

# **Philippine Corporate Governance: Environment and Policy and their Impact on Performance and Finance**

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## **Abstract**

The Asian Development Bank initiated a study of Corporate Governance and Finance in Selected Developing Member Countries in November 1998. The objectives of the Study for the Philippines are to evaluate the history and current state of corporate governance in the Philippines; establish a sound analytic basis for policy and regulatory reform measures to strengthen corporate governance of Philippine companies and recommend reform measures for the Philippine government and the Bank. It analyzes the historical developments of the corporate sector, the legal and regulatory framework for corporate governance, the ownership and control of publicly listed companies, and corporate performance and financing relative to corporate governance factors.

The study addresses weaknesses in corporate governance by introducing reforms in the policy and regulatory framework and by actively promoting the development of both capital market and product-factor markets. The two major areas for reforms can be divided into the two traditional classes of controls on corporate governance-internal control system and external controls and discipline. Internal controls are the corporate governance systems within the company that are mandated by the Corporation Code and enforced within the company. External controls and discipline emanate from actions by customers and investors in the product and capital markets, respectively. The government, acting in the public interest, regulates companies to prevent malpractice and to promote the development of markets.

## **1. INTRODUCTION**

The Asian Crisis of 1997 was attributed to a failure of corporate governance in five Asian countries including the Philippines. Controlling shareholders mismanaged the resources of all shareholders through their poor investing and risky financing decisions. The larger framework of corporate governance was weak to the extent that early warning signals did not generate counter measures to curb poor management decisions. The crisis coincided with a structural change in the capital markets and financial systems of Asian crisis that initially clouded the causal role of weak corporate governance. The crisis caused a re-examination of the "Asian Miracle" and the corporate governance practices of crisis-affected Asian countries. Such re-

examination covered the ownership and management of companies, internal control systems, the role of creditors in monitoring and disciplining companies, the capital market and the market for corporate control and disclosures and transparency. In sum, it is an examination of the management systems that caused such losses of capital and of the capital market that allowed management to do so by not taking corrective measures until it was too late.

The Asian Development Bank initiated a Study of Corporate Governance and Finance in Selected Developing Member Countries in November 1998. The objectives of the Study for the Philippines are to evaluate the history and current state of corporate governance in the Philippines, establish a sound analytic basis for policy and regulatory reform measures to strengthen corporate governance of Philippine companies and recommend reform measures for the Philippine government and the Bank. The present report, the Country Report for the Philippines, presents the results of the Study for the Philippines. It analyzes the historical developments of the corporate sector, legal and regulatory framework for corporate governance, ownership and control of publicly listed companies, and corporate performance and financing relative to corporate governance factors. The Study used financial and other data in the decade preceding the Asian Crisis, from 1988 to 1997. Part II presents the major findings and conclusions of the Study. Part III presents the recommendations toward strengthening corporate governance in the corporate sector.

## **2. FINDINGS AND CONCLUSIONS OF THE STUDY**

### **A. Influence of Historical development policies on the Philippine Corporate Sector**

Past economic and industrial development policies of the country shaped the corporate sector. Past policies of import substitution, protection of domestic industries from foreign competition and promotion of large start-up businesses made industries import dependent, concentrated in a few leading companies and oriented to domestic markets. The family based ownership of Philippine companies originates from early efforts of the government to encourage entry of local investors in industries. Reforms introduced in the last two decades are restructuring industries by reducing the dominance of leading companies and increasing competition. The prospects of dominating an industry and earning superior profits are important incentives for large family based shareholders to maintain their ownership control.

### **B. Performance of the Philippine Corporate Sector**

The Philippine corporate sector has been relatively efficient in investing and financing. In the ten years preceding the Asian crisis, the Philippine corporate sector earned acceptance rates of returns. Rates of leverage were within Asian norms but above developed country standards. The foreign subsector was most profit-

able but also most leveraged. Foreign companies heavily access domestic debts but are efficient investors. The privately owned subsector was the largest in the corporate sector but the least profitable. The publicly listed subsector had the highest profit margins and lowest leverage among the locally owned corporate subsectors. The group of companies subsector had higher returns and lower leverage than the independent subsector. Company size and industry characteristics partly explained performance. The medium-size subsector was more profitable than the large- and small-sized subsectors. The real estate and utility subsectors stand out for their pronounced cyclical patterns.

