the conduct of regular, periodic mandate reviews. Mandate reviews would be led by the shareholder representative and supported by outside expertise. The review would assess the continuing validity of the mandate, including an assessment of the SOEs record of cost-effective performance. The results of the review would be shared with all parties in the SOE accountability framework, including Parliament.

In South Africa, the mandate of DBSA is subject to periodic internal and external review. The current review (2007) is being undertaken in the context of a broader review of the overall development finance system, including all state development finance institutions.

### **The Board of Directors**

The principal roles of the board should include i) to appoint key executives, to evaluate management performance, and to develop a succession plan for key managers; ii) to help formulate, monitor and approve the institution's strategy;<sup>17</sup> iii) to approve key policies; iv) to ensure that internal financial and operational controls are in place; v) to establish performance indicators and benchmarks;<sup>18</sup> and vi) to monitor disclosure and public communications processes to ensure financial statements and other disclosures fairly present the institution's performance, financial condition, business and risks.

Many of these roles may be prescribed in law and regulation. To the extent they are not, they should be made explicit by the shareholder representative. Key purposes in doing so are to ensure that board members understand their role, to differentiate their role from that of executive management, and to make explicit the board's legitimacy and authority to oversee management and hold it accountable.

### ***Appointing the CEO and Holding Executive Management Accountable***

- **The CEO Appointment Process**

In many countries, the shareholder representative (or a higher ranking member of the government administration, such as the Prime Minister or President), has the power to appoint the CEO. While quite common in practice, this arrangement clearly undermines the ability of the board to hold the CEO and executive management accountable, and in turn undermines the ability of the shareholder representative to hold the board accountable.

The board should have a direct role in the appointment and potential dismissal of the CEO. In Norway, Finland and New Zealand, SOE boards are granted authority to recruit,

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<sup>17</sup> In the context of objectives set out in the *ownership policy* and further elaborated by the shareholder representative in agreements with the board such as a *shareholder compact*, *statement of corporate intent* and *corporate plan*.

<sup>18</sup> Elaborating upon those set by the shareholder representative.



hire, dismiss and set the compensation of the CEO.<sup>19</sup> More countries will likely move in this direction. For example, in 2006 a Canadian government commission recommended that SOE boards be given the power to appoint and dismiss the board, and the Government of British Columbia has already granted this authority to the boards of provincial level SOEs.

When it proves politically impractical to give the board explicit authority to appoint and dismiss the CEO, an alternative arrangement is for the board at least to take the lead in the CEO recruitment process. In this model, the board, or a board committee, would lead the search for CEO candidates. The board would recommend a shortlist of candidates to the shareholder representative, and interview short-listed candidates. The shareholder representative would then interview the candidates and make the selection in consultation with the board. This approach has been used in certain instances in Canada, where it is viewed by chairpersons, boards and CEOs as the most effective arrangement among several alternatives in supporting good corporate governance and a strong accountability relationship between the CEO and the board.<sup>20</sup>

In exercising its authority to appoint or participate in the appointment of the CEO, the board should adopt clear rules and procedures. Selection criteria should be explicit, and based on professional qualifications and experience. The board might well utilize the services of a professional executive search firm to support their efforts.

When adopting arrangements granting the board greater authority to appoint the CEO, or to participate in CEO selection, there may be a need for transitional arrangements in certain SFIs, for example, where the board itself is not properly constituted (e.g., members do not meet the qualification criteria suggested earlier in this note) or there are significant gaps on the board (e.g. vacant seats, members serving beyond the expiration of their term pending replacement). The nature of the transitional arrangements will vary, but should have as their goal providing assurance that the board is sufficiently supported by the government and/or outside professional firms in the task of recruiting the CEO.

- **CEO Compensation**

A necessary complement to the authority of the board to appoint the CEO or influence CEO selection, and to its responsibility to monitor management performance, is that it have significant influence over CEO compensation. In principle, CEO compensation should be market-based, and related to performance. Some countries have begun to define explicit guidelines for CEO (as well as director) compensation. For example, in Norway, the state has issued advisory guidelines for wholly-owned SOEs which state that “the wage development in companies fully-owned by the State should be competitive, but not pacesetter in terms of wage development within their industries.” Similarly, in Australia, the government has issued policy documents describing the principles and guidelines for remuneration of CEOs and other executives in SOEs and expectations of

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<sup>19</sup> In Finland, SOE boards are to follow Helsinki Stock Exchange guidelines for CEO appointments. The shareholder representative retains the power to dismiss the CEO in certain circumstances.

<sup>20</sup> The alternatives were an arrangement where the shareholder representative and the state select the CEO and notify the board, and where the shareholder representative and state select the CEO in consultation with the chairperson as a proxy for the board. *Governance of Crown Corporations, Report of the Auditor General of Canada*, December 2000.

the board in this regard. The board is expected to establish, approve and maintain a remuneration policy for senior executives and provide detailed information to shareholders and the public on remuneration policy.

### ***Organizing the Work of the Board***

- **Overall Board Mandate**

The role and organization of the board to some extent will be set by law and regulation, and further defined in the state's ownership policy and by the shareholder representative. One tool by which to elaborate and give emphasis to these legal, regulatory and policy requirements is through a **board charter**. A board charter would present in one document the various requirements that guide the operation of the board. It would thus serve as a key source of guidance to board members, and an important component of the board orientation process. Such a charter is a requirement of the South African government's *Protocol on Corporate Governance in the Public Sector*. See **Box F** for a description of DBSA's board charter.

#### **Box F – The Board Charter of the Development Bank of Southern Africa**

The DBSA Board Charter is a document agreed by the shareholder representative and the board. The purpose of the Charter is to highlight key provisions of relevant legislation relating to the composition, powers and functioning of the board, and to set out matters of policy that the shareholder representative and the board will follow in order to ensure good governance.

The Board Charter defines the mission of the board, recites the legal fiduciary responsibilities of board members, defines policy relating to board composition and to the selection and orientation of board members, recites legal requirements relating to conflicts of interest by board members (including those arising when government officials serve as board members), and sets out the board committee structure. It recites regulatory stipulations for the conduct of board meetings, and defines additional policies in that respect. It emphasizes the role of the board in determining the policies and processes necessary to ensure the integrity of internal controls and risk management. It requires the board to adopt a code of conduct defining principles and standards of ethical business practice, and to be responsible and accountable for compliance.

The Board Charter requires that the chairperson annually evaluate each board member and the board as a whole, and that the board remuneration committee formally evaluate the performance of the CEO semi-annually. It stipulates that the chairperson, in consultation with the CEO, determines a succession plan for the CEO and other key executive managers. Finally, the Charter grants all board members access to any DBSA staff member as required to support board decision-making.

See: <http://www.dbsa.org>

- **Role of the Chairperson**

Primary responsibility for ensuring the efficient and effective operation of the board falls to the chairperson of the board. The role of the chairperson should be defined in writing (for example, in the board charter). That role should include primary responsibility for direct contacts with the shareholder representative, for organizing the work program of the board and for setting board meeting agendas, for agreeing with the shareholder representative the skills and experience the board should possess to ensure its effectiveness, and for ensuring the performance of the CEO and the board itself is formally appraised.

- **Board Committees**

A key means by which to promote good board performance is to establish sub-committees for certain specialized tasks. Many countries now require that boards

establish at least an **audit committee**. Audit committees play an essential role in overall corporate governance by ensuring the accuracy, timeliness and relevance of information flows. (The duties of audit committees are described more fully below.)

Some countries, including Australia, Sweden and Norway, now require that the board establish a **remuneration committee**. Generally, remuneration committees are tasked with formally assessing the performance of the CEO and reviewing the performance of other key managers, setting remuneration principles, recommending senior management remuneration to the board, making recommendations regarding board remuneration to the shareholder representative, and ensuring disclosure of principles and actual remuneration.

Boards also often establish a specialized **risk management committee**. Generally, risk management committees are responsible for ensuring the adequacy of risk management policies and management's adherence to such policies, including specific risk limits. The committees explicitly addresses credit, interest rate, foreign exchange rate, and operational risk.

All board committees should have a written terms of reference that define their duties, authorities, composition and working procedures. Committees should report to the full board, and minutes of committee meetings should be circulated to all board members.

## **The Information, Reporting and Disclosure Regime**

Effective corporate governance depends on the flow of accurate, timely and relevant information internally within the organization, and externally to the government, legislature and public. This includes internal reporting to management (e.g. management information systems – MIS), management reporting to the board, board reporting to the shareholder representative, shareholder representative reporting to the government and legislature, as well public reporting via the published accounts. Ensuring adequate reporting at all levels requires an investment in accounting and information systems, in internal controls, and in internal and external auditing. It involves formulating and documenting policies and procedures, putting in place hardware and software systems, and recruiting and training qualified staff, among other tasks.

Key tasks of the board therefore are to ensure a functioning system of internal financial and operational control, to monitor disclosure, reporting and public communications processes, and to ensure that financial statements and other disclosures fairly present the institution's performance, financial condition, business and risks.<sup>21</sup> The critical nature of these tasks, the specialized skills they involve, and the commitment of time and attention to detail they require, are among the reasons many countries require boards to establish audit committees dedicated to, and accountable for, this work.

### **• The Composition and Role of Audit Committee**

The audit committee should have explicit responsibility for oversight of internal and external audit functions, for approval, dismissal and compensation of the external auditor,<sup>22</sup> for approving the external and internal audit plans, and for reviewing audits

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<sup>21</sup> Ensuring the accuracy of required reporting to the regulatory and supervisory authorities is also relevant in this regard.

<sup>22</sup> Or for recommending approval to the full board, or via the board to the shareholder representative.

and ensuring management takes appropriate action in response to identified deficiencies. It should be comprised solely of independent board members who are financially literate.<sup>23</sup> The chairperson of the audit committee should not be the chairperson of the board. The committee should have the authority to meet with any officer of the institution. It should meet annually with the external auditor, routinely with the internal auditor, and periodically with the official supervisory authorities. It also should maintain a dialogue with the state's supreme audit institution (the Auditor-General).

- **The Audit Functions**

The **internal audit** function, while reporting administratively to executive management, should be accountable to the audit committee and have unrestricted access to the chairperson of the board and all board members. It should provide the board an independent check and assurance on the information received from senior management on the operations, performance and condition of the SFI. The internal audit function should follow an internal audit plan based on a formal risk assessment of the SFI.

The **external audit** should be conducted according to international standards.<sup>24</sup> An external audit is both a means and an incentive for the board and management to perform their duties professionally. The external audit provides the board an independent assessment of the accuracy of reporting by management, and the state of internal financial and operational control. The audit committee should use clear procedures for the selection of the external audit firm, which ensure the firm is independent of management and the state (as shareholder), among other criteria.<sup>25</sup> The external audit firm should be required to utilize international accounting and auditing standards. Among its tasks, the external audit firm should review the internal control processes related to the public disclosure of financial statements and other information.

### ***Section III. Additional Challenges with Development Institutions***

#### **Overview**

In contrast to SCB, the main objective of which is to maximize profit/value, SDB/DFI are expected to pursue public policy mandates as well as meet financial performance objectives. Fulfilling policy mandates typically involves providing services to targeted groups on less than fully commercial terms, for example, granting concessionary loans or providing technical assistance and training services at no or low cost to certain clients.<sup>26</sup> Fulfilling policy mandates, therefore, can conflict with financial performance objectives and can jeopardize long-run financial sustainability unless adequate arrangements are in place for compensating SDB/DFI for delivering such services. On the other hand, financing arrangements for policy activities can be misused to cover operational inefficiencies and

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<sup>23</sup> In general terms, a board member is "independent" when he/she has no direct or indirect relationships or interests of a financial, commercial, professional or philanthropic nature which are likely to interfere with the quality of their decisions as regards the interests of the firm.

<sup>24</sup> Audits performed by the state supreme audit entity (Auditor General) may mainly focus on the use of public funds and budget resources, and generally are not considered a substitute for an external financial audit.

<sup>25</sup> It is important to ensure that the independence of the external audit firm is not comprised by non-audit work performed by the SFI.

<sup>26</sup> In effect, then, fulfilling policy mandates involves providing some form of subsidy to recipients of services.

losses unrelated to policy activities. Institutionalizing the means by which to make tradeoffs between policy and financial objectives and to efficiently fulfill policy mandates is a key governance challenge facing SDB/DFI.

As noted in Section I, given their responsibility for potential contingent fiscal liabilities, finance ministers are important stakeholders in SFI governance. In addition, for SDB/DFI, it is often finance ministries that bear ultimate responsibility for financing policy activities. For this reason, arrangements such as those set out in Box B are particularly important in the context of SDB/DFI governance.

