# MAKING GOOD CORPORATE GOVERNANCE A REALITY IN THE EBRD REGION

The Electrica story illustrates the importance of adopting the highest standards of corporate governance for businesses seeking to attract external capital.

Since Romanian power company Electrica started trading on the London and Bucharest stock exchanges in 2014, the former entirely state-owned utility has significantly increased the amount of electricity it distributes to its 3.7 million customers and witnessed a strong rise in profits.

Electrica owes much of this improved performance to extra investment from its new shareholders – including the EBRD – who bought 51.2 per cent of the company in what was Romania's largest initial public offering (IPO). The success of the oversubscribed IPO was partly the result of Electrica's commitment, with EBRD support, to bringing its corporate governance in line with international standards.


"Good corporate governance improves accountability and makes companies more efficient and competitive."

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"Without the robust guarantees for minority shareholder rights and the sound risk mitigation measures contained in the company's corporate governance action plan, investors would have lacked the reassurance needed to participate in such a landmark equity transaction," says EBRD Senior Counsel Gian Piero Cigna, who leads the Bank's legal reform efforts in the field of corporate governance and worked extensively on the Electrica deal.

The Electrica story illustrates the importance of adopting the highest standards of corporate governance for businesses seeking to attract external capital. More broadly, governments in the EBRD region that hope to stimulate private sector growth need to foster better corporate governance through their institutional and legal frameworks.

This is why the EBRD regards improving corporate governance as a major goal of its Legal Transition Programme (LTP) and an essential ingredient in the Bank's efforts to promote the development of well-functioning market economies in the countries where it invests.

"Bad corporate governance poses substantial risks. Investing in a company that does not disclose who does what carries much more uncertainty than investing in a company that is transparent," says Gian Piero. "However it is not just about risk mitigation. Good corporate governance improves accountability and makes companies more efficient and competitive.

"The establishment of efficient communication and accountability lines between the board and management streamlines decision-making and control processes, increasing efficiency and performance."

## TWO-FOLD APPROACH

The EBRD has a two-fold approach to raising corporate governance standards, as demonstrated by its activities in Romania. The first part of the approach is the Bank's work with investee companies and an example of this is the corporate governance action plan that helped Electrica win the confidence of investors. Electrica developed the plan in close cooperation with the EBRD before the Bank purchased an equity stake in the utility.

A similar strategy was followed with Romanian natural gas producer Romgaz, which floated on the London and Bucharest bourses in 2013. The first independent research report by an investment bank on Romgaz after the IPO[1] recommended a "buy" rating and a target price that was 42 per cent above the flotation price. It noted the corporate governance action plan and the role that the EBRD was set to play in its implementation.

The corporate governance action plans of Electrica and Romgaz helped them to comply with the recommendations of the corporate governance code of the Bucharest Stock Exchange (BVB), which are to be implemented under the so-called "comply or explain" approach. Since listing, the Bank has worked with both companies to ensure that they implement their action plans and meet their commitment to improve their corporate governance.

The second part of the EBRD approach to improving corporate governance involves cooperating with institutions to create legal and regulatory frameworks that support sound corporate governance practices. In Romania, the EBRD helped BVB develop a new corporate governance code, which came into force in January 2016. This ongoing technical cooperation project now focuses on helping BVB strengthen implementation of the code by actively monitoring listed companies' compliance with its recommendations.

As stressed by the European Commission, the executive body of the European Union (EU), efficient monitoring at the national level is needed in order to motivate companies to comply with the code or to better explain departures from it.[2] In Romania, this would also promote good practice within the corporate sector and improve the overall investment climate.

"Developing a corporate governance code is just the start," says Gian Piero. "We also need to educate investors that good corporate governance adds value and reduces risk. If investors appreciate the value of good governance and consider it in their investment decisions, then companies willing to access finance will be encouraged to implement the new code."

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## WORKING WITH INVESTEE COMPANIES

We will now look in more detail at the first part of the Bank's approach to raising corporate governance standards. The EBRD carries out rigorous integrity checks on all companies in which it is considering investing, whether the investment is a loan or an equity stake. To support the due diligence process, the LTP has developed a corporate governance review toolkit for use by the investment project team.

The toolkit consists of a screening tool designed to highlight any corporate governance issues that need further investigation by the project team, a questionnaire and a matrix. The banker – or operation leader – leading the project sends the questionnaire to any business that has been identified by the screening tool as having possible corporate governance shortcomings. The matrix benchmarks the questionnaire answers and rates the company according to its corporate governance practices in five areas (commitment to good corporate governance; structure and functioning of the board; control environment and processes; transparency and disclosure; and the rights of minority shareholders).

