

# Private Sector Opinion

# 40

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## The State of Governance at State-Owned Enterprises

Simon C. Y. Wong

Commercial enterprises that are owned and controlled by governments continue to constitute a significant portion of business activity in many parts of the world. This paper examines three critical areas for strengthening the quality of governance of state-owned firms—professionalizing government ownership, strengthening commercial orientation, and developing stronger, more independent boards—and the challenges involved in implementing reforms.

### Foreword

This Private Sector Opinion by Simon Wong is very timely. The reform of state-owned enterprises (SOEs) is again a high priority in many World Bank Group client countries around the world. This is an old topic for us, as the Bank has been involved with SOEs since its inception. What is new is the focus on governance structures that can help to increase professionalism and autonomy – the creation of ownership agencies, and independent and objective boards of directors.

Simon is not a newcomer to this debate. His past writing on SOEs was important because it built on his hands-on governance experience, and moved beyond the language of international standards to clarify the key issues. This article continues that tradition. In his advisory work he has tackled the governance of SOEs from different angles – he has advised state ownership entities, he has looked at individual SOEs and helped boards improve their functioning and he has, in the context of state owned institutional investors considered investment and stewardship activities.

This article focuses on the most important topics of SOE governance reform: the creation of a professional ownership unit, the clarification of the goals and objectives of the SOE, and the establishment of stronger, more independent boards. Reforming state ownership arrangements remains the key challenge. The goal is to professionalize and depoliticize state ownership, and the article correctly emphasizes that improved ownership arrangements can take many forms around the world. The classifications

presented (decentralized, dual, centralized) are a starting point for reviewing options. While the centralized model is generally accepted as “best practice”, we usually argue that the creation of other forms (e.g. a coordinating body) is a significant improvement over traditional decentralized models. The creation of a professional ownership unit is perhaps the most important step discussed in the article because it creates an institution that will push for the required changes in governance at the company level, including legal and regulatory reform, improved governance standards, and a capacity to implement modern performance management.

The Private Sector Opinion also underlines the importance of a balanced and independent board. For the board to fully exercise its duties and responsibilities, its members need to possess the objectivity and be empowered to make decisions in the best interests of the corporation and not solely in that of a shareholder. The article emphasizes the importance of strong, independent boards while highlighting implementation challenges.

“Big-bang”-style SOE reform is difficult. The Private Sector Opinion underscores that implementation is the key challenge. I especially appreciated the observation that it is important to “remain ever vigilant” to avoid the “two steps forward, one step back” phenomenon. We have in fact now seen several cases where initial steps are taken to initiate reform, at either the company level or the country level, but the reforms are not permanent. This is due not only to changes in political leadership but also due to “key person risk”, when the key corporate leader leaves a job (or is forced out of) the ownership agency and the agency reverts to old patterns of behavior.

The reform package outlined in the article has proven to be especially difficult to implement in low income countries, where the defects in governance are most severe and the costs of inaction are the largest. This is due to many factors, including low capacity, higher levels of corruption, and a private sector that does not serve as a source of inspiration.

The more that the importance of these issues is highlighted, the greater the consensus for reform, despite entrenched interests.

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# The State of Governance at State-Owned Enterprises

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Notwithstanding the privatization waves in recent decades, governments remain major owners of commercial enterprises in many parts of the world. According to a 2009 survey, 25 OECD<sup>2</sup> member countries—encompassing a wide range of developed and emerging markets—held stakes in more than 2,000 state-owned enterprises (SOEs) with a total value of \$1.2 trillion and accounting for 15 percent of aggregate GDP (World Bank Group 2014, 4).

In reality, the impact of SOEs is likely to be greater than those statistics suggest, because many operate in infrastructure industries—telecommunications, transportation, financial services, and so forth. This means that their performance, good and poor, will have substantial knock-on effects across the economy. While efforts to strengthen the governance of SOEs have lagged behind progress made in the private sector, governments in developed and emerging countries have sought to catch up in recent years.

*Getting governance right at SOEs is daunting because of the added complexity of their operating model.*

Getting governance right at SOEs—including those listed on stock exchanges and therefore subject to the same regulations as privately owned firms—is daunting because of the added complexity of their operating model. The unique challenges facing SOEs include, among other things, the need to balance commercial and policy objectives, the risk that political masters will abuse their authority over SOEs for self-interested reasons, and fewer tools available to incentivize and discipline employees. (See Table 1 for a comparison of private firms and SOEs.)

