

MANUAL for the Corporate Governance Toolkit for banks, NBFIs and MFIs

1. Introduction

What is Corporate Governance?

Corporate governance ('CG') refers to the structures and processes for the direction and control of companies and concerns the relationships among the management, board of directors or supervisory board, controlling shareholders, minority shareholders and other stakeholders. Good CG contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital.

Why Corporate Governance Matters for our Investee Companies

- Access to Capital: An increasing amount of empirical evidence indicates that well-governed companies receive higher market valuations. Improving CG will also increase other capital flows to companies in developing countries: from domestic and global capital; equity and debt; and from public securities markets and private capital sources.
- Improving Performance: Good CG leads to better performance for our investee companies. Improved governance structures and processes help ensure high quality decision making, encourage effective succession planning for senior management and enhance the long-term prosperity of companies, irrespective of the type of company and its sources of finance.

Why Corporate Governance Matters for FMO

- Adding Value. CG is a priority for FMO because it presents opportunities to manage risks and add value to investee companies through increased performance and access to capital. FMO's approach to corporate governance is captured in its ESG Policy.
- Reducing Investment Risk. It is in the interest of FMO to reduce the risk of our investments by improving the governance of investee companies.
- Avoiding Reputational Risk. FMO assumes a reputational risk if involved with companies with poor governance, and may become tainted by corporate scandals at investee companies.
- Developing Capital Markets. Improving CG contributes to the development of the public and private capital markets.

2. Corporate Governance Toolkit

Introduction to the Toolkit

The purpose of the Corporate Governance Toolkit for banks, non-banking financial institutions and microfinance institutions is to properly assess the overall risk related to CG according to five key risk areas:

- The Commitment to Corporate Governance
- Structure and Functioning of the Board of Directors
- Control Environment and Processes
- Transparency and Disclosure
- Shareholder Rights
- *(Technology risk – only when applicable)*
- *(Family-owned risk – only when applicable)*

The process of identifying, attributing and, at times, mitigating these risks in the investment decision will be called a *Corporate Governance review*. The toolkit facilitates the investment teams with the assessment of the Corporate Governance structures and practices. A *Corporate Governance review* needs to be performed for every deal except for:

- start-up deals under project finance and SPVs (mainly in the Energy Department),
- investment deals in funds
- deals for which the Corporate Governance structures will be established as part of the equity investment. A Corporate Governance Officer will be part of the deal team in this case.

Scope of Application

The Corporate Governance Toolkit for Financial Institutions can be applied to all financial institutions (i.e. banks, non-banking financial institutions and microfinance institutions) in emerging markets.

For family-owned financial institutions, the family business-related aspects of the Corporate Governance Toolkit for Family-Owned entities, non-listed and listed companies can be taken into account as well to properly evaluate aspects of family governance.

Overview on Different Tools

The Corporate Governance Toolkit for banks, non-banking financial institutions and microfinance institutions includes four key CG tools for analyzing the governance of FIs, namely:

Assessment tools:

1. **CIP CG Questionnaire:** This questionnaire supports the investment staff with identifying initial risk factors and to decide whether a CG Officer needs to get further involved in the Due Diligence process. Under each of the five risk areas of CG (Commitment to Corporate Governance, Structure and Functioning of the Board of Directors, Control Environment and Processes, Transparency and Disclosure and Shareholders Rights) two statements are posed that relate to main risks that could be identified in an emerging market setting from a CG point of view.

The **CIP CG Questionnaire** provides an early indication of Corporate Governance risk factors. The Due Diligence should, amongst others, focus on how these risk factors are addressed.

2. **FP Questionnaire:** The **FP Questionnaire** is a more detailed questionnaire that should be filled in by the investment team during Due Diligence. The questionnaire requires the investment team to discuss Corporate Governance with the client and to conclude on the appropriateness of the Corporate Governance practices. The investment team should provide a short and to-the-point answer to all questions (1-3 sentences). The completed questionnaire is an annex to the FP. The categories “Family-owned” and “Technology/Fintech” are only applicable in case the company can be classified as such.

The investment team needs to score the Corporate Governance practices for all 5 topics presented. The investment team should use their judgement and select the maturity level (Basic , Emerging, Developed) that best corresponds with the structures and practices of the assessed institution. The simple average of the score (automatically calculated by the template) is input for the scorecard at FP stage.

