

Corporate Governance of State Owned Enterprises: The Problems of State Owned Enterprises' Board of Directors

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Abstract

This research aims to resolve the agency problems of state owned enterprises' board of directors. The research will be focused on the matters which related to the nomination and composition of the board of directors, roles and responsibilities of the board of directors, and remuneration of the board of directors. By doing so, this paper tries to examine the problems under these criteria and provide some suggestions of the mentioned issues. From the studying, it could be seen that the root causes of corporate governance issues of state owned enterprises are about 'agency problem' and the ignoring to apply corporate governance framework by government and state owned enterprises. Thus, this research suggests state owned enterprises to (i) a good structure and transparency of the nomination process, (ii) set up a clear mandate and ultimate responsibility for a company's performance, (iii) develop a policy and a procedure for board of directors practices, (iv) limit the size of the board of directors, and (v) establish remuneration policy and a remuneration committee. In addition, the adoption of corporate governance principles is recommended for state owned enterprises, even though there are a small number of the international frameworks of corporate governance for state owned enterprises or there is no domestic legal framework. So, it is essential that state, as a controlling shareholder and a regulator, should promote and ensure high standard of corporate governance in state owned enterprises policies and practices in order to improve the decision making process, enhance the controlling environment and reduce the operation cost of state owned enterprises.

Keywords: Corporate Governance, State Owned Enterprises

บทคัดย่อ

บทความฉบับนี้มีวัตถุประสงค์ในการแก้ไขปัญหาตัวการ-ตัวแทนของคณะกรรมการบริหารรัฐวิสาหกิจ โดยมุ่งเน้นและให้ความสำคัญกับปัญหาการแต่งตั้งและองค์ประกอบของคณะกรรมการบริหารรัฐวิสาหกิจ, หน้าที่และความรับผิดชอบของคณะกรรมการบริหารรัฐวิสาหกิจและปัญหาค่าตอบแทนของคณะกรรมการบริหารรัฐวิสาหกิจ จากการศึกษา พบว่า ปัญหาตัวการ-ตัวแทนของคณะกรรมการบริหารรัฐวิสาหกิจและการละเลยไม่นำหลักการบรรษัทภิบาลสำหรับรัฐวิสาหกิจมาใช้ทั้งในส่วนของรัฐวิสาหกิจและองค์การรัฐวิสาหกิจเป็นอุปสรรคสำคัญในการกำกับดูแลองค์กร ดังนั้นแล้วบทความฉบับนี้จึงเสนอแนะให้รัฐวิสาหกิจจัดทำขั้นตอนการแต่งตั้งคณะกรรมการบริหารที่ดีและมีความโปร่งใส, จัดทำคำสั่งและกำหนดความรับผิดชอบที่ชัดเจนสำหรับการดำเนินการขององค์กร, พัฒนานโยบายและขั้นตอนการปฏิบัติงานของคณะกรรมการบริหารรัฐวิสาหกิจ, จำกัดจำนวนคณะกรรมการบริหารรัฐวิสาหกิจให้มีความเหมาะสม และจัดทำนโยบายการจ่ายค่าตอบแทนที่ชัดเจนรวมทั้งการจัดตั้งคณะกรรมการพิจารณาค่าตอบแทนของคณะกรรมการบริหารรัฐวิสาหกิจถึงแม้ว่ากรอบหลักบรรษัทภิบาลระหว่างประเทศสำหรับรัฐวิสาหกิจจะมีจำนวนไม่มากนักและยังมีสถานะเป็นกฎหมายอย่างอ่อนหรือบางประเทศไม่ได้มีการจัดทำกรอบบรรษัทภิบาลสำหรับรัฐวิสาหกิจไว้เป็นกรอบภายในประเทศเพื่อใช้บังคับกับรัฐวิสาหกิจโดยเฉพาะแต่รัฐวิสาหกิจเองก็ควรที่จะต้องพิจารณารับและนำหลักบรรษัทภิบาลมาใช้ภายในองค์กร ดังนั้น รัฐในฐานะผู้ถือหุ้นข้างมากและผู้บังคับใช้กฎหมายควรที่จะสนับสนุนและรับรองมาตรฐานขั้นสูงของหลักบรรษัทภิบาลทั้งในสำนวนนโยบายและการดำเนินงานของรัฐวิสาหกิจ เพื่อพัฒนากระบวนการตัดสินใจภายในองค์กร ส่งเสริมลักษณะที่ดีของการเป็นผู้ถือหุ้นข้างมาก และลดค่าใช้จ่ายในการดำเนินงานของรัฐวิสาหกิจ