Shareholder representative as well as finance ministers need to create incentives for boards and executive managers to effectively and efficiently engage in policy activities while meeting financial and operating efficiency performance objectives, and to ensure long run financial sustainability without resort to extraordinary state support. Within the context of the basic governance arrangements set out Section II, this can be promoted by clearly defining policy mandates and the means by which those mandates are to be financed, by requiring that the costs involved in undertaking policy activities be quantified and dynamically assessed in the context of overall strategic and financial planning, and by requiring that actual performance in achieving policy objectives is quantified and assessed, and that costs versus outcomes are periodically evaluated.

## **Defining Policy Mandates and Means of Financing**

- **Policy Mandates**

SDB/DFI generally have been established by governments as a means to fill perceived gaps in financial markets (e.g. lack of sufficient long-term finance, agriculture finance, or SME finance). Yet, in many cases, the nature of these gaps, and in particular their root causes, have not been well analyzed or understood, which otherwise would have facilitated design of a possibly narrow state intervention to resolve those root causes. Instead, it is common for the mandates of policy institutions to be defined in broad and general terms, particularly in relevant law (e.g. founding legislation) and implementing regulations.

Broad mandates themselves may be a root cause of the problems encountered by many SDB/DFI. They can enable boards and executive management to pursue a wide range of businesses beyond those originally envisioned by governments or legislatures. They can make it more difficult to measure board, management and institutional performance.

For these reasons, shareholder representatives and finance ministers should define SDB/DFI policy mandates as explicitly and narrowly as feasible. This can be achieved by means of tools such as Shareholder Mandates, Corporate Plans and Statements of Shareholder Intent discussed in Section II.

The nature of market gaps is by definition dynamic. The boundaries between what is commercially viable and what requires state invention changes with the evolution of the financial services industry and the needs of users of financial services. Periodic Mandate Reviews, as described in the Section II, are a good instrument through which to reassess the existence of market gaps and to refine the SDB/DFI policy mandates.

- **Financing Policy Activities**

In principle, there are several means by which to finance the provision of financial and other services on concessionary terms. In practice, the various means cited below often are used in combination. None are without their drawbacks.

A common means to finance policy activities is to **cross-subsidize** concessionary business with profits from commercial business. The problem is that cross-subsidization creates incentives for managements and boards to expand the commercial activities of the institution with the justification that this will enable them to engage in more policy activities and/or to offer greater concessions to needy clients. The effect is often to under-price commercial business, to crowd-out the private sector in commercial financial markets, and/or to undermine new private entry into those markets and thwart financial market development.<sup>27</sup> To mitigate this risk, shareholder representatives and/or finance ministries need to ensure internal monitoring and reporting mechanisms are in place to make transparent and delimit the commercial activity undertaken by SDB/DFI. In addition to these internal systems, governments can consider to create mechanisms that enable the private sector to formally table concerns regarding perceived unfair competition from state institutions. To mitigate the risk of under-pricing by state institutions, shareholder representatives can require that certain commercial activity financed by SDB/DFI be co-financed and jointly priced by private institutions.<sup>28</sup>

Another means to finance concessionary business is for the shareholder representative to adopt **soft financial performance targets** (i.e. allow the institution to earn a below market), with the differential between market returns and actual returns allocated to cover the cost of policy-related activities.<sup>29</sup> A complement to this approach is to forego dividends or to endow the institution with excess capital. A related means is for the government to grant the institution **exemptions from income and other taxes**, with the savings used to financial policy activities. These type provisions, however, place SDB/DFI at a competitive advantage relative to private sector institutions, and again, to the extent that they are permitted to engage in commercial activities, can have the effect of undermining the private sector and thwarting market development.

Another alternative for financing policy activities is for the government to **administratively reduce the cost of funds** of SDB/DFI. This can involve guaranteeing the institution's debts, forcing state companies, other financial institutions, or public pension funds, to purchase bonds or place deposits with the institution at below market rates, or granting soft loans to the institution (e.g. by the central bank). This method represents, in effect, a tax on funds providers which can weaken their finances, distort financial markets and set back market development. Guaranteeing debts of policy institutions also weakens the potential for market discipline to be brought to bear on management and the board.

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<sup>27</sup> Another result can be that the institution strays far beyond its mandate, takes on far more business and risk than is necessary to fulfill its policy mandate, and in the process incurs greater losses or creates greater contingent fiscal liabilities for government.

<sup>28</sup> This is particularly feasible in the context of funding large infrastructure projects.

<sup>29</sup> It would not, however, involve allowing the institution to operate at a loss.

Finally, governments can make **direct fiscal transfers** to compensate SDB/DFI for costs incurred in undertaking policy activities. This method avoids potential market distortions, and has the benefit of being more readily quantifiable and transparent.<sup>30</sup> Yet it is not without its problems, in that annual fiscal transfers, being subject to the annual budgetary process, are less predictable and can impair effective long-term planning by management and the board.

Whatever method or combination of methods is employed, effective governance requires that the manner in which policy activities will be financed be specified by the government or shareholder representative, in consultation with the board. The goal is to agree and make transparent the source of financing for policy activities and to take complementary steps to mitigate any potential negative consequences. Financing arrangements should not be subject to frequent change.

### **Managing, Monitoring and Evaluating Policy Activities and Performance**

With a clear definition of policy mandates and agreement on the means to finance them, the shareholder representative is in a position to agree specific policy, financial and operational performance targets with the board and executive management. **Policy targets** would give more detailed specification to the policy mandate, would be expressed as much in possible in quantifiable, measurable terms, including in terms of development outcomes. **Financial targets** would seek to ensure that the management and board assures long-term financial sustainability without potential resort to extraordinary government support. **Operational targets** would, in effect, seek to ensure that compensation for policy activities is passed on to users of financial services or other clients and is not absorbed by inefficient operations (excessive costs) or other losses.

See **Box G** for a description of the means by which the DBSA measures performance and balances the tradeoffs inherent in policy activities.

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<sup>30</sup> It also has the benefit of potentially being made available to private institutions.

## **Box G –Policy Mandates, Tradeoffs and Performance Measurement at DBSA**

DBSA's mandate is broadly defined in the DBSA Act and implementing regulations, and is further specified in the Shareholder Compact and in the Corporate Plan. The Shareholder Compact also records key assumptions and principles (including that DBSA will remain financially sustainable while delivering development impact, and that a certain percentage of its profits will be contributed annually to the DBSA Developmental Fund, its subsidiary which provides grants for municipal capacity building). The Corporate Plan defines DBSA's strategic goals and objectives, as well as performance measures and targets.

Performance measures and targets in the Corporate Plan are articulated using a Balanced Scorecard (BSC) methodology. The BSC is cascaded from corporate to divisional to unit level. Divisional and unit level BSCs are an important input to their business plans. The corporate level BSC forms the basis of reporting by the board in the Annual Report. In practice, the shareholder representative defines overall strategic direction, while specific strategic objectives and performance measures and targets are proposed by the CEO, executive management and the Board, and negotiated and agreed with the shareholder representative.

The BSC is frequently refined. Recent objectives of these efforts have been to measure development outcomes rather than simply outputs, to better quantify the development impact of projects that have been supported financially by DBSA, and to quantify qualitative aspects of development impact, such as that resulting from the research and policy advice provided by DBSA. External stakeholders' views of the value and quality of DBSA work are ascertained through surveys conducted by independent third parties.

The current BSC defines a total of 25 performance measures associated with the broad strategic goals and specific strategic objectives set out in the Corporate Plan. Targets are set for each performance measure for the current and next two years. Performance against each target is rated using a standardized point-based system, and ratings are aggregated using weights assigned to each performance measure. Aggregate performance against the corporate level BSC determines the annual bonus pool available for staff. (A separate bonus pool for executive management is determined by the BSCs and other factors). Division and unit BSC performance determines the staff bonus allocation to the unit level, though bonuses actually paid to individual staff members are determined by a number of additional factors.

Among the BSC performance measures are volume targets for loan and equity investment commitments and disbursements, with an appropriately low aggregate weight of 9%. By comparison, a new performance measure for the volume of grants mobilized to complement investment projects carries a 7% weight. Other development impact measures include the value of loans, grants and equity investments granted to certain historically disadvantaged groups, the number of outside persons receiving training in priority skills, and the number of project managers trained and deployed to needy municipalities. The DBSA's mandate to facilitate private sector participation in municipal finance is expressed as a measure of the ratio of DBSA funding relative to others' funding in DBSA funded projects. Like certain other performance measures, the co-funding target ratio (1:1.2) is cascaded to divisions and units in a differentiated manner, such that some units (urban infrastructure) have higher target ratios than others (units lending to the poorest municipalities). Other performance measures assess external clients' satisfaction with DBSA's delivery on its capacity building initiatives, market perceptions of DBSA's image in the development finance community and its research quality, and client and partner satisfaction with the value, quality and relevance of expertise offered by DBSA.

DBSA's mandate to maintain financial sustainability is expressed in terms of four measures relating specifically to financial performance (aggregate 15% weight). Others measure internal operational performance (e.g. turn-around time for project evaluations and decisions, and accuracy and reliability of all operations system data as assessed by audit reports – aggregate 18% weight). Complementary performance measures assess staff satisfaction with the knowledge management function (specifically, their ability to readily access and leverage internal knowledge) and the ICT (information, communications and technology) function.

A key tool used by DBSA for managing and balancing the tradeoffs in delivering concessionary finance and other services to targeted groups, while assuring of financial sustainability, is a detailed financial analysis model run by DBSA's Corporate Finance Division. This scenario analysis capacity is used to assess the potential impact of policy decisions on the bank's long-run financial performance and sustainability. The implicit objective inherent in the model is to maintain the real value of capital. The model has been used, for example, to test the viability of the shareholder representative's desire that DBSA direct more funding to infrastructure in poorer municipalities and communities, and on more concessionary terms. The model can be used to assess different pricing policies for developmental activities.

Besides reporting externally on its BSC results, DBSA reports on the non-financial impacts and outcomes of its lending utilizing Social Accounting Matrix models (SAM). The SAMs take into account the linkages of DBSA projects with others, such as through the purchase of materials, hiring of workers, etc. The SAMs are used to estimate the impact of DBSA projects on GDP, employment, and low income households.

See: <http://www.dbsa.org>



## **Section IV. Detailed Evaluation Framework and Case Study**

In the previous sections this note has highlighted key governance arrangements and practices relevant for SFI, including state commercial banks and state financial institutions with policy mandates. In practice, there are many other matters to be addressed when putting in place a comprehensive governance regime. As a means to illustrate the potential scope of an exercise, presented below is a case study of the governance arrangements at the Development Bank of Southern Africa employing a comprehensive framework for assessing SFI corporate governance. The framework was derived from the OECD's 2005 *Guidelines on Corporate Governance of State-owned Enterprises*, and the Basel Committee on Banking Supervision's report *Enhancing Corporate Governance for Banking Organizations*.

The DBSA was established in 1983 to undertake a broad range of economic development functions under South Africa's homeland constitutional arrangements. New constitutional arrangements were put in place in 1994 and the bank was subsequently oriented more narrowly toward infrastructure finance starting in 1996. The loan portfolio relating to other sectors (e.g., agriculture, SMEs) was spun off to other institutions shortly thereafter. The bank was reconstituted under the DBSA Act of 1997 with a mandate to provide "financial, technical and other assistance...with a focus in its investments activities on infrastructure funding broadly defined and with the object of acting as a catalyst to maximize private sector access to opportunities in the provision of public funding." Today the DBSA falls administratively under the Ministry of Finance and forms part of South Africa's Development Finance System, which also includes the Land and Agricultural Development Bank (under the Department of Agriculture), the Industrial Development Corporation (Department of Trade and Industry), the National Housing Finance Corporation (Department of Trade and Industry), and Khula Enterprise Finance Ltd. (for SME finance, under the Department of Trade and Industry).

The DBSA's governance arrangements are an example of good practice in many respects. They are particularly strong with regard to: i) the specificity of the mandate, ii) the clarity with which the respective roles of the owner, board and management are defined, iii) board composition, iv) the extent to which commercial principles are embedded in the legal and governance arrangements, v) the manner in which its performance objectives are set, measured and evaluated, and vi) public reporting and disclosure.

Legislatively, the DBSA is subject not only to the DBSA Act and the implementing regulations issued pursuant to the Act, but also to the comprehensive Public Finance Management Act (PFM Act). The PFM Act stipulates detailed rules for financial management and reporting to be followed by governing bodies and management of all SOEs with the objective to secure transparency, accountability and sound management of SOEs. It promotes this by establishing comprehensive responsibilities for, especially, the boards of directors. It requires the use of generally accepted accounting practices and the implementation of sound internal control and risk management systems. It sets standards for budgeting and annual reporting, establishes notification requirements for certain transactions, and establishes procedures for borrowing, issuance of guarantees and procurement.

