IMPROVING CORPORATE GOVERNANCE OF INVESTEE COMPANIES – A COMMON GOAL OF DEVELOPMENT FINANCE INSTITUTIONS

Good corporate governance is essential for companies wishing to access external capital and for countries aiming to stimulate private sector investments. If companies are well run, they will prosper. Poor corporate governance weakens the company's potential and paves the way for financial difficulties and even fraud.

The EBRD has a two-fold approach to raising corporate governance standards. The first is to work with investee companies to identify issues that need to be corrected to ensure sound and prudent corporate governance. The second is to work with regulators in the EBRD region to ensure that the legislative framework is aligned to best standards.

This article focuses on the first approach, which is part of a joint effort by many development finance institutions.

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GIAN PIERO CIGNA
SENIOR COUNSEL, EBRD
CignaG@ebrd.com

2
PAVLE DJURIC
PRINCIPAL COUNSEL, EBRD
DjuricP@ebrd.com

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As a major investor in companies in central and eastern Europe, Central Asia and the southern and eastern Mediterranean regions, the EBRD has always sought to improve corporate governance standards alongside its investment operations.

DFI COMMON APPROACH FOR IMPROVING CORPORATE GOVERNANCE OF INVESTEE COMPANIES

In early 2006, the EBRD joined forces with other development finance institutions (DFIs) including the International Finance Corporation (IFC), the Dutch Development Bank (FMO), the Asian Development Bank, the Black Sea Trade Development Bank and the Development Bank of Latin America (CAF) to forge a common approach for the promotion of corporate governance in the context of DFIs' investment activities.

At the Annual Meetings of the World Bank Group and the IMF in 2007, 31 DFIs signed and committed to the joint "Approach Statement"[1] which emphasises the importance of good corporate governance practices in the entities in which they are prepared to invest. The Approach Statement calls for DFIs to "*develop or adopt guidelines, policies or procedures on the role of corporate governance considerations in its due diligence and investment supervision operations*".

After the signing, a working group – set up with representatives of major DFIs — including the EBRD — developed the DFI Toolkit on Corporate Governance, a set of tools (including a questionnaire, a progression matrix, instruction sheets and many useful sample documents), aimed at providing a common methodology for assessing corporate governance in the DFIs' investment work.[2]

As a follow-up to the Approach Statement and the toolkit development, in September 2011, a total of 30 DFIs (including the EBRD) signed the Corporate Governance Development Framework[3] as an answer to the G-20's call for DFIs to strengthen their coordination and ensure accomplishment of certain key institutional reforms, such as an increased commitment to transparency, accountability and good corporate governance. Through the framework, the signatories endorsed the toolkit as a common platform for evaluating and enhancing governance practices in their investee companies.

With the aim of raising awareness, both at the private and public sector levels, of the importance of good governance to sustainable economic development, the signatories of the Framework have undertaken to:

- integrate corporate governance in their investment operations by adopting procedures and tools in line with the framework, conduct corporate governance assessments of their investment clients, and develop action plans when appropriate
- identify staff responsible for implementation and oversight of the framework
- provide or procure training to ensure capacity building and share knowledge on corporate governance
- collaborate with other signatories to share experiences and resources on training and implementation
- report annually on the implementation of the framework.

As of December 2018, 35 DFIs[4] had subscribed to the framework. This signals an unwavering commitment by the DFI community to improve corporate governance practices in corporations world-wide.

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THE IMPORTANCE OF CORPORATE GOVERNANCE IMPROVEMENTS IN EBRD'S INVESTEE COMPANIES

The transformation of the EBRD's regions' economies from centrally planned to market economies has exposed enterprises from these countries to the financial interests and expectations of foreign investors, which provoked the need for better governance practices.

But why is corporate governance important to investors?

First, even the most capable management – if not properly directed - can make bad decisions, leading to undesirable results for a company and its shareholders. Good corporate governance helps shareholders to hire the right directors and managers, and helps ensure that they account for their actions.

Further, good corporate governance can help to improve company performance and contributes to companies achieving higher market valuations. Also, corporate governance can help investors to properly measure and evaluate the risks and opportunities of the companies they invest in, which will in turn allow for a more realistic investment pricing and a more efficient allocation of resources, while at the same time helping investors to avoid risks whose impact can be quite high, such as reputational risk. Lastly, it encourages the development of local capital markets and helps to increase the number of market participants, thus diversifying access to finance.

In addition to these issues that are relevant to most investors, the EBRD has other reasons to promote good corporate governance. Namely, fostering transition in the Bank's regions is at the very core of the EBRD's mandate and is firmly rooted in the Agreement Establishing the Bank.

