3
The Philippines

Cesar G. Saldaña[1]

3.1 Introduction

In recent years, the Philippine corporate sector has played a leading role in the government's efforts to get the country on track toward sustainable economic development. This has come about following a political and economic upheaval from 1983 to 1987, about a decade before the recent Asian crisis. Issues such as State ownership of businesses, state-sanctioned monopolies, and government subsidies were tackled during that period, aiming at eventually limiting the Government's role to economic policy setting and allowing the private sector to conduct most economic activity. The Government pursued the privatization of various state-owned corporations as part of its financial rehabilitation programs sponsored by the World Bank and the International Monetary Fund (IMF).

The lifting of the debt moratorium in 1991, after the completion of debt negotiations with the IMF and Paris Club, allowed the Government and the corporate sector to gradually access foreign debt markets after a long absence. Companies of other Asian countries were already using these markets to finance investment and growth. When the Asian crisis erupted in 1997, the Philippine economy and corporate sector were in a relatively sound financial position. From 1993 to 1996, healthy profits from the previous five years and new equity raised through successful initial public offerings (IPOs) in a robust stock market allowed the corporate sector to accelerate investments and borrowings. The Asian financial crisis revealed that, overall, the Philippine nonfinancial corporate sector had managed its borrowing risks relatively well by largely avoiding imprudent use of debts and risky investments.

---

[1] Principal, PSR Consulting, Inc., the Philippines. The author wishes to thank Juzhong Zhuang, David Edwards, both of ADB, and David Webb of the London School of Economics for their guidance and supervision in conducting the study, the PSR Consulting, Inc. staff, in particular Francisco C. Roble, Denise B. Pineda, and Liza V. Serrana, for their research assistance, the Philippine Stock Exchange for its help and support in conducting company surveys, and Lea Sumulong and Graham Dwyer for their editorial assistance.

Still, the corporate sector showed structural weaknesses similar to those in neighboring Asian countries. The highly concentrated and family-based ownership of corporate groups has resulted in governance structures that depend largely on internal control systems. Investments of large corporate groups tend to focus on obtaining market shares and industry dominance. Corporate financing relies excessively on bank loans. Companies finance long-term investments with short-term debt, usually with the acquiescence of bank creditors. Banks have significant presence as members of affiliated business groups, which leads to their easing of due diligence and monitoring standards when lending to group members.

This study reviews the Philippine corporate sector in terms of its historical development, regulatory framework, patterns of ownership, control by internal and external governance agents, patterns of financing, and responses to the financial crisis. It analyzes the impact of corporate governance on company financial performance and financing, on family-based and controlled conglomerates, and on the financial crisis.

3.2 Overview of the Corporate Sector

3.2.1 Historical Development

During the 1950s and 1960s, nationalist sentiments led to policies that favored import substitution and heavy government intervention in business. To implement these policies, the Government overvalued the local currency and imposed high import tariffs. Companies were profitable because of protection from foreign competition. But protectionist policies made labor relatively more expensive and, therefore, companies were necessarily large and capital-intensive. While new manufacturing industries were successfully established, their growth could not be sustained. An industrial elite, composed mostly of families previously in trading businesses, emerged to influence industrial policies. These early industrialists naturally opposed any initiative to reduce tariffs, yet they did not risk new capital required for modernizing and expanding manufacturing capacity. Sugar refining and textile mills are examples of industries that floundered in the 1980s because of government import substitution policies.

Government interventions under the notion of "master planning" for economic and social development characterized the 1970s and early 1980s. The policy was crafted by the martial law regime at that time. The Board of Investments (BOI) was created to draw up an investment priorities

plan (IPP) to encourage private sector investments by offering tax and other incentives. The Government signaled through the IPP its intent to shape the future industrial landscape, organizing industries into sectors and picking "winners." No strategic industry could take off without the Government's participation in its management and operations. Foreign ownership was allowed only in industries with high technological and market barriers, i.e., the "pioneer" industries identified in the IPP. Quantitative restrictions and tariff protection of preferred industries remained firmly in place. Exports were not competitive because of the high costs of imported materials. Following government initiatives in the control of the infrastructure and utilities sectors, the State took over the generation and distribution of electricity, assumed ownership of the largest petroleum refining company, and initiated the development of alternative energy sources in response to the oil crises.

The 1980s were marked by a peaceful transition of political power. Reforms in policies, including the reduction of tariffs, quantitative restrictions, and import licensing requirements, clearly shifted economic management toward reliance on markets rather than on decisions by bureaucrats in the Government. Better access to cheaper imported raw materials improved the competitiveness of local manufacturers. Starting in 1981, the Government continuously revised the enabling law of BOI so that incentives were reduced in number, made less associated with capital investments, and oriented toward exports. Nevertheless, BOI incentives retained a strong bias in favor of capital-intensive enterprises and domestic-oriented industries.

In the early 1990s, the Government narrowed the range of tariff rates by commodity categories and reduced the average tariff rate from 28 to 20 percent. In 1991, the legislative body passed the Foreign Investment Act (FIA). The FIA allowed foreign equity investment in many areas and at the same time provided a transparent, advance notice of areas where the country disallowed or restricted foreign investment. It limited the bureaucratic cost and discretion that accompanied the necessary approvals of foreign investments.

Probably the most significant effects of tariff protection and biases for capital intensity were the corporate sector's high degree of concentration, dominance by large companies, and orientation toward domestic markets. In many industries, the top three companies accounted for a disproportionately large share of total sales and assets. The high industrial concentration led to practices of price leadership and output restrictions and the rise of industry lobby groups—common features of an oligopolistic

market. With economic reforms introduced in the 1980s and 1990s, however, competition from liberalized imports had somewhat reduced oligopolistic tendencies and concentration in many industries.

A comparison of the Philippines' economic performance in terms of real gross domestic product (GDP) growth with selected countries in Southeast Asia places the succeeding review of the corporate sector's performance in context. The Philippines substantially lagged behind other countries from 1990 to 1995 (Table 3.1). Its growth rate began to catch up with others in 1996, only to be unsettled by the crisis of 1997.

