VII Corporate Governance

Prakash Loungani

Good "corporate governance"—the system by which corporations are directed and controlled—is critical in building market confidence and encouraging stable, long-term investment flows, particularly foreign capital flows. In addition, good corporate governance practices with respect to debt restructuring improve economic dynamism by facilitating the transfer of capital from weak firms to stronger ones.

This section examines how Philippine corporate governance practices compare with those of other countries, particularly a group of Asian comparators. The comparison covers four basic aspects of governance: shareholder rights; creditor rights; accounting, disclosure, and enforcement; and ownership and control. The main findings are the following.

- Shareholder rights are afforded about the same degree of legal protection in the Philippines as in most other Asian countries.
- There is scant legal protection for creditor rights, making the Philippines a clear outlier among the comparator countries. In addition, the process for debt resolution works in a manner that is highly prejudicial to the interest of creditors, particularly secured creditors.
- Philippine accounting standards compare favorably with those of other Asian countries, but enforcement appears to be weak.
- The dominance of a few families is a notable feature of the Philippine corporate sector; for instance, about 17 percent of total market capitalization can be traced to the ultimate control of a single family, much higher than in other Asian countries. The linkages between (nonfinancial) corporations and banks also appear to be tighter in the Philippines than in the other countries.

While no two countries' laws are identical, they are sufficiently similar in some critical respects to permit a classification of countries into legal "families." Building on the work of legal scholars, La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998; henceforth La Porta and others) identify four such families: English, French, German, and Scandinavian. English law is common law (made by judges and subsequently incorporated into legislation), whereas the other three follow civil-law tradition, which dates back to Roman law (laws made by scholars and legislators). La Porta and others show that the legal rules from these traditions differ in the extent to which they provide protection to shareholder and creditor rights, and in the degree of ownership concentration.

The Philippines belongs to the French family under this classification. The Asian comparator countries are distributed over the first three families.

English origin:	Hong Kong SAR, Malaysia, Singapore, and Thailand
French origin:	Indonesia, Philippines
German origin:	Japan, Korea, and Taiwan Province of China

Shareholders' Rights

Shareholders' rights are exercised through voting for directors and on major corporate issues. La Porta and others measure—on a scale of 0 to 6—how strongly the legal system favors minority shareholders against managers or dominant shareholders in the corporate decision-making process by (1) allowing proxy votes by mail (rather than in person); (2) not blocking selling of shares prior to a shareholders' meeting; (3) allowing cumulative voting for directors and proportional representation on the board of directors; (4) giving minority shareholders legal mechanisms against perceived oppression by directors; (5) granting shareholders a preemptive right to buy new issues of stock; and (6) setting a high percentage of share capital needed to call an extraordinary shareholders' meeting.

On average, English-origin countries offer the best protection to minority shareholders, while French-origin countries offer the least; the Philippines is a little above the average within its category (Table 7.1). In practice, the legal safeguards in the Philippines do not always secure the rights of minority shareholders. The high concentration of ownership in a few hands (described below) provides opportunity for self-dealing at the expense of outsiders.

Table 7.1. Shareholders' Rights

English-origin average	4.00
Hong Kong SAR	5.00
Malaysia	4.00
Singapore	4.00
Thailand	2.00
French-origin average	2.33
Indonesia	2.00
Philippines	*3.00*
German-origin average	2.33
Japan	4.00
Korea	2.00
Taiwan Province of China	3.00
Scandinavian-origin average	3.00
Sample average (49 countries)	3.00

Source: La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998).
Note: Shareholders' rights are measured on a scale of 0 to 6, with 0 indicating low protection of these rights.

The lack of effective enforcement and noncompliance and light penalties for violations of the law often lead to expropriation of minority shareholders' interests.[1]

Creditor Rights and Debt Restructuring

The most basic right of a senior collateralized creditor is the right to repossess—and then liquidate or keep—collateral when a loan is in default. Alternatively, creditors may have powers against borrowers through their votes in decisions on a reorganization of the company. La Porta and others measure—on a scale of 0 to 4—how strongly countries protect creditor rights by (1) not imposing an automatic stay on assets (which would prevent secured creditors from getting possession of loan collateral); (2) assuring secured creditors the right to collateral in reorganization, as opposed to giving priority to other groups, such as government and workers; (3) placing restrictions on filings for reorganization, such as creditor consent; and (4) replacing management by a party appointed by the court or the creditors during the reorganization process.