The Bank has operationalised the concept of transition around the so-called "*six qualities of transition*",[5] through which the merits of each proposed investment are assessed. One of those transition qualities is "well-governed", which encompasses both state-level governance and corporate-level governance that relates to the system of rules, practices and processes by which companies are directed and controlled. This means that improving corporate governance of an investee company can be one of the very concrete and tangible sources of transition impact in our regions.

THE EBRD APPROACH

The EBRD promotes "transition" through both its banking operations and the policy dialogue it conducts with country authorities. In its banking operations (both equity and debt), the EBRD has followed the approach set out in the toolkit and incorporated it into its internal process called the "Corporate Governance Review".

Once the banking team determines that a prospective client is either interested in improving its corporate governance practices or that there are some governance deficiencies that need to be addressed, the EBRD undertakes a detailed assessment of the client's practices. To that end, a questionnaire is sent to and answered by the client, embedding key issues on the client's corporate governance practices.

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The information gathered during this exercise – complemented with additional due diligence, as necessary – is then systematised and benchmarked against applicable standards and best practices which depend on the type of client and its strategic plans and aspirations (for example, the OECD/G-20 Principles of Corporate Governance, the UK Corporate Governance Code, but also some other national corporate governance codes, including those of the company's country of incorporation).

This leads to a better understanding of the "gap" that needs to be addressed by improvements. To guide this benchmarking, the Bank relies on internationally recognised best practices, but it also uses the progression matrix similar to the one from the toolkit, to act as a roadmap of sorts, guiding investee companies towards good and best practice corporate governance practices as they evolve over time.

Based on the collected information, the Bank's corporate governance specialists within the Legal Transition Programme (LTP) provide an explanation of the weaknesses (if any) in the client's current practices and prepare a set of potential actions that can be undertaken to improve the investee's corporate governance. These actions are set out and described in a so-called "Corporate Governance Action Plan" (CGAP) which is then sent to and discussed with the client with the aim of being included in the financing documentation.

In order to ensure that the proposed actions are relevant to the client and capable of fostering transition, the EBRD's corporate governance specialists also check whether the actions that are proposed correspond to key corporate governance challenges of the investee company's main country of operations. To support this work, the EBRD conducts an in-depth assessment of the legal framework and disclosed practices of the largest (listed) companies in each economy where it invests. Besides a detailed comparative analysis of both the quality and effectiveness of national corporate governance legislation (including corporate governance codes), the assessment seeks to provide an indication of whether the legal framework is both sound and well implemented, which feeds back to the actions to be implemented through a CGAP.

Once the CGAP actions have been agreed with the client, they are usually referred to in financing documentation in order to demonstrate the client's commitment and set concrete milestones that can then be monitored during the life of the investment.

UNIVERSAL AREAS OF ATTENTION AND SECTORAL SPECIFICITIES

Being a private sector-focused bank, the spectrum of clients whose corporate governance is analysed is vast and spans from simple family-owned small and medium-sized enterprises and larger privately owned companies to listed companies, complex financial institutions, as well as heavily regulated state-owned enterprises (SOEs) such as energy utilities and infrastructure companies.

However, despite a great variety in terms of companies being analysed, there are a few areas which are reoccurring and can be examined across the board. For instance, every company needs to have a qualified and independent main decision-making body (board of directors or a supervisory board in the case of two-tier governance systems) which is properly authorised and empowered to set the strategic direction of the company, determine the resources a company should have

The 2018 Annual DFI Corporate Governance Conference

The importance of corporate governance in investment operations and greater engagement with investee companies was one of the main themes of the 12th Annual Development Finance Institutions Corporate Governance Meeting, held in March 2018 in London, at the EBRD. Of the 35 signatory institutions, representatives from 26 DFIs attended the conference, along with over 60 external guests.

The first day of the conference was open to outside guests and introduced the latest corporate governance topics, such as the impact of technology on corporate governance, the role of institutional investors in the promotion of corporate governance, cyber security risks and board effectiveness and diversity.

Highlights included a keynote speech by Erik Vermeulen, a professor of business and financial law at Tilburg University in The Netherlands, on the impact of technology on companies' business models and its implications for governance in the future. Break-out sessions looked at features of the UK's Stewardship Code and the strategies deployed by investment funds to improve the governance practices of their client companies. In another session, an expert panel discussed cyber security as an emerging governance challenge.