คำสำคัญ: บรรษัทภิบาล รัฐวิสาหกิจ

Introduction

State owned enterprises are considered as the main mechanism of the government in several countries for driving and developing domestic economy and bringing the prosperity to the citizens. Particularly in Thailand and other developing countries where private sectors have not enough powers to offer fundamental infrastructures and services, state owned enterprises have played an important role to provide these facilities such as railway, road, telecommunication, water supply and electricity etc.

Regarding to the operation of state owned enterprises in the current economic situation, state plays an important role as controlling shareholder of state owned enterprises who makes a contract with management to ensure and pursue public sector's objectives.¹ One of the most essential problems of corporate governance in state owned enterprises is about 'conflict of interest'. This problem occurs generally and especially in the relationship between an enterprise management and an enterprise shareholder, which is usually referred as 'Agency problem'. However, agency problem is not only referred to the conflict of a relationship between the enterprise

shareholders and the enterprise management, but also the conflict between majority and minority shareholders, and between enterprise itself and other parties whom the enterprise contracts with.

Generally, state owned enterprises are operated under different legal regimes in different countries. In some countries, state owned enterprises are regulated by general domestic company law or security law, if state owned enterprises are listed on the stock exchange market. For the latter case, the enterprises will be regulated under the code of corporate governance for listed companies of Security and Exchange Commission. In order to set the regulatory framework of corporate governance for state owned enterprises in domestic level, many states have referred to international frameworks as a guideline of state's practices. Some of them refer to Baltic Guidance on the Governance of Government-owned Enterprises, which is covered in three countries; Estonia, Latvia and Lithuania. However, most of them have referred to the OECD Guidelines on Corporate Governance of State-owned Enterprises 2005.

However, several state owned enterprises, especially unlisted companies

¹ *State-Owned Enterprises and Privatisation* (OECD Publishing, 1998), p. 15.

remain inactive and deny applying good governance principles. Thus, the problems of corporate governance of state owned enterprises need to be realized and referred as the significant issues and become the subjects of this paper.

Root of Corporate Governance Issues on State Owned Enterprises' Directors

Typically, the fundamental problems of corporate governance appear from the issue of agency theory. Likewise directors of private firms, directors of state owned enterprises are considered as the agents while the principals are shareholders. Under the agency theory, the welfare of one party, termed the 'principal', depends upon actions taken by another party, termed the 'agent'². Acting as an agent, directors should perform their best for the principal's interests rather than simply for the agents' own interests. The problems will occur when the directors seek to maximize their own personal benefits by taking any action that is advantageous to themselves but detrimental to the shareholders.³

In addition, there is no international legally binding agreement available in order to control and regulate the practices of state owned enterprises. Only a few non-binding instruments are available such as the OECD guidelines on Corporate Governance of State-owned Enterprise 2005 and the Baltic Guideline on the Governance of Government-owned Enterprises. Nevertheless, these available guidelines are usually applied by their member states only. Meanwhile other states, especially the developing countries, often deny adoption of good governance principles from these instruments into their domestic level due to non-legally binding status.

The above practices could be seen as se root causes which lead to corporate governance issues of state owned enterprises' board of directors, specifically problems in the fields of such as the nomination and composition, roles and responsibilities, qualifications, transparency and remuneration. However, this paper will focus on the three main issues, namely;

1. Nomination and composition of state owned enterprises' board of directors

² John Armour, Henry Hansmann and Reinier Kraakman, *Agency problem, legal strategies and enforcement*, Discussion Paper No. 644, Harvard John M, Olin center for Law, Economics and Business (2009), p. 2.

³ Bob Tricker, *Corporate governance: principles, policies and practices*, (UK: Oxford university Press, 2012), p. 60.