The Philippines stands out as a clear outlier in affording scant protection to creditor rights. In the sample given in La Porta and others, about 80 percent of the countries require that secured creditors be paid first, whereas roughly one-half do not have an automatic stay on assets, restrict unilateral filings of reorganization, and remove management in reorganization proceedings. In the Philippines, none of these rights are given to secured creditors, placing it below the French-origin average for creditor rights, and far below the sample average for all countries (Table 7.2).

In some countries (for example, Taiwan Province of China), a legal reserve requirement forcing firms to maintain a certain level of capital to avoid automatic liquidation serves as an alternate measure of protecting creditor rights. This alternative, however, is not available in the Philippines (Table 7.2). The Philippines also stands as an exception to the finding that creditor rights tend to be stronger in poorer than in richer countries.[2]

The formal framework for debt restructuring in the Philippines leaves much to be desired. In 1976, the Securities and Exchange Commission supplanted the court system as the venue for resolving the debts of distressed companies.[3] The Securities and Exchange Commission has the power to impose stays of actions by creditors against corporate debtors; permit debtors to suspend payments to their creditors; decide whether a debtor should be liquidated or permitted to attempt rehabilitation; and appoint receivers, members of management committees, and liquidators. The manner in which debt suspension cases are handled by the Securities and Exchange Commission appears highly prejudicial to the interests of creditors and seldom leads to the rehabilitation of distressed firms.[4] Of the 93 cases filed between 1982 and 1998, 41 had ongoing hearings, and 12 had ongoing rehabilitation—including 2 cases dating back to the 1980s (Table 7.3). There have been no instances of the existing procedures leading to the successful rehabilitation of the companies concerned.

[1]Claessens, Djankov, Fan, and Lang (1999) attempt to measure the extent of expropriation of minority shareholders' interests in East Asian countries, including the Philippines.

[2]La Porta and others suggest that this finding arises because poorer countries adapt their laws to facilitate secured lending to compensate for a lack of other financing opportunities.

[3]Creditor-debtor relations can be regulated by the courts (under the Civil Code and the Insolvency Law, enacted in 1909) or by the Securities and Exchange Commission (under Presidential Decree No. 902-A, proclaimed in 1976). As a result of the decree, and two important court decisions in 1994 and 1998, the Securities and Exchange Commission has supplanted the courts as the venue for decisions on debt resolution.

[4]The Asian Development Bank (1999) states: "The process is quite remarkable for a number of reasons. In effect, it has shifted what was once a judicial process into a quasi-judicial process. There appear to be few, if any, but the most basic rules to govern the process. It gives the appearance of being far from a transparent process. The involvement of creditors appears problematic."

Table 7.2. Creditors' Rights

	No Automatic Stay on Assets	Secured Creditors Paid First	Restrictions on Going into Reorganization	Management Does Not Stay in Reorganization	Creditors' Rights	Legal Reserve Required as a Percentage of Capital
English-origin average	0.72	0.89	0.72	0.78	3.11	0.01
Hong Kong SAR	1	1	1	1	4	0.00
Malaysia	1	1	1	1	4	0.00
Singapore	1	1	1	1	4	0.00
Thailand	1	1	0	1	3	0.10
French-origin average	0.26	0.65	0.42	0.26	1.58	0.21
Indonesia	1	1	1	1	4	0.00
Philippines	*0*	*0*	*0*	*0*	*0*	*0.00*
German-origin average	0.67	1.00	0.33	0.33	2.33	0.41
Japan	0	1	0	1	2	0.25
Korea	1	1	0	1	3	0.50
Taiwan Province of China	1	1	0	0	2	1.00
Scandinavian-origin average	0.25	1.00	0.75	0.00	2.00	0.16
Sample average	0.49	0.81	0.55	0.45	2.30	0.15

Source: La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998).
Note: Creditors' rights are measured on a scale of 0 to 4 by summing up the scores in the four previous columns.

Lim and Woodruff (1998) and World Bank (1999) identify several deficiencies in the process that need to be addressed:

- Without due process or indemnification against loss, secured creditors are prevented from exercising their contractual rights.
- The process lacks clear and coherent rules and time-bound procedures.
- There is no prohibition against assigning fiduciary powers and responsibilities for the management of distressed enterprises to individuals who have serious conflicts of interest.