Table 3.1
GDP Growth of Southeast Asian Countries, 1990-1999
(percent)

Year	Indonesia	Korea, Rep. of	Malaysia	Philippines	Thailand
1990	9.0	9.5	9.7	3.0	11.2
1991	8.9	9.1	8.6	(0.6)	8.5
1992	7.2	5.1	7.8	0.3	8.1
1993	7.3	5.8	8.3	2.1	8.3
1994	7.5	8.3	9.2	4.4	9.0
1995	8.2	8.9	9.8	4.7	8.9
1996	7.8	6.8	10.0	5.8	5.9
1997	4.7	5.0	7.5	5.2	(1.7)
1998	(13.2)	(6.7)	(7.5)	(0.5)	(10.2)
1999	0.2	10.7	5.4	3.2	4.2

Source: ADB, *Key Indicators of Developing Asian and Pacific Countries 2000.*

3.2.2 Growth and Financial Performance

Performance of All Companies

The analysis of corporate performance in this section used financial data from the Securities and Exchange Commission (SEC)-*BusinessWorld* Annual Survey of Top 1,000 corporations, which was taken as a representation of the Philippine corporate sector.[2] During 1988-1997, net sales of the top 1,000 Philippine companies grew 17.5 percent per year (Table 3.2). This rate of growth was sustained by a comparable 18.8 percent growth in fixed

[2] The SEC-*BusinessWorld* Annual Survey of the Top 1,000 Corporations covers financial and nonfinancial companies. In this section, only nonfinancial companies were used.

Table 3.2
Growth and Financial Performance of the Top 1,000 Companies, 1988-1997

Indicators	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	Compound Growth (%)
Growth Indicators (P billion)											
Net Sales	464.7	519.1	629.6	741.3	862.3	954.1	1,177.6	1,394.0	1,697.5	1,978.9	17.5
Net Income	28.4	33.6	35.2	46.5	64.8	72.9	144.4	148.3	193.5	96.5	14.6
Fixed Assets	260.8	290.2	378.4	411.9	480.9	617.2	776.9	941.2	1,191.4	1,225.9	18.8
Total Assets	618.6	707.1	861.4	952.6	1,123.5	1,317.1	1,781.2	2,341.1	3,160.1	3,893.9	22.7
Total Liabilities	426.5	468.7	555.3	570.1	615.3	714.4	900.1	1,209.7	1,647.5	2,332.4	20.8
Stockholders' Equity	192.1	238.4	306.1	382.5	508.2	602.7	881.2	1,131.4	1,512.7	1,561.5	26.2
Retained Earnings	51.4	63.1	95.8	136.4	188.6	218.0	338.0	411.7	443.6	446.9	27.2
Financial Ratios (%)											**Average**
Leverage	222	197	181	149	121	119	102	107	109	149	146
ROE	14.8	14.1	11.5	12.2	12.8	12.1	16.4	13.1	12.8	6.2	12.6
ROA	4.6	4.7	4.1	4.9	5.8	5.5	8.1	6.3	6.1	2.5	5.3
Turnover	75	73	73	78	77	72	66	60	54	51	68
Net Profit Margin	6.1	6.5	5.6	6.3	7.5	7.6	12.3	10.6	11.4	4.9	7.9
Other Indicators											
No. of Companies	899	887	896	903	902	900	898	900	898	896	898
Sales per Company (P billion)	0.5	0.6	0.7	0.8	1.0	1.1	1.3	1.6	1.9	2.2	1.2

Leverage = total liabilities/stockholders' equity, net profit margin = net income/net sales, return on assets (ROA) = net income/total assets, return on equity (ROE) = net income/stockholders' equity, turnover = net sales/total assets.
Source: SEC-*BusinessWorld* Annual Survey of Top 1,000 Corporations in the Philippines.

assets. Net income consistently increased from 1988 to 1996 and declined only in the crisis year 1997. Total assets grew at an average annual rate of 22.7 percent. Asset growth was funded by debt that grew at an average of 20.8 percent per year, and by equity that grew at a higher average annual rate of 26.2 percent. The data suggest no evidence of excessive borrowing in the run-up to the crisis in 1997.

Return on equity (ROE) and return on assets (ROA) averaged 12.6 percent and 5.3 percent, respectively, for the 10-year period. These rates of return are high compared with other Asian countries. The debt-to-equity ratio ranged from 222 percent in 1988 to 102 percent in 1994. This is high compared with developed countries but compares favorably with other Asian countries. Further, leverage increased from 109 percent in 1996 to 149 percent in 1997, but the extent of the increase was not as dramatic as in other Asian countries, indicating that the corporate sector's exposure to foreign currency-denominated loans was not as significant as in other countries. Net profit margins for the top 1,000 companies averaged 7.9 percent for the period.

The growth rates of corporate sales for the period 1988-1997 exceeded those of the country's GDP for the same period (Table 3.3). Assuming

Table 3.3
The Corporate Sector and Gross Domestic Product, 1988-1997

		Top 1,000 Companies	
Year	**GDP (P billion)**	**Net Sales (P billion)**	**Ratio of Estimated Value Added[a] to GDP (%)**
1988	799	465	17.5
1989	925	519	16.8
1990	1,077	630	17.5
1991	1,248	741	17.8
1992	1,352	862	19.1
1993	1,474	954	19.4
1994	1,693	1,178	20.9
1995	1,906	1,394	21.9
1996	2,172	1,697	23.4
1997	2,427	1,979	24.5
Average Growth (%)	**13.1**	**17.5**	

[a] Value-added is assumed to be 30 percent of net sales.
Sources: ADB, *Key Indicators of Developing Asian and Pacific Countries 1999;* and the SEC-*BusinessWorld* Annual Survey of Top 1,000 Corporations in the Philippines, various years.

a constant ratio of value added to sales, these figures suggest a significant and increasing contribution of the corporate sector to GDP.

A study of company performance by ownership type, size, corporate control structure, and industry reveals further structural characteristics of the growth and financial performance of the corporate sector. The premise is that these variables have a direct bearing on corporate performance and growth.