### **C. Corporate Ownership Structure**

Privately owned companies that hold shares for large, family based shareholders are the main stockholders of publicly listed companies. Families founded companies and pooled their wealth through holding companies. Holding companies have majority shares of the average publicly listed company. As a result, holding companies constitute the largest sector in the Philippine Stock Exchange (PSE), accounting for about 27 percent of the market capitalization of the non-financial sector. A holding company is attractive because it offers family members a means for exercising control on a company. Individuals and nominees are only minority shareholders. Financial institutions are not significant shareholders of publicly listed companies.

### **D. Concentration of Ownership**

Publicly listed companies are not truly publicly owned. Only five to twenty shareholders control most PSE-listed companies. Ownership is highly concentrated even among publicly listed companies. The largest five shareholders own more than 65 percent and the largest 20 shareholders more than 75 percent of an average publicly listed company. Ownership concentration means that large shareholders can completely dominate minority shareholders in all decisions involving the company including those that require two-thirds majority vote by the board and those that require approval by shareholders in annual general shareholders' meetings (AGSM). The largest 20 shareholders own at least 80 percent of more than 45 percent of publicly listed companies. These results show that public listing rules of PSE allow a high proportion of publicly listed companies to remain privately owned.

### **E. Family-based Groups of Companies in the Philippine Corporate Sector**

Large shareholders form groups of companies, usually with a commercial bank in their midst, to efficiently organize their family-based resources. The conglomerate organization is a successful model of organizing companies under common ownership, usually of a family. If the traditional ranking of Philippine companies considered each group of companies as a separate "economic entity", they would have occupied seven out of ten and 25 of the top 50 largest corporate entities in the

Philippines in 1997. About 40 known groups of companies account for about one-fourth of the total sales of the largest 1000 corporations in the Philippines in 1997.

Family-based groups of companies invest in industries where their superior financing capacities and political/social influence give them unique advantages. Large companies owned or controlled by groups of companies tend to dominate their industries, are more profitable and grow faster than independent companies. Groups of companies operate in many industries, but only a few of those industries account for a large share of the group's revenues and profits. A commercial bank is an important part of most groups of companies. Even with a minority share of a commercial bank, a bank can often account for a large share of a group's net profits. Groups of companies are present in industries where regulatory barriers and capital costs are prohibitively high because these are precisely when they could employ their political influence and their superior capacities to raise large amounts of capital to obtain near oligopoly position in an industry.

#### **F. How Large Family based Shareholders Control Groups of Companies**

A family-based group of companies is typically organized in a pyramid structure with a publicly listed but privately controlled holding company at the apex. Large, family-based shareholders gain control through such means as forming holding companies, selectively public-listing companies and centralizing management and financing. The privately owned holding company is at the apex of the group. It is means for pooling the resources of the family, for enforcing a sharing of risks among members of the family and for ensuring joint management decisions. Importantly, it enables the family to regulate the degree of public ownership of companies founded by the family. Groups employ two types of organizational models -- the vertical pyramid or direct control model and the cross-shareholdings or indirect control model. The pyramid model is suitable for using a flagship holding company to centrally manage diversified companies. Most groups use this model, for example, Ayala Corporation Group. The cross-shareholdings model is suitable for using several companies to control large businesses that require large amounts of capital like public utilities. An example is the Lopez Group. To the extent that they want to privately capture the profits of highly profitable companies in the group, controlling shareholders have no incentive to get these companies publicly listed. Instead, controlling shareholders could limit the participation of public investors in the group to their holding companies.

#### **G. Internal Management Control Structure**

##### *1. Control through the Board of Directors*

The Corporate Code mandates the board to conduct business and control the resources of the corporation and require ratification by shareholders of its deci-

sions. Majority shareholders control the chairman and CEO through appointment, compensation and tenure. The law does not require companies to appoint independent directors. The Corporate Code empowers the board to manage and control resources of the company. The typical chairman and CEO of a Philippine corporation actually owns only 7.5 percent of the company. Controlling shareholders determine the appointment, compensation and term of the chairman. By keeping tenure to an average of one year and selecting those with whom they have good relationship, controlling shareholders ensure that the board chairman is aligned to their interest. Since the law does not mandate the appointment of independent directors, Philippine companies do not appoint independent directors.