The second day was open to the representatives of DFIs only and focused on progress with the framework implementation by various DFIs. On the side of DFIs, participants showed strong support to continuing implementation of the framework and promoting regional cooperation initiatives among signatories. Also the signatories will aim to promote technical analysis and collaboration (for example, corporate governance in project finance and infrastructure projects) in their future works and will explore the possibilities of opening the initiative up to non-DFI investment communities.

and the risks it should take in pursuit of its business, and monitor the management's implementation of the strategy and more broadly the company's performance.

Also, while the board size and the profile and competences of its members vary according to the size and activity of a company, the principle that a board should be diverse and fit for purpose is emerging as universally relevant. Companies that rely on any kind of external financing must also adhere to certain transparency requirements, in order to provide adequate assurance on the company's operations to investors and other stakeholders. Lastly, every company should have some sort of internal control environment aimed at ensuring proper application of all the policies, processes and practices necessary for the company's proper functioning.

Some improvements will necessarily be more relevant for some types of companies. For instance, prudential regulation for banks has been significantly strengthened in recent years, which requires practices to follow suit, especially with regards to the scope and level of intensity in the board's involvement in key issues affecting a bank and the risks that it is taking. Therefore, it can be expected that potential improvements will address questions of risk appetite and internal control systems (which in banks are usually structured along the "three lines of defence" model that includes controls at the level of business lines, second-line functions such as risk management and compliance, and internal audit as the third line).

Also, governance of SOEs is usually regulated in detail, which means that some of the improvements will focus on the regulation behind the practices. On the other hand, family-owned businesses will need greater assistance in establishing basic governance structures and succession planning, perhaps the most important issue to be addressed for these kind of companies. "For the family business to survive into its next stage, the founders should make the necessary efforts to plan for their succession and start grooming the next leaders of the company".[6]

Companies looking to have an initial public offering will benefit from greater assistance in preparing for such an event and applying the corporate governance code of the planned listing venue.

Of course, the above areas are just common themes that warrant attention in all reviews. Since one size clearly does not fit all, individual responses (in terms of CGAP actions) will always need to be tailored to the particular situation of each investee company and the challenges it is facing, while observing the need for the practices to go “above and beyond” mere compliance with legal requirements to ensure that corporate governance adds value to the company’s operations.

LESSONS LEARNED AND WAY FORWARD

With more than 20 years’ experience working with investee companies, we believe that the current approach of leveraging policy dialogue with investments provides for good transition outcomes. Policy dialogue at the level of the client, or in the case of SOEs: at the level of both the client and the authorities, ensures that the business case for corporate governance is better understood and accepted, while financial leverage provides a basis for the clients’ continuous commitment.

However, agreed CGAPs are just the start of reform efforts that in some cases may take years to complete. In that sense, the CGAP is not an end in itself, but a starting point and a basis for further dialogue. It is essential to maintain good engagement (and if needed, pressure) with the client because what has been agreed needs to be translated into practice to have any real impact.

Because of this, the EBRD is increasingly active in providing technical assistance to investee companies in implementing the CGAP in accordance with descriptions and deadlines provided therein. We see this as a natural extension of the Bank’s efforts for meaningful reform. In specific operations, such as equity investment, good progress on delivering reforms can also be achieved by having one or more of the Bank’s nominee directors as part of the investee company’s board.

1 The Approach Statement is available at: https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/ifc+cg/cg+development+framework/a+corporate+governance+approach+statement+by+development+finance+institutions (last accessed 21 December 2018).

2 The DFI toolkit is available at: http://cgdevelopmentframework.com/cg-development-framework/toolkit-corporate-governance/ (last accessed 21 December 2018).

3 The Corporate Governance Development Framework is available at: http://cgdevelopmentframework.com/wp-content/uploads/2017/02/CorporateGovernanceDevelopmentFramework.pdf (last accessed 21 December 2018).

4 The 35 DFIs that signed the statements are listed at: http://cgdevelopmentframework.com/cg-development-framework/signatories-page/ (last accessed 21 December 2018).

5 The six qualities included in the EBRD’s concept of transition are: inclusive, well-governed, environmentally friendly, resilient and integrated. Read more about the EBRD transition qualities at: https://www.ebrd.com/cs/Satellite?c=Content&cid=1395237696921&d=Mobile&pagename=EBRD%2FContent%2FContentLayout (last accessed 21 December 2018).

6 See IFC Family Business Governance Handbook, available at: https://www.ifc.org/wps/wcm/connect/region__ext_content/ifc_external_corporate_site/east+asia+and+the+pacific/resources/ifc+family+business+governance+handbook (last accessed 21 December 2018).