Performance by Ownership Type

The Philippine corporate sector can be categorized into four groups based on ownership: (i) publicly listed, (ii) foreign-owned, (iii) Government-owned, and (iv) privately owned. Averaging 42.8 percent of the corporate sector's total sales between 1988 and 1997, privately owned companies constituted the largest group (Table 3.4). The foreign-owned companies were the

Table 3.4
Growth and Financial Performance of the Corporate Sector by Ownership Type, 1988-1997

Indicators	Publicly Listed	Privately Owned	Foreign-Owned	Government-Owned
Growth Indicators (Compound Annual Growth Rate, %)				
Net Sales	20.0	17.3	21.8	4.0
Net Income	19.4	22.0	3.9	4.3
Fixed Assets	19.6	28.4	26.3	9.8
Total Assets	29.4	28.5	22.8	14.1
Total Liabilities	26.4	27.0	22.9	12.9
Stockholders' Equity	32.5	31.8	22.7	17.0
Retained Earnings	30.1	2.9	22.0	5.4
Financial Ratios (%)				
Leverage	89	158	142	190
ROE	15.1	13.0	22.2	5.7
ROA	8.0	5.2	9.3	2.1
Turnover	53	103	146	22
Net Profit Margin	15.5	5.3	6.3	10.3
Other Indicators				
Share of Sales (%)	17.8	42.8	27.9	11.5
No. of Companies	73	606	196	23
Sales per Company (P billion)	2.5	0.8	1.5	4.8

Source: SEC-*BusinessWorld* Annual Survey of the Top 1,000 Corporations in the Philippines, various years.

second largest at about 27.9 percent, followed by publicly listed ones. Publicly listed companies had a minor though steadily increasing share in total sales. Only 84 of the 221 public companies listed on the Philippine Stock Exchange (PSE), or 38 percent, were among the top 1,000 companies in 1997, meaning that the remaining 62 percent were relatively small in sales and assets. However, while there were few of them, these companies were comparatively large, selling an average of P4.1 billion per company in 1997, compared with P2.75 billion per company for foreign-owned companies. The privately-owned companies were only about one third of the average size of per company sales of the publicly listed companies. Government-owned companies in the top 1,000 list, although small in number, registered the largest per company sales at about P9 billion in 1997. These were mostly large public utilities.

The compound annual sales growth rate was 21.8 percent for foreign-owned companies and 20 percent for publicly listed companies during 1988-1997, exceeding the 17.5 percent average growth rate of the entire corporate sector. Privately-owned and Government-owned companies grew at slower rates. With an average leverage ratio of 142 percent, a level high by Western standards but at par with those of other Asian countries, foreign-owned companies borrowed more than publicly listed ones. But by being most efficient in employing assets, they generated the highest return on investments, with an average ROE of 22.2 percent and ROA of 9.3 percent. Publicly listed companies had the lowest leverage at 89 percent, the highest net profit margin of 15.5 percent, reflecting the significant presence of holding companies as the gross revenues of holding companies flow through to operating income, the second best ROE and ROA, and the second lowest asset turnover. The government-owned companies had the highest leverage at 190 percent but lowest ROA and ROE because these are primarily public utilities and companies in the energy sector where turnover is low, the asset base is large, and low return on investment is the norm. It should also be added that the profit margin of Government-owned companies is distorted by the presence of holding companies such as the Philippine National Oil Company, Bases Conversion Development Authority, and government-subsidized agencies such as the National Food Authority and Local Water Utilities Administration. The privately-owned companies had a high average leverage ratio of 158 percent. Their ROA and ROE were both more than twice as high as those of government-owned companies, but lower than those of foreign-owned and publicly listed companies.

Performance by Control Structure

By control structure, a company can be a member of a conglomerate or independent. The independent companies contributed about 56 percent of corporate sales on average during the period 1988-1997, compared with 32.3 percent for the conglomerates. But the conglomerates were larger measured in sales per company, grew faster, had a lower leverage ratio, and achieved higher returns on invested assets than independent companies (Table 3.5).

Table 3.5
Growth and Financial Performance of the Corporate Sector by Control Structure, 1988-1997

Indicators	Group Member	Independent
Growth Indicators (Compound Annual Growth Rate, %)		
Net Sales	20.2	18.7
Net Income	21.2	2.0
Fixed Assets	25.7	25.2
Total Assets	32.3	23.0
Total Liabilities	30.7	22.4
Stockholders' Equity	34.1	24.6
Retained Earnings	32.3	26.0
Financial Ratios (%)		
Leverage	98	166
ROE	15.8	15.8
ROA	8.0	6.1
Turnover	67	124
Net Profit Margin	12.3	5.0
Other Indicators		
Share in Sales (%)	32.3	55.6
No. of Company	159	715
Sales per Company (P billion)	2.1	0.8

Source: SEC-*BusinessWorld* Annual Survey of Top 1,000 Corporations in the Philippines, various years.

Performance by Firm Size

By firm size, the corporate sector is divided into large, medium, and small companies, depending on assets and sales. Sales and resources of the

Philippine corporate sector are highly concentrated among the large companies, which, for this study, are defined as the largest 100 companies in the top 1,000 list. Sales per company in this group averaged P13.4 billion in 1997. Medium-sized companies, defined in this study as the next 200 largest companies in the top 1,000 list, averaged a far less P3 billion in per company sales, while small companies, referring to the remaining companies in the list, averaged only P920 million in per company sales during the same year.

Large companies accounted for 56.1 percent of the total sales of the corporate sector, although they comprised only 8.8 percent of the total number of companies in the list (Table 3.6). However, sales of medium-sized companies grew faster than large companies. Medium-sized companies also performed better in terms of ROE, averaging 16 percent, indicating that they deployed resources more efficiently than large and small companies.

Table 3.6
Growth and Financial Performance of the Corporate Sector by Firm Size, 1988-1997

Indicators	Large	Medium	Small
Growth Indicators (Compound Annual Growth Rate, %)			
Net Sales	15.7	19.6	19.9
Net Income	1.3	47.2	26.2
Fixed Assets	15.5	29.9	25.4
Total Assets	18.4	32.5	28.1
Total Liabilities	18.2	25.6	25.0
Stockholders' Equity	18.9	49.6	32.7
Retained Earnings	13.9	36.0	44.5
Financial Ratios (%)			
Leverage	158	156	128
ROE	13.1	16.0	10.1
ROA	5.3	7.1	4.5
Turnover	65	81	73
Net Profit Margin	8.2	9.5	6.6
Other Indicators			
Share in Sales (%)	56.1	12.9	31.0
No. of Companies	79	89	730
Sales per Company (P billion)	7.3	1.6	0.5

Source: SEC-*BusinessWorld* Annual Survey of Top 1,000 Corporations in the Philippines, various years.

Small companies, although the largest in number, showed the lowest ROE, averaging 10.1 percent. Poor returns appear to have been caused by the low profit margin at 6.6 percent, compared with 9.5 percent for medium-sized companies and 8.2 percent for large ones. Medium-sized companies apparently enjoyed efficiencies associated with economies of scale and made more productive use of their assets.