### *2. Protection of Minority Shareholders*

Standard provisions in the Corporation Code designed to protect minority shareholders are not sufficient in practice because the high levels of ownership concentration deter the effective exercise by minority shareholders of their rights. The SEC has not taken an activist stance in implementing these provisions and gaps still remain in the legal protection of shareholders. The Corporation Code provide for the protection of minority shareholders through cumulative voting of directors, appraisal rights, voting by proxy, right to demand an inspection of company records and mandatory AGSMs. In practice, controlling shareholders can regulate the exercise of these rights. In particular, highly concentrated ownership makes the AGSM an ineffective venue for the exercise of rights by minority shareholders. SEC has not adopted a pro-active stance in disciplining management of companies that curb the exercise of minority shareholders of their rights. SEC has not been effective in protecting minority shareholders against self-dealing and insider trading. There is an absence of shareholder activism in the Philippines even in the presence of well-known cases of losses by investors arising from imprudent decisions, self-dealing and insider trading by management of companies.

### *3. Auditing, Disclosures and Transparency*

There are sufficient provisions requiring competent external audits, disclosure and transparency but enforcement needs improvement. Most publicly listed companies have local firms that are affiliated with reputable international audit firms as their external auditors. They follow either local or international accounting standards. Quality of auditing and disclosure is much lower outside the publicly listed subsector. SEC has sufficient requirements for disclosure, consistent with its shift in policy stance from regulatory to full disclosure. However, implementation is a problem and investor confidence on company information is low. The national accounting association (PICPA) and SEC has not resolved many past incidents of poor disclosure and apparent deficiency in audited financial statements.

## **H. Influence of Corporate Governance on Financing**

The corporate sector relied on internally generated funds and equity before resorting to borrowings. The sharp rise in bank loans came shortly before the crisis. Tight financial conditions prevailing in the country up to 1992 influenced the financing patterns of the corporate sector in the 1990s. The corporate sector except for the foreign subsector consistently relied on internally generated funds and equity before resorting to borrowings. The publicly listed and privately owned subsectors consistently invested and built capacities except for the foreign owned subsector invested aggressively during stable economic periods but divested during periods of economic or political crisis. The publicly listed subsector showed decreasing efficiency of investments and increasing leverage in the years preceding the crisis. Because the publicly listed subsector was dependent on short-term bank loans, it was vulnerable to the crisis.

### **I. External Controls: Creditor Control and the Market for Corporate Control**

Banks serve as external controllers of companies under the unwritten rules of relationship finance. Liberalized banking regulations increased competition among banks and limited the effectiveness of their standard control tools (covenants and collateral). Reliance on bank loans by companies makes banks their natural external control agents. Banks practice relationship finance with relationships averaging more than five years. Companies indicate that banks do not intervene in management, do not get in the way of their operations and want to maintain credit relationships even if they go through work-outs of troubled debts. Liberalization in bank entry and branching increased competition among banks but also reduced the capacity of banks to discipline corporate borrowers. Affiliate banks of group of companies could not be expected to be a disciplining force of the group.

There is no market for corporate control (threat of hostile take-over) to discipline inefficient and self-dealing management. The broader capital market does not serve as an external control agent. Not enough investment analysts track the performance of publicly listed companies. The threat of a hostile take-over of a badly performing company by another group that can manage it better to capture the gains is a disciplining factor in sound capital markets but not in the Philippines. Because of concentrated ownership, it is almost impossible for outside investors to do a hostile take-over of a publicly listed Philippine company. An exception was the recent take-over of Philippine Long Distance Telephone (PLDT) by First Pacific. It was made possible because the currency devalued. PLDT's institutional investors apparently sold their shareholdings at a premium to First Pacific and the largest shareholders held only a minority ownership of PLDT.

