HOW CORPORATE GOVERNANCE IN THE EBRD REGION NEEDS TO IMPROVE

In 2017 the EBRD published the findings of its latest regional Corporate Governance Sector Assessment. Senior Counsel Gian Piero Cigna, who leads the Bank's reform efforts in the field of corporate governance, oversaw the assessment exercise together with Counsel Pavle Djuric and other members of the Legal Transition Programme (LTP). Gian Piero and Pavle spoke about the assessment, its main conclusions and how countries in the EBRD region can strengthen their frameworks and practices in this area.

What did the Corporate Governance Sector Assessment consist of?

Gian Piero: We examined the corporate governance legal framework and practices of 34 EBRD countries of operations over two years, producing a detailed report on each of those countries.[2] For every jurisdiction, we considered the quality of the legal framework in place (including voluntary corporate governance codes); the capacity of the institutional framework (for example, courts and regulators) to enforce legislation; and the effectiveness of these frameworks in practice. We measured effectiveness by examining the corporate governance disclosure of the 10 largest[3] companies in each country and gauging whether what companies did was aligned with the law and best practice. Transparency and disclosure are key pillars of corporate governance and central to shareholders' ability to exercise their rights on an informed basis.

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Pavle: In each country we first sent questionnaires to these companies, as well as to law firms, auditors, national regulators and stock exchanges, seeking information on corporate governance legislation and how it is implemented. Then we analysed the legal framework in each country along with the websites and annual reports of the largest companies and regulators. We also screened reports produced by a wide range of other institutions, including international financial institutions (IFIs), the Organisation for Economic Co-operation and Development (OECD), non-governmental organisations, central banks and universities.

Finally, we matched our internal analysis with the questionnaire responses and established a grid, based on international best practice benchmarks, which analysed the performance of the corporate governance environment of every country. We focused on five dimensions: (i) the structure and functioning of the board of directors; (ii) the transparency and disclosure of company information; (iii) internal control; (iv) the rights of shareholders; and (v) stakeholders and institutions.

What are the main findings of the assessment?

GPC: As expected, countries in the European Union (EU) tend to have better corporate governance legislation and practices. There is, however, room for improvement in all countries in the EBRD region, including those in the EU. Some countries seemed to perform well in one area but poorly in another. This is not good, as corporate governance is like a jigsaw puzzle: if just one piece is missing or in the wrong place, the overall picture is incomplete or distorted. Similarly, if just one dimension of corporate governance is weak, then all the others are weakened too.

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We identified several key weaknesses in all the corporate governance systems we examined. We expected better quality disclosure from the listed companies. Often, the information provided was insufficient on the composition and qualifications of the board and its committees or on compliance with the national corporate governance code. This might be due to investors and regulators not fully appreciating the value of good disclosure and putting insufficient pressure on issuers to provide quality disclosure beyond financial information. But this is a short-sighted approach as the quality of financial data depends on the competence of those preparing it.

This leads me to another problem area: the functions and composition of the board of directors. The core functions of the board are to approve the strategy, budget and risk appetite of a company and to ensure managers keep within agreed budgetary and risk constraints when implementing strategy. To be able to do these jobs, the board should have the authority to appoint and remove executives – especially if they do not perform well. Only in a handful of countries, however, is the legislation clear in assigning all of these functions to the board. In most cases, these powers stay with the general shareholders' meeting and we really asked ourselves what purpose the board served.

PD: When looking at board composition, we noticed that corporate governance systems paid little attention to board diversity, which is key to avoiding "group thinking", a phenomenon identified as one of the main contributing factors to the recent financial crisis. We were particularly struck by the lack of gender diversity on boards. There is increasing evidence of the strong link between high levels of gender diversity on boards and good corporate performance, so this is an issue that cuts to the heart of what corporate governance is all about: improving a company's decision-making so that it generates more wealth while protecting the interests of stakeholders.

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Globally, the countries that are the most successful with gender diversity on boards seem to be those that have introduced quotas by law, such as France, Iceland and Norway. Nevertheless, introducing quotas in EBRD countries of operations may not be the solution as there could be a high degree of cultural resistance to such a move. We believe – before talking about quotas – it would be important to focus on raising awareness of the value of gender diversity to companies, as well as to wider society. For example, when corporations launch initial public offerings (IPOs) and seek Bank support, we can encourage them to adopt a gender diversity policy. With state-owned enterprises (SOEs) too, we can help them to appreciate that having a better gender balance can lead to better results, which will help them meet the expectations of taxpayers.

GPC: This is an issue that we are discussing with other development finance institutions (DFIs) involved in the DFI Corporate Finance Working Group. It is important that we all sing from the same hymn sheet on this matter so that clients don't compare the different requirements we have in relation to gender diversity and go for the lowest requirements. I think this is an area where IFIs, including the EBRD, could do more.

What were your other concerns about the way boards are structured and how they function?