The next step is for the project team, including the EBRD's lawyers, economists and corporate equity experts, to begin discussions with the client on a corporate governance action plan to remedy any defects in its existing arrangements. Once the project team and the client have agreed on the draft action plan, it is included in the term sheet for the EBRD investment and forms part of the contract between the two parties.

After the Bank has committed the investment, the operation leader monitors the implementation of the action plan, with support from LTP as required. This process is in line with the methodology for assessing corporate governance in investee companies established by development financial institutions (DFIs) that are signatories to the Corporate Governance Development Framework.[3] The EBRD is a founding signatory to the Framework.

"In this manner, the EBRD uses the terms and conditions of its investment operations to positively influence the internal structure and operation of investee enterprises," says Gian Piero. "As well as ensuring that the transaction represents an appropriate level of risk for the Bank itself, this enhances the attractiveness of the company to other investors who might otherwise be reluctant to extend debt or equity financing to the business in question."

## ELECTRICA

In the case of Electrica, the corporate governance action plan provided for the nomination of three qualified and independent directors on the company's supervisory board. This ensures that the board includes people who have the appropriate qualifications and can view matters objectively, without any conflict of interest. Given that the Romanian government would remain the largest single shareholder in Electrica after the IPO with a 48.8 per cent stake, reforms designed to guarantee the objectivity of the board and the protection of minority shareholders' rights were crucial for the success of the share issue.

The action plan also sets out Electrica's position on its nomination and remuneration policy, board committees, articles of incorporation and internal control framework. This framework promotes efficiency and the assessment and mitigation of risk, enabling executives and the board to have a clearer view of any risks the company might be facing.

"The colossal liabilities associated with the Deepwater Horizon explosion in the Gulf of Mexico underscore the importance of stringent risk management policies in the energy sector," notes Gian Piero.

Thanks to the inflow of capital generated by the IPO, Electrica invested in its power grids, replacing obsolete equipment that was costly to run with new transformer stations that increased the company's supply and distribution capacity. In 2015, when most of the corporate governance action plan was implemented, Electrica distributed 17.07 terawatt hours (TWh) of electricity, up from 16.31 TWh in 2014, and increased its net profit by 17 per cent. In the first nine months of 2016, net profit rose by 9 per cent and distribution was up 2.1 per cent compared with the first nine months of 2015, according to the latest figures available at the time of writing.[4]

"The second dimension of the EBRD's work on promoting better corporate governance is its collaboration with governments and regulators on improving the legal and institutional environment."

## NAFTOGAZ

Another high-profile EBRD transaction in which the inclusion of a corporate governance action plan played a major part was the US$ 300 million (€276 million equivalent)[5] loan to Naftogaz, the Ukrainian national oil and gas company, signed in October 2015. As a condition of the EBRD financing for the purchase of winter gas, the Ukrainian government and Naftogaz agreed to implement an action plan that provides for the creation of a supervisory board of independent and qualified directors.

The plan also aims to strengthen the state-owned company's internal audit, compliance, anti-corruption and risk management functions and establish an ownership and governance structure in line with best international practice. As of late 2016, implementation of the corporate governance action plan at Naftogaz was ongoing and the EBRD continued to closely monitor this process.

## IMPROVING CORPORATE GOVERNANCE THROUGH LEGAL REFORM

The second dimension of the EBRD's work on promoting better corporate governance is its collaboration with governments and regulators on improving the legal and institutional environment. The Bank performs this function through donor-funded technical cooperation (TC) projects that make use of consultants who are international experts in specific areas of corporate governance best practice. These consultants help the EBRD to assess the current regulatory and institutional framework in a given country, give advice on how this can be improved, and provide training to officials on the implementation of new procedures.

The EBRD supports these TC projects with periodic Corporate Governance Sector Assessments to determine the quality of corporate governance-related laws and regulations in the Bank's countries of operations. These assessments identify gaps between local laws and practices and international standards and examine how effectively corporate governance legislation is implemented. As a result, the EBRD can advise governments on the weaknesses that companies and legislators need to address to improve their national corporate governance frameworks and attract more international investors.

In 2016, the Bank completed 34 country assessments. It published them on its website[6] and on LinkedIn in order to further the debate between stakeholders on reform in this area.

## THE ROMANIAN EXAMPLE

The Romanian market stands out for its commitment to corporate governance legal and regulatory reform. Before its acquisition in late 2014 of a 4.99 per cent stake in the Romanian bourse, the EBRD launched a TC project to help BVB develop a new corporate governance code. The new code, which came into effect in January 2016, is much more precise regarding the duties of listed companies. For instance, it provides a clear list of functions that are expected from the audit committee and emphasises the value of establishing a continuous relationship with investors and improving the quality of disclosure.