### **J. The Crisis and Corporate Restructuring in the Aftermath of the Crisis**

The adverse effects of the Asian crisis on the corporate sector's performance were cushioned by the country's late entry into the foreign currency debt market

due to the debt moratorium. The crisis came when the Philippine economy was in a relatively stable financial position with a recently restructured public debt, strong international exchange reserves position, low inflation, government budget surplus and a market-oriented policy environment. The corporate sector was also in good financial condition because it accumulated internal funds during a series of profitable years, built up a strong capital position from initial public offerings in a buoyant stock market and maintained overall creditworthiness. The corporate sector came into the foreign currency debt market much later than their Thai, Indonesian and Malaysian counterparts because of the country's long-drawn debt moratorium that ended only in 1992. Still, the corporate sector's borrowings rose sharply higher even as the productivity of its investments decreased a few years before the crisis in a pattern similar to Asian crisis countries. The crisis, when it came, caused a tightening of credits to the corporate sector and a spike in interest rates.

The government's prudent fiscal and monetary policies prevented the crisis from deepening. The Philippine central bank (BSP) can be credited with containing the adverse impact of the Asian crisis. BSP improved the liquidity of the system, worked to bring down interest rates, tightened its supervision and imposed controls on loan portfolios of banks. As the crisis wore on in 1998, there were sharp rises in bankruptcies and petitions for debt relief, mostly by highly leveraged companies and speculative investors in real estate. BSP imposed limits on the size of commercial banks' real estate loans portfolio and NPL levels, resulting in accelerated restructuring by banks of troubled real estate debts. The crisis led to petitions to SEC by a number of large debtors for suspension of payments to creditors and rehabilitation under a law (promulgated under the martial law regime) called Presidential Decree (P.D.) 902-A.

#### **K. Relationship Between Corporate Governance and Ownership Concentration on Financial Performance**

Companies borrow to finance marginally profitable investments so long as they generate returns to shareholders. Companies belonging to conglomerates and publicly listed companies tend to have lower leverage. Return on assets decreases with leverage and were higher for foreign owned subsector. Leverage decreases with return on assets but increases return on equity. Just like in Thailand in the years before the crisis, the efficiency of investments by the corporate sector declined and borrowings was used heavily to finance investments. Leverage is negatively related to three corporate governance variables - group member, publicly listed and foreign owned variables. The results of lower leverage for members of conglomerates and publicly listed companies are consistent with prior studies. Internal financial markets operated by groups of companies allow them to optimize their financial resources at lower external debt levels. Publicly listed companies are responsive to investors' requirements for prudent use of debts.

Companies with high levels of ownership concentration have higher returns

and leverage. Ownership concentration was positively related to both returns and leverage. Companies whose shareholders have higher degree of control tend to borrow more but generate better returns. Companies controlled by a few individuals tend to borrow more because they controlled management's profitable use of debt funds. Consequently, they tend to have a higher tolerance for leverage risks.

#### **L. Corporate Governance Reforms in Response to the Crisis**

Because the effects of the crisis have not been severe, the Securities and Exchange Commission (SEC) and Philippine Sock Exchange (PSE) have not undertaken reforms in the legal framework and supervision of the corporate sector. As the crisis wore on in 1998, there were sharp rises in bankruptcies and petitions for debt relief, mostly by highly leveraged companies and speculative investors in real estate. Controls on portfolio quality and NPL levels and minimum capital requirements resulted in accelerated restructuring by banks of troubled loans. Under P.D. 902-A, SEC exclusively decides on whether the petitioner should be rehabilitated or liquidated. SEC can consult the creditors but the law suspends essentially all prior claims of creditors. It is a poor legal framework for settlement of troubled debts because it does not discipline borrowers. It leads to moral hazard problems because debtors could divert bank credits to highly speculative investments or consumption with the intention of claiming protection under PD 902-A if downside risks occur. Implementation of the law has been ineffective. SEC has not successfully rehabilitated any of the financially troubled companies that petitioned for protection since promulgation of the decree more than 16 years ago. Poor legal framework and improper implementation of liquidation procedures raise the cost of credit and diminish the role that banks play as external controls of large shareholder-dominated management. The government has not taken radical steps to reform the corporate debt restructuring and rehabilitation of troubled debts. PSE has not adopted measures similar to those taken by other stock exchanges like in Thailand and Malaysia to raise standards of disclosures and quality of governance.

