A Country Paper on
CORPORATE OWNERSHIP AND CORPORATE GOVERNANCE: ISSUES AND CONCERNS IN THE PHILIPPINES

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Corporations today are responsible for generating the majority of world economic activity. They are prominent players in all markets, ranging from goods and services to capital and human resources. The ability of corporations to attract investments, generate profits and create employment has direct bearing on the economic prosperity of the countries where these corporations are located.

The Asian economic crisis and the collapse of regional capital markets have focused attention on fundamental regulatory weaknesses in Asia's financial and corporate sectors. Concerns relating to unsound investment practices, poor standards of disclosure and accountability of large corporations, and the degree to which these contributed to the recent economic destabilization of the Asia Pacific region are now being aired. Government officials and business people are in the process of reforming corporate governance structures in Asian businesses to help restore economic stability and revive investor confidence.

On the other hand, these structures are also being reformed in response to the forces of globalization. "Stewardship" of corporations based on internationally accepted models is relevant to the process of Asian reform because it defines standards of structure, conduct and public accountability for the direction and control of corporations. The stakeholders of companies continue to expand, and building credibility in this new environment demands an adherence to principles that can be recognized, respected and understood by a broader regional and global community.

Corporate Governance in the Philippines[1]

When the Asian crisis came in 1997, the Philippine government was in an advantageous fiscal position, the financial system was strong, and the corporate sector had accumulated internal funds from three years of robust profits. More importantly, the Asian crisis did not catch the corporate sector investing, and financing it by debt, into a recession. The Asian financial crisis revealed that the Philippine non-financial corporate sector has been a relatively efficient user of

[1] This section largely cites Dr. Cesar Saldana's paper entitled "Philippine Corporate Governance Environment and Policy and their Impact on Corporate Performance." The paper was presented in a Conference on Corporate Governance in Asia: A Comparative Perspective held in Seoul from 3-5 March 1999.

funds of Philippine savers. (Although there were indications of over-expansion using leverage a few years before the 1997 Asian crisis.)

Looking at the Philippine corporate governance environment however, four structural issues still need to be addressed. These issues revolve around ownership structures and control systems, affecting the country's corporate governance environment and limiting future economic growth.

1. ***Most publicly listed companies are not widely held by public investors.***

According to Michael Jensen[2], ownership is the key element in corporate control and governance. Of the four central forces that resolve problems regarding the compatibility of corporate decisions and social good, Jensen notes that two – external control through the capital market and the corporate internal control system –depend on the degree of share holding.[3]

Companies that are publicly listed *and* widely held enable dissatisfied shareholders to exit by selling their shares. Capital market investors control these companies and discipline management of companies toward broad, market standards of efficiency. In under-developed capital markets, publicly listed companies may not be widely held by public investors. In that case, external control is not present. In the Philippines, public listing rules require public issuance of only 10 to 20 percent of outstanding shares. Ownership by large shareholders of publicly listed companies limits the trading of those shares. Public investors could not readily influence the price of shares through their trading activities. The growth and survival of those companies then depend on the effectiveness of control systems within the company's organization. Because large shareholders manage these internal control systems, any disciplining force generated by such systems is about equal to that coming from self-control.

Degree of ownership defines management control. The Philippine Corporation Code requires approval of management decisions by a majority vote of the board of directors. Strategic decisions, because of their major impact on a company, require a two-thirds majority. On average, the largest five shareholders held sufficient majority ownership to approve operating and strategic management decisions of companies. Minority shareholders could not achieve majority without the support of one or more of the five largest shareholders. Well-organized minority shareholders can probably elect only a member of the board of directors and even then only with effective use of cumulative voting privileges. Concentration of ownership at these high levels reveal that publicly listed Philippine companies are not truly publicly owned. Many companies listed in the Philippine stock exchange have issued only the minimum number of shares

[2] Michael Jensen. "The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems," Journal of Finance, 48, pp. 831-80 (1993)
[3] The other two are legal/regulatory systems and product/factor markets. The product/factor markets provides the ultimate discipline because a firm could not survive if it does not provide products and services competitively.

needed to gain public listing. By limiting the ownership shares issued to public investors, controlling shareholders reduce minority shareholders to passive roles in corporate governance.

2. ***Large shareholders that dominate ownership of companies pursue a financing policy characterized as trading-on-equity, resulting in further dominance by these companies in their industries.***

In many Asian countries, large shareholders controlling corporate groups emerged from development policies of the government and historical circumstances that enabled certain entrepreneur groups to accumulate capital. When capital markets and legal structures are weak, shareholders deal with the problem of moral hazard in governance by accumulating controlling ownership shares. The Saldana study investigated the importance of these shareholder groups and the characteristics of this control structure. And concluded that the conduct and structure of corporate groups were molded by the government's past industrial and infrastructure development policies and the recent emergence of new industry leaders. There was a high concentration of industry sales in a few leading companies. Large shareholders owned dominant companies. To leverage their holdings, large shareholders organized their companies into conglomerate groups. These corporate groups gathered capital and allocated them to an internal market of affiliates. To ensure a continuing flow of external financing, they acquired active minority or majority ownership of a large commercial bank. Due to social benefits generated by their businesses (e.g., employment, tax payment, etc.) their leading shareholders gained influence in society and government. Large shareholders leveraged this influence by entering industries that have high entry barriers. Dominant ownership shares and assurance of bank financing for the corporate group were the means whereby large shareholders achieved control of corporate groups.