Following the introduction of the new code, the ongoing TC project has focused on strengthening and monitoring its implementation. In particular, the project looks at the degree to which listed companies comply with the code and disclose required information. BVB has also pledged to establish a corporate governance committee that will become the reference point for good corporate governance in Romania.

Beyond Romania, the LTP is active in many markets seeking to improve their corporate governance frameworks. In Turkey, a recent TC project sought to strengthen the capacity of the Capital Markets Board (CMB) to monitor the compliance of companies listed on Borsa İstanbul with mandatory corporate governance standards. It also sought to improve the CMB's monitoring of companies' reporting on their implementation of voluntary principles.

The Bank is developing and implementing a methodology to assess the corporate governance practices of listed companies, monitor their reporting practices, review the quality of compliance statements and produce the disclosed information in reader-friendly reports. It is also preparing guidelines to help listed companies implement the best standards of corporate governance and facilitate CMB monitoring of their compliance.

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## GREECE'S SYSTEMIC BANKS

Last year, the EBRD conducted a legal reform project aimed at restoring confidence in the Greek financial sector by strengthening the corporate governance of the country's four systemic banks. The EBRD supported the recapitalisation of the following four banks – Alpha Bank, Eurobank, the National Bank of Greece and Piraeus Bank – by purchasing shares in them in 2015. In 2016 the Hellenic Financial Stability Fund (HFSF), the vehicle created to support the Greek banking system and financed by international creditors, requested EBRD assistance for a review of the boards and board committees of these banks.

The review sought to ensure that the banks set up and operate their boards and committees in line with best international practice; to improve levels of corporate expertise within the banking sector; and to reduce the degree of influence politicians have over Greece's systemic banks.

"High rates of non-performing loans[7] are a significant problem in the Greek banking sector and a sensitive political issue in light of the country's lengthy recession," says Gian Piero. "The HFSF hoped that, by ensuring that board directors and the heads of committees handling risk, audits and remuneration are picked purely on the basis of their professional knowledge and without regard for political allegiance, these banks would be in a stronger position to address mounting levels of NPLs."

As a result of the review project, the composition of the banks' boards changed radically. After the appointment of a new chairman and board at Piraeus Bank, Nick Tesseyman, EBRD Managing Director for Financial Institutions, said the new members "bring international experience and a new outlook to help steer Greece's largest bank on its road to recovery. High standards of corporate governance are important and we are confident that the newly composed board will ensure that this is adhered to."[8]

The recruitment process for the new board members was notable for its openness. For example, the National Bank of Greece advertised for the positions of Chair of the Board, and Chair of the Audit Committee and for one other board role in the international and domestic press. It was the first time that a bank in Greece had recruited board members in such a transparent manner.

## WORK IN ALBANIA AND SLOVENIA

The EBRD is helping the Bank of Albania to improve its capacity to assess the corporate governance of that country's banking sector. The assignment,

launched in 2016, is reviewing the corporate governance legislation and practices of banks and assessing the Bank of Albania's supervisory framework and methodology. It also advises the institution on practices by selected banking supervisors in EU countries. In addition, the LTP will help the Bank of Albania draft a new supervisory methodology and provide training to its staff to aid with implementation of this methodology.

The EBRD is also assisting efforts to strengthen corporate governance in Slovenian banks, which were badly affected by the financial crisis. A TC project helped the Bank of Slovenia develop and implement a methodology to assess the suitability of bank executives, board directors, committee heads, remuneration policies and internal control frameworks. Following the successful completion of the first project, a second project – targeting banks' risk appetite –is under way.

## CONCLUSION

"By combining support for legal, regulatory and institutional reform with direct assistance to investee companies, the EBRD is helping to significantly raise the standards of corporate governance in the countries where it operates," says Gian Piero. "This work is essential for improving the investment climate in the EBRD region and attracting the financing that businesses need in order to grow, create jobs and contribute to society's wider prosperity."

1. Report by Wood & Company dated 11 November 2013 on Romgaz, initiation of coverage.
2. See 2014/208/EU: Commission Recommendation of 9 April 2014 on the quality of corporate governance reporting ("comply or explain").
3. http://cgdevelopmentframework.com/ (last accessed 13 January 2017).
4. http://www.electrica.ro/wp-content/uploads/2016/11/Press-release_Q3-2016.pdf (last accessed 18 January 2017).
5. Using the conversion rate at the end of 2015.
6. http://www.ebrd.com/what-we-do/sectors/legal-reform/corporate-governance.html
7. NPLs.
8. http://www.prnewswire.co.uk/news-releases/piraeus-bank-announces-appointment-of-new-chairman-and-board-members-599558991.html (last accessed 13 January 2017).