### **3. RECOMMENDATIONS FOR THE PHILIPPINE GOVERNMENT**

The Philippine government should address weaknesses in corporate governance by introducing reforms in the policy and regulatory framework and by actively promoting the development of both the capital market and product-factor markets. The major areas for reforms can be divided into the two traditional classes of controls on corporate governance -- internal control system and external controls and discipline. Internal controls are the corporate governance systems within the company that are mandated by the Corporation Code and enforced within the organization and ownership structure of a company. At the heart of internal control



systems are the board of directors system and the exercise of shareholder votes in the AGSM. External controls and discipline emanate from actions by customers and investors in the product and capital markets, respectively. The government, acting in the public interest, regulates companies to prevent malpractice and to promote the development of markets.

## **A. STRENGTHENING THE CORPORATE INTERNAL CONTROL SYSTEMS**

### *1) Promote a Broader of Ownership of the Corporate Sector*

The highly concentrated ownership of the publicly listed corporate sector should be a concern of SEC and PSE because of systematic risks involved in highly concentrated ownership as demonstrated in the Asian crisis. The Study recommends an amendment of the Corporation Code to improve disclosures of ownership and to address the current high level of ownership concentration in Philippine business. Among the specific recommendations are: a) requiring disclosures of the identity of ownership of shares held by nominees and holding companies and b) requiring disclosure of material changes in ownership. SEC, working with PSE, should increase the minimum percentage of outstanding shares for public listing in the stock exchange from the present 10 to 20 percent depending on the size of the company to 25 percent of outstanding shares. The adjustment should be made over a fixed period of time.

### *2) Increase the Statutory Accountability of Directors and Strengthen the Board of Directors System*

The government should make a statutory definition of the fiduciary accountability of the board of directors and strengthen its composition. A clear specification of the fiduciary duties of directors shall enable the SEC to enforce prudential requirements on management of companies. It shall enable minority shareholders to pursue grievances against their board. Clear legal accountability is a pre-condition to successful shareholder activism. Another proposed measure is to impose a statutory limit on the number of directorship for board directors. This proposal aims to control the current practice of appointing as directors prominent individuals who could not perform their duties effectively. It complements the provision on mandating the fiduciary duties of directors. To strengthen the board, PSE Listing Rules should require that a minimum number of independent directors be appointed in the board of publicly listed companies. Because independent directors tend to adopt the perspective of minority shareholders in board decisions, their presence curbs the powers of controlling shareholders. PSE listing rules should mandate the criteria and selection process to ensure that nominees for directorships are truly independent and qualified.

### *3) Strengthen Minority Shareholder Rights*

The Study recommends that measures be adopted to prevent controlling share-

holders from expropriating the wealth of minority shareholders through risky investing and financing decisions, inadequate disclosures, insider information and self-dealing. There should be a revision of the Corporation Code to raise the required majority percentage votes on critical corporate decisions. Minority shareholders could not use traditional venues like AGSMs to prevent controlling shareholders from expropriating their wealth. They need legal empowerment like higher majority voting requirements, e.g., raising the current two-thirds majority to three-fourths majority. This statutory change should be complemented by tighter disclosure requirements regarding self-dealings. Finally, the Corporation Code should be amended to impose sufficiently stiff penalties for self-dealings.

#### *4) Promote Shareholder Activism*

The government has not tried to promote shareholder activism by encouraging small shareholders to actively monitor management and file suitable lawsuits and take other actions. Pre-requisites to fruitful shareholder activism are transparency and disclosure on corporate affairs that potentially involve expropriation of wealth of minority shareholders. Another pre-requisite is a legal provision to facilitate class action suits against corporate directors, management and external auditors. The government should encourage the organization of shareholder and stakeholder groups that shall monitor the actions of management from the viewpoint of minority shareholders and stakeholders. They should have sufficient basis for monitoring management and a fair chance of successfully prosecuting mismanagement of corporate resources.

### **B. ENFORCING MARKET DISCIPLINE AND PUBLIC INTEREST REGULATIONS**

#### *1) Promote Competition in the Product and Factor Markets*

The Philippine government should pursue industrial development policies that promote competition through elimination of subsidies, guarantees, entry and exit barriers and various other forms of protection. The government's competition policies should aim to enable the free entry and exit of domestic and foreign companies and the regulation of anti-competitive practices. The government should continue to improve the infrastructure for companies. By providing the infrastructure, the government makes small and medium-scale companies more competitive relative to large companies. The government should continue its efforts at reducing graft and corruption, improve enforcement of the rule of law and provide quality basic services. The export processing and special economic zones demonstrate that quality infrastructure attracts local and foreign investments. The government should encourage foreign direct investments as a way of quickly setting up globally competitive enterprises in Philippine industries. The government should simplify administrative procedures for the entry and operation of foreign companies in the country.