The DBSA also is subject to the Protocol on Corporate Governance in the Public Sector issued by the Department of Public Enterprises in 2002, which articulates the respective roles and responsibilities of government as shareholder, the board, the chairperson and the chief executive for SOEs. The Protocol seeks to amplify, with respect to SOEs, the principles set out by the King Committee on Corporate Governance in its Code of Corporate Practices and Conduct of 2002, which distilled the recommendations of a number of task teams codifying a range of corporate governance matters under the auspices of the Institute of Directors, South Africa.

The Minister of Finance (as shareholder representative) appoints all directors as in practice the DBSA board is comprised largely of independent non-executive directors. Under policies set out in the Board Charter (an agreement between the shareholder representative and the board that is required under the Protocol and was described earlier in Box F), the chairperson and CEO are to assist the Minister in identifying potential board members, while the Minister extends the invitation to join the Board. In practice, the Minister calls for nominations and consults with the board and other Ministries with a stake in DBSA's operations (e.g., Department of Provincial and Local Government). The board elects its chairperson from among its members, subject to the consent of the Minister.

There are a number of arrangements in place to provide clarity regarding the owner's (Minister's) expectations regarding the role of the board, the ongoing mandate of DBSA, and specific performance objectives. The DBSA Act implementing regulations define the duties, responsibilities and powers of the board as well as board procedures. The regulations require that the board appoint an audit committee and a remuneration committee. They specify board recordkeeping requirements (as does the PFM Act). The Board Charter also highlights relevant statutory requirements, documents matters of policy that the board and shareholder will follow, and articulates the duties of the board, the chairperson and board committees.

The DBSA's mandate (which was cited above) is defined in the DBSA Act implementing regulations (the Act itself sets out main and ancillary objectives). In addition, the National Treasury regulations issued pursuant to the PFM Act require that the board agree annually with the Minister of Finance a Shareholder Compact which further defines the objectives of the DBSA. Under the PFM Act, the board must submit annually to the Minister a Corporate Plan which must document key performance measures against which organizational performance is assessed. (In practice the Corporate Plan is annexed to the Shareholder Compact.) These legal arrangements provide for clear delineation of the DBSA's mandate as well as its public policy objectives.

The DBSA's financial performance, operating and policy performance are subject to extensive evaluation. Performance measures and targets are set and evaluated annually. These were described above in Box G.

The DBSA makes extensive public disclosure of information about its financial, operational and policy performance. As with other key matters of governance, the DBSA's disclosure practices are subject to a number of legal underpinnings. The DBSA

Act requires the board to publish an annual report “on the financial status and the achievement of the objectives” of the DBSA, and requires that DBSA be audited annually by persons registered under the Auditing Profession Act. Under the DBSA Act implementing regulations the bank is subject to the Accounting and Disclosure requirements of the Companies Act and is required to adhere to South African Generally Accepted Accounting Practices. (In practice the DBSA uses the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board.) The PFM Act requires the board to submit an annual report and audited financial statements, based on generally accepted accounting practices, to be tabled before Parliament.

In practice, the DBSA publishes an Annual Report that includes the Annual Financial Statements including a Director’s Report. The financial statements are audited by an affiliate of an international auditing firm. In the Annual Report the Minister of Finance provides his assessment of the performance of the DBSA and his expectations regarding strategic direction and future performance. The Director’s Report discusses objectives and performance in detail, and includes an Economic Report, an Environmental Report and a Social Report. The Economic Report covers, among other matters, the actual delivery of products and services and their geographic and business sector focus, and reports on the developmental impact of the Bank. The Environmental Report provides a qualitative discussion of the environmental impact of the DBSA’s products and services and its own operations. Similarly, the Social Report provides a qualitative discussion of activities and impacts in areas such as human resource development. The Directors’ Report is subject to the external audit to confirm its quantitative and qualitative content. The DBSA also has published annually an Activities Report that describes the development impact of its activities during the year.<sup>31</sup> All these reports, as well as extensive additional information, are available on DBSA’s website ([www.dbsa.org](http://www.dbsa.org)).

These are only some of the key highlights of governance practices at the DBSA. For more detail, see Table One, which employs the comprehensive framework for assessing SFI corporate governance mentioned above.

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<sup>31</sup> The Activities Report was discontinued in 2007, with its content incorporated into the Annual Report.

**Table One: Corporate Governance Evaluation Framework and Case Study**

Corporate Governance Benchmark	Evaluation of DBSA
<b>1. Legal and Regulatory Foundations</b>	
<p>The state finance institution (SFI) has <i>clear legal form</i> as a corporate entity, either under general corporate or banking law, or an institution-specific statute.<sup>32</sup> The law stipulates a board of directors as a required governance body.<sup>33</sup></p>	<p>DBSA was established in 1983 and is registered as a company in terms of the Companies Act (1973), although it is not subject to the provisions of Companies Act, except as noted below. DBSA was reconstituted under the Development Bank of Southern Africa Act (1997).</p> <p>The DBSA Act requires DBSA to have a Board of Directors. Through its Board, DBSA is accountable to the South African government as sole shareholder.</p>
<p>There is clear <i>administrative separation</i> of responsibilities within government for exercising SFI ownership, and for SFI regulation and supervision, setting national industrial policy and exercising ownership functions for state industrial and other non-financial firms.</p>	<p>Under the DBSA Act the Minister of Finance is authorized to act as owner of the shares held by the government.</p> <p>Under the Public Finance Management Act (PFM Act),<sup>34</sup> DBSA and its Board are accountable to the Minister of Finance both in his capacity as the “executive authority” for DBSA (the Cabinet member accountable to Parliament for DBSA) and in his capacity as head of the National Treasury.<sup>35</sup></p> <p>DBSA is not subject to regulation or supervision by the South African Reserve Bank, though it does file certain reports relating to its borrowing and currency management policies with SARB. It is subject to regulatory oversight by the Financial Services Board<sup>36</sup> and to the Financial Intelligence Centre.<sup>37</sup></p>

<sup>32</sup> **Good Practice:** Incorporating the SFI under general corporate or banking law can leverage upon the governance standards in those laws, may provide greater flexibility to the state to take actions to professionalize governance, including through ownership diversification, and will help to establish a more level playing field among potentially competing financial institutions.

<sup>33</sup> This is in contrast to non-corporatized SFIs where management may report directly to a ministry.

<sup>34</sup> **DBSA:** The PFM Act stipulates detailed rules and regulations related to financial management and reporting to be followed and observed by SOE governing bodies and management. Its objective is to secure transparency, accountability and sound management of public institutions, and promotes this by establishing clear and comprehensive responsibilities for especially the boards of directors of public entities. The PFM Act is applicable to all public entities including central government SFIs such as DBSA. Among its provisions, the PFM Act requires the use of generally accepted accounting practices, requires internal control and risk management systems be in place, sets standards for budgeting and annual reporting, establishes notification requirements for certain transactions, and establishes procedures for borrowing, guarantees and procurement.

<sup>35</sup> **DBSA:** In this latter context, DBSA is accountable to the Minister of Finance in the same manner as are all South African SFIs and other “national public entities.”

<sup>36</sup> **DBSA:** The Financial Services Board oversees non-bank financial institutions and promotes investor protection.

<sup>37</sup> **DBSA:** With respect to anti-money laundering legislation.

Corporate Governance Benchmark	Evaluation of DBSA
<p>Law and regulation clearly define and delineate the <i>roles, responsibilities and authorities of the governance bodies</i> (owner, board of directors, senior management).<sup>38</sup></p>	<p>The DBSA Act specifies that: i) the shareholder(s) exercise overall authority, but may delegate to the Board all powers except the power to issue and transfer shares, to appoint directors, and to approve dividend payments; ii) the Board controls the business of DBSA and may exercise all power not reserved for the shareholder; iii) the CEO is responsible for managing the operations of DBSA, and iv) the powers of the Board may be delegated to the CEO who may delegate such powers to staff.</p> <p>The DBSA Act provides that the Minister of Finance, at the request of the shareholder or the Board, may make regulations (<i>Article 17 regulations</i>) addressing matters that mostly relate to the functions of the governance bodies. Article 17 regulations in fact specify requirements for the annual general meeting (AGM) of shareholders, appointment and disqualification of directors, required disclosures by directors in the case of potential conflicts of interest, proceedings at directors' meetings, and the power of directors.</p> <p>In its Protocol on Corporate Governance in the Public Sector (<i>the Protocol</i>), the government has articulated the respective roles and responsibilities of government as shareholder, the board, the chairperson and the chief executive for public companies generally.<sup>39</sup></p> <p>Finally, the PFM Act establishes clear and comprehensive responsibilities for the Minister of Finance as shareholder representative and for the board of directors.</p>

<sup>38</sup> **Good Practice:** Roles, responsibilities and authorities are comparable to those for private financial institutions or companies.

<sup>39</sup> **DBSA:** *Protocol on Corporate Governance in the Public Sector*, Department of Public Enterprises, September 2002, section 5. The Protocol seeks to amplify, with respect to state-owned enterprises, the principles set out by the King Committee on Corporate Governance in 2002 in its Code of Corporate Practices and Conduct. The King Code distilled the recommendations of a number of task teams codifying a range of corporate governance matters under the auspices of the Institute of Directors, South Africa.

Corporate Governance Benchmark	Evaluation of DBSA
<p>Law or regulation clearly define the <i>fiduciary responsibilities</i> (standards of care, conflicts of interest) <i>and liabilities</i> of board members.</p>	<p>The PFM Act sets out the fiduciary responsibilities of the members of the boards of state-owned enterprises (SOEs), which are applicable to the DBSA Board.<sup>40</sup> The Article 17 regulations make applicable to DBSA all principles of the Companies Act.<sup>41</sup> The Protocol requires the Board to adopt a <i>Board Charter</i> which is explicit that the implication of the application to DBSA of the principles of the Companies Act is that individual Board members carry the same fiduciary responsibilities as do directors of a private company.<sup>42</sup> The Article 17 regulations address situations of Board member conflicts of interest. Detailed rules are set out in DBSA’s written <i>Code of Ethics</i>.<sup>43</sup></p> <p>The PFM Act defines the liabilities of Board members.<sup>44</sup> Members can be held individually and severally liable for all decisions taken by the Board.<sup>45</sup></p>
<p>Law or regulation provides that the <i>owner is able to obtain from the SFI all necessary information</i> to effectively undertake its ownership responsibilities.</p>	<p>The PFM Act establishes the responsibility of the Board to provide the Minister of Finance, as shareholder representative, with all material facts which in any way may influence his decisions and actions.<sup>46</sup> The Minister has additional power to obtain information as head of the National Treasury.<sup>47</sup> The DBSA Board has prepared and the National Treasury has accepted a Framework of Acceptable Levels of Materiality and Significance (<i>Materiality Framework</i>) defining quantitative and qualitative reporting thresholds.<sup>48</sup></p>

<sup>40</sup> **DBSA:** For example, Board members must “exercise the duty of utmost care...”, “act with fidelity, honesty, integrity and in the best interests of (DBSA) in managing its financial affairs”, and may not “use...confidential information...for personal gain or to improperly benefit another person”. Board members “must disclose...any direct or indirect personal or private business interest that (they)...may have in any matter before” the Board, and “must withdraw from the proceedings” of the Board when the matter is considered.

<sup>41</sup> **DBSA:** Article 121.

<sup>42</sup> **DBSA:** Section 4.3.5.4. of the Protocol requires the board to adopt a charter setting out its responsibilities, which are to be disclosed in the Annual Report. At a minimum, the charter is to confirm the board’s responsibility for the adoption of strategic plans, monitoring of operational performance and management, determination of policy and processes to ensure the integrity of risk management and internal controls, communication policy, and director selection, orientation and evaluation. With respect to the board charter, the Protocol is elaborating upon recommendations in the King Code (King 2.1.17.).

<sup>43</sup> **DBSA:** The Code of Ethics is required under the Protocol (Section 6.5), elaborating upon recommendations of the King Code (King 5.2).

<sup>44</sup> **DBSA:** Article 83.

<sup>45</sup> **DBSA:** This point, somewhat ambiguous under the PRM Act, is clarified in the Protocol (5.2.4.).

<sup>46</sup> **DBSA:** Article 50. (1) (c).

<sup>47</sup> **DBSA:** The PFM Act provides that the Board must submit to the National Treasury and/or the Auditor-General any information, returns, documents, explanations and motivations as may be prescribed by them. Article 54. (1). The PFM Act also stipulates requirements for preparation and submission of financial statements. Article 55.