Accounting, Disclosure, and Enforcement

Accounting plays a critical role in corporate governance. Contracts between managers and investors typically rely on the verifiability in court of some measures of firms' income or assets. In addition, basic accounting standards are needed to make company disclosures of information meaningful to potential investors.

Philippine accounting standards, including those dealing with consolidation, are comprehensive and appear to adequately cover all basic accounting prin-

Table 7.3. Suspension of Payments Cases Filed with Securities and Exchange Commission

	Number of Cases	Ongoing Hearings	Ongoing Rehabilitation or Liquidation	Dismissed or Withdrawn
1980s	3	0	2	1
1990 to 1996	34	13	7	14
1997	20	4	3	13
1998	36	24	0	12
Total	93	41	12	40

Source: Securities and Exchange Commission.

Table 7.4. Rating on Accounting Standards

English-origin average	70
Hong Kong SAR	69
Malaysia	76
Singapore	78
Thailand	64
French-origin average	51
Indonesia	n.a.
Philippines	*65*
German-origin average	63
Japan	65
Korea	62
Taiwan Province of China	65
Scandinavian-origin average	74
Sample average (49 countries)	61

Source: La Porta, Lopez-de-Silanes, Schleifer, and Vishny (1998).
Note: Accounting standards are measured on a scale of 0 to 100 based on examination of company reports from the different countries.

Table 7.5. Average Ownership of Ten Largest Nonfinancial Domestic Firms by Three Largest Shareholders

English-origin average	0.43
Hong Kong SAR	0.54
Malaysia	0.54
Singapore	0.49
Thailand	0.47
French-origin average	0.54
Indonesia	0.58
Philippines	*0.57*
German-origin average	0.34
Japan	0.18
Korea	0.23
Taiwan Province of China	0.18
Scandinavian-origin average	0.37
Sample average (49 countries)	0.46

Source: La Porta, Lopez-de-Silanes, Schleifer, and Vishny (1998).

ciples. In addition, the rules require disclosure of all matters that might affect the decision of an investor to buy or sell the securities of the company. All companies with quarterly sales in excess of ₱100,000 must have their financial statements audited and signed by a certified public accountant.

While Philippine accounting standards compare favorably with those of other Asian countries, enforcement appears to be weak. In a survey of 41 countries used by La Porta and others, the quality of Philippine accounting standards is rated above the sample average (Table 7.4). Lim and Woodruff (1998) report that according to users of financial statements, including banks and investment banks, accounting and disclosure standards compare favorably with those in many Asian countries. However, the same users report that enforcement by regulators is weak and auditors seldom issue caveats that might raise questions about the reliability of the information contained in client financial statements. In addition, there is no tradition of legal actions by investors and lenders against company officers or auditors in connection with cases of deficient or misleading financial reporting. The use of light penalties and extensions of amnesty on violation of disclosure requirements appear to have led to significant noncompliance.

Over time, assuming improvements in the efficiency and fairness of the judicial system, investors and shareholders may become more willing in seeking compensation for losses resulting from violations of disclosure rules and misleading financial statements. However, in the meantime, the Securities and Exchange Commission could add teeth to its regulations by imposing fines large enough to deter noncompliance. The Securities and Exchange Commission could also facilitate class actions by providing lawyers willing to represent investors, on a contingency fee basis, with access to any evidence of noncompliance by the defendants in such actions.

Ownership and Control

Concentration of ownership is the norm around the world. In the La Porta and others sample of countries, the average ownership of the three largest shareholders is 46 percent (Table 7.5). The highest concentration of ownership tends to be found in the French civil-law countries; the Philippines is close to the average for the French-origin countries.

The ultimate control of corporations is largely concentrated in the hands of families and the state, even in some of the most developed countries. La Porta, Lopez-de-Silanes, and Shleifer (1999) study the extent to which corporations in 29 rich countries are controlled by a few shareholders, that is, they trace the chain of ownership to identify the ultimate owners of capital and of voting rights in firms. In particular, they classify firms into either (1) a widely held corporation or (2) corporations with ultimate owners; the latter is divided further into four categories: family-controlled, state-controlled, con-

Table 7.6. Control of Publicly Traded Companies in East Asia
(In percent of total)

		Corporations with Ultimate Owners			
	Widely Held Corporations	Family-controlled	State-controlled	Controlled by widely held financial institution	Controlled by widely held corporation
Hong Kong SAR	7	67	1	5	20
Indonesia	5	72	8	2	13
Japan	80	10	1	6	3
Korea	43	48	2	1	6
Malaysia	10	67	13	2	7
Philippines	19	45	2	7	27
Singapore	5	55	24	4	12
Taiwan Province of China	26	48	3	5	17
Thailand	7	62	8	9	15

Source: Claessens, Djankov, and Lang (1998).

trolled by a widely held financial institution, and controlled by a widely held corporation.