The Asian financial crisis affected large companies most severely, with their ROE dropping to 3.8 percent in 1997, from 14.8 the previous year. ROE dropped from 10.7 percent in 1996 to 8.7 percent in 1997 for medium-sized companies. For small companies, ROE dropped to 7.4 percent in 1997 from 11.7 percent a year earlier. Leverage was the highest for large companies, at 158 percent on average during 1988-1997. Medium-sized companies' leverage level was slightly lower, at 156 percent. But small companies' leverage was significantly lower, at 128 percent for the period. Large- and medium-sized companies did not substantially increase their leverage in years running up to the crisis in 1997, unlike their counterparts in other Asian countries.

Performance by Industry

This study also looked at corporate performance by industry, specifically those industries least and most affected by the financial crisis. The growth and financial performance of selected industries, i.e., manufacturing, utilities, real estate, and construction, are shown in Table 3.7. Manufacturing companies represented more than half of the corporate sector in number in the period 1988-1997 and accounted for about 82 percent of total sales. The sector showed consistent growth in sales, profits, assets, and equity up to 1996, but suffered its largest decline in net profits in 1997, as indicated by the negative annual growth, at -12.8 percent, of net income. Net income declined from P54.1 billion in 1996 to P4.2 billion in 1997 for this sector. The leverage ratio of the manufacturing sector was higher than that of the real estate and property sector, but lower than that of construction, and utilities and services sectors.

Growth of sales, net income, and assets was much higher for the real estate and property, and the construction sectors than for the manufacturing, and utilities and services sectors, reflecting to some extent a "bubble" phenomena in the former two sectors, especially during the period 1994-1996. The real estate and property sector also suffered significantly in sales, net income, and profitability in 1997 when the crisis started. Sales revenue and net income declined from P76.7 billion and P35.8 billion in

Table 3.7
Growth and Financial Performance of the Corporate Sector by Industry, 1988-1997

Indicators	Manufacturing	Utilities and Services	Real Estate and Property	Construction
Growth Indicators (Compound Annual Growth Rate, %)				
Net Sales	16.9	17.7	39.2	27.3
Net Income	(12.8)	17.3	37.8	55.9
Fixed Assets	20.5	12.4	48.2	23.0
Total Assets	19.4	19.6	45.7	23.0
Total Liabilities	18.3	20.8	52.8	25.7
Stockholders' Equity	21.4	16.3	41.7	19.0
Retained Earnings	17.1	10.6	28.6	21.7
Financial Ratios (%)				
Leverage	142	181	69	192
ROE	13.9	5.7	16.7	9.1
ROA	5.9	2.0	10.1	2.7
Turnover	112	24	24	83
Net Profit Margin	5.2	8.5	42.4	2.9
Other Indicators				
Share in Sales (%)	82.2	12.6	3.0	2.2
No. of Company	454	17	31	28
Sales per Company (P billion)	1.3	5.4	0.7	0.6

Source: SEC-*BusinessWorld* Annual Survey of Top 1,000 Corporations in the Philippines, various years.

1996 to P56.9 billion and P24.7 billion in 1997, respectively. As a result, the sector's ROE dropped from 15.7 percent to 10.4 percent. But the impact of the Asian crisis on the real estate and property sector was much smaller than that on the manufacturing sector, and was also much more limited compared with the property sectors in other Asian countries. Its knock-on effect on the economy was small as it accounted for less than 3 percent of the top 1,000 companies' total sales on average during 1988-1997. With a modest increase in total liabilities and leverage level of less than 100 percent in 1997, it does not appear to have been excessively exposed to foreign currency-denominated loans. The sector's buildup in equity during the stock market boom of 1994-1996 may have cushioned the impact of the crisis.

The utilities sector had the second highest leverage during 1988-1997 at 181 percent on average, reaching up to 313 percent in 1997. The currency devaluation bloated the foreign currency-denominated loans of these companies. Overall, the leverage of all four industries was low, unlike in neighboring countries hit by the Asian crisis.

3.2.3 Legal and Regulatory Framework

The Corporation Code of 1980 is the main law governing the corporate sector. Two other pertinent laws are Presidential Decree (PD) 902-A, which is also the organic law governing the operations of SEC, and the Insolvency Law. For publicly listed companies, the Revised Securities Act (RSA) and PSE's public listing requirements also apply. The General Banking Law, which regulates banks and nonbank financial institutions except insurance companies, contains some provisions affecting corporations' dealings with banks.

Corporation Code of 1980

Supplanting the old Corporation Law of 1906, which was based on American corporate law, the Corporation Code of 1980 is a compilation of important juridical rulings, administrative regulations, and recognized rules on corporate practices. It provides the basic constitutional structure for the organization, operation, and dissolution of corporations. It specifies the minimum information to be indicated in the articles of incorporation,[3] which serve as the company's declaration that the minimum percentage of authorized capital required by law has been subscribed and paid-up. Under the Code, the ownership of Filipino citizens in the corporation is not less than the legally required percentage of capital stock.

Amendments to the articles of incorporation require approval by a majority of the board of directors and a two-thirds vote of outstanding capital stock. One month after registration, the Code requires a corporation

[3] A company's articles of incorporation should include: (i) corporate name; (ii) purpose of the corporation; (iii) principal office; (iv) term of existence; (v) number of directors (not less than five nor more than 15); (vi) names, nationalities, and residences of incorporators and directors; (vii) number, par value, and amount of authorized capital stock; and (viii) names, nationalities, and residences of original subscribers, and amount subscribed and paid by each. The articles of incorporation may also include other matters such as waiver of preemptive right and classes of shares such as founders' or redeemable shares describing their rights, privileges, and restrictions.

to adopt a code of bylaws or rules for its internal governance. To be valid, the bylaws must be consistent with the law, the corporation's articles of incorporation, and public policy; must be general, uniform, and reasonable; and should not impair vested rights.[4]

Philippine corporate law distinguishes between management decisions that require only a majority vote of the board and major decisions that require a two-thirds majority vote of shareholders. A majority of the outstanding shares of shareholders must vote to authorize amendments to the bylaws. However, shareholders may delegate this power to the board of directors by a two-thirds vote of outstanding capital stock.

Securities and Exchange Commission: PD 902-A

SEC is the government agency responsible for implementation of the Corporation Code. Its mandate is to supervise corporations in order to encourage investments and protect investors. It implements rules and regulations that protect minority shareholders from possible fraud and misbehavior by controlling shareholders, directors, or officers.