<b>Corporate Governance Benchmark</b>	<b>Evaluation of DBSA</b>
<p>Law or regulation provides for adequate <i>transparency</i> and establishes adequate <i>disclosure requirements</i>, including <i>standards for accounting and auditing</i>.</p>	<p>The DBSA Act requires the Board to publish an annual report “on the financial status and the achievement of the objectives” of DBSA.<sup>49</sup> It requires that DBSA be audited annually by persons registered under the Public Accountants’ and Auditors’ Act (now replaced by the Auditing Profession Act (2005)).<sup>50</sup> Under the Article 17 regulations DBSA is subject to the Accounting and Disclosure requirements of the Companies Act.<sup>51</sup> The PFM Act requires the Board to submit an annual report and audited financial statements, based on generally accepted accounting practices, to be tabled before Parliament.<sup>52</sup> The Article 17 regulations require DBSA to adhere to South African Generally Accepted Accounting Practices.<sup>53</sup> In fact, DBSA has adopted and uses the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board. See additional details in Section 4 (Transparency and Disclosure) below.</p>
<p>Relevant law or regulation identifies and delimits the objectives of the SFI, including the <i>public policy objectives</i> of institutions with policy mandates.<sup>54</sup></p>	<p>The DBSA Act defines DBSA’s main objects,<sup>55</sup> its ancillary objects,<sup>56</sup> and its powers.<sup>57</sup> The Article 17 regulations further define the mandate of DBSA.<sup>58</sup> The PFM Act requires that the Board submit annually to the Minister<sup>59</sup> a <i>Corporate Plan</i> which is to document key performance measures against which organizational performance is assessed.<sup>60</sup> The National Treasury regulations issued pursuant to the PFM Act<sup>61</sup> require that the Board agree annually with the Minister of Finance as the executive authority (shareholder representative) of DBSA a <i>Shareholder Compact</i> which further defines the objectives of DBSA. (In practice the Corporate Plan is annexed to the Shareholder Compact.) These legal arrangements provide for clear delineation of DBSA’s social and public policy objectives. (Details regarding the Shareholder Compact and Corporate Plan are discussed in section 2, below, which addresses the ownership function.)</p>

<sup>48</sup> **DBSA:** The Materiality and Significance Framework is required under the Treasury regulations issued pursuant to the PFM Act, Section 28.3.

<sup>49</sup> **DBSA:** Article 16. (2).

<sup>50</sup> **DBSA:** Article 16. (3).

<sup>51</sup> **DBSA:** Article 51.

<sup>52</sup> **DBSA:** The audited financial statements must also be submitted to the Minister as shareholder’s representative, to the National Treasury, and to the Auditor-General. Article 55.

<sup>53</sup> **DBSA:** Article 122.

<sup>54</sup> **Good Practice:** Relevant regulation/law and/or the corporate charter specify the manner in which social services are to be conveyed to clients/beneficiaries (e.g., via below market pricing for certain specified

Corporate Governance Benchmark	Evaluation of DBSA
The law/regulation provide guidance on how the <i>costs associated with the provision of social/public services are to be covered.</i> <sup>62</sup>	The income tax exemption granted under the Income Taxation Act is one key means by which DBSA covers the costs of its social/public services (developmental activities). The substantial capital base (details provided below in this section), on which the DBSA is not asked to pay dividends, is the other key means.
The nature of any <i>state obligations to recapitalize and/or to repay the debts of the SFI</i> are specified in law. <sup>63</sup>	The DBSA Act and the Article 17 regulations provide that the Board may require the state to provide additional capital under a ZAR4,800million callable capital facility. <sup>64</sup>  Under the PFM Act, DBSA may not borrow or guarantee in such a way that commits the state (the National Revenue Fund) unless approved by the Minister of Finance. <sup>65</sup> It is clear that DBSA's debts and other obligations are not guaranteed by the state.

services for certain specified clients) and the manner in which public policy objectives (e.g. financial sector development) are to be achieved.

<sup>55</sup> **DBSA:** The promotion of economic development and growth, human resources development, institutional capacity building, and the support of development projects and programs in the national territory of the Republic of South Africa and the national territories of the countries determined by regulation. Article 3. (1). DBSA focuses its investment activities on infrastructure funding, broadly defined, with an additional objective of acting as a catalyst to maximize private sector access to opportunities in the provision of public funding in the Southern African region.

<sup>56</sup> **DBSA:** To assist other international, national, regional and provincial initiatives in order to achieve an integrated finance system for development, and to assist other institutions (international or national, public or private) with the management of specific funds. Article 3. (2).

<sup>57</sup> **DBSA:** The DBSA's powers are very broad and include, with respect to development projects and programs: to mobilize wholesale funding; to lend, invest (equity, debt) and underwrite; to own and deal in movable and immovable property; to provide guarantees; and to act as agent or trustee. Article 4.

<sup>58</sup> **DBSA:** "The mandate of the Bank shall be focused on the provision of financial, technical and other assistance to achieve the objects of the Bank as provided (in the DBSA Act), with a focus in its investments activities on infrastructure funding broadly defined and with the object of acting as a catalyst to maximize private sector access to opportunities in the provision of public funding." Article 4.

<sup>59</sup> **DBSA:** In his capacity both as shareholder's representative and as Minister responsible for the National Treasury.

<sup>60</sup> **DBSA:** Article 52. The Corporate Plan covers the following three years. It is submitted to the Minister both in his capacity as owner's representative, and as head of the National Treasury.

<sup>61</sup> **DBSA:** Treasury Regulations for Departments, Trading Entities, Constitutional Institutions and Public Entities, March 2005, Article 29.2.

<sup>62</sup> **Good Practice:** Any planned or potential fiscal transfers or other potential calls on fiscal resources are explicit and delimited under law or regulation.

<sup>63</sup> **Good Practice:** Avoid explicit state guarantee of SFI debts, and seek to minimize expectations of implicit guarantee. Resulting potentially higher funding cost can be offset by greater market discipline exerted over management performance.

<sup>64</sup> **DBSA:** The Act and regulations provide a defined mechanism to trigger the callable capital facility which is taken into consideration by the international rating agencies that assign credit ratings to certain of DBSA's obligations.

<sup>65</sup> **DBSA:** Article 66. (2).



Corporate Governance Benchmark	Evaluation of DBSA
<p>Relevant laws/regulations do not prohibit the owner from adjusting the <i>capital structure</i> of the SFI.</p>	<p>Of 500,000 ordinary shares authorized, 200,000 have been issued (ZAR200 million book value). The government has, in addition, provided permanent (non-repayable), non-interest bearing funding of ZAR3,792 million.</p> <p>Under the DBSA Act, i) the government may transfer its shares to any institutional shareholder (including national, international or multilateral institutions, but not individuals); ii) the Board has the power to raise additional capital, subject to the approval of the shareholders, including by calling upon shareholder(s) to subscribe additional shares; and iii) the Board authorizes the declaration of dividends subject to the approval of the shareholders. The Article 17 regulations offer additional flexibility to issue new capital.</p>
<p>Overall, the legal and regulatory framework provides for a <i>level playing field</i> between the SFI and private and state commercial financial institutions.<sup>66</sup></p>	<p>Under the DBSA Act the Bank cannot be wound-up except by an Act of Parliament. It is exempt from income tax under the Income Tax Act. It is exempt from the Companies Act and the Banks Act (1990),<sup>67</sup> although under the DBSA Act the Minister of Finance has the power to apply to DBSA any provision of the Companies Act or the Banks Act not inconsistent with the DBSA Act, and has done so via the Article 17 regulations. In addition to the provisions mentioned above, the Article 17 regulations apply to DBSA the requirements of the Companies Act with respect to required accounting records and the provision of half yearly accounts to any holder of securities issued by DBSA. While DBSA is not required to comply with the prudential bank regulations of the South African Reserve Bank, the Article 17 regulations mandate that it seek to adhere to international corporate best practices,<sup>68</sup> and the Bank benchmarks itself against other development finance institutions internationally.<sup>69</sup></p> <p>Finally in this regard, the DBSA Act requires the Bank to pursue its objectives by “facilitating the participation of the private sector” in its development projects and programs.<sup>70</sup></p>

<sup>66</sup> **Good Practice:** The SFI is not exempt from laws and regulations applicable to other (private) financial institutions (e.g. prudential banking regulation, general contract law, general labor laws, etc.), or any extraordinary exemptions are specified in law, well reasoned, and narrowly circumscribed. The principles and means by which the SFI will avoid displacing the private sector is defined in law/regulation and/or corporate statute. As a potential complement, the mandate of development finance institutions includes drawing-in the private sector to service new geographic, product/service and/or client markets.

<sup>67</sup> **DBSA:** It is relevant in this context that DBSA is prohibited from taking deposits from the general public.

<sup>68</sup> **DBSA:** Article 122.

<sup>69</sup> **DBSA:** Such as the European Bank for Reconstruction and Development.

<b>Corporate Governance Benchmark</b>	<b>Evaluation of DBSA</b>
The SFI's <i>corporate statutes</i> (charter, articles of association, by-laws and/or similar internal instruments) are consistent with and reinforce the above.	The Shareholder Compact, Corporate Plan and Board Charter are key instruments giving effect to the legal and regulatory foundations of DBSA's corporate governance.
<b>2. Professional Ownership Function</b>	
The <i>shareholder's representative</i> responsible for the exercise of ownership rights for the SFI is clearly identified within the state administration. Where there is more than one ministry or administrative department involved in exercising SFI ownership rights, and/or there is more than one state-owned SFI in which ownership rights are exercised by other ministries or administrative departments, there is a clearly identified <i>coordinating entity</i> that serves to harmonize and coordinate the actions and policies undertaken by different ownership departments in the various ministries. <sup>71</sup>	<p>The sole shareholder is the government of the Republic of South Africa. The Minister of Finance represents the shareholder's interests. One ministry with a close interest in the activities of DBSA, the Ministry of Provincial and Local and Government, is represented on the DBSA Board, but does not have a direct role in the ownership function.</p> <p>The Minister of Finance does not serve as representative of the state's shareholding in the other South African SFIs.<sup>72</sup> However, the Minister of Finance and the National Treasury function to a significant extent as the coordinating entity for all SFIs (and other SOEs) under the provisions of the PFM Act.</p>

<sup>70</sup> **DBSA:** Article 3. (1) (c). This provision is interpreted as requiring DBSA to “crowd-in” the private sector, and in practice it nearly always cofinances projects with private sector financial institutions.

<sup>71</sup> **Good Practice:** The ownership function for all central government owned SFIs is centralized in a single *ownership entity* that is clearly identifiable within a single ministry (i.e. clear departmental and individual responsibility for functioning as the ownership entity), or is a stand-alone entity reporting to the administration (and legislature). The interests of ministries with a direct stake in the performance of the SFI(s) are represented and integrated within this ownership entity, and exert influence on the SFI(s) only through this entity. Relevant responsibilities within the ownership entity (departments, individuals) are clear.

<sup>72</sup> **DBSA:** The other South African SFIs and their shareholder representatives are: Land and Agricultural Development Bank (Department of Agriculture), Industrial Development Corporation (Department of Trade and Industry), National Housing Finance Corporation (Department of Trade and Industry), and Khula Enterprise Finance (Department of Trade and Industry). All are development finance institutions.

<b>Corporate Governance Benchmark</b>	<b>Evaluation of DBSA</b>
<p>The government has defined an <i>ownership policy</i> that defines the overall objectives of SFI ownership, the state’s role in SFI governance, and how its ownership policy will be implemented. The ownership policy has been publicly disseminated, and has not been subject to frequent change.</p>	<p>The PFM Act serves to define important elements of the state’s ownership policy, in that it establishes comprehensive foundations for the prudent operations of state entities and for transparency. In addition, the Protocol provides comprehensive guidance on corporate governance standards for SOEs. The principles set out in that document are framed as being a cornerstone of the government’s overall strategic vision for SOEs, and explicitly apply to DBSA and the other South African SFIs. With respect specifically to DBSA, the Shareholder Compact further defines the state’s ownership policy.</p>
<p>The shareholder’s representative <i>exercises ownership functions</i> mainly by i) participating and voting in shareholders’ meetings, ii) electing and removing board members, iii) obtaining information from the SFI (and others) necessary to monitor and evaluate the board, management and the SFI, and iv) approving extraordinary transactions.<sup>73</sup></p>	<p>Under the DBSA Act the Minister of Finance is empowered to vote the state’s shares in shareholders’ meetings and to appoint all directors. As noted in section 1, above, the PFM Act gives authority to the Minister of Finance, both as shareholder representative and as head of the National Treasury, to obtain any necessary information from the Board and DBDA. (More detail on these points is provided later in this section.) Under the PFM Act the DBSA Board must notify the Minister before undertaking certain transactions (although, under the Act, the Minister may exempt DBSA from this requirement).<sup>74</sup></p> <p>The Minister of Finance, as shareholder representative, also exercises ownership functions by means of regular meetings with the Board Chairperson and the CEO. These meetings have a standing agenda including discussions on the Bank’s performance. They are a key input to the Minister’s evaluation of the performance of the Bank, the Chairperson, the Board and the CEO. Records of the meetings are maintained in the same manner as other Board documents.</p> <p>The National Treasury, under the PFM Act, scrutinizes the Bank’s Corporate Plan and the borrowing program therein, and ensures the Bank complies with the Materiality Framework.</p>

<sup>73</sup> **Good Practice:** The ownership entity’s ability to issue direction in regard to the board’s day-to-day activities is in writing and subject to clear limits.