2. Roles and responsibilities of state owned enterprises' board of directors

3. Remuneration of state owned enterprises' board of directors

Nomination and Composition of State Owned Enterprises' Board of Directors

The nomination or appointment of the board of directors by state who holds a controlling block of voting shares for decision making has led to the problems that qualification of the board of director bases on and is affected by political affiliation and their independence. In regard with this problem, political connection with directors may be identified by present or past activities in the political area, as represented by the political charge, membership of the political party or candidate for election.⁴ Directors are considered to have a political connection when they are the members of parliament, head of state, associated or close to

a political party or when their relative or close friends are.⁵ These political connections of an appointment process in some jurisdictions will lead to an impediment to consistent and transparent process.⁶

Normally, the board of directors of state owned enterprises always composes of government, political and stakeholder representatives who have limited commercial, financial knowledge or experience. As a result, they are not suitable to shoulder responsibilities required of state owned enterprises board⁷ such as having a limited knowledge of risk management or internal control and audit which lead to ineffective of monitoring, managing or providing the strategic guidance⁸. In addition, these compositions of the board may not take into account economic or financial matters of the enterprises due to the fact that they excel to ensure that state owned enterprises are attentive to the politic goal or policy, not for economic or financial goal.

⁴ Menozzi1, María Gutiérrez Urtiaga and Davide Vannoni, *Board Composition, Political Connections and Performance in State Owned Enterprises*, Carlo Alberto Notebooks No. 185 (2010), p. 7.

⁵ Ibid.

⁶ *Board of Directors of State-Owned Enterprises: An Overview of National Practices*, (OECD Publishing, 2013), p. 30.

⁷ *Corporate Governance of State-Owned Enterprises*, (World Bank Group, 2014), p. 163.

⁸ Ibid. 7.

One of the most important reasons of these problems is the absence of properly prescribed requirements to board members which is included the clear policy or guideline for nominating and appointing members of the board, especially the requirement for independent directors, procedure for evaluating of their performance and clarity in objectives that the government agencies should have set for the enterprises⁹.

Roles and Responsibilities of State Owned Enterprises' Board of Directors

Generally, the primary task of board of directors is to ensure that management is acting in favor of the shareholders through an advisory and monitoring role¹⁰. Someone may consider that the board of directors of state owned enterprises acts as an

intermediary between state, enterprises and the executive management¹¹. Thus, the board of directors holds the responsibilities to carry out the state owned enterprises' performance under fiduciary duty and good faith. The principle of fiduciary duty implies to a legal duty to act solely in another party's interest. Parties own this duty is called fiduciaries. The individuals to whom they own a duty are called principals. Fiduciaries may not profit from their relationship with principals unless they have the principal's express informed consent. They also have a duty to avoid any conflicts of interest between themselves and principals or between their principals and the fiduciaries' other clients¹². In this regard, the basic relationship of fiduciary duty is based on reasonable trust¹³ and breaching of the fiduciary duty owned to shareholders in some circumstances may lead to the dramatic

⁹ Alexander Filatov, Vladimir Tutkevich and Dmitry Cherkaev, *Board of Directors at State-Owned Enterprises (SOE) in Russia*, (OECD Publishing), p. 5.

¹⁰ Maria Vagliasindi, *The Effectiveness of Board of Directors of State Owned Enterprises in Developing Countries*, (World Bank Group, 2008), p. 2.

¹¹ *Board of directors of state-owned enterprises: an overview of national practices*, (OECD Publishing, 2013), p. 21.

¹² Legal Information Institute, *Fiduciary duty*, available at: <http://www.law.cornell.edu/wex/fiduciary_duty>, accessed on 23 December 2014.

¹³ Tamar Frankel, *Fiduciry law in the twenty-first century*, Boston University Law Review, Volume 91 issue 3 (2011), p. 1291.

impact to the public interest¹⁴. The problems will occur when board of directors cannot perform their acts under a fiduciary duty by trying to use their power to maximize their own profits rather than enterprise which finally bring about the corruption issue.