**Table 1: Differences Between Private Sector Firms and State-Owned Enterprises**

	PRIVATE SECTOR FIRMS	SOEs
OBJECTIVES	Clear focus on value maximisation	Pursue commercial and non-commercial objectives
AGENCY ISSUES	Single agency—concerned about self-interested behaviour by managers or controlling shareholders	Double agency—concerned about self-interested behaviour by managers and politicians/bureaucrats
INCENTIVES/DISCIPLINE	Strong market-driven incentives and discipline (e.g., threat of takeover/bankruptcy, termination of under-performing staff, availability/use of restricted stock and other performance-based pay)	Limited mechanisms to incentivize and discipline (e.g., insulation from takeover/bankruptcy, stronger job protection for staff, limited use of performance-based remuneration tools)

Source: Author.

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<sup>2</sup> OECD = Organisation for Economic Co-operation and Development.

Nonetheless, a variety of good practices have emerged in the SOE arena to address and overcome these difficulties. Exemplars hail from regions as diverse as Latin America, Asia-Pacific, and Europe. This article focuses on three areas of development critical to improving SOE governance:

- Professionalization of government ownership,
- Strengthened commercial orientation,
- Stronger, more independent boards.

It also discusses implementation challenges—especially those relating to inappropriate political meddling—that continue to frustrate the realization of good SOE governance.

## Notable Areas of Reform

While SOE reforms have covered a wide terrain, the three areas examined here stand out as particularly critical to bolstering their governance. Notably, all of them seek, to varying degrees, to insulate SOEs from undue political interference.

### Professionalization of Government Ownership

With regard to organization and supervision, many SOEs, including those engaged in commercial activities, were historically viewed and treated as part of government, with oversight authority often distributed across multiple ministries. For example, Latvia's port operations—which together handle more than 60 million tons of cargo annually and account for 5–7 percent of the country's GDP—have legal status as a “derived public person” or are established under special legislation rather than incorporated under the company law (OECD 2015c, 22–23). They are also overseen by a mixture of local and federal authorities.

Importantly, a supervisory agency might exercise both regulatory and ownership responsibilities, even when an SOE operates in a sector with private sector competitors. In the banking sector, for example, the central bank may be the majority shareholder of a lending institution as well as its regulatory supervisor.

Moreover, it is not uncommon for supervisory agencies to be endowed with broad and overlapping managerial authority, but structured coordination among the relevant bodies is not always in place. According to the OECD, under Lithuania's decentralized SOE supervisory framework, “there is no clear overall separation between the state's ownership function and other functions that can influence conditions for Lithuanian SOEs,” with several line ministries concurrently exercising sectoral regulation and ownership rights in SOEs (OECD 2015d, 16). Similarly, the OECD observes that Colombia's decentralized ownership and supervisory approach generally provides “no formal mechanisms for resolving the discrepancies that can, in these cases, arise as a result of the different points of view of ministries as regards decisions that correspond to the state as owner” (OECD 2015b, 25).

In a growing number of countries, substantial efforts have been made to professionalize the government's approach to owning and managing SOEs in order to strengthen the clarity and coherence of its overarching policy objectives, improve oversight of SOEs, and insulate these entities from undue political interference. Major reforms in this area include the following:

- Legal separation of SOEs from government through incorporation under the company law,
- Centralization of the government's ownership function,
- Increasing specificity and disclosure of ownership objectives,
- Clearer segmentation of SOEs,
- Greater clarity and limits on intervention rights.

To strengthen the governance of SOEs, many governments have taken a fundamental step to change the legal status of these businesses through incorporation under the company law. An example is the government-controlled Postal Savings Bank of China, which commenced postal banking operations in 1986. As part of the Chinese government's effort to modernize and strengthen the governance of the banking sector, it converted the institution into a limited liability company in 2007, and then a joint stock company in 2012, before having it go public on the Hong Kong Stock Exchange in 2016.

Incorporation signals to politicians, civil servants, and the general public that an SOE is a commercial entity that is formally separate from government and subject to the legal constitutional requirements of private sector peers, including in how authority is distributed among shareholders, the board of directors, and management. In New Zealand, the government explains, "A key principle under the company model is the separation and maintenance of a clear division between the Government's ownership, purchasing and regulatory interests" (COMU 2012, 10). It stresses that each SOE operates at arm's length from government, and the SOE's board of directors is responsible for overseeing the company's management and affairs. In Norway, the government acknowledges that incorporation of SOEs as a limited liability company means that "the state relinquishes its right to directly influence the enterprise's day-to-day operations" (Norway 2008, 59).