The investment team should conclude on the appropriateness of the Corporate Governance structures and practices and could either suggest risk mitigation for identified risks or additional steps needed to be taken to eventually mitigate the CG risks identified (such as involvement of the CG Officer, a CG consultant, etc.).

A short and to the point summary of the Corporate Governance structure, summarized conclusion and prioritized CG improvements are an integral part of the body of the FP.

Reference materials for the Investment Team:

3. **Annex 1: Due Diligence Questions:** This list of questions supports the investment teams in assessing the Corporate Governance structures and practices during Due Diligence. The questionnaire can be used to structure Due Diligence meetings around Corporate Governance with key company representatives. This questionnaire is organized to correspond to the five risk areas of governance in the **CIP CG Questionnaire**, **CG Progression Matrix**, and the **FP Questionnaire**.
4. **Annex 2: CG Progression Matrix:** The **CG Progression matrix** relates the five risk areas of governance to four levels of achievement. The use of a matrix framework emphasizes the importance of ongoing improvements in the governance practices of investee companies, rather than trying to apply rigid and static minimum standards. It is also there to provide for an orientation to the investment staff as well as the client. The **CG Progression Matrix** lends itself to identify potential mitigations for the particular risks identified rather than assessing the risk level.

The progression matrix can be shared with the client and can be used as a tool for self-evaluation.

3. Guidelines

Assessment tools:

1. The CIP CG questionnaire

The rapid risk screening should be applied to all deals except

- start-up deals under project finance and SPVs (mainly in the Energy Department) and
- investment deals in funds.
- deals for which the Corporate Governance structures will be established as part of the equity investment. The Corporate Governance officer will be part of the deal team in this case.

Two questions are posed under each of the five risk areas (Commitment to Corporate Governance, Board structure, Control environment, Transparency & disclosure, Shareholder rights). Each question is answered with either 'TRUE' or 'FALSE'. All questions can be answered based on public information (i.e. Annual report, company website) and/or initial high-level client discussions.

The questions in the CIP CG Questionnaire relate to prioritized risk factors. The CIP CG Questionnaire provides input and direction for the Due Diligence. Specific research during the Due Diligence phase is required if the answer to a question is 'TRUE'. After the Due Diligence it should be clear whether the Corporate Governance practices are adequate given the characteristics of the company and whether specific risk factors are adequately addressed.

The CIP CG Questionnaire should help the investment team focus its forthcoming Due Diligence on the key CG risk factors. It also has a direct implication at the CIP stage: in case there are at least two questions answered with 'TRUE', a CG Officer should be consulted and, depending on the outcome of the consultation, may decide to get involved already during the Due Diligence process. In case of the CG Officer's involvement, the deliverable at FP stage is his/her direct responsibility.

The deal team is of course free to consult with or involve the CG Officer in other cases as well. In case that it only turns out after Due Diligence that there are indeed two or more questions answered with 'TRUE', which were not properly identified during the CIP stage, the deal team must again consult the CG Officer to contemplate his or her involvement.

The CIP CG Questionnaire provides direction for the DD and does not give a risk indication of the CG practices. **1,8 – 2,21** is to be used as the default input for the scorecard as the CIP CG questionnaire does not provide insight in any risk classification.

2. The FP questionnaire

The FP questionnaire provides a number of open and closed questions that need to be answered by the investment team as part of the Due Diligence. The questions relate to the five risk areas (Commitment to Corporate Governance, Board structure, Control environment, Transparency & disclosure, Shareholder rights). There are two additional risk areas that only need to be scored in case they are applicable to the institution (Family-Owned company and Technology/Fintech company).

As an outcome of the Due Diligence the investment team should draft a conclusion on the Corporate Governance practices of the client. In case that the CG Officer has been involved, it is his/her responsibility to complete the questionnaire and to provide a conclusion.

The investment team should determine whether:

- The Corporate Governance practices are adequate for the specific institution given the company characteristics, risk profile and complexity
- There are any required Corporate Governance mitigating activities that need to be included:

- Individual action items
- Corporate Governance action plan
- Detailed Corporate Governance review to be performed by a CG officer

The investment team needs to score the current state of the Corporate Governance practices. The investment team should use their judgement and select the maturity level (Basic, Emerging, Developed) that best corresponds with the structures and practices of the assessed institution. The simple average score is input for the Scorecard.