<sup>74</sup> **DBSA:** The transactions include establishment of a company, acquisition or disposal of a significant asset or shareholding in a company, and commencement or cessation of a significant business activity. Article 54. This provision is further interpreted by the Framework of Acceptable Levels of Materiality and Significance cited in section 1.

Corporate Governance Benchmark	Evaluation of DBSA
<p>The shareholder representative's <i>staff</i> is competent, composed of individuals with relevant legal, financial, economic and managerial expertise. It has the resources and power to hire outside expertise when required.</p>	<p>Staff of the National Treasury function in this capacity. The Treasury has assigned specific Chief Directorates to execute specific responsibilities for oversight of the Bank. In addition, the Treasury has a dedicated Chief Directorate to oversee PFM Act compliance and related matters in public entities. The Minister has advisers and has access to independent external expertise if required.</p>
<p>The shareholder's representative <i>publicly reports</i> on its performance in exercising state ownership and achieving state objectives. It is held accountable for its performance in exercising the ownership function.<sup>75</sup></p>	<p>The Minister of Finance is accountable to Parliament for his performance as shareholder representative under the DBSA and PFM Acts. The Minister tables the Bank's Annual Report before Parliament. He makes separate presentations on DBSA's performance to Parliament's Standing Committee on Public Accounts and to its Select Committee on Finance.</p> <p>In addition, the Auditor-General annually presents a report to Parliament on all public entities (including DBSA).</p>
<p>Instances where the shareholder's representative must seek from the legislature <i>ex ante approval of decisions</i> (e.g., significant changes in the ownership policy, decisions on significant investments or divestments) are explicitly and publicly specified.</p>	<p>In the PFM Act the legislature has defined the specific actions and decisions requiring notification to and prior approval by the responsible Cabinet minister, as well as ex ante notification to the National Treasury.<sup>76</sup> As noted, these PFM Act provisions are subject to and interpreted by the Materiality Framework.</p>
<p>The shareholder's representative's <i>relationships with other state bodies</i> (e.g., financial sector regulators and supervisors, state supreme audit institution) are well defined and not ambiguous.</p>	<p>Responsibilities are well defined and there is no ambiguity. The SARB (central bank) has no involvement in the ownership function. The relationship between the Minister of Finance as shareholder representative and the Auditor-General is governed by the PFM Act. The Auditor-General has the legal authority under the Public Audit Act (2004) to audit DBSA, but does not do so, relying instead on the professional external audits commissioned by the Board.<sup>77</sup> The Public Prosecutor has the right to investigate the Bank under the Public Prosecutor Act (1994).</p>

<sup>75</sup> Usually by representative legislative bodies such as the Parliament or Congress (specified in OECD).

<sup>76</sup> **DBSA**: Article 55

<sup>77</sup> **DBSA**: This is in contrast to some other South African SFIs. For example, the Auditor-General audits the Land Bank, and is the auditor of account for Land Bank's Annual Report.

Corporate Governance Benchmark	Evaluation of DBSA
<p>The shareholder’s representative employs a <i>structured process to identify, nominate and elect board members</i>, subject to explicit policies and guidelines.<sup>78</sup> Policies and guidelines are consistent with ability of the board to exercise its responsibilities in an independent manner. Competence and experience requirements are explicit and consistent with the strategy and business of the SFI.<sup>79</sup></p>	<p>Under the DBSA Act: i) the Board consists of from 10 to 15 members; ii) the Minister of Finance appoints all directors;<sup>80</sup> iii) Board members are appointed “on the grounds of their ability and experience in relation to socio-economic development, development finance, business, finance, banking and administration;” iv) the Board elects the Chairperson from among its members, subject to the consent of the shareholders, and; v) Board members hold office for three years but are eligible for reappointment. Under policies set out in the Board Charter, the Chairperson and CEO normally assist the Minister in identification of potential Board members and the Minister extends the invitation to join the Board.<sup>81</sup> In practice, the Minister calls for nominations and consults with the Board and other Ministries with a stake in DBSA’s operations. The Cabinet has final approval authority.</p>
<p>Board members have <i>finite terms</i>. Terms are staggered.</p>	<p>Board members have three year terms and are rotated on that basis. Terms are staggered.</p>
<p>The number of <i>board members who serve as a representative of the shareholder’s representative or are employees of the coordinating entity</i> (or are other state officials or representatives of political constituencies) is restricted by policy and limited in practice.</p>	<p>The Protocol stipulates that a majority of Board members be independent. In practice, only three government officials are Board members, serving as representatives of their ministry/office (the Office of the President of South Africa, the National Treasury, and the Department of Provincial and Local Government). The National Treasury official implicitly represents the Minister but does not have any extraordinary role at the board.</p>

<sup>78</sup> **Good Practice:** The ownership entity is given sole responsibility for organizing the state’s participation in the nomination process. Consultations with other major shareholders are held in advance of the general meeting of shareholders at which board members are elected.

<sup>79</sup> **Good Practice:** Competence and experience requirements are informed by the annual evaluation of the board and board members. See section 1.C. below addressing Board of Directors.

<sup>80</sup> **DBSA:** Should other shareholders exist, the Minister appoints the number of directors proportional to the government’s share ownership.

<sup>81</sup> **DBSA:** The Board Charter also defines relevant considerations to guide identification of potential Board members.

Corporate Governance Benchmark	Evaluation of DBSA
<p>Board members who are employees and/or representatives of the shareholder’s representative or the coordinating entity (or are other state officials or representatives of political constituencies) have the <i>same duties and responsibilities as other board members</i>, including to act solely in the interests of the SFI and all its shareholders. The respective state versus personal capacity and liability of such board members are clear.</p>	<p>Neither the PFM and DBSA Acts nor the Board Charter provides for any distinction with respect to responsibilities and duties (or otherwise) as between non-executive independent members and representative members. All Board members have personal liability for their conduct. The Bank’s directors’ personal liability insurance covers all Board members.</p>
<p>The state, the shareholder’s representative or the coordinating entity have adopted <i>disqualification guidelines</i> applicable to board members.<sup>82</sup></p>	<p>Under the DBSA Act no person may be a Board member if they are: i) disqualified to serve as a director under the Companies Act (1973); or ii) are a member of any legislature or executive council in the Republic, or of a similar government institution in the region. The PFM Act defines conditions under which a Board member may be dismissed or suspended.<sup>83</sup> The Protocol provides that a Board member may be disqualified for legal disability, insolvency, misconduct, or a criminal record,<sup>84</sup> and defines the grounds for Board member dismissal.<sup>85</sup></p>
<p>The shareholder’s representative determines <i>board member remuneration</i>,<sup>86</sup> which is sufficient to attract individuals with the requisite knowledge, skills and experience, and is not driven by short-term performance.</p>	<p>The Article 17 regulations provide that Board members’ remuneration shall be approved at the AGM, and that the Board’s Remuneration Committee considers Board (and senior management) remuneration. In practice, the Remuneration Committee benchmarks Board member remuneration against the private sector and other development finance institutions and recommends remuneration to the Minister. The Minister determines and approves remuneration in line with guidelines for remuneration of directors in public entities. The Chairpersons of the Board and its committees are paid a monthly retainer. Otherwise, Board members are paid meeting attendance fees and expenses incurred on account of the Bank’s business. Remuneration is at a level necessary to attract and retain members with the requisite skills.</p>

<sup>82</sup> **Good Practice:** Potential board members are subject to standards and background investigations comparable to those required for listed companies and under the commercial bank law.

<sup>83</sup> **DBSA:** Article 83. (4).

<sup>84</sup> **DBSA:** Section 5.1.10.

<sup>85</sup> **DBSA:** Section 5.1.6.3.

<sup>86</sup> Likely in consultation with the board chairperson and the board remuneration committee.

<b>Corporate Governance Benchmark</b>	<b>Evaluation of DBSA</b>
<p>The shareholder’s representative has ensured the <i>size of the board</i> is appropriate to its circumstances and is not unduly large.</p>	<p>The Board has 15 members, including one executive (the CEO) three government representatives (as noted above), and eleven independent directors. At 15, the Board is at its maximum size under law. As part of the annual evaluation of the effectiveness of the Board, Board size (and composition) is explicitly assessed.</p>
<p>The shareholder’s representative has communicated <i>overall expectations</i> to the board, including the board’s long term <i>mission/mandate</i>, overall <i>board responsibilities and duties</i>, the <i>role of the board chairperson</i>, which <i>specialized board committees</i> should exist, and <i>recordkeeping and reporting requirements</i>.</p>	<p>As noted above, the mandate of DBSA is defined by the DBSA Act (main and ancillary objectives) and the Article 17 regulations. The Article 17 regulations define the duties, responsibilities and powers of the Board, and Board procedures. They require that the Board appoints an audit committee and a remuneration committee. They specify Board recordkeeping requirements (as does the PFM Act). The Board Charter further serves to highlight relevant statutory requirements, to document matters of policy that the Board and shareholder must follow in order to ensure good corporate governance, and to articulate Board duties, as well as those of the Chairperson and the Board committees.</p>
<p>The shareholder’s representative has communicated <i>specific financial and non-financial objectives</i> to the board (and management).<sup>87</sup> Objectives are prioritized and publicly issued. Objectives are set by the shareholder’s representative or the coordinating entity, in consultation with the state and the SFI board. The objectives are formally endorsed annually by the general meeting of shareholders, the board and management.</p>	<p>The Shareholder Compact, a formal agreement between the Board and the shareholder representative, serves to document government’s policy and strategic objectives as well as key performance measures and indicators to be attained by the Bank.<sup>88</sup> The Corporate Plan, annexed to the Shareholder Compact, elaborates upon agreed objectives, performance indicators and quantitative targets. In addition, the Minister is able to communicate overall expectations via his periodic meetings with the Board chairperson and CEO.</p> <p>In practice, the strategic objectives and performance measures and targets largely are proposed by the CEO, executive management and the Board and agreed with the Minister as shareholder representative. They form the basis of reporting by the Directors on performance against specific financial and non-financial objectives in the Annual Report and in other reports. See details in section 4.</p>

<sup>87</sup> **Good Practice:** Financial objectives include at least after-tax return on equity, productivity objectives (e.g. costs relative to various measures of output), loan loss provisioning and related targets, and dividend requirements. Non-financial objectives include to avoid distorting markets or displacing private financial activity.

<sup>88</sup> **DBSA:** The Shareholder Compact is signed by the Minister of Finance (as representative of the shareholder), the Chairperson of the Board (on behalf of DBSA), a representative of the Office of the

Corporate Governance Benchmark	Evaluation of DBSA
<p>The shareholder’s representative and the board have agreed the <i>manner in which the costs of undertaking activities on concessionary terms are to be covered</i> (e.g. internal cross-subsidization coupled with lower or no dividend payments, direct fiscal transfers, etc.).<sup>89</sup></p>	<p>As noted in section 1, the income tax exemption and the large capital contribution by the shareholder on which, in addition, no dividends are required to be paid, serve as the key means by which DBSA’s developmental activities are funded. The Shareholder Compact records relevant assumptions, including that DBSA will remain financially sustainable while delivering developmental impact, that the income tax exemption will be maintained, and that a certain percentage of profits will be contributed annually to the DBSA Developmental Fund, DBSA’s sole subsidiary, which provides grants for, and otherwise is engaged in, municipal and community capacity building.<sup>90</sup> Periodic fiscal transfers are not required nor contemplated.</p>
<p>The shareholder’s representative has specified <i>reporting requirements</i> that provide necessary, accurate, timely information that enables it to routinely monitor SFI activity and assess its financial and non-financial performance and financial situation.</p>	<p>Reporting requirements are specified in the PFM Act and in the Companies Act provisions that have been applied to DBSA. The Protocol requires the Board to submit to the Minister, as shareholder representative, a budget (defined), Corporate Plan (defined) and borrowing plans, at least one month before the beginning of a new financial year.<sup>91</sup> The Shareholder Compact addresses requirements for regular and extraordinary reporting. In practice the Bank makes quarterly reports to the National Treasury, and responds to ad hoc requests by Treasury on matters concerning the Bank’s operations and performance. See section 4.</p>

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Minister of Finance (on behalf of the National Treasury), as well as by the CEO and the Chairman of the Audit Committee of the Board.