Regarding supervision, the trend globally has been to centralize the oversight of SOEs (particularly commercially oriented ones), with governments usually adopting either a dual ownership or a centralized model (OECD 2011b). *Under the dual ownership model*, two ministries share responsibilities for exercising the government's ownership functions. For example, prior to switching from a dual ownership to a centralized model in 2009, New Zealand tasked the Ministry of Finance with responsibility for the economic efficiency and fiscal impact of the SOE portfolio, while the line ministries—with the assistance of what was then the Crown Ownership Monitoring Unit—monitored the performance and appointed the boards of directors of SOEs in their respective sectors.

*To strengthen the governance of SOEs, many governments have taken a fundamental step to change the legal status of SOEs through incorporation under the company law.*

*Under the centralized model*, the government’s ownership function is concentrated in one ministry. In Finland, responsibilities for directly owned SOEs is given to the Ownership Steering Department in the Prime Minister’s Office.<sup>3</sup> Other countries using this model include Australia, Belgium, China (for the largest SOEs), France, Indonesia, the Netherlands, New Zealand, Poland, and Sweden.

Considering relative merits, the dual ownership model may be suitable as a transitional measure (as it may face less political opposition), where the SOE portfolio may be too large for a centralized oversight unit to manage effectively, or where the sector ministries possess unique skills needed for effective monitoring of SOEs. By contrast, some countries have moved to a centralized model in the belief—often after experimenting with a dual ownership model—that regulatory and ownership functions need to be distinguished more clearly or that coordination would be more effective if a single agency were fully empowered to exercise the government’s shareholder role. Centralization could also encourage the pooling of expertise, which may be particularly advantageous in countries where the required skills are in short supply.

In most countries, the government’s ownership function is placed under an existing ministry—frequently the Ministry of Finance or Treasury as in Australia, France, Lithuania, and New Zealand. However, a few countries, such as Belgium and Indonesia, have established a separate SOE agency. It is notable that Finland has placed its ownership function at the highest political level—in the Prime Minister’s Office—rather than under an existing or a new agency. Indeed, it has been my experience that maintaining strong SOE governance requires highly visible and steadfast support from the most senior political leaders.

A variant found in several countries, such as Malaysia and Singapore, is the creation of investment companies to manage the government’s strategic stakes in domestic SOEs as well to invest in sectors that could aid the country’s economic growth and competitiveness. (See Tables 2a and 2b for examples of centralized ownership arrangements.)

**Table 2a: Centralized Ownership Under Government**

COUNTRY	NAME OF ENTITY	LOCATION OF ENTITY
<b>OWNERSHIP UNDER GOVERNMENT</b>		
<b>Ownership ministries</b>		
Indonesia	Ministry of State Enterprises	Ministry of State Enterprises
<b>Ownership departments in a ministry</b>		
Finland	Ownership Steering Department	Prime Minister’s Office
France	Agence des Participations de l’Etat	Ministry of Economy and Finance
Norway	Ownership Department	Ministry of Trade and Industry
Poland	Department of Ownership Supervision	Ministry of Treasury
South Africa	Department of Public Enterprises	Ministry of Treasury
<b>Ownership agencies</b>		
Chile	Sistema de Empresas	Ministry of Economy
China	State-Owned Assets Supervision and Administration Commission	State Council

Source: (World Bank Group 2014, 82).

<sup>3</sup> This excludes “special assignment companies” (companies with a specific state-defined mission or enjoying a special regulatory exemption) for which supervisory responsibilities are divided among seven ministries.



**Table 2b Centralized Ownership Under Company-Type Structure<sup>4</sup>**

COUNTRY	NAME OF ENTITY	LOCATION OF ENTITY
<b>COMPANY-TYPE STRUCTURE</b>		
Bhutan	Druk Holding and Investments	Ministry of Finance
Hungary	State Holding Company	Directed by the National State Holding Board
Malaysia	Khazanah Nasional	Ministry of Finance
Mozambique	Institute for the Management of State Holdings	Ministry of Finance
Peru	Fondo Nacional de Financiamiento de la Actividad Empresarial del Estado Holding company	Ministry of Finance
Singapore	Temasek Holdings	Wholly owned by Ministry of Finance
Vietnam	State Capital Investment Corporation	Wholly owned by Ministry of Finance
United Kingdom	UK Government Investments Ltd	Wholly owned by the UK Treasury

Source: (World Bank Group 2014, 82).