In 1976, PD 902-A expanded SEC's mandate to include absolute jurisdiction, supervision (regulatory), and control (adjudicative) of all corporations. In addition, PD 902-A also granted SEC the exclusive jurisdiction to hear and decide cases involving: (i) complaints about devices or schemes employed by the board of directors and officers amounting to fraud and misrepresentation that may be detrimental to the interest of the public or shareholders; (ii) controversies arising out of intra-corporate relations, among shareholders, between the shareholders and the corporation, and between the corporation and the State concerning its franchise or right to exist; (iii) controversies in the election or appointments of directors and officers of corporations; and (iv) petition of corporations to be declared in a state of suspension of payments in cases when their assets cover all debts but they cannot pay these debts when they fall due.

[4] Some of the items that a corporation may provide in its bylaws are the following: (i) time, place, and manner of calling and conducting regular or special meetings of the directors and shareholders; (ii) required quorum in shareholders' meetings, manner of voting, and forms of proxies and manner of voting them; (iii) qualifications, duties, and compensation of directors, officers, and employees; (iv) time for holding annual election of directors and manner of giving the election notice; (v) manner of election or appointment and term of office of all officers other than directors; (vi) penalties for violation of the bylaws; and (vii) manner of issuing certificates in the case of stock corporations.

The last item of PD 902-A is the special jurisdiction granted to SEC over applications by corporations for "suspension of payments" to creditors, a role of the regular courts that was originally part of the Insolvency Law. Under this authority to approve applications for suspension of payments, SEC has the power to appoint rehabilitation receivers or management committees for petitioning corporations.

A presidential writ issued in 1981 placed SEC under the supervision of the Ministry of Finance, but in 1998, control of the agency was returned to the Office of the President.

Insolvency Law

The Insolvency Law is designed to effect an equitable distribution of insolvent debtors' properties among their creditors. It permits debtors to be discharged from their liabilities to enable them to start afresh with property set apart for them from assets to be used as payment to creditors. The regular courts have jurisdiction for insolvency proceedings including suspension of payments for individual debtors. A debtor can petition the court to suspend payment of debts or to be discharged from liabilities and debts by voluntary or involuntary insolvency proceedings.

Revised Securities Act: Law on Securities Dealing

Like its predecessor, the 45-year-old Securities Act, the RSA was patterned after several US securities acts. The RSA is primarily designed to prevent the exploitation of investors through the sale of unsound or fraudulent securities. For this purpose, the law requires full and accurate disclosure of all material facts concerning the issuer and the securities it proposes to sell, and prohibits misrepresentations, manipulations, and other fraudulent practices in the sale of securities. To enforce these regulations, the law requires the registration of securities. The registration requirement covers full and accurate disclosure of the character of the securities to be sold to the public, including detailed information regarding past dealings between the issuer and its directors, officers, and principal shareholders.

Public Listing Rules of the Philippine Stock Exchange

PSE is the country's facility for secondary trading of shares of publicly listed companies. In 1998, SEC, which originally supervised PSE, granted the exchange the status of a "self-regulated" organization. Thus, PSE now

has the authority, within general guidelines set by SEC, to set rules and regulations for PSE members and listed companies.

The general requirements for maintenance of listed status include submission of financial reports that conform with generally accepted accounting principles (GAAP) and regulations established by PSE, and compliance with laws relating to securities and exchange regulations, board resolutions, and agreements executed with the agency. Violations of PSE requirements are subject to sanctions, including delisting.

PSE is responsible for ensuring that listed companies follow the exchange's rules of disclosure and fair treatment of investors. It has the power to impose sanctions on any company that fails or erroneously discloses material information that affects the rights and benefits of investors and misrepresents information in its application, prospectus, financial statements, or reports. In the area of corporate governance, PSE requires corporations to resolve, and, where possible, eliminate arrangements within groups of companies and own-company dealings that can lead to conflicts of interest. Upon complaints by minority investors, PSE can review the deals in question, using such criteria as benefits to the company, adequate disclosure to shareholders, and internal control procedures to ensure fair and reasonable terms.

Banking Laws Affecting Corporations

Some aspects of banking laws affect the governance of corporations. The important ones concern: (i) the capacity of officers of corporations to assume positions as members of the board of directors of banks, (ii) limits on ownership of banks by nonfinancial corporations, (iii) limits of lending by banks to corporations, and (iv) rules on lending to directors and other insiders.

The General Banking Law governs the regulation of the establishment, management, and operations of banks. As the highest policymaking body of the banking system, the Monetary Board prescribes the qualifications of bank directors and reviews the qualifications of those appointed as bank directors and officers. It could disqualify anyone found, for whatever reason, unfit for the position. There are no other restrictions on corporate officers to be appointed as members of the board of directors of banks.

A corporation, including its wholly or majority-owned subsidiaries, can own common shares of banks up to a maximum of 30 percent of banks' voting stock. In the event that the corporation is majority-owned by one person or by relatives, the limit is 20 percent of banks' voting shares.

Regulations on the single borrower limit (SBL) put a ceiling on the maximum amount that a bank can lend to a debtor. SBL rules limit the total liabilities of any borrower of a commercial bank to 15 percent of the bank's unimpaired capital and surplus, and an additional 15 percent for "adequately secured loans," to a maximum 30 percent ("unimpaired capital and surplus" refers to the total paid-in capital, surplus, and undivided profits, net of valuation reserves of a bank). SBL limits exclude risk-free loans such as Government-guaranteed loans and loans secured by cash deposits. Total corporate liabilities include all liabilities of the debtors and their majority-owned subsidiaries. The Monetary Board may prescribe the consolidation of the liabilities of subsidiaries with the parent corporation under certain conditions.

Central Bank (Bangko Sentral ng Pilipinas [BSP]) regulations do not prohibit loans by the bank to its directors, officers, shareholders, and other related interests, known as DOSRI. However, they are subject to certain prudential requirements under banking laws, as follows: (i) a director or officer of a bank can only borrow or become a guarantor, endorser, or surety for loans from the bank with the written approval of all other directors of the bank (i.e., excluding the director concerned); (ii) the amount of outstanding credit accommodations that a bank extends to its shareholders shall be limited to an amount equal to the sum of their unencumbered deposits and book value of their paid-in capital contributions; and (iii) loans and advances given to officers in the form of fringe benefits shall not form part of liabilities under DOSRI.

3.3 Corporate Ownership and Control

3.3.1 Patterns of Corporate Ownership

The historical development of Philippine corporate ownership is rooted in the country's colonial past, the industrial policies of the Government, and the recent emergence of industrialists and an entrepreneurial class. During the Spanish and American period up to World War II, a small number of families acquired land and owned large businesses. These families built and preserved their businesses over several generations. Many of them became controlling shareholders of family-based corporations and business groups that are major players in the present-day Philippine corporate sector.