There are large differences in the distribution of ultimate control across East Asian countries. Applying the La Porta, Lopez-de-Silanes, and Shleifer methodology to nine East Asian countries, Claessens, Djankov, and Lang (1998) find that family-controlled corporations form the largest category in each case, with the exception of Japan (Table 7.6). Relative to other ASEAN countries, the Philippines has a higher share of widely held corporations (19 percent) and a lower share of family-controlled corporations (45 percent).

Despite the lower overall share of family-controlled firms, the dominance of a few families is a notable feature of the Philippine corporate sector (Table 7.7). About 17 percent of total market capitalization can be traced to the ultimate control of a single family. The largest 10 families in Indonesia, the Philippines, and Thailand control one-half of the corporate sector in terms of market capitalization.

Some other findings of the Claessens, Djankov, and Lang study with respect to the Philippines are:

- The share of family-controlled firms increases for smaller-size firms, but to a lesser extent than in most other countries (for instance, the share of family-controlled firms is 40 percent for the largest 20 firms and 45 percent for the smallest 50 firms).
- The Philippines does not stand out as an outlier among the East Asian countries in the use of various other mechanisms to enhance corporate control, such as deviations from one-share-one-vote voting rights; use of pyramid structures; cross-holdings; absence of a second controlling owner; and lack of separation of control and management (Table 7.8).[5]

A high degree of ownership concentration may not necessarily be bad. Economies of scale arguments would suggest some positive correlation be-

[5]The apparent separation of management and control in the case of the Philippines is partly due to the practice of having interlocking directorates and management boards (Tan (1993)).

Table 7.7. Concentration of Family Control

	Percent of Total Market Capitalization That Families Control		
	Top family	Top 5 families	Top 15 families
Hong Kong SAR	6.5	26.2	34.4
Indonesia	16.6	40.7	61.7
Japan	0.5	1.8	2.8
Korea	11.4	29.7	38.4
Malaysia	7.4	17.3	28.3
Philippines	17.1	42.8	55.1
Singapore	6.4	19.5	29.9
Taiwan Province of China	4.0	14.5	20.1
Thailand	9.4	32.2	53.3

Source: Claessens, Djankov, and Lang (1998).

Table 7.8. Means of Enhancing Control in East Asian Corporations
(Percent of total)

	Deviations from One-Share-One-Vote[1]	Pyramids with Ultimate Owners	Cross Holdings	Absence of Second Controlling Owner	Management Is from Controlling Family
Philippines	18.7	40	7	35	42
ASEAN-3 average	18.8	40	6	36	79
East Asia average	19.2	41	9	51	67
Range	18.1 (Malaysia)	13 (Thailand)	1 (Thailand)	19 (Thailand)	37 (Japan)
	19.9 (Japan)	67 (Indonesia)	16 (Singapore)	87 (Japan)	85 (Malaysia)

Source: Claessens, Djankov, and Lang (1998).
[1]This column shows the average minimum percent of the book value required to control 20 percent of the vote.

tween ownership concentration and efficiency of operations as well as higher levels of profitability. In the Philippines, however, the top families also control most of the major banks in the country (in addition to owning and controlling major sectors of the manufacturing and services sector). The high ownership concentration and the tight linkage between the corporate and banking sectors—tighter than in many other Asian countries (Table 7.9)—has also led to a significant concentration of loans outstanding. For instance, the top 100 corporate borrowers account for 30 percent of the loans outstanding in the banking system. Combined with extensive cross-shareholdings of banks, large firms can easily circumvent prudential controls on commercial bank lending, leading to significantly higher leverage and increased vulnerability to a downturn in the economy. Moreover, controlling shareholders could become so important that they could expropriate wealth from minority shareholders.[6] For instance, in the Philippines, buyers in takeovers can deal only

[6]Morck, Shleifer, and Vishny (1988) show that as ownership becomes more concentrated in U.S. firms, the value of the firm declines, suggesting that wealth is diverted from minority shareholders through various means.