Remuneration of State Owned Enterprises' Board of Directors

Normally, remunerations of the board of directors in state owned enterprises are varied according to country, size, complexity of the enterprises, listing status and types of the directors. For the executive directors, general salaries and benefits are considered as sufficient compensation. Thus, they will not normally receive any additional compensation for being a member of the board. Special attention is paid to the compensation strategies to attract and influence senior executives or CEOs of the enterprises. Moreover, in some enterprises, remuneration policies are approved by the remuneration committees or, in many enterprises, by the government. Especially for the latter approval, the question of transparency has taken place. For the non-executive directors, good practice

requires the competitive board remuneration which is set in a way that attracts, motivates, and retains qualified people and served the interests of the enterprise.

Owing to the absence of the remuneration committee and remuneration policy, the problems of remuneration might occur in many state owned enterprises. In some cases, remuneration issues have never been discussed in the board meeting because it is often set or regulated by the government rather than the board that contrary to good practice. Moreover, the amount of remuneration payable to the managers in many state owned enterprises has never been disclosed. Sometimes, benchmarks, requirements, conditions or structures for the payment of remuneration are not available in several state owned enterprises which bring about the arbitrary decision by the board of directors. Furthermore, special issue for remuneration of non-executive directors is about the remuneration of civil servants who serves as government nominees on the board¹⁵. Civil servants are treated as the other board members in term of fees and directors liability, they are offered with an incentive

¹⁴ Cherly L. Wade, *Fiduciary duty and the public interest*, Boston University Law Review, Volume 91 issue 3 (2011), p. 1191.

¹⁵ *Corporate Governance of State-Owned Enterprises*, (World Bank Group, 2014), p. 199.

to take no more directorships. Thus, they may neglect their duties as the public servants or, sometime, they may not prepare for board meeting.

How about Thailand?

Likewise other countries, state owned enterprises in Thailand also confront with the same problems, particularly unlisted enterprises that always face with the political intervention.

Up to now, there are fifty-six of state owned enterprises operating in the economic system of Thailand. Among these enterprises, many of them are listed in The Stock Exchange of Thailand, such as PTT Public Company Limited, Thai Airways International Public Company Limited and Airports of Thailand Public Company Limited etc. Then, these listed enterprises are regulated by Thailand Stock Exchange rules and The Security and Exchange Commission rules which cover corporate governance regime that base on the OECD Principles of Corporate Governance¹⁶. However, over thirty state owned enterprises in Thailand have not published their

corporate governance policy. So, do they comply with corporate governance?

Even though many unlisted state owned enterprises have not provided their corporate governance policy, the Standard features for directors and employees of state owned enterprises Act. B.E. 2550 has indicated the basic qualifications for state owned enterprises' directors included limitation of the director age (65 years old), the requirement of the proper knowledge and experience of the directors, the prohibition of obtaining political officer status, directors of the political party or being the shareholders of state owned enterprises etc. These requirements can be seen as the rules under the corporate governance regime which intend mainly to improve the qualification of state owned enterprises' directors. However, these requirements cannot prohibit political affiliation effectively because the politicians still have a strong power to nominate their representative into the board and the basic policy for remuneration is still considered by the cabinet.

¹⁶ *Corporate Governance*, available at: <http://www.sec.or.th/EN/RaisingFunds/EquityDebt/Pages/link-Laws_Regulations/CorporateGovernanceCG.aspx>, accessed on 11 May 2015.

How to Improve Corporate Governance of State Owned Enterprises' Board of Directors?

In order to reduce political connection in state owned enterprises, state owned enterprises need to establish a well structure and transparent board nomination process¹⁷. By doing so, a strong policy framework and a clear nomination process for professionalize board composition should be done by considering the following approaches.

Firstly, creation of balance boards¹⁸ which focus mainly on the reduction of government representative on board of directors and nomination of independent directors. Under this element, many countries decide to prohibit ministers and other political appointees from taking some positions on boards or restrict the number of government representatives on boards while increasing the share of private sectors. Prohibition of the government officials who have a regulatory role from participating on board position are widely

accepted. However, if the nomination of government representative cannot be avoided, other criteria such as conflict of interest, delegation of the role to other officials and chair or deputy chair need to be considered before appointing new board members. Besides these considerations, an appointment of the government representative should be made on the basis of the relevant skills and the government representative appointee should be subject to the same performance evaluations and terms of appointment as other directors. In addition, they should share the same liabilities and reputation risks as other directors and responsible for maintaining the same skills or governance competencies as other directors¹⁹.