<sup>89</sup> **Good Practice:** The ownership entity has agreed with the board the manner in which the cost of undertaking any non-commercial activities (fulfilling policy mandates by providing loans and other services on concessionary terms) are to be measured and reported.

<sup>90</sup> **DBSA:** The mission of DBSA Development Fund is to capacitate municipalities and communities for effective service delivery and local economic development in poorly resourced areas and improve the quality of lives.” Its specific objective is to address development failure by building capacity to manage development initiatives at various levels, particularly in the poorer local governments.

<sup>91</sup> **DBSA:** Section 5.2.5.



<b>Corporate Governance Benchmark</b>	<b>Evaluation of DBSA</b>
<p>The shareholder’s representative utilizes a clear <i>evaluation methodology</i> to assess SFI performance in meeting its financial and non-financial objectives.<sup>92</sup></p>	<p>Under the terms of the Shareholder Compact, the DBSA utilizes a <i>Balanced Scorecard</i> methodology to measure and report upon its performance against strategic and business unit objectives.<sup>93</sup> The Balanced Scorecard utilizes four perspectives: sustainable development impact (e.g. new loans approved, new customers acquired, new products launched, new technical assistance engagements), financial sustainability, effective business processes, and learning and growth. The Bank also reports on the non-financial impacts and outcomes of its lending utilizing a <i>Social Accounting Matrix</i> methodology. See more detail in section 4.</p>
<p>The SFI is subject to <i>external audit</i>, and the shareholder’s representative or the coordinating entity maintains a regular dialogue with the external auditors,<sup>94</sup> consistent with relevant law and with the role of the board’s audit committee.</p>	<p>DBSA is subject to an annual professional external audit (see details in section 3 below). As noted, the Treasury has a dedicated Chief Directorate to oversee PFM Act compliance and related matters in public entities, including those related to the external audit. In addition, the Auditor-General evaluates the work of the external auditors..</p>
<p>The shareholder’s representative requires the board to prepare an <i>annual Directors’ Report</i> to accompany the annual financial statements.<sup>95</sup></p>	<p>The Protocol defines the required content of the annual Directors’ Report.<sup>96</sup> The Directors’ Report is an integral component of DBSA’s Annual Report, and conforms to the Protocol requirements. The Directors’ Report is based on the objectives and key performance measures and indicators set out in the Shareholder Compact and the Corporate Plan. The Annual Report also includes a short report by the Chairperson of the Board and additional reporting by management regarding strategy, organization, and performance. (See section 4.)</p>

<sup>92</sup> **Good Practice:** Benchmarking against comparable firms is used to evaluate SFI performance (e.g., with respect to productivity and efficient use of labor, assets and capital).

<sup>93</sup> **DBSA:** The Balanced Scorecard methodology is DBSA’s a principal tool for managing and monitoring the implementation of its strategy.

<sup>94</sup> This regular dialogue could take the form of routine exchanges of information, meetings or ad hoc discussions when problems arise.

<sup>95</sup> **Good Practice:** The Director’s Report gives information and comment on the organization, financial and social/developmental performance, material risk factors, significant events, relations with stakeholders, and the effects of direction from the owner.

<sup>96</sup> **DBSA:** Section 5.1.15.1.

<b>Corporate Governance Benchmark</b>	<b>Evaluation of DBSA</b>
The shareholder's representative encourages the SFI to obtain a credit rating and to raise funds in the public debt markets. <sup>97</sup>	DBSA has obtained a credit rating from three international credit rating agencies: Fitch (long term debt): AAA; Moody's (foreign currency issuer rating): Baa1; S&P's: BBB. It raises funding in the domestic capital markets. Funding from international markets are sourced solely from multilateral or bilateral development institutions.
Where applicable, the shareholder's representative has publicly issued guidelines regarding the equitable treatment of minority shareholders.	No minority shareholders at this time. The DBSA Act and the Article 17 regulations make provisions for potential other shareholders.
The shareholder's representative or the coordinating entity publishes an <i>annual report</i> on its performance, addressing i) SFI performance, financial situation and value, ii) how the state has implemented its ownership policy, iii) the organization and functioning of the ownership entity, iv) changes in SFI board composition, and v) other relevant information. <sup>98</sup>	As noted above, the Minister tables the Bank's Annual Report before Parliament and makes presentations on DBSA's performance to two Parliamentary committees. While no annual report by the ownership function, per se, is published, the public reporting by DBSA addresses much of the benchmark content. Similarly, there is no consolidated reporting on the performance of the portfolio of state SFIs as a group. The Auditor-General does present annually to Parliament a consolidated report on the overall performance of all public entities as a portfolio, including the SFIs.
<b>3. The Board of Directors</b>	
Board members meet an explicit <i>standard of independence</i> . <sup>99</sup> The board is comprised mainly of independent, non-executive, members who have relevant competence and experience. <sup>100</sup>	A majority of the Board is composed of independent members drawn from the private sector. Only one member of the Board is executive (the CEO). Explicit guidelines and procedures are in place (e.g. in the Board Charter) to help ensure that the members all have relevant competence and experience.

<sup>97</sup> **Good Practice:** A credit rating by an international agency is obtained, and funds are raised in international markets.

<sup>98</sup> **Best Practice:** The annual reporting is part of a report on the aggregate performance of all state-owned financial institutions.

<sup>99</sup> **Good Practice:** Independent directors are defined as members who are not a representative of the owner, have not been employed by the SFI in any executive capacity for the preceding three years (and are not an immediate relative of such a person), are not professional advisors to the SFI (other than as a board member), are not significant suppliers to, or customers of, the SFI, and have no significant contractual relationships with the SFI.

<sup>100</sup> **Good Practice:** The majority of independent non-executive members are from the private sector.

<b>Corporate Governance Benchmark</b>	<b>Evaluation of DBSA</b>
<p>Board members have, in effect, the same <i>responsibilities and liabilities</i> as under company law. Board responsibilities, articulated in relevant legislation and regulation and further elaborated by the shareholder’s representative or the coordinating entity, are reinforced by the SFI’s statutes. Board members have an explicit obligation to act in the best interests of the SFI and all shareholders. All board members have the same obligations and liabilities.<sup>101</sup></p>	<p>As noted, board responsibilities are set out clearly in the DBSA and PFM Acts and the Article 17 regulations, and are reinforced in the Shareholder Compact and the Board Charter. All members have the same obligations and liabilities.</p> <p>All Board members have access to the advice and services of DBSA’s Corporate Secretary whose functions are in line with those prescribed in the Companies Act, including providing guidance to Board members on their responsibilities and liabilities.<sup>102</sup></p>
<p><i>Board duties</i> are explicit and include i) to help formulate, to approve and to monitor the SFI’s strategy, in the context of objectives defined by the state and its ownership entity, including balancing the tradeoffs inherent in achieving social/public policy objectives while adhering to sound business principles; ii) to approve key policies; iii) to ensure a functioning system of internal financial and operational controls is in place; iv) to establish performance indicators and benchmarks; v) to monitor disclosure and public communications processes to ensure financial statements and other disclosures fairly present SFI performance, financial condition, business, and risks; vi) to evaluate management performance, and; vii) to develop a succession plan for key managers.</p>	<p>Board responsibilities are explicit, including in law, regulation, the Shareholder Compact and the Board Charter, and are generally in accord with those set out in the King Code.<sup>103</sup></p> <p>As noted in section 2, in the context of shaping the Shareholder Compact the Board has a significant role in defining strategy. It approves all key policies.<sup>104</sup> Under the PFM Act the Board is accountable for DBSA’s management of risk and for the systems of internal financial and operational controls.<sup>105</sup> It evaluates management performance. The Chairperson determines, in consultation with the CEO, a succession plan for the CEO and for executive management.<sup>106</sup></p>

<sup>101</sup> **Good Practice:** The board has a charter which sets out its responsibilities and liabilities, and which is disclosed in the annual report.

<sup>102</sup> **DBSA:** More specifically, these functions include, among others, providing Board members collectively and individually with guidance as to their duties, responsibilities and powers; making Board members aware of all law and legislation relevant to the DBSA, and; ensuring that minutes of all shareholders' meetings, Board' meetings and Board committee meeting are properly recorded.

<sup>103</sup> **DBSA:** The Bank has formally assessed and documented its adherence to the King Code.

<sup>104</sup> **DBSA:** The Board has approved the following policies: treasury counterparty limits, interest rate risk, approved financial instruments, foreign currency risk, liquidity risk, single obligor limits, equity/quasi-equity limits, investment in third-party managed funds, country exposure limits, capital adequacy, loans loss provisioning, exposure to high-risk clients, core vs. non-core funding limits, loan risk spread and pricing, security for loans, country risk pricing, compliance framework, and reputation risk framework.

<sup>105</sup> **DBSA:** Article 51.(1). Among its explicit responsibilities for risk management, as articulated in the Annual Report (pg. 48), are to oversee the whole risk management process, to establish risk strategy policies (in liaison with the CEO and senior management), to determine DBSA’s appetite for risk as expressed in risk management policies, to approve risk management policies, to ensure DBSA has implemented effective processes to proactively manage risk exposures, to ensure use of adequate systems of risk management and internal control. Per the Annual Report (pg. 42), control systems include clearly defined lines of accountability and delegation of authority, and provide for full reporting and analysis against approved budgets and adherence to policies, processes and guidelines. Executive management is explicitly accountable for determining the adequacy, extent and operation of these systems.

<sup>106</sup> **DBSA:** Per the Board Charter.

<b>Corporate Governance Benchmark</b>	<b>Evaluation of DBSA</b>
The board has an agreed procedure under which a member may, if considered necessary, solicit <i>independent professional advice</i> at the expense of the SFI.	Board members have the ability to request advice from outside parties at the expense of DBSA.
The board maintains a formal <i>orientation program</i> that familiarizes incoming directors with the SFI's operations, senior management and business and regulatory environment, and that ensures they are aware of the duties, responsibilities and potential liabilities. Board members have access to <i>training</i> to ensure their ongoing financial literacy and to enable them to stay abreast of relevant legal, regulatory and business developments.	The orientation of new Board members is addressed in the Board Charter. Within 30 days of appointment new Board members are provided an induction program, including a description of their fiduciary duties and an orientation to the business and operations of the Bank. The annual effectiveness review of the Board (see more below) serves to identify training needs, and training programs are provided in response to identified needs. Board training is a line item in the annual budget.
The board has the authority to <i>appoint and dismiss the CEO</i> and other key senior managers. <sup>107</sup> It has adopted transparent rules and procedures for nominating and appointing the CEO, based on professional criteria. Any role of, or agreements with, the shareholder's representative or the coordinating entity (or other state bodies) with respect to the appointment and dismissal of the CEO or other senior managers are publicly disclosed. The performance of the CEO is evaluated annually.	Under DBSA Act, the Minister has the power to appoint the CEO, unless the power is delegated to the Board. The power has not been delegated to the Board. As noted above, under the Board Charter the Chairman has an explicit role in CEO succession.
The <i>CEO is not the board chairperson</i> . <sup>108</sup>	The Chairperson is an independent non-executive director.
The <i>role of the chairperson</i> is clearly defined. It includes responsibility for direct contacts with the shareholder's representative or the coordinating entity, for ensuring the efficient and effective operation of the board, <sup>109</sup> for agreeing with the shareholder's representative or the coordinating entity the skills and experience the board should possess to ensure its effectiveness, and for ensuring the performance of the CEO is formally appraised annually.	The role of the Chairperson of all public entities is specified in the Protocol, which addresses the benchmark elements. <sup>110</sup> The role of the Chairperson is further specified in the Board Charter, and includes assisting the shareholder in identifying potential Board members, annually proposing the assignment of Board members to Board committees, setting the agenda for and managing Board meetings, reporting annually to the shareholder on the performance of each Board member and the Board collectively, and determining a succession plan for the CEO and executive management, among other defined tasks.

<sup>107</sup> Although perhaps in consultation with, or with the concurrence of, the shareholder's representative or the coordinating entity, especially where the state is the sole shareholder.

<sup>108</sup> **Good Practice:** The chairperson is an independent, non-executive board member.

<sup>109</sup> Including by setting the agenda for board meetings and prioritizing among agenda items, by distributing the workload to board committees, by ensuring all board members are fully involved and informed of any decision that has to be taken, and by ensuring that board members remain aware of their responsibilities.