*2) Improve Financial System Regulations and Strengthen Their Implementation*

BSP should improve the bank supervision systems to enable banks to perform their role as external control agents of their corporate debtors. To further improve banking regulations and supervision, the study recommends: a) limits to shareholding of companies in banks and of banks in non-financial companies; b) adoption of international standards of capital adequacy for commercial banks; c) requirement for banks to follow international financial accounting, reporting and disclosure standards; d) limits to cross guarantees by companies in affiliated groups.

*3) Wean the Corporate Sector from Bank Loans by Expanding the Debt Securities Markets*

The Philippine corporate sector relied on bank loans because controlling shareholders do not want to dilute their control by issuing equities. Given this concern, the government should develop the debt securities market as a source of corporate financing. The Study recommends that the government pursue an aggressive development of the local debt securities markets. It should develop a medium-term yield curb for the corporate debt markets by strengthening the government bond market. By issuing government treasury securities in longer tenors, governments could develop the market for future issues of corporate bonds.

*4) Broaden the Supply of Equity Securities in the Stock Market.*

PSE and SEC need to build a liquid and efficient market. The PSE should campaign for toptier companies to go public. It should work with SEC in encouraging publicly listed companies to expand their share offerings to the public. The SEC should require that a larger percentage of the outstanding shares of publicly listed companies be sold to the public, for example, at least 25 percent from the present 10 to 20 percent. The increase in percentage of public holdings should be a gradually implemented over a period of time.

*5) Reform the legal and regulatory basis for the establishment and operation of investment funds and venture capital funds.*

The Philippine capital market does not have active institutional investors. In developed capital markets, institutional investors lead public investors in providing market signals to the company. The absence of institutional investors indicates that the legal and regulatory basis for the operations of investment funds is inadequate. Presently, SEC appears to be taking a primarily regulatory posture in the operation of investment funds. Its priority is to protect prospective fund investors from unscrupulous fund managers. By supporting the establishment and operation of institutional investors, the SEC and PSE can help ensure that these external control agents provide market discipline even for companies controlled by large investors. Institutional investors impose market discipline by voting their agreement or disagreement with corporate management with their checkbook.

*6) Improve External Audit Standards and Information Disclosures.*

Current disclosure requirements of SEC and external auditors are not acceptable to public investors. The quality of disclosures needs improvement. The Study recommends that SEC, PSE and PICPA mandates the adoption of international accounting standards by publicly listed companies. SEC needs to specify disclosure standards and review the system of penalties on companies and external auditors and other professionals that violate disclosure rules. SEC should strictly implement current provisions on information statements. It should encourage shareholder activism by providing shareholders better access to remedies against inadequate disclosure by management.

*7) Address the Deficiency in the Current Legal Framework for Corporate Reorganization and Liquidation, Specifically that on Suspension of Payments.*

Reforming the current law on rehabilitation and liquidation of troubled debts should be made a priority of the government. In the present system, a bureaucracy, rather than market players, decides on asset allocation, financial settlement and liquidation of financially troubled companies. The law is clearly not in line with the current government's policy of allowing market mechanisms to work and not intervening in private sector business. The law on suspension of payments replaces a market-oriented solution with a political process that, based on past cases, lacks transparency and uniform process and consistent implementation. It results in moral hazard problems to the extent that borrowers engage in shirking behavior by filing for suspension of payments to their creditors when they encounter difficulties arising from their own bad decisions. In spite of poor results, complaints by creditors and the current crisis, the government has undertaken minimal reforms in the law. The costs of corporate rehabilitation and liquidation are prohibitively high because of this law.

The Study recommends that the law be amended in a way that preserves the integrity of the original credit agreement. The rights of creditors under that agreement must be maintained. The Philippine practice is not in line with other countries in the simple aspect of maintaining creditor rights in cases of troubled debts. A simple revision of the law is to revert to the old law requiring that two-thirds majority of creditors accept any rehabilitation plan of troubled debtors. While SEC can remain an arbiter in troubled debt restructuring, this revision will enable SEC to perform its role in a transparent manner.