In addition, the board of directors of state owned enterprises should be increasingly introduced independence directors or outside directors who do not have a material or pecuniary relationship with company or related persons, except sitting fees²⁰. These independence directors are the necessary tools due to their abilities

¹⁷ *OECD guideline on corporate governance of state owned enterprises*, (OECD Publishing, 2005), p. 13.

¹⁸ *Corporate Governance of State-Owned Enterprises*, (World Bank Group, 2014), p. 163.

¹⁹ *Ibid.*, p. 166.

²⁰ Independent director, available at: <http://en.wikipedia.org/wiki/Independent_director>, accessed on 7 February 2015.

to alter the board discourse, setting the stage for a more open discussion and allowing an opportunity for dissenting voices to be heard when key decisions are being considered²¹. According to Adrian Cadbury point of view, outside directors regard strategies as the field in which they feel they should be able to make their greatest contribution. They also place governance next and give a lower rating to operational issues²². So, they are considered as the board's assistant who can bring about the business's prosperity and the business's performance via the involvement in the formulation of strategy²³.

Secondly, adoption of professional criteria for selection and removal of board members²⁴ such as separation of chair and CEO, minimum requirements for education and experience, industrial, financial, business, legal, corporate governance skills, term and rotation. These criteria are required in order to set up the global profile of the board of directors, which can be served as

a touchstone for periodic evaluation of board composition²⁵. Then, this professional criterion is necessary in order to avoid the absence of properly prescribed requirements of board members and create the professional board with an independent judgment.

Thirdly, development of nomination process structure, many state owned enterprises have delegated nomination process to the newly setting organ such as an advisory body, expert panel, centralized ownership entity, or nomination committee. Advisory body may provide an advice to line ministries which bring about better results to improve the prospects of identifying more qualified and merit-based boards²⁶. However, special expert may be introduced by some state owned enterprises to provide supplementary advice for board nominations. For the example, state owned enterprises in Chile, Malaysia and Canada, centralized ownership entity or nomination committee has direct responsibility for board

²¹ *Corporate Governance of State-Owned Enterprises*, (World Bank Group, 2014), p. 168.

²² Adrian Cadbury, *Corporate governance and chairmanship: A personal view*, (UK: Oxford University Press, 2002), p. 55.

²³ *Ibid.* 22, p. 56.

²⁴ *Ibid.* 21, p. 169.

²⁵ Lutgart Van den Berghe and Liesbeth De Ridder, *International standardisation of good corporate governance: Best practice for the Board of directors*, (Dordrecht: Kluwer Academic Publishers, 1999), p. 81.

²⁶ *Corporate Governance of State-Owned Enterprises*, (World Bank Group, 2014), p. 173.

nomination.

Fourthly, timely appointment and public disclosure of the results are important to ensure professionalism and transparency. A publication of the selected profile may be made in an annual report or in any events²⁷ that available to the public.

For the improvement of the roles and responsibilities of state owned enterprises' board of directors, clarifying and implementing board responsibilities are the most important aspect of professionalizing state owned enterprises' boards²⁸. In order to fulfill this approach, OECD guideline on corporate governance of state owned enterprises 2005 has suggested that boards of state owned enterprises should be assigned a clear mandate and ultimate responsibility for a company's performance. These refer to the development of state owned enterprise policy and procedure for board of director practices that should be set in accordance with the listing rules and

state owned enterprises law. To support this perspective, good practice calls for the role of the board of directors to focus mainly on strategic guidance and corporate performance, and shift focus away from a traditional conformance role²⁹, focusing on conformance can give boards and owners a false sense that they are fulfilling their fiduciary functions³⁰. In addition, the board should be fully accountable to the owners, act in the best interest of the company and treat all shareholders equitably³¹. Moreover, there should not be any difference between liabilities of different board members, whether they are nominated by the state or any other shareholders or stakeholders³². In order to fulfill these preferences, training program of liability and responsibility of the board of directors' members should be provided. The board member should follow the best practices and be limited in size due to the assumption that the good strategic discussion will be provided by a small size

²⁷ Lutgart Van den Berghe and Liesbeth De Ridder, *International standardisation of good corporate governance: Best practice for the Board of directors*, (Dordrecht: Kluwer Academic Publishers, 1999), p. 78.