Ownership is a key element in corporate control and governance. Public listing rules of PSE require that a minimum of 10 to 20 percent of

outstanding shares, depending on the size of the company, be available for trading in the stock exchange. As companies usually only issue the minimum required number of shares, large blocs of controlling shareholders often dominate corporate decision making in publicly listed companies. Public investors and minority shareholders are not in a position to influence management. Moreover, the presence of large controlling shareholders makes takeovers by other companies difficult. For these reasons, the resolution of conflicts between the interests of controlling shareholders, minority shareholders, public investors, and creditors in Philippine companies depends very much on the effectiveness of internal control systems.

Ownership Concentration of Listed Companies

This study measures ownership concentration in terms of shareholdings by the top one, five, and 20 shareholders.[5] Table 3.8 shows that the top shareholder owned 40.8 percent of the market value of an average nonfinancial company. The shareholding of the top shareholder varied across sectors. It was highest for the property sector at 54.8 percent, followed by holding companies (as a sector) at 53 percent. One shareholder held majority control of an average company in these two sectors. The average shareholding of the largest shareholder was less than 25 percent only in sectors with large market capitalization, such as power and energy, and transportation, and in sectors with high risks, such as oil exploration and mining. These figures suggest that for publicly listed companies, a single shareholder often has substantial or even dominant control.

Combined, the holding of the top five shareholders in an average company was about 65.3 percent for the nonfinancial sector and 59.2 percent for the financial sector. The five largest shareholders held majority control over an average Philippine publicly listed company, except in three sectors—transportation; food, beverage, and tobacco; and oil exploration. Ownership by the five largest shareholders was on average most concentrated among holding companies (78.4 percent), and in construction (74 percent), property (69.8 percent), manufacturing and trading (68.4 percent), and communications (67.3 percent).

[5] The study derived ownership data for 194 (169 nonfinancial) companies out of 221 (190 nonfinancial) listed on the Philippine Stock Exchange as of 1997. Shareholdings by the top one, five, and 20 shareholders were estimated for each company and averaged by using the market capitalization of each company as a weight.

Table 3.8
Ownership Concentration of Philippine Publicly Listed Companies by Sector, 1997

Sector	Top 1	Top 5	Top 20[a]
Financial Institution			
Banks	26.9	59.2	76.4
Financial Services	41.3	63.2	65.8
Average Shareholding[b]	**27.2**	**59.2**	**76.2**
Nonfinancial Company			
Communication	35.4	67.3	76.9
Power and Energy	21.5	55.4	72.1
Transportation Services	23.8	48.4	69.2
Construction and Other Related Products	47.7	74.0	86.2
Food, Beverage, and Tobacco	22.7	44.1	69.7
Holding Companies	53.0	78.4	86.0
Manufacturing, Distribution, and Trading	37.4	68.4	42.6
Hotel, Recreation, and Other Services	28.9	55.3	68.0
Property	54.8	69.8	74.5
Mining	23.4	56.0	51.9
Oil	19.9	45.1	64.3
Average Shareholding[b]	**40.8**	**65.3**	**75.9**

[a] Information on the top 20 shareholders is not available for five holding companies, 10 manufacturing companies, and two property companies.
[b] Weighted by market capitalization.
Source: PSE databank.

The shareholding of the 20 largest shareholders in an average company was 75.9 percent for the nonfinancial sector and 76.2 percent for the financial sector. In 12 out of 13 sectors, the top 20 shareholders owned more than 50 percent of the voting shares of an average company. In 10 out of 13 sectors, the top 20 shareholders held more than a two-thirds majority control of an average company.

Ownership Concentration at Critical Levels of Control

PSE listing rules require that a minimum of 10 to 20 percent of outstanding shares of a company be issued to the public, depending on its size. An interesting question is whether in reality Philippine publicly listed companies issue enough shares to be truly widely held or whether they barely meet this minimum requirement. The answer to this can be gleaned from an

analysis of the number of companies in which the top one, five, or 20 shareholders owned more than 50 percent (signifying operating control), 66 percent (signifying strategic control), or 80 percent (only nominally publicly listed) of outstanding shares.

Table 3.9 shows that in 44 companies, or about 30 percent of the total, a single shareholder held operating control of a company. In 21 companies, or 14 percent of the total, a single shareholder held two-thirds majority control. In four companies, or 3 percent of the total, a single owner owned more than 80 percent of outstanding shares. In 111 companies, or almost 75 percent of the total, the top five shareholders owned more than 50 percent of the voting shares. In 76 companies, or 51 percent of the total, the top five shareholders held more than two-thirds majority control of a company. In 116 companies, or 78 percent of the total, the top 20 shareholders collectively owned a majority of a company's shares.

With such high levels of ownership concentration, minority shareholders are unlikely to be able to influence the strategic and operating decisions of a company without the support of one or more large shareholders. The limited volume of shares issued to the public is one of the causes of the underdevelopment of the Philippine stock market. The shares of publicly listed companies are thinly traded and illiquid, and share prices are sensitive to movements of foreign funds.

Composition of Ownership of Publicly Listed Companies

Another important issue concerning corporate ownership is the composition of the controlling shareholders. Who are the top one, five, and 20 shareholders? In Table 3.10, the top five controlling shareholders were classified into eight groups. The largest group is nonfinancial corporations, including pure holding companies, controlling an average of 52.1 percent of publicly listed companies in the Philippines in 1997. In four of 11 nonfinancial sectors, nonfinancial corporations held majority control. Individuals did not constitute a significant shareholder group among the top five shareholders, holding only an average of 2.2 percent of outstanding shares of publicly listed companies.

Nonfinancial corporations with controlling shareholdings are likely to be holding companies, which are mostly privately owned and controlled by family-based shareholder blocs. Parent companies usually spin off operating units into new companies that they continue to control as affiliates. There are advantages to establishing pure holding companies. Through these, large and family-based shareholders pool the family's ownership over many

Table 3.9
Ownership Concentration at Critical Levels of Control Over Publicly Listed Companies, 1997

Sector	% of Firms with Top Shareholders Controlling more than 50% of Shares			% of Firms with Top Shareholders Controlling more than 66% of Shares			% of Firms with Top Shareholders Controlling more than 80% of Shares		
	Top 1	Top 5	Top 20[a]	Top 1	Top 5	Top 20[a]	Top 1	Top 5	Top 20[a]
Communication	30	90	100	20	70	90	—	40	60
Construction	40	80	87	13	60	80	13	33	67
Food, Beverage, and Tobacco	50	86	93	43	57	86	7	50	64
Manufacturing, Distribution, and Trading	20	72	36	8	48	36	—	28	20
Holding	31	73	82	14	49	76	2	27	47
Power	—	50	100	—	50	100	—	50	50
Transportation	14	57	100	—	14	71	—	—	43
Property	24	72	80	8	52	76	—	28	36
Total	**30**	**74**	**78**	**14**	**51**	**72**	**3**	**30**	**45**

— = not available.
[a] Data for top 20 shareholders were not available for five holding companies, 10 manufacturing companies, and two companies in the property sector.
Source: PSE databank.