Groups of companies in the Philippines operate at varying degrees of effective central control. Some members of the groups have autonomous operations. They separate operating management from central control and allow them to raise their own financing without gross guarantees. Other corporate groups have a central management that makes all major investment and financing decisions for the group. Philippine corporate groups are characterized by the presence of a large family-based shareholder group, majority or active minority ownership of affiliate companies, and a CEO who is a large shareholder. Philippine groups of companies tend to diversify toward industries related to the flagship company's business. This strategic direction ensures availability of competent management within the group and scale economies from central purchasing, logistics and financing.

Corporate governance depends on ownership type and control by corporate groups. Owners with greater control are more likely to avoid management inefficiencies (that is, the moral hazard problem of management-controlled companies) but may tend to over-borrow, knowing they could pass on any loss from credit-financed projects to creditors (that is, the moral hazard problem of creditors). Stated another way, corporate groups can be expected to show good profitability but may have higher leverage risks.

3. ***Corporate groups with affiliate banks enjoy advantages in terms of access to financing and economies of investments and operation in related industries.***

Groups of companies commonly include commercial bank and other financial institutions like insurance and finance companies. Large shareholders either directly owned these banks or controlled them through companies that they owned. Commercial banks hold the largest share of financial resources in the country. Past government policies sought to ensure stability in the financial system through regulations at the expense of growth and competition. Past government policies restricted entry, set up minimum capital requirements and limited the number of local branches and foreign bank operations in the Philippines. With the capital markets still underdeveloped, commercial banks came to control the financial resources of the system and to capture excess profits in the process. Corporate financing depended on intermediation by commercial banks. Large groups responded by acquiring significant ownership of commercial banks. Once banks were part of a corporate group, member companies of the group improved their prospects for accessing loans at favorable interest rates and terms. BSP (Bangko Sentral ng Pilipinas, the Philippine Central Bank) introduced major reforms to strengthen the banking system and increase competition. Some of these reforms are the liberalization of interest rates and foreign exchange in the 1980s, entry of foreign banks in the 1990s, and as a response to the Asian crisis, increased capital requirements.

BSP's reforms are probably changing the conduct but not necessarily the structure of banks.In particular, banks' ownership remains large shareholder and family-based. Through common ownership, ties of commercial banks with corporate groups of companies remain strong.
Concentration of ownership in banks weakens the regulatory capacities of BSP. To accelerate recovery from the crisis, BSP sought to reduce the lending rates by bringing down Treasury bill rates, the bellwether for lending rates. It did not get the expected response from banks. Foreign banks increased in number but not local banks still dominated domestic credit and deposit markets. By raising capital requirements, BSP wants to strengthen the capital base and increase the size and stability of banks as a safeguard against future financial crisis. However, capital build-up demonstrates the advantage of corporate groups in raising capital from their own internal capital market. Increasing capital shall heighten the concentration of ownership and expand the scope of own-group lending by these larger banks in the future. Several banks merged after the Asian crisis in a

process that involved divestments by large shareholder group and increased ownership by another.

4. ***The regulatory framework for corporate governance is inadequate in the context of Philippine conditions like large shareholder-dominated companies, corporate groups and ownership of banks by groups of companies.***

The Philippine Corporation Code and the main agency enforcing it, the SEC, are patterned after their U.S. counterparts. SEC requires all securities to be registered with the registry open for inspection to the public. Corporate stock and transfer books are open for inspection by the company's stockholders. Basic rights of shareholders are adequately protected. Shareholders enjoy one-share-one- vote rule, with proxy voting legally allowed and practiced. The Corporation Code requires the annual general shareholder meeting (AGSM) to confirm decisions of management. A shareholder can voice out his/her concern during AGSM without any required minimum shareholdings for such privilege. However, since the minority shareholders could not influence the vote, since there is no real discussion of board decisions during such meetings. Major transactions of the company require approval by two-thirds majority vote of shareholders. Examples of these transactions are as amendment of the articles, bonded indebtedness, sale of major corporate assets, investments in other companies and mergers.