²⁸ *Corporate Governance of State-Owned Enterprises*, (World Bank Group, 2014), p. 181.

²⁹ *Corporate governance: Boards of directors of state owned enterprises: An overview of national practices*, (OECD Publishing, 2013), p. 25.

³⁰ *Ibid.*, 29.

³¹ *OECD guideline on corporate governance of state owned enterprises*, (OECD Publishing, 2005), p. 17.

³² *Ibid.*, 31, p. 48.

of the board of director rather than a large one. Furthermore, there is the suggestion that effective implementation of the board responsibilities may require reducing its role in operational details and secondary matters, thereby striking the right balance with management³³.

To avoid board of directors' remuneration issues, remuneration policy and remuneration committee should be set up in accordance with OECD guideline on corporate governance of state owned enterprises 2005. For remuneration policy, board remuneration level should be decided by referring to the competition regime in order to motivate and attract qualified officers and protect enterprise benefits. In practice, remuneration criteria are determined by the variety of factors which normally related to state owned enterprises' size, workload, wage indices in the sector or company, as well as usual practice in the sector concerned³⁴.

However, in theory, there are five core principles introduced by the World Bank in

order to progress good remuneration policy. Firstly, remuneration policy should be compared with other state owned enterprises. So, grouping state owned enterprises, according to their size and industry, is necessary. Secondly, the primary benchmark for state owned enterprises remuneration is the practices of private companies. Thirdly, remuneration should be competitive and commensurate with the directors' responsibilities and accountabilities³⁵. Fourthly, level of fees should not be so high because it will affect to an independence of directors and fees for all of the non-executive directors should be the same amount. Lastly, the structure of remuneration policy should not be complicated and should be structured in a way that provides incentives for taking on additional responsibilities, for example, the chairmanship of a committee³⁶. Hence, good practice calls for board remuneration that should reflect market conditions which is necessary to attract and retain highly qualified directors³⁷. However, setting only remuneration policy is not enough. Remu-

³³ Ibid. 28, p. 182.

³⁴ *Corporate governance: Boards of directors of state owned enterprises: An overview of national practices*, (OECD Publishing, 2013), p. 69.

³⁵ *Corporate Governance of State-Owned Enterprises*, (World Bank Group, 2014), p. 202.

³⁶ Ibid.

³⁷ Ibid., 34.

neration committee is suggested in order to determine the board of director remuneration and bring remuneration issues to be discussed.

In order to prevent inappropriate practices and ensure the transparency process of remuneration, good practice also provides the suggestion for the remuneration of civil servants. Under this suggestion, there is no additional fee should be paid to civil servants rather than civil service salaries because fees compromise their duty of loyalty to state owned enterprises (since the civil servants are beholden to ministers or others who nominate them) and can lead to the perverse incentives.

Conclusion

Up to now, there is no agreement on precisely which government practices are the most important as well as there is no perfect rule or guideline on corporate governance which is suitable for all state owned enterprises. Besides this, good governance is required for state owned enterprises' operation thus adoption of corporate governance principles into state owned enterprises policies and practices is necessary.

From this point of view, state owned enterprises should accept corporate

governance practices by freely referring to international guidelines for good governance of state owned enterprises such as the OECD guidelines on Corporate Governance of State-owned Enterprise 2005, the Baltic Guideline on the Governance of Government-owned Enterprises or other rules which they do not need to become a party of these instruments. From these instruments perspective, professionalizing board nomination and composition, setting board remuneration policy and providing the board of director training will be the basic principles for developing good practice of the board of directors.

Hence, this is not necessary that corporate governance principles will be provided in each jurisdiction as hard law or soft law instruments or offered some punishments for any violations of these principles. The most important aspect is the adoption of those corporate governance principles voluntarily by state owned enterprises. Even though many state owned enterprises decided to adopt corporate governance due to the consideration of their reputation risk, there are several state owned enterprises who have not yet accepted corporate governance into their practice. Thus, it is essential that state, as a controlling shareholder and a regulator,

should promote and ensure high standard of corporate governance in both state owned enterprises policies and practices. Without good corporate governance, state owned enterprises' potential and financial will be damaged which will affect directly to other stakeholders' trust, prosperity and economic growth of state owned enterprises.

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