Governments’ drive to be more systematic in their approach also includes elucidating the rationale for SOE ownership as well as its objectives. In countries such as Finland, New Zealand, Norway, and Sweden, the government will periodically review and disclose its rationale for the continuing ownership of SOEs and any changes in its ownership policy. In Finland, the latest ownership policy, issued in 2016, focuses on the benefits of state ownership “in the early stages of the emergence of new markets or when a sector is undergoing radical change, where experimentation with new methods and practices in the marketplace is needed.” The government emphasizes that state ownership can be deployed as “an active tool for renewal in society” (Finland 2016, 1–2).

*An increasingly common practice is to segment SOEs into discrete categories.*

An increasingly common practice is to segment SOEs into discrete categories. In Finland, companies in which the state maintains an interest are slotted into one of three categories: strategic interest, financial interest, and state companies with a special assignment. (See Table 3.)

<sup>4</sup> The table has been updated to reflect that the United Kingdom’s former Shareholder Executive, an ownership department in a ministry, has been folded into the UK Government Investments Ltd.

**Table 3: Finland—Basis for State Ownership**

	DESCRIPTION
<b>STRATEGIC INTEREST</b>	A strategic interest may relate to national defence, the security of supply, the maintenance of the infrastructure or the obligation to provide certain basic services. The strategic interest is defined by the ministries responsible for the related regulation.
<b>FINANCIAL INTEREST</b>	A financial interest does not constitute permanent grounds for ownership. Instead, the capital committed to companies that are owned merely for a financial interest should be allocated at the best possible time to boost growth in the national economy more effectively. No limit is established by Parliament for the size of the holdings in companies of financial interest, and decisions regarding their ownership base may be made by the Government.
<b>NATURAL MONO-POLY/SPECIAL ASSIGNMENT</b>	<ul style="list-style-type: none"> <li>• In the case of a natural monopoly, the solution most efficient for the national economy is attained with a single actor. Due to the problems involved with regulation, the best monopoly solution is often a public monopoly.</li> <li>• State-owned companies entrusted with special assignments have societal objectives related to some central function vital to society that is nevertheless most efficiently organised in a company form.</li> </ul>

Source: (Finland 2016, 2).

Similarly, Lithuania categorizes its SOEs into three groups (OECD 2015d, 15):

- **Group 1A:** Enterprises from which the state expects business-value growth and returns in the form of dividends (for limited liability companies) or profit contributions (for statutory SOEs);
- **Group 1B:** Enterprises from which the state expects, in addition to business-value growth and dividends or profit contributions, the safeguarding of national strategic interests (national economic security, implementation of strategic projects, quality infrastructure, and other objectives); and
- **Group 2:** Enterprises in which the state prioritizes the implementation of social and political objectives, and where profit-seeking activities assume a secondary importance.



Clarity on ownership objectives, coupled with segmentation of SOEs, can help provide high-level steering to state-owned firms and keep the state accountable.

Going further, some governments have adopted a structured approach to the development of mandates for individual SOEs. In New Zealand, SOE-specific mandates take the form of a Statement of Corporate Intent that is negotiated annually between the government and the SOE. Under the State-Owned Enterprises Act, the Statement of Corporate Intent (SCI) is required to contain the following information:

- Objectives of the SOE;
- Nature and scope of the activities to be undertaken;
- Ratio of consolidated shareholders' funds to total assets;
- Accounting policies;
- Performance targets and other metrics by which the SOE's performance may be assessed in relation to its objectives;
- Statement of the principles adopted in determining the annual dividend and an estimate of the proportion of annual post-tax earnings that is intended to be distributed to the Crown;
- Information to be provided by the SOE during the period covered by the SCI, including the information to be included in each semiannual report;
- Procedures to be followed before the SOE acquires shares in any company or other organization;
- Any activities for which the board seeks compensation from the Crown (whether or not the Crown has agreed to provide it);
- Such other matters as are agreed by the state and the board;
- The board's estimate of the current market value of the Crown's investment in the SOE and a statement of the valuation methodology.

Efforts to professionalize the government's ownership approach have also included clarifying its intervention rights. As the controlling owner, the state should be able—subject to applicable legal limits—to “direct” an SOE. In practice, however, government intervention has frequently destroyed value—in profitability, productivity, distortion of competition, and so forth. For this reason—and to increase transparency to bolster the public's confidence in the government's SOE stewardship—countries are increasingly placing checks on and narrowing the scope of their intervention rights.