Shareholders have preemptive rights under the law but the right can be denied or waived in a company's articles of incorporation. An important concern given the large shareholder groups in the Philippine corporate sector is the possible conflict of interest on transactions by managers or large shareholders. There are provisions addressing dealings by the company with directors or officers, contracts between corporations with interlocking directors and for cases when directors are in businesses that compete with the company. These explicitly identified cases require approval by the board of directors. There is no requirement of disclosure to shareholders unless transactions are presented to them for approval. A special case of conflict of interest is insider trading. The Revised Securities Act specifically prohibits insider trading and provides for strict liability by presuming violation of insider trading rules when directors, officers and principal shareholders conduct trades around insider information dates. Insider trading regulations are important because most publicly listed companies have a high degree of owner concentration and are thinly traded. However, enforcement has always been a question. Nobody has been successfully prosecuted for insider trading although SEC and the media have discussed various possible insider trading cases. The much-celebrated BW scandal in recent months appears to be the biggest insider trading case being faced by SEC, but that is still far from being resolved due to the politicking that continues because of it.

In sum, the legal framework for shareholder rights is generally adequate. However, in practice, shareholder protection is eroded by the dominance of large shareholders in corporations even for major decisions involving two-thirds vote. A serious limitation of the legal framework is its inability to protect minority investors from management dominated by large shareholders in areas involving conflict of interest and insider trading. There is very little deterrent on management regarding conflict of interest because at worst, the Corporation Code only requires special approval by two-thirds vote in AGSMs that can be done due to dominant control by large shareholders. Insider trading regulations has been poorly enforced in the past although there is hope in the current revision of the law.

The board of typical Philippine large public company is composed of between seven to 11 members representing the largest shareholders of the company. There is no requirement in law or in practice of representing stakeholders on boards. The board of directors is not explicitly mandated by the Corporation Code to consider the interest of minority shareholders. The Corporation Code prohibits the removal of a director without cause only if minority shareholders shall lose their representation in the board of directors as a result of such action. Interlocking directorates are common and extensive, especially for corporate groups. Directors are elected during the GM by shareholders. Outside directors are not common and not mandatory. Outside directors, if present, are brought in by controlling shareholders. Having an “independent” director is not acceptable for most companies because family members and close associates prefer to discuss business issues of highly confidential nature within the family.

A stockholder can file a derivative suit against its directors. The SEC is the special body that handles conflicts involving corporations and their shareholders. Although intended to speed up resolutions of intro-corporate conflicts, SEC proceedings are known to be costly and take a very long time to resolve. In effect, enforcing the protection of minority shareholders through the courts is costly and not effective.

The Real Issue: Dynamics of Philippine Corporate Ownership

Again emphasizing the point that these four issues essentially revolve around the ownership structure of Philippine corporations, it would be important to note that the familial aspect of the culture is the single greatest factor that has shaped Philippine corporate ownership (and Philippine politics as well) throughout the country’s history. Sociologist Yasushi Kikuchi (in McCoy, 1999) argues that “Filipinos define kinship bilaterally,[4] thus widening their social networks and narrowing their generational consciousness. Instead of learning the principle of family loyalty by revering distant male ancestors, Filipinos act as principals in ever-extending bilateral networks of real and fictive kin.”

[4] Bilateral kinship is defined as ancestry that is traced through both the mother’s and the father’s line.

Once a stable "kinship network" is formed, such familial coalitions bring some real strengths to the competition for political office and profitable investments. In his book "An Anarchy of Families: The Historiography of State and Family in the Philippines," Alfred McCoy mentions that a kinship network has a unique capacity to create an informal political team that assigns specialized roles to its members, thereby maximizing coordination and influence. He cites an example during the postwar Republic, that when Eugenio Lopez became a leading businessman in Manila, his younger brother Fernando was an active politician at both the provincial and national levels. In particular, pursuing the state's economic largesse can depend upon the success of such teams, or kin-based coalitions, in delivering votes to a candidate for national office (say, senator or president). If elected, the politician will repay the investment many times over through low-cost government credit, selective enforcement of commercial regulations, or licenses from state-regulated enterprises such as logging and broadcasting.

Philippine political parties usually have acted as coalitions of powerful families. As the Marcos era demonstrated, regimes can become the equivalent of the private property of the ruling family. In the postwar period leading banks were often extensions of family capital. In his studies of Philippine banking, political scientist Paul Hutchcroft has found that "There is little separation between the enterprise and the household, and it is often difficult to discern larger 'segments of capital' divided along coherent sectoral lines." (in McCoy, 1999)

Similarly, the chief of the Securities and Exchange Commission, Rosario Lopez, noted in a July 1992 paper that only eighty corporations among the country's top 1,000 were publicly listed because most Filipino companies "are actually glorified family corporations." Noting that Filipinos seem to prefer relatives as partners and shareholders, Lopez explained that "There are sociocultural practices that endanger the situation, particularly the Filipino habit of having [an] extended family concept. In the Philippine political economy, banks and other major corporations are often synonymous with the history of a few elite families and their rent-seeking practices.