<sup>110</sup> **DBSA:** Section 5.1.2

Corporate Governance Benchmark	Evaluation of DBSA
<p>The board has formed <i>specialized committees</i> for, at least, audit, risk management and remuneration. Each committee has a written terms of reference that defines its duties, authority, composition and working procedures. Committees report to the full board, and minutes of committee meetings are circulated to all board members.<sup>111</sup></p>	<p>Under the DBSA Act, the Board determines which committees to establish, the functions of the committees, and the procedures for electing chairpersons of committees. Under the Article 17 regulations, the Board is required to establish an audit committee and a remuneration committee. Both committees must have at least three members, the majority of which must be non-executive.</p> <p>Until recently the Board maintained an Audit and Finance Committee, a Credit Committee, a Remuneration Committee and a Knowledge Strategy Committee.<sup>112</sup> In 2005, in response to the Treasury regulations issued pursuant to the PFM Act which prescribe a specialized and focused mandate for audit committees, the Audit and Finance Committee was split. The Audit, Finance and Credit Committees have responsibilities for risk management within DBSA</p> <p>All committees have written terms of reference that are reviewed annually. All committees are chaired by independent non-executive Board members. Minutes and resolutions of Board committee meetings are tabled at the subsequent Board meeting.</p>

<sup>111</sup> **Good Practice:** Board committees are chaired by independent non-executive board members. At least, the majority of committee members, if not all, are non-executive.

<sup>112</sup> **DBSA:** The first three Board committees are addressed in the body of this section. The Knowledge Strategy Committee consists of four members. Its primary purpose is knowledge management, human capital transformation and human resources development.

<b>Corporate Governance Benchmark</b>	<b>Evaluation of DBSA</b>
<p>The <i>audit committee</i> is responsible for oversight of internal and external audit functions, for approving the external auditor,<sup>113</sup> for compensation and dismissal of the external auditor, for approving the external audit scope and frequency and the internal audit plan, for reviewing audits and ensuring management takes appropriate action in response to identified deficiencies. All committee members are non-executive and financially literate. The Chairperson is an independent, non-executive member and not the Chairperson of the board.<sup>114</sup> The committee has the authority to meet with any SFI officer. It meets annually with the external auditor, routinely with the internal auditor, and periodically with the official supervisory authorities. It maintains a dialogue with the state supreme audit institution.</p>	<p>The Treasury regulations issued pursuant to the PFM Act require public entities to have an audit committee and specify detailed requirements for committee composition and responsibilities.<sup>115</sup> Under the Article 17 regulations the audit committee is responsible to the Board i) for reviewing financial statements and accounting policies, ii) for the effectiveness of management information systems, other systems of internal control, and the audit function, and iii) to deal with the auditor’s findings.</p> <p>The Audit and Finance Committee has six members, four of which are non-executive. The chair is an independent non-executive member. A Finance and Risk Management (sub)Committee reports to the Audit and Finance Committee. A Fraud Management (sub)Committee reports to the Finance and Risk Management (sub)Committee.</p> <p>The Audit and Finance Committee evaluates the audit policy and audit plan, evaluates management processes with respect to internal control, recommends appointment of the external auditors to the Board, manages and evaluates the external auditors, considers significant matters arising from the external audit, and reviews and evaluates management’s comments on internal and external audit reports.<sup>116</sup> (As noted, the Audit and Finance Committee was recently split to form two separate committees, in part to sharpen the focus of the committees.) Committee members have the authority to meet with any officer.<sup>117</sup></p> <p>The Chairperson of the Audit Committee has unrestricted access and reports to the Minister of Finance, as Shareholder representative.<sup>118</sup> Should any report from the internal or external auditors or any other source implicate any Board member, the Chairperson of the Audit Committee has a statutory obligation to report to the National Treasury and the Auditor-General.<sup>119</sup> The Audit Committee meets with the Auditor-General annually.</p> <p>In 2003 the DBSA established an independent compliance function headed by the Group Compliance Officer who has direct access to the CEO and the Chairpersons of the Board and its Audit and Finance Committee.<sup>120</sup> In 2005 the DBSA finalized a group-wide compliance strategy and adopted a group compliance manual.</p>

<sup>113</sup> Or for recommending to the board, shareholder’s representative, coordinating entity or ownership entity for its approval.

<b>Corporate Governance Benchmark</b>	<b>Evaluation of DBSA</b>
<p>The board causes the SFI to employ a <i>professional, independent external audit firm</i>.<sup>121</sup> The board or its audit committee has established clear procedures for the selection of the audit firm, which ensures the firm is independent of management and the state (as shareholder), among other criteria.<sup>122</sup> The audit firm utilizes international accounting and auditing standards. The audit firm reviews internal control processes related to the public disclosure of financial statements.</p>	<p>Under the Article 17 regulations the Board shall recommend annually to the Minister of Finance, as shareholder representative, the appointment of the external auditors, at remuneration that the Board determines.</p> <p>The 2005/06 financial statements<sup>123</sup> were audited by KPMG Inc, and Gobodo, Inc., both Registered Accountants and Auditors in South Africa, in accordance with International Standards on Auditing, the South African Statements of Generally Accepted Accounting Practice, and the Accounting and Disclosure requirements of the Companies Act, as well as other reporting requirements in the PFM Act.</p>
<p>The board ensures the SFI has a <i>professional internal audit function</i> that reports directly to the audit committee and has unrestricted access to the Chairperson of the board and all board members.<sup>124</sup> The internal audit plan is based on a formal risk assessment. The board requires timely correction of problems identified by internal auditors.</p>	<p>The Treasury regulations issued pursuant to the PFM Act specify detailed requirements for a risk-based internal audit function.<sup>125</sup> The independence, standards, functions and roles of the Bank’s internal audit are further specified in an Internal Audit Charter approved by the Board. The Bank conducts an external review of the internal audit function. In 2005 this review was undertaken by the Institute of Internal Auditors which determined the function was independent and conformed to international best practice.</p>

<sup>114</sup> **Good Practice:** The Chairperson of the board is not a member of the audit committee, but could be invited to attend audit committee meetings as necessary by the Chairperson of the audit committee.

<sup>115</sup> **DBSA:** Section 27.1.

<sup>116</sup> **DBSA:** The Audit and Finance Committee has additional responsibilities with respect to risk management, which are discussed below in the body of this report. In addition, it reviews and approves the annual budgets and annual and interim financial statements. It advises the Board on i) appropriate financial policies, investment limits and funds mobilization strategies, ii) the annual income, expenditure and capital budget requirements, and iii) compliance and procurement policies.

<sup>117</sup> **DBSA:** Under the Board Charter, all Board members have authority to meet with any senior staff member.

<sup>118</sup> **DBSA:** As noted, the Chairperson of the Audit Committee is a signatory to the Shareholder Compact.

<sup>119</sup> **DBSA:** Treasury regulations issued pursuant to the PFM Act, Section 27.1.11.

<sup>120</sup> **DBSA:** In line with the provisions of the Public Finance Management Act.

<sup>121</sup> Audits by the state supreme audit entity are not considered a substitute, in part because such entities usually focus mainly on the use of public funds and budget resources.

<sup>122</sup> **Good Practice:** Such criteria include limits on the provision of consulting services by the firm to the SFI, and periodic rotation of engagement partners and audit firm. BCBS P5.

<sup>123</sup> **DBSA:** Year-end March 31, 2006.

<sup>124</sup> Though the internal auditor may report administratively to the CEO.

<sup>125</sup> **DBSA:** Section 27.2.

Corporate Governance Benchmark	Evaluation of DBSA
<p>The <i>risk management committee</i> is responsible for ensuring the adequacy of risk management policies and management’s adherence to such policies, including specific risk limits. The committee explicitly addresses credit, interest rate, foreign exchange rate, and operational risk</p>	<p>The Audit and Finance Committee assists the Board in evaluating the adequacy and effectiveness of risk management processes, reviews significant risk exposures, performs an assurance function in respect of enterprise-wide risk management, and provides strategic direction regarding asset and liability management.<sup>126</sup></p> <p>The specialized Credit Committee of the Board is comprised of five members, four of which are non-executive, and is chaired by an independent non-executive member. It reviews and approves all credit extensions and is accountable to the Board for portfolio management, the review of significant credit exposures, and the adequacy of provisions for credit losses.<sup>127</sup></p> <p>DBSA has a Chief Risk Officer (CRO) to which report a Credit Risk unit and an Operational Risk unit that are functionally independent of line risk managers. The CRO has access to the CEO and the chairpersons of the Board and the Audit Committee.<sup>128</sup></p>

<sup>126</sup> **DBSA:** The Committee is supported in these respects by two management committees (the Asset and Liability Management Committee and the Finance and Risk Management Committee).

<sup>127</sup> **DBSA:** To perform this function the Credit Committee reviews DBSA’s credit strategy, its credit risk management program, credit extensions to legal entities in which officer or Board members have an interest (including related policies), trends in portfolio quality and the credit risk management policies approved by the Board.

<sup>128</sup> **DBSA:** DBSA categorizes risk as between credit risk (including country risk), interest rate risk, currency risk, liquidity risk and operational risk.



<b>Corporate Governance Benchmark</b>	<b>Evaluation of DBSA</b>
<p>The <i>remuneration committee</i> is responsible for formally assessing the performance of the CEO and reviewing the performance of other key managers, and for recommending to the board senior management remuneration.<sup>129</sup> The committee is responsible for making recommendations to the shareholder’s representative or the coordinating entity regarding board remuneration.</p>	<p>Under the Article 17 regulations the Remuneration Committee must consider the remuneration of the Board and the executive members of management. Under the Board Charter the Remuneration Committee twice a year is to make a formal evaluation of the CEO, in consultation with the Chairperson, and to provide a report of its findings for consideration by the Board. The Committee must annually consider the remuneration of the Board and executive managers, ensuring that levels or remuneration are sufficient to attract, retain and motivate executives of the quality required by the Board. To assist the Committee, the CEO is required to cause an independent report to be prepared that relates the remuneration of the Board to other similar institutions in South Africa. The Committee is also to take account of the result of the annual evaluation of the Board and its members. Changes in remuneration are proposed to the shareholder only after consideration by the Committee and endorsement by the Board.</p>
<p>The board has appointed a <i>corporate secretary</i> who reports to the board, and whose role it is to support the effective functioning of the board. The corporate secretary provides board members, collectively and individually, with guidance as to how their responsibilities should be discharged in the best interests of the SFI. The corporate secretary’s role is not less comprehensive than that specified under company law.<sup>130</sup></p>	<p>The role of the Company Secretary is specified in the Protocol and is in line with the functions under the Companies Act. The Board Charter highlights the important role of the Company Secretary in corporate governance. DBSA’s Board in fact has appointed a Company Secretary who performs the benchmark functions, among other duties.</p>
<p>The board receives <i>timely and sufficient information</i> to judge management performance. Performance is measured in financial and non-financial terms. The board requires that senior management prepare an <i>annual budget</i> as one element against which performance is measured.</p>	<p>The Board receives quarterly and periodic reports from management and the Board committees. Reporting includes financial and non-financial measures of performance. Besides regular financial reporting, the Board receives reports under the Balanced Scorecard and Social Accounting Matrix frameworks noted above. See section 4 for details. The Balanced Scorecard methodology is used in translating high level strategic objectives and targets into an annual budget.</p>

<sup>129</sup> **Good Practice:** Rates of compensation are generally in line with comparable private sector businesses. Any performance-related incentives are related to objective measures of long-term SFI performance.

<sup>130</sup> **Good Practice:** The corporate secretary has explicit responsibility to support the chairperson and CEO in determining and administering the annual board plan, to ensure the appropriate induction of new board members, to serve as a key source of guidance to the board on matters of ethics and good governance, and to otherwise assist the chairperson and individual directors to ensure they have access to necessary advice and training. The performance of the corporate secretary is evaluated annually in the same manner as individual board members.

Corporate Governance Benchmark	Evaluation of DBSA
<p>The board has ensured that <i>accounting and management information systems</i> provide the information necessary to determine the costs and results of the <i>provision of social and public services</i>.<sup>131</sup></p>	<p>The Balanced Scorecard and Social Accounting Matrix frameworks seek to measure the results of DBSA's developmental activities. The Bank's contributions to the Developmental Fund are clearly identified and reported. The Bank might be able to make more explicit its accounting for and reporting of the costs of activities undertaken by the Bank itself on less than a fully commercial basis.<sup>132</sup></p>
<p>The board uses explicit <i>procedures to ensure the integrity of financial and non-financial reporting</i>.<sup>133</sup></p>	<p>See above comments regarding the Audit and Finance Committee.</p>
<p>The board, by means of the annual Directors' Report and/or published financial statements, is explicit about how it <i>balances tradeoffs between financial objectives, social service objectives and developmental objectives</i>.</p>	<p>The Directors' Report in the Annual Report reports extensively on performance against objectives, including by disclosing performance against the targets set out in the Balanced Scorecard. The Directors' Report addresses economic/financial, environmental and social outcomes. See section 4.</p>
<p>The board undertakes an <i>annual self-evaluation</i> to appraise its performance. The evaluation scrutinizes the performance of the overall board, the chairperson, and individual members. It assesses, among other matters, the adequacy of the mix of the skills and experience of the board, and the processes for nomination and election of board members and for management of conflicts of interest. The results of the evaluation are communicated to the ownership entity.</p>	<p>The Protocol sets out requirements for an annual assessment of the performance of the Board, requiring a review of its size, mix of skills, expertise and experience, and covering the Board collectively, the Chairperson, the CEO and each individual Board member. The assessment is to measure performance in achieving the objectives set out in the required Shareholder Compact. The Board Charter specifies that the Chairperson must annually report to the shareholder on the performance of each Board member and the Board collectively, and specifically review areas in which the Board or its functioning could be improved. As an example, in the 2004/05 financial year, the review determined that improvement was required in terms of continuous provision of information and training on business and accounting developments.</p>

<sup>131</sup> This might, for example, include maintaining separate accounts for such activities.