Table 3.10
Composition of Top Five Shareholders of Philippine Publicly Listed Companies by Sector, 1997
(percent)

Sector	Nonfinancial Company	Investment Trust Fund	Nominee Company	Individual	Commercial Bank	Government	Securities Broker	Insurance Company
Financial Company								
Banks	33.9	1.3	3.0	9.1	5.4	2.3	2.6	1.7
Financial Services	6.6	0.0	10.2	7.6	19.3	1.0	18.6	0.0
Average Shareholding[a]	**33.5**	**1.2**	**3.1**	**9.0**	**5.6**	**2.3**	**2.8**	**1.6**
Nonfinancial Company								
Communication	53.5	8.5	3.9	0.0	0.0	0.2	0.6	0.6
Power and Energy	26.3	12.6	0.2	0.0	5.7	10.7	0.0	0.0
Transportation Services	37.2	0.0	3.2	5.1	0.0	0.0	2.6	0.2
Construction and Other Related Products	59.4	1.3	3.0	6.6	0.6	1.2	1.5	0.1
Food, Beverage, and Tobacco	29.8	12.3	1.5	0.4	0.0	0.0	0.0	0.0
Holding Companies	66.0	0.2	4.2	5.5	1.7	0.0	0.8	0.1
Manufacturing, Distribution, and Trading	45.9	0.8	5.6	4.3	0.3	0.3	11.0	0.2
Hotel, Recreation, and Other Services	36.7	0.0	5.7	5.3	0.0	0.0	7.6	0.0
Property	67.3	0.2	0.7	1.0	0.1	0.0	0.6	0.0
Mining	26.8	1.7	3.9	0.4	5.8	5.0	12.5	0.0
Oil	21.9	0.0	0.4	8.5	0.0	0.0	13.7	0.5
Average Shareholding[a]	**52.1**	**4.7**	**2.4**	**2.2**	**1.3**	**1.4**	**1.1**	**0.1**

[a] Weighted by market capitalization.
Source: PSE Databank.

companies and share in the risks and profits of the group. They can also better manage their income taxes because income from affiliated companies passes through a holding company. Such advantages have contributed to the popularity of holding companies among publicly listed companies.

Holding companies as a sector had the largest market capitalization in PSE in 1997, accounting for P258.6 billion or 26.7 percent of market capitalization of the nonfinancial publicly listed companies. Holding companies were themselves 66 percent owned by other nonfinancial corporations. Privately-owned pure holding companies own a majority of shares and exercise control of publicly listed holding and operating companies through a multilayered pyramid structure. This complex layering of ownership masks the identity of individuals or families that actually own and control operating companies, while still allowing the public to own minority shares.

As a group, financial institutions did not have a significant ownership in nonfinancial corporations, with an average of only 7.2 percent in 1997. The financial institutions among the top five shareholders of nonfinancial corporations are investment trust funds (with 4.7 percent of shareholdings), commercial banks (1.3 percent), securities brokers (1.1 percent), and insurance companies (0.1 percent). The 7.2 percent shareholding by the financial institutions was even inflated to some extent because securities brokers held trading portfolios for their clients rather than long-term investments. Insurance companies were very minor investors in the stock market because prudential regulations prevent them from investing significant amounts even in equities of large companies.

Investment trust funds were the most important institutional investors. These are mainly the Social Security System (SSS) and the Government Service Insurance System (GSIS). Funds of SSS and GSIS consist mainly of compulsory contributions from members of the country's private sector and government workforce, respectively. These institutions keep a stock portfolio mostly in shares of a few companies with large capitalization and high liquidity in select industries. These include Philippine Long Distance Telephone Company (PLDT) in telecommunications, Petron and MERALCO in power and energy, and San Miguel Corporation (SMC) in food and beverages. The investment funds' presence in these sectors ranged from 8.5 to 12.6 percent of market capitalization in 1997. Because of limited ownership by institutional investors, there was no real market for investment information. The Philippine capital market did not have an active analyst community comparable to those in more developed capital markets.

Family-Based Ownership and Business Groups

The Asian Development Bank (ADB) survey of publicly listed companies conducted for this study reveals that about one third of responding companies started out as family businesses. More than three fourths of the respondents are either a parent or subsidiary (about 70 percent of these are domestic nonfinancial companies), suggesting that most publicly listed companies are parts of business groups. Most family businesses that went public did so because they wanted to raise capital and to gain the prestige associated with being a public company. However, many companies in family-owned groups are not publicly listed.

To understand the ownership and governance characteristics of family-owned business groups, the study put together a list of prominent business groups, identified the companies belonging to each of these groups, and tracked the financial performance of each company from 1992 to 1997, using data on the Philippines' top 1,000 companies.[6]

The total sales of these groups in 1997 were estimated at P806 billion (Table 3.11). Family-based groups have larger companies since their total sales were about 33.4 percent of the top 1,000 corporations' sales, but they comprised only 23.8 percent of total companies in number. All major industries were represented, suggesting that business groups are common in all major markets. Some 20 financial institutions were affiliated with these groups, including 16 commercial banks. This is significant considering that there were only 31 local commercial banks in the country in 1997.[7]

[6] The study used publicly available shareholder information and published reports. The process identified a total of 238 companies belonging to 39 business groups from the SEC-*BusinessWorld* Annual Survey of the Top 1,000 Corporations in the Philippines.