New Zealand, for example, confines its interventions in wholly owned state-owned enterprises to four areas: strategic plan (including performance levels), dividend levels, board appointments, and taking necessary remedial steps with SOEs that fail to meet agreed performance targets. At listed SOEs where ownership is shared with outside minority investors, such as Air New Zealand, the government will not intervene except through voting its shares at shareholder meetings.

In Finland, the state's intervention rights in companies operating on "market terms" are limited to voting at shareholder meetings, although the state may be represented directly on an SOE board and sit on a nomination committee to recommend board candidates for shareholders' approval. However, similar to the way listed companies engage with major shareholders, the board and management of SOEs may choose to consult the Ownership Steering Department on key strategic and other matters, such as transactions requiring the issuance of new shares.

Concerning "special assignment"<sup>5</sup> companies, the Finnish government will determine the content of the special assignment and, if necessary, exercise regulatory and financial control in furtherance of such objectives. However, the strategy for commercial operations will be determined by the company's executive management, although it is expected that the Ownership Steering Department and SOE management will cooperate to coordinate the commercial strategy and special assignment.

## Strengthened Commercial Orientation

A major challenge for many SOEs is that they are charged with expansive social responsibilities. Oil giant Saudi Aramco, for example, has carried out a wide range of activities to support the surrounding communities and the development of the broader economy, from operating schools and running hospitals to constructing a new university on behalf of the Saudi Arabian government. Recently, the government assigned the company a major role in developing the country's non-oil economic sectors.

Considerable efforts have been exerted to inject a stronger commercial focus into SOEs, including, as a first step, incorporating SOEs under the company law. In Brazil, for example, the Corporation Law deems all joint stock companies, regardless of their corporate purposes, to be "commercial" entities and profit seeking.

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Similarly, governments have floated SOEs on local and international stock exchanges as a way to subject them to market and outside shareholder discipline. In some cases, operating subsidiaries stripped of social and other noncommercial responsibilities have been listed, with the parent company retaining those obligations. Other notable steps in this direction include the following, which we will discuss further:

- Transparency of, and stronger limits on, noncommercial objectives,
- Costing and separate funding of noncommercial objectives,
- Use of private sector peers as benchmarks when evaluating SOE performance,
- Adoption of private sector compensation practices.

<sup>5</sup> Finavia Corporation is an example of a "special assignment" company. It is tasked with developing and maintaining an integrated and coordinated state airport network and a domestic air navigation system to serve the needs of the commercial, civil, military, and other official aviation segments (Finland 2011a, 2).

Regarding the transparency and funding of noncommercial objectives, the *OECD Guidelines on Corporate Governance of State-Owned Enterprises* state that “special responsibilities and obligations should be clearly mandated and motivated by laws and regulations. They could also be incorporated into corporate bylaws” (OECD 2015a, 33). To maintain a level playing field for private competitors, the OECD Guidelines for SOEs also specify that “any costs related to the fulfilment of public policy objectives [should] be clearly identified, disclosed and adequately compensated by the state” (OECD 2015a, 49).

In New Zealand, the State-Owned Enterprises Act 1986 acknowledges that an SOE may pursue noncommercial objectives but “requires Ministers to enter into an agreement with the [SOE] to pay for any goods or services that they wish [an SOE] to provide to any person” (KiwiRail 2017). For example, the 2011 strategic plan of Genesis Energy states that it “will seek full compensation from the Crown for any activities or obligations which will result in a reduction of the company’s net profit or net worth, which the company is required by the Crown to undertake under the provisions of the Act, and for which a commercial return is not forthcoming” (Genesis Energy 2011). At Banco do Brasil, in which the Brazilian government holds a 57.7 percent stake, the national treasury compensates the lender for the extension of subsidized loans to the agricultural sector in amounts that allow it to realize a net return of 3 percent (Cortes 2010).

A helpful way to evaluate the performance of SOEs and maintain accountability is to use privately owned companies as comparators. For Finnish “commercial” SOEs, their “operating principles, financial structure, and return targets” need to be comparable to those of privately owned firms in the same sector (Finland 2011b, 3). Similarly, SOEs in New Zealand need to “operate as a successful business and, to this end, to be as profitable and efficient as comparable businesses that are not owned by the Crown” (Treasury 2015). Where suitable peers in the private sector exist, their performance data will be used in assessing the performance of SOEs.