GPC: Independent directors are a crucial component of a well-functioning board but how this independence is defined is often inadequate in many parts of the Bank's region. Frequently the only criterion for independence is that of non-affiliation with the company's executives or owners. Non-affiliation is, however, just the start. Independent directors also need to be highly engaged and demonstrate objectivity of mind and a challenging attitude. They are key to a company's performance as they can provide a perspective that controlling shareholders might not have. They are also an essential element in ensuring that corporate decision-making is protected from conflicts of interest.

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However, to perform this role, independent directors should at a minimum attend all board meetings in person – and disclosure should clearly evidence this. Especially when they sit on committees, independent directors should be able to challenge managers on key issues and their performance could be measured according to the robustness of internal control mechanisms such as a whistleblowing function. Annual reports should at least mention what they have done in practice to demonstrate their independence and engagement. Investors should pay attention to this disclosure as the independence of these directors is crucial to ensuring that a company's financial statements are reliable. Unfortunately, we are still far from this situation.

PD: This brings us to a recurring theme from the assessment: we need better quality disclosure, rather than more disclosure. Describing what independent directors have done to demonstrate their objectivity is an example of the "qualitative" data that we would like to see companies sharing more widely. This is something that we often encourage in our investee companies through our corporate governance action plans, especially if the companies are listed or systemically important.

GPC: It seems that in many cases companies and investors in our region do not fully appreciate the importance of board diversity and the role of independent board members. Too often investors limit their engagement to the appointment of directors, without focusing on whether they are playing an effective role. We frequently see examples of supposedly independent board members silently nodding to all board decisions and going along with whatever the Chief Executive Officer says. Good quality disclosure should reveal whether management is duly challenged.

1 Unless otherwise stated, Mike McDonough, Staff Writer, EBRD Communications, wrote some of the articles in this year's journal. He also co-edited this edition. He can be contacted at McDonouM@ebrd.com

2 www.ebrd.com/what-we-do/sectors/legal-reform/corporate-governance/sector-assessment.html (last accessed 20 December 2017).

3 That is, the companies with the biggest market capitalisation. In countries that do not have a stock exchange, or where there were fewer than 10 listed issuers or no data on capitalisation, the assessment selected the 10 companies with the biggest revenue and labour force. In some countries where all 10 companies were in the same sector, the sample was corrected to reflect other parts of the economy. The working hypothesis was that the 10 largest listed companies offer the best disclosure in each country. The assessment presumed that when certain practices were not disclosed by them, they were unlikely to be disclosed by smaller or unlisted companies.

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Independent directors have a crucial role and if they are unable to do their job, they should resign, as recently happened at Naftogaz, the Ukrainian state-owned power company,[4] rather than carry on with business as usual. Such a move – albeit extreme – sends a strong message to the market that there are serious concerns. In turn, the market should understand the seriousness of this signal.

Beyond the issue of board composition and functions, what other issues did the assessment reveal?

PD: In many countries there is a need to improve the internal control system by strengthening the role of the audit committee, which performs key board functions. Because of that, we believe that audit committees, which are frequently made up of external experts, should instead consist of a majority of independent directors from the board. That way, when an audit committee recommends specific actions to the board, the directors who are part of that committee can vote for them at board level, thereby reinforcing the objectivity of the board's judgement.

Furthermore, we believe that committee members should have a thorough understanding of a corporation's business when performing their duties, while "outsiders" – who do not sit on the board – might only have a partial vision and understanding of the corporation's activities. While it is legitimate that committees might need external advice or expertise on specific issues, they should be able to request such advice without allowing outsiders to take the place of board members in their decision-making.

What does the Bank do with the findings of this assessment?

GPC: In many countries where the EBRD invests, there are good things in place at the same time as significant shortcomings. But we are not just pointing these flaws out and leaving it at that: the Bank works closely with policy-makers and companies to improve the corporate governance framework and culture in the EBRD region. For example, we had a successful engagement with the Central Bank of Russia (CBR) over the review and implementation of the Russian Corporate Governance Code. We assisted the CBR in reviewing the code and establishing a methodology for monitoring companies' disclosure on their compliance with the code, which was an absolute novelty for Russia.

Thanks to the EBRD's assistance, in May and December 2017 the CBR published its first ever monitoring reports. We are very pleased to see the active dialogue that the CBR is having with issuers and how the quality of disclosure has improved as a result. The CBR is also setting its corporate governance reform priorities by assessing companies' practices and disclosure.

We have a long journey in front of us, but we are committed to our role and we hope that the next assessment will show further progress.

4 www.naftogaz.com/www/3/nakweben.nsf/0/6D7C544D5F376866C22581A0006883A0?OpenDocument&year=2017&month=09&nt=News& (last accessed 20 December 2017).

5 The CBR monitoring reports are available at: http://www.cbr.ru/StaticHtml/File/14233/Review_17042017.pdf and http://www.cbr.ru/Content/Document/File/33001/Review_27122017.pdf (last accessed 4 January 2018).