As mentioned earlier, in the final conclusion part, the investment team could either suggest risk mitigation for identified risks or additional steps needed to be taken to eventually mitigate the CG risks identified (such as involvement of the CG Officer, a CG consultant, etc.). At times, the investment team may decide to simply suggest the acceptance of existing risks, in particular if there is no internal champion within the client that would facilitate the improvement on their governance practices or if the regulatory environment does not allow for improvements.

Reference materials for Investment Team:

3. Annex 1: Due Diligence Questions:

A list of individuals who would normally be interviewed during a Corporate Governance assessment is provided below. It is important that FMO's investment staff meet with those people who, as a practical matter, are responsible for establishing and maintaining the principal corporate governance framework, irrespective of their job titles.

As a minimum, it is suggested to meet at least with one non-executive and/or independent director (ideally the chair of the audit committee) apart from integrating CG related questions into the Due Diligence with existing counterparts such as CEO, CFO, and the corporate secretary.

The Due Diligence Questions matches the individuals to interview with each of the five areas of corporate governance:

- Representatives of controlling shareholders
- Minority Shareholders (especially those with past or current disputes with the Company)
- Chairperson and members of the Board of Directors, including any independent Board members and the chairs of the audit and other special committees of the Board
- Chief Executive Officer
- Chief Financial Officer (or senior accounting officer)
- Corporate Secretary and/or Chief of Investor Relations
- Chief of the Internal Audit function and Chief of Risk Management
- Independent External Auditors

4. Annex 2: The CG Progression Matrix

The CG Progression matrix relates the five risk areas of governance to four levels of achievement and can be used during Due Diligence phase together with the questionnaire. The use of a matrix framework emphasizes the importance of ongoing improvements in the governance practices of investee companies, rather than trying to apply rigid and static minimum standards. It is there to provide an orientation to the investment staff as well as the client.

The first level of the matrix represents the basic governance practices that investee companies might have in place. The next three levels describe more advanced practices towards which investee companies should gradually progress.

The investment staff needs to consider the overall size, industry and growth trajectory of the FI among other factors to make this final judgment. The strength of the regulatory environment, in particular the central banks guidance on CG, can affect the final score in each of the categories.

4. Quick reference card – CG toolkit FIs version 2018

CIP	Due Diligence	FP
<p>Assessment tool:</p> <ul style="list-style-type: none"> • <u>CIP CG Questionnaire</u> <p>Output:</p> <ul style="list-style-type: none"> • <u>Completed CIP CG Questionnaire</u> • Insight in risk factors to be addressed in detail during DD • Decision on whether to reach out to the CG officer 	<p>Assessment tools:</p> <ul style="list-style-type: none"> • <u>FP Questionnaire</u> <p>Reference material:</p> <ul style="list-style-type: none"> • <u>CG Progression Matrix</u> • <u>Due Diligence questions</u> 	<p>Assessment tools:</p> <ul style="list-style-type: none"> • <u>FP Questionnaire</u> <p>Reference material:</p> <ul style="list-style-type: none"> • <u>CG Progression Matrix</u> • <u>Due Diligence questions</u> <p>Output:</p> <ul style="list-style-type: none"> • <u>Completed FP Questionnaire</u> as annex to the FP • Summarized description of the CG structure in the body of the FP • Summarized conclusion on appropriateness of CG in the body of the FP • Overview of mitigating measures (if any) in the body of the FP
<p>Summarized guidelines:</p> <ul style="list-style-type: none"> • <u>CIP CG Questionnaire</u> to be completed for every client/opportunity • <u>CIP CG Questionnaire</u> provides direction for DD (i.e. identified risk factors) • Contact CG officer if >1 'True' • Default score in Scorecard: 1,8 – 2,21 	<p>Summarized guidelines:</p> <ul style="list-style-type: none"> • Allocate sufficient time for Corporate Governance during DD (i.e. meeting with Director, CEO and head of IA) • Reference materials help the investment team to structure the discussions on Corporate Governance • Discussion/interviews should provide more insight in actual working practices (instead of focusing on CG on paper) 	<p>Summarized guidelines:</p> <ul style="list-style-type: none"> • Responsibility of the Corporate Governance Officer if involved • Mitigating activities are defined in case there are any required improvements or in case there is an opportunity for FMO to add value • Questions on 'Family-owned' and 'Fintech/Technology-owned' are only applicable in case you are dealing with such an institution. • Input CG score in scorecard