*Through the adoption of performance-based pay and awarding compensation in the form of restricted stock, listed companies throughout the world use remuneration as a tool to align the interests of executives with those of shareholders at large.*

In Sweden, an SOE’s calculated cost of capital, defined as the return that an investor could expect from an alternative investment with a similar risk profile and duration, provides the baseline for measuring the enterprise’s performance.

Through the adoption of performance-based pay and awarding compensation in the form of restricted stock, listed companies throughout the world use remuneration as a tool to align the interests of executives with those of shareholders at large. In countries such as Australia, the United Kingdom, and the United States, variable compensation (as opposed to fixed salary and other work-related perquisites) often constitutes 60 percent or more of total compensation. By contrast, SOEs, including some that are listed on stock exchanges, have historically compensated their executives mostly or entirely in cash and only a small proportion based on company performance. Some governments have deliberately applied such “low-powered” incentives to ensure that managers are not “too incentivized to increase profits at the expense of more general social objectives” (Musacchio and Lazzarini 2012, 37).

To enhance the commercial orientation of executives at SOEs with predominantly economic objectives, the OECD Guidelines for SOEs argue, “There is a strong case for aligning the remuneration of board members of SOEs with private sector practices” (OECD 2015a, 45).

Some SOEs, particularly publicly traded firms, are heeding this advice. At Statoil, in which the Norwegian government holds a 67 percent stake, top executives receive shares equal to 20–30 percent of salary. Shares awarded must be held for three years, after which they can be sold (Statoil 2015a, 3). Notably, Statoil explains that top executives are granted long-term incentives in the form of restricted stock to strengthen “alignment with shareholder interests” (Statoil 2015a, 2). At Banco do Brasil, 50 percent of the variable compensation awarded to its 36 “executive officers” is paid in the form of shares (Banco do Brasil 2015, 293).

At the same time, governments are sensitive about excessive remuneration. The Swedish remuneration guidelines for SOEs, for example, emphasize the need to be extra careful about paying too much (see Table 4). Some countries explicitly caution that the quantum of pay at SOEs cannot be market-leading, although it should be competitive.

**Table 4: Key Provisions of Swedish SOE Guidelines on Executive Compensation**

DESCRIPTION
<ul style="list-style-type: none"><li>• Total remuneration for senior executives (CEO and other individuals in the “executive management of the company”) shall be “reasonable and well-considered”</li><li>• Remuneration for senior executives shall be “competitive, with a set ceiling and appropriate for its purpose”</li><li>• Salary level shall not be “leading in relation to comparable companies but be characterized by moderation”</li><li>• The compensation for senior executives shall not contain a variable component (i.e., no bonuses)</li><li>• In the event of termination, severance payment may not exceed 18 months’ salary of the individual concerned</li><li>• If the board deviates from these guidelines, it shall explain its reasons for doing so</li></ul>

Source: (Sweden 2009).

## Stronger, More Independent Boards

In contrast to their private sector counterparts, many SOE boards have struggled to play a significant and leading role in directing the affairs of their companies. This is due to, among other factors, limited authority over strategy, senior executive appointments, and other important matters.

Even when endowed, on paper, with significant power, an SOE board may find it hard to exercise such authority in practice. At one Latin American SOE that is listed on a major international stock exchange, a former independent director observed that it possessed “one of the most detailed and comprehensive governance [systems] that I have ever seen. . . . Unfortunately, it is only fantastic on paper.” Its shortcomings included, among other things, succumbing to the government’s choice of chief executive officer, interference on pricing strategy, and priorities regarding major projects to undertake.

Fortunately, there is growing appreciation in some countries that meaningful SOE reform needs to include an independent and professional board. Efforts to strengthen boards have encompassed the following:

- Explicit commitment by the government to respect the board’s authority,
- Empowering the board to make executive appointments,
- Increasing independent directors’ presence on the board and professionalizing the nomination process.

The OECD calls on governments to grant SOEs “full operational autonomy to achieve their defined objectives” and, in particular, to allow their boards to carry out their delegated responsibilities and to respect their independence (OECD 2015a, 20). Under the OECD Guidelines for SOEs, key board responsibilities include the following:

- Assuming ultimate responsibility for the enterprise’s performance,
- Providing strategic guidance within the framework of the overall corporate objectives,
- Establishing appropriate performance indicators and identifying key risks,
- Developing and overseeing effective risk management,
- Monitoring disclosure and communication processes,
- Assessing and monitoring management performance,
- Deciding on chief executive officer remuneration,
- Appointing and, where necessary, removing the chief executive officer and developing effective succession plans for key executives.