<sup>132</sup> **DBSA:** For example, the interest income forgone by charging below market interest rates on loans.

<sup>133</sup> **Good Practice:** Board members sign publicly disclosed financial reports.

<b>Corporate Governance Benchmark</b>	<b>Evaluation of DBSA</b>
<p>The board has approved a <i>code of ethics</i> that defines standards for professional conduct and for dealing with conflicts of interest applicable to board members, management and employees. The board has ensured the standards are well communicated within the SFI, and has implemented a compliance program.<sup>134</sup> The board is free of conflicts of interest or the appearance of conflicts.</p>	<p>The Board has adopted a comprehensive written Code of Ethics that commits management and staff to high standards of ethical conduct in their dealings with the Bank’s clients and stakeholders. The Code is reviewed annually to benchmark it against best practice in other development finance institutions.</p>
<b>4. Transparency and Disclosure</b>	
<p>Overall, SFI accounting, auditing, transparency and disclosure <i>standards are comparable to those for publicly listed firms.</i><sup>135</sup></p>	<p>As noted, DBSA is subject to the Accounting and Disclosure requirements of the Companies Act.<sup>136</sup> Its actual disclosure practices are extensive, including an Annual Report incorporating the audited Annual Financial Statements and the Director’s Report, an accompanying Activities Report describing the development impact of the Bank’s activities during the year, an Information Manual issued in accordance with the Promotion of Access to Information Act (2000), and interim (six-monthly) results incorporating a strategic overview. All reports, as well as extensive additional information, are available on DBSA’s website (<a href="http://www.dbsa.org">www.dbsa.org</a>). In addition, DBSA submits financial and operational information to the National Treasury quarterly.</p>
<p>The board is responsible for and ensures publication of an <i>annual report</i>, which is the principal vehicle for most of the disclosures cited in this section. The annual report also includes <i>full financial statements</i>, including a detailed balance sheet, income statement, supporting notes and schedules, and a report on internal controls.<sup>137</sup></p>	<p>DBSA publishes full annual audited financial statements with accompanying descriptive notes.<sup>138</sup></p>

<sup>134</sup> **Good Practice:** The board has established procedures for employees to communicate material and bona fide concerns directly or indirectly (e.g. through an independent audit or compliance process) and confidentially to the board.

<sup>135</sup> **Good Practice:** Use of international standards of best practice.

<sup>136</sup> **DBSA:** As well as to related requirements in the DBSA and PFM Acts.

<sup>137</sup> Supporting notes include disclosure of significant accounting policies employed.

<sup>138</sup> **DBSA:** The Annual Financial Statements include the following: statement on Board responsibility for financial reporting; report of the independent auditors to the Minister of Finance; assurance report of the independent auditors to the Minister of Finance; Board of Directors’ report; balance sheet; income statement; cash flow statement; statement of changes in equity, and; notes to the financial statements.

<b>Corporate Governance Benchmark</b>	<b>Evaluation of DBSA</b>
<p><i>Ownership structure</i> is disclosed and transparent, including major share ownership (including legal ownership of state shares) and voting rights. Any special rights or agreements that may alter the ownership or control structure (e.g., golden shares or special veto powers granted the state), are disclosed and transparent. Responsibility for exercising the state's ownership (i.e., the ownership entity) are disclosed and transparent.</p>	<p>The ownership structure (100% government of the Republic of South Africa), and the responsibility of the Minister of Finance for exercising the state's ownerships rights, are fully disclosed and transparent. There are no special arrangements altering the ownership or control structure.</p>
<p>The <i>state ownership policy</i> is disclosed, including overall objectives of state ownership, the state's role in SFI corporate governance, and the manner in which the ownership policy is implemented.</p>	<p>As noted, the state ownership policy for SOEs generally is framed largely by the PFM Act, the National Treasury regulations issued pursuant to that Act, and the Protocol, as well as, for DBSA specifically, the DBSA Act and the Article 17 regulations. The Minister of Finance in the Annual Report provides his assessment of the performance of DBSA and his expectations regarding strategic direction and future performance. As noted, the Minister also reports to two Parliamentary committees in this regard.</p>
<p><i>Board structure</i> is disclosed, which includes bylaws, board size, board membership, board member selection process, board member qualifications, other directorships held by board members, criteria for independence, any member's material interests in transactions or matters affecting the SFI, as well as board committees' terms of reference and committee membership.</p>	<p>Board and Board committee size, membership and records of attendance, Board committee responsibilities and processes, and basic information about the academic qualifications and current employment of Board members are disclosed. Bylaws, other directorships held by Board members, and member's interests in transactions or matters affecting the SFI are not disclosed publicly. However, the Corporate Secretary maintains a register of Board members' declaration of interests which is updated annually and at the beginning of every Board and Board committee meeting.</p>
<p>The <i>number of board and committee meetings and the attendance records</i> of individual members is disclosed in the annual report.</p>	<p>Fully disclosed in the Annual Report.</p>
<p><i>Senior management structure</i> is disclosed, which includes responsibilities, reporting lines, qualifications and experience.</p>	<p>Senior management is disclosed in the Annual Report along with basic information regarding their academic qualifications.</p>

<b>Corporate Governance Benchmark</b>	<b>Evaluation of DBSA</b>
<p>The <i>organizational structure</i> is disclosed, including the general organizational chart, key business lines and business processes, subsidiaries and affiliates, and management committees.</p>	<p>In its Annual Report and elsewhere on its website DBSA provides extensive information about its organization, businesses, and business processes, including progress on steps being taken to strengthen the organization and align its capacity to its mandate and strategy.</p>
<p>Information regarding <i>board and senior management remuneration</i> is disclosed, including policies, and board and senior management base and incentive compensation.<sup>139</sup></p>	<p>The Annual Report discloses fees, subsistence and travel payments for each Board member. It discloses individual salaries, benefits and performance incentive payments for nine senior managers.</p>

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<sup>139</sup> **Good Practice:** Disclosure of remuneration on an individual basis.

<b>Corporate Governance Benchmark</b>	<b>Evaluation of DBSA</b>
<p>The SFI discloses its <i>overall objectives</i> and whether and how they have been fulfilled. It discloses the manner in which it deals with inherent tradeoffs among objectives.</p>	<p>The Directors' Report in the Annual Report discusses objectives and performance in detail. It takes the form of an Economic Report, an Environmental Report and a Social Report. The Economic Report covers, among other matters, the actual delivery of products and services and their geographic and business sector focus, and reports on the developmental impact of the Bank. The Environmental Report provides a qualitative discussion of the environmental impact of the Bank's products and services and its own operations. Similarly, the Social Report provides a qualitative discussion of activities and impacts in areas such as human resource development, health and gender equality, and well as with respect to its employees. The Directors' Report is subject to external audit to confirm its quantitative and qualitative content.</p> <p>Interim (six-monthly) reports provide additional descriptive information regarding objectives. DBSA's marketing program seeks, in part, to increase the public's awareness of its mandate and performance.</p> <p>DBSA has developed and is enhancing a model that evaluates the potential financial performance outcomes of alternative strategic decisions. The model is a tool to quantify the impact of tradeoffs inherent in its objectives and business policies (e.g. providing lower cost financing increasingly to higher risk municipal clients while maintaining financial self-sufficiency).</p>
<p><i>Key business and financial performance indicators</i> are employed in disclosing how objectives are fulfilled.</p>	<p>The Annual Report provides key financial performance indicators and prior year comparators. The Economic Report in the Directors' Report quantifies and discusses, in the Balanced Scorecard format, DBSA's performance against 31 specific targets under nine strategic objectives, including comparators to the prior year.<sup>140</sup> It provides performance information on the economic impacts (e.g., in terms of GDP, employment, and on low-income households) and social impacts (e.g., low cost houses constructed) of DBSA's activities that are generated via internal economic models and the Social Accounting Matrix. Details regarding the models are disclosed in a separate report accompanying the Annual Report.<sup>141</sup></p>

<sup>140</sup> **DBSA:** The high-level strategic objectives are: grow lending and investment business; broaden the menu of products and services to customers; promote and forge smart partnerships (including a target to attract one rand in co-financing by others for each rand financed by DBSA); optimize the benefits of interventions (including Black Economic Empowerment procurement targets); become an advanced knowledge-based

<b>Corporate Governance Benchmark</b>	<b>Evaluation of DBSA</b>
<p><i>Measurable and verifiable social and public policy outcome indicators</i> are employed in disclosing how objectives are fulfilled.</p>	<p>In addition to those indicators presented in the Directors' Report in the Annual Report, additional indicators are provided in the accompanying Activities Report, which also describes the methodology employed for calculating developmental impacts.</p> <p>A key element of DBSA's mandate is to promote the role of the private sector in the provision of public finance. DBSA policy limits the percent of larger projects that can be financed by the Bank. The relevant publicly reported direct outcome indicator is the ratio of DBSA's investment in its projects relative to funding provided by others. The target value is 1:1. Besides seeking co-financing, DBSA promotes achievement of this objective through its local municipality capacity building and knowledge management programs geared especially to poorer local governments in South Africa, for which indicators are also published.</p>
<p><i>Material risks</i> and the means employed to manage and control risks are disclosed.</p>	<p>DBSA's Annual Report provides a detailed description of the Board and management processes applicable to the management of risks.</p>
<p>The nature and extent of any <i>state financial assistance</i> (e.g., subsidies) or guarantees to the SFI is disclosed.<sup>142</sup></p>	<p>The fact that DBSA is exempt from income tax and is not requested to pay dividends, as well as the state's capital contribution to DBSA and its high level of capitalization, are all disclosed.</p>
<p>The SFI's <i>code of ethics</i> and related policies and processes are disclosed. The disclosures include a statement by the board regarding the extent to which it believes the code of ethics and related policies and processes are adhered to.</p>	<p>The Bank's Annual Report provides a detailed description of corporate governance and the Code of Ethics.</p>
<p>Information related to <i>conflicts of interest</i> are disclosed, including the SFI's policies related to conflicts of interest, the nature and extent of transactions with affiliates and related parties, and any matters on which any board members or senior managers have material interests.</p>	<p>Legal requirements and policies, and the nature and extent of transactions with affiliates and related parties, are disclosed. Matters on which board members or senior managers have material interests are not disclosed, although the register of Board member interests maintained by the Corporate Secretary is accessible to all DBSA employees.</p>

institution (external); maintain sound financial health (including seven financial performance targets); ensure the business processes deliver effectively and efficiently on strategic objectives; attract, develop and retain competencies in line with employment equity requirements (including target for investment in training), and; become (internally) an advanced knowledge-based institution. The 31 specific targets against which performance is publicly reported comprise a significant subset of those set out in the Corporate Plan annexed to the Shareholder Compact.

<sup>141</sup> **DBSA**: Activities 2004/05.

<sup>142</sup> See also Parts 2 and 3 of this evaluation framework.

<b>Corporate Governance Benchmark</b>	<b>Evaluation of DBSA</b>
<i>Amounts paid to the external auditors for non-audit services</i> are disclosed and described in the notes to the financial statements.	Not disclosed.
<i>Board members have signed published financial statements.</i> <sup>143</sup>	DBSA's published Annual Financial Statements are approved by the Board and are signed by the Chairperson of the Board, the Chairperson of the Audit and Finance Committee, and the Managing Director (CEO). The Annual Report includes a description of the Board's accountability for the preparation, integrity and objectivity of the financial statements.
The <i>frequency</i> of disclosure corresponds to the nature of the information being disclosed and the needs of users.	The frequency of disclosure is appropriate, being in line with South Africa's comprehensive statutory requirements.

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<sup>143</sup> **Good Practice:** The CEO and CFO certify that published financial statements in all material respects appropriately and fairly represent the operations and financial condition of the SFI.