[7] A common feature of corporate ownership of a business group is the centrality of a commercial bank. Large shareholders and their families own these banks directly or through their controlled companies. Commercial banks hold the largest share, about three fourths, of the financial resources in the country. Corporate financing depends on intermediation by banks. For this reason, a nonfinancial company that owns a commercial bank has better access to loans at favorable rates and terms. The Central Bank deregulated interest rates and foreign exchange, liberalized the regulations on entry of foreign bank branches and foreign ownership of local banks, and increased the capital requirements for all types of banks. Prudential regulations, including SBL and DOSRI rules, remain in force to control excessive lending of banks to insiders. Still, the Central Bank's reforms are probably changing the conduct but not necessarily the structure of the banking system. Foreign banks have a growing presence but have not necessarily increased the supply of credit to the corporate sector, so far limiting their involvement to selected products. Banks that are members of business groups have an advantage in raising funds from the internal capital market of the group. This could further increase the concentration of ownership and expand the scope of own-group lending by these larger banks.

Compared with other Asian countries, an average group in the Philippines has fewer member companies. Together, the top 10 family-based business groups had only 119 companies in the top 1,000 companies, or an average of about 12 per group. The main constraint may be the availability of family members that could be drawn for top management positions.

In terms of number of companies, the largest family-based business group was the Ayala Corporation Group, with 27 affiliated companies in the top 1,000. In terms of sales, the largest was the Eduardo Cojuangco group, the principal owner of SMC, the biggest private company in the Philippines.

The significance of family-based business groups in the Philippine corporate sector is immediately evident in the 50 largest corporate entities, including business groups and independent companies, ranged according to their sales (Table 3.12). These corporate entities accounted for 53.6 percent of the total sales of the top 1,000 corporations in 1997. Significantly, the three largest entities were family-based groups, namely, Cojuangco, Lopez, and Ayala. Also, 25 out of the 50 top corporate entities were family-based groups. Family-based business groups are most dominant in sectors such as manufacturing, real estate, construction, and banking. Foreign-owned companies mainly serve the export markets.

Interlocking Relationship between Financial and Nonfinancial Firms

Although financial institutions as a whole did not own directly significant proportions of shares of nonfinancal corporations in the Philippines, as discussed in previous sections, the two were closely related through their affiliations to business groups. Commercial banks are often affiliated to a particular business group. To show this, the study used the four largest business groups—Ayala, Gokongwei, Lopez, and Henry Sy—as examples.

In 1997, nonfinancial companies contributed about 36 to 60 percent of total profits for these groups. For the Ayala group, the nonfinancial sector was real estate (60.4 percent of the group's 1997 profits); for the Gokongwei Group, it was manufacturing (36.2 percent); for the Lopez group, broadcasting (49.8 percent); and for the Henry Sy group, retail merchandising (69.1 percent). In the meantime, for each of these groups, a substantial proportion of group profits came from its financial subsidiaries. Commercial banking contributed about 40 percent of group profits for the Ayala group and Gokongwei group, and more than 20 percent for the Lopez group and Henry Sy group. It is also noteworthy that, with the exception of Banco de Oro, which was majority-owned by the Henry Sy group, in most

Table 3.11

Total and Per Company Sales, Sector Orientation, Flagship Company, and Affiliated Bank of Selected Business Groups, 1997

Business Group	Major Sector Orientation	Estimated No. of Affiliated Companies	Total Sales (P billion)	Average Sales Per Company (P billion)
1. Eduardo Cojuangco	Beverages, food, coconut oil, and packaging	19	123.7	6.5
2. Lopez Family Group	Power distribution and mass communications	15	98.8	6.6
3. Ayala Corp. Group	Real estate, food, and car manufacturing	27	84.5	3.1
4. George Ty	Car manufacturing and real estate	12	49.4	4.1
5. John Gokongwei	Food and telecommunications	12	48.5	4.0
6. Henry Sy	Department store and real estate	9	47.5	5.3
7. Lucio Tan	Airlines, beverages, agriculture, and tobacco	4	46.5	11.6
8. Ramon Cojuangco Family Group	Telecommunications	6	44.0	7.3
9. Del Rosario/Phinma Group	Cement and construction materials	11	26.5	2.4
10. Zuellig Group	Pharmaceutical and distribution	4	26.0	6.5
11. First Pacific/ Metro Pacific Group	Real estate, telecom, and personal care prods	8	17.5	2.2
12. Aboitiz Family Group	Shipping, power, and food	9	17.2	1.9
13. Jose Concepcion/RFM Group	Food, beverages, and dairy products	5	16.3	3.3
14. Alfonso Yuchengco	Investments, construction, and mining	4	15.5	3.9
15. Andres Soriano Family Group	Management, real estate, and tourism	5	13.0	2.6
16. George Go	Credit card	6	13.0	2.2
17. Wilfred Uytengsu/ General Milling Group	Food and dairy products	4	10.4	2.6
18. David M. Consunji	Construction and mining	3	10.1	3.4

19.	Jollibee Foods	Fast food	4	8.5	2.1
20.	Luis Lorenzo Family Group	Beverages and agro-industrial products distribution	7	8.3	1.2
21.	Alcantara Family Group	Cement and wood products	5	7.9	1.6
22.	Bienvenido Tantoco	Retail merchandising	2	7.8	3.9
23.	Elena Lim	Electronic appliances	4	6.9	1.7
24.	Andrew Gotianum	Real estate	4	6.2	1.6
25.	Brimo Family Group	Mining	3	6.0	2.0
26.	Andrew Tan	Real estate	2	5.6	2.8
27.	J. P. Enrile/JAKA Group	Telecommunication, distribution, and real estate	5	5.4	1.1
28.	Jaime Gow	Retail merchandising	7	5.2	0.7
29.	Guoco Group	Ceramics and real estate	5	4.7	0.9
30.	Jose Go	Department store and real estate	5	4.4	0.9
31.	Jardine Davies	Cement and sugar central	2	3.7	1.9
32.	Gerardo Lanuza	Real estate and securities trading	3	3.4	1.1
33.	Alfredo C. Ramos	Bookstore, mining, and real estate	2	3.3	1.7
34.	Gaisano Family Group	Department store	3	2.5	0.8
35.	Felipe Yap	Mining	2	2.0	1.0
36.	Felipe F. Cruz	Construction	2	1.8	0.9
37.	Jose Luis Santiago	Telecommunication	2	1.4	0.7
38.	Keppel Group	Shipyard and power	2	1.1	0.6
39.	Robert John Sobrepeña/ Fil-Estate Group	Real estate	4	1.1	0.3
	Total		**238**	**805.6**	**2.8**

Sources: PSE Databank, SEC-*BusinessWorld* Annual Survey of Top 1,000 Corporations (1997), and various company annual reports.

Table 3.11 (continuation)

Total and Per Company Sales, Sector Orientation, Flagship Company, and Affiliated Bank of Selected Business Groups, 1997

	Business