Table 7.9. Aspects of Corporate Relations with Banks

	Indonesia	Korea	Malaysia	Philippines	Taiwan Province of China	Thailand
Sources of banks' permissiveness in credit decisions	Lack of information hinders risk assessment. Central bank support of banks bailing out corporations	Elements other than risk, such as employment, are often involved in credit decisions	Some weakness in risk assessment capability	Strong influence of politicians favoring projects and "relations"	Adequate risk assessment. In case of large corporate distress, Ministry of Finance coordinates grace period	Strong ties between politicians, banks, and conglomerates. Lending to friendly parties without risk assessment
Banks' ownership of equity	Restricted	Restricted, but control is possible	Restricted	Legal	Generally not permitted	Restricted
Banks' representation on corporate boards	Rare	Usual with equity	Rare	Usual even without ownership	No	Usual

Sources: Asian Development Bank (1998); and Hussain and Wihlborg (1999).

with the owners of controlling share blocks and are under no obligation to offer the same purchase price to minority shareholders. The close relationship between banks and corporations has also encouraged both parties to exploit the arbitrage opportunities presented by the considerable distortion in the tax treatment across institutions and currency (see Section IV, Table 4.4), which allows firms to profit more from dollar intermediation through foreign currency deposit units than from peso intermediation. Arbitrage activities in response to these incentives lead to increases in exchange rate risk, credit risk, and market risk in the banking system.

To ensure that firms face proper incentives to prevent a buildup of excessive short-term and unhedged foreign borrowing, the risk and liquidity management practices in the banking system must be strengthened; distortions that have led to significant regulatory and tax arbitrage across institutions, currency, and investors must be reduced; and the supervisory oversight of the Bangko Sentral ng Pilipinas and the Securities and Exchange Commission must be improved to encourage transparency and enforce compliance with prudential regulations.

Until recently, the main prudential measures in place governing bank lending to the corporate sector were limits on the exposure of banks to a single borrower. In particular, the total liabilities of a borrower to a bank were not allowed to exceed 25 percent of the unimpaired capital of the bank; and the direct and indirect lending of banks to directors, officers, stockholders, and other related interests (DOSRI loans) were limited to 15 percent of the total loan portfolio of the bank or 100 percent of the adjusted capital accounts of the bank. Furthermore, the unsecured direct or indirect lending to DOSRIs could not exceed 30 percent of the aggregate ceiling on the outstanding direct and indirect loans, whichever was lower. During the regional financial crisis, however, the Bangko Sentral ng Pilipinas took additional measures to regulate bank lending to corporate borrowers and to level the playing field between dollar and peso intermediation. These measures include, inter alia (1) preventing overexposure to the real estate sector by reducing the limit on property loans from 30 percent to 20 percent of a bank's total loan portfolio; (2) reducing the ratio of loans against acceptable collateral from 70 percent to 60 percent of the appraised value; (3) reducing the statutory reserve requirements on peso deposits to 10 percent from 15 percent, and imposing a 7.5 percent withholding tax on foreign currency deposits; (4) requiring that foreign currency deposit units maintain 100 percent cover on liabilities, with at least 30 percent of the cover required to be in the form of liquid assets; and (5) reducing tax arbitrage opportunities by requiring that interest expense savings be limited to 20 percent.

While these measures are in the right direction, more can still be done. In particular, the tax on peso intermediation remains relatively high while enforcement of prudential regulations can be made stricter by imposing stiffer penalties for noncompliance.

Conclusions

Philippine corporations were able to withstand the Asian crisis fairly well. Unlike corporations in other Asian crisis countries, most corporations in the Philippines entered the crisis period with manageable levels of total indebtedness and exposure to foreign debt. Furthermore, exports remained robust (as discussed in Section V).

Nevertheless, the survey conducted above reveals that much can be done to improve corporate governance in the country. In particular, strong efforts are needed to:

- afford greater protection to creditor rights;
- reform the policy and administrative framework for debt resolution and insolvency;
- improve enforcement of accounting standards and disclosure rules; and
- ensure that banks adhere to high standards for prudential lending, particularly with respect to DOSRI limits and loans to related corporate borrowers.

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