In some countries, the government makes an explicit commitment to empower and respect the authority delegated to SOE boards and executive management. In Finland, the 2011 state ownership policy specifies that “all decision-making powers regarding the business operations are retained by the corporate administrative bodies” (Finland 2011b, 1). In Norway, the government stresses that “one of the main tasks of the state as an owner is to establish competent boards that are duly capable of dealing with the strategic challenges faced by the companies they oversee” (Norway 2014, 60).

*Concerning board composition, a key change taking place in an expanding pool of countries is to restrict politicians and civil servants from serving on the board of an SOE, while concurrently increasing the presence of “independent” directors.*

Among emerging markets, the 2016 Brazilian SOE governance reform law requires the government to “preserve the independence” of SOE boards. In Estonia, SOEs are forbidden by legislation from taking “instructions” from government. The main mechanism for government influence is through the approval of “business plans” by the shareholders meeting.

Notably, the OECD Guidelines for SOEs declare that a key function of SOE boards should be the appointment and dismissal of the chief executive officer and that, without

this authority, it would be difficult for them to discharge their monitoring function fully and be accountable for the enterprise’s performance (OECD 2015a, 70). Indeed, one of the challenges facing SOE boards is that management teams are bypassing them on key matters, because they do not feel accountable to the board.

At present, only a minority of countries, such as Australia, Germany, New Zealand, Norway, and Sweden, explicitly empower SOE boards to appoint the chief executive officer, although a number of other states are actively debating doing so or are granting such authority on a limited or experimental basis.

Importantly, the World Bank argues that “empowering the board to appoint and, subject to clear terms, remove the CEO. . .reduces the scope for government interference in operational decision making” (World Bank Group 2014, 187).

Concerning board composition, a key change taking place in an expanding pool of countries is to restrict politicians and civil servants from serving on the board of an SOE, while concurrently increasing the presence of “independent” directors.

According to the World Bank, SOE boards that “comprise ministers and other politically connected persons, party leaders, elected officials, and civil servants. . .may excel at ensuring that the SOE is attentive to political or policy goals; but they may pursue those goals to the detriment of the economic and financial health of the SOE” (World Bank Group 2014, 163).

Countries such as Australia, Denmark, the Netherlands, New Zealand, and Norway prohibit public servants—including politicians—from sitting on SOE boards. The concern is that their presence would increase the likelihood of inappropriate political intervention, create opportunities for political patronage, or send the wrong signal to the outside world. A further concern is that senior politicians who serve on SOE boards may not attend board meetings consistently or come adequately prepared, and their presence may harm board dynamics because other board members may defer excessively to them.









These considerations have influenced Norway’s decision to exclude from SOE boards active politicians (including members of parliament), government ministers, and civil servants who have regulatory or supervisory authority over a company. The Norwegian government explains that such a prohibition is warranted to “avoid problems of partiality and conflicts of interest, which could arise when the interests of the shareholders as a whole are not fully in harmony with the interests of the state” (Norway 2008, 74) as well as “to avoid political responsibility for commercial decisions” (Norway 2014, 41).

Chile has taken a similar, although less extensive, position. In 2009, the government enacted a law for state-owned copper producer Codelco that led to the exclusion of ministers, undersecretaries, and other senior government officials from its board of directors (OECD 2011a, 44).

Concurrently, many countries have introduced independent directors to the SOE boardroom (see Table 5 for some examples). In Lithuania, the Ministry of Economy declared that independent directors were needed, because “the boards of state-owned enterprises, composed of political office-holders and government officials, are often unable to ensure the balance of business, political and social objectives” in decision making (Lithuania 2012).

**Table 5: Outside and Independent Director Requirements**

	DESCRIPTION
 <b>France</b>	One-third of the board must be “qualified personalities” (deemed to be independent of SOE management and government)
 <b>Malaysia</b>	At least one-third of the board should be independent
 <b>Slovakia</b>	A majority of board members at SOEs must be independent
 <b>South Korea</b>	The boards of large SOEs are required to have a majority of outside directors (including the chairman)
 <b>Sweden</b>	A majority of board members at SOEs must be independent
 <b>United Kingdom</b>	At least half of the board should be independent

Source: Press search.

According to the OECD Guidelines for SOEs (2015a), an SOE board should comprise a “sufficient number of competent non-executive board members who are capable of independent judgment.” The OECD Guidelines further specify that these members should be recruited from the private sector.

Notably, some countries, such as Malaysia, Sweden, and the United Kingdom, have deliberately replicated the board independence requirements applicable to listed companies. Also, independent nomination committees have started appearing at SOEs, particularly listed firms, although their features may differ.

At Singapore Exchange-listed Singtel, in which the Singaporean government holding company Temasek holds a 51.2 percent stake, the corporate governance/nomination committee—charged with making recommendations to the board on the appointment and renomination of directors—consists of a majority of independent directors (including the chairman).

*Effective implementation remains a work in progress in a number of areas, and gaps often exist between formal corporate governance arrangements and day-to-day practice.*

At Oslo and New York Stock Exchange-listed Statoil, the nomination committee comprises four shareholders or their representatives (including representatives of the state)<sup>6</sup> and is independent of the board of directors and the company’s management (Statoil 2015b, 6). Its tasks include making recommendations to the corporate assembly regarding the shareholder-elected members of the board of directors.<sup>7</sup>

## Concluding Thoughts

The developments discussed in this article—along with other notable reforms, such as strengthening transparency and promulgating measures to ensure competitive neutrality between government-owned and privately owned companies—indicate substantial efforts to strengthen the governance of SOEs. Also encouraging is the ongoing engagement among governments across the globe to share their experience in SOE reform and agree on best practices.

Nonetheless, effective implementation remains a work in progress in a number of areas, and gaps—sometimes substantial—often exist between formal corporate governance arrangements and day-to-day practice. For example, at a large government-controlled emerging-market lender, the post-IPO board still meets only four times a year (with each meeting lasting no more than four hours) and has limited involvement in strategy and other fundamental matters. Especially disconcerting is the tendency of some SOE boards, despite possessing de jure autonomy, to continue to bend to the will of political leaders on matters where they have been granted decision-making authority.

<sup>6</sup> “In listed companies, board members are normally nominated by nomination committees. As a rule, the state wishes to be represented on nomination committees in which the state, in cooperation with representatives of the other shareholders, endeavours to arrive

<sup>7</sup> Although the chairman and the chief executive officer of Statoil are not members of this committee, they are invited to attend at least one nomination committee meeting before its recommendations are finalized. In addition, the nomination committee invites other large shareholders to submit board nominations for its consideration.

Beyond educating SOE boards and management on their legal responsibilities and corporate governance best practices,<sup>8</sup> improving implementation of enacted reforms requires appointing directors and managers of high courage and personal integrity who will diligently and faithfully discharge their responsibilities and zealously guard the SOE's autonomy. This includes forcefully resisting any attempts to encroach on their delegated authority by government overseers and other political actors.

At listed SOEs, private shareholders also have a role in keeping political intrusion at bay—through meetings with government, coordinated campaigns, and, as a last resort, litigation. In 2016, the Brazilian press reported that a large private shareholder of a listed Brazilian SOE stepped in to voice his opposition to the government's alleged plan to replace the company's chief executive officer, whom the board and private shareholders continued to support. On this occasion, the government ultimately backed off.

A mindset shift among government overseers is also required. Politicians and civil servants, particularly those worried about being blamed for unpopular commercial decisions, must learn to become comfortable allowing SOEs to operate at arm's length.

In guarding against government interference, it is essential to remain ever vigilant, as “two steps forward, one step back” appears to be a common phenomenon in the SOE world. Often, progress achieved during one period is followed by backtracking a short time later, particularly after a change of political leadership.

In a large emerging market, for example, the election of a leftist government led to the reversal of expanding operational autonomy for the country's SOEs, some of which were compelled to shoulder additional obligations to aid the country's economic development. Besides using SOEs to further their policy priorities, the governing coalition also exploited the state's authority to appoint board and management members to perpetrate illicit patronage practices.

Given the power and authority of government, formal boundaries and other protections erected to insulate SOEs can usually be subverted by determined politicians and other officials. It cannot be emphasized enough that checking political intrusion requires visible and steadfast commitment at the highest level of government. Moreover, vigilance will always be required—on the part of SOE directors and executives, the media, and the public at large—to ensure that the formal governance arrangements are functioning effectively.

<sup>8</sup> Many countries have instituted board training programs to strengthen SOE directors' understanding of their responsibilities, equip directors with new analytical and other relevant skills, and help improve day-to-day board functioning. See World Bank Group 2014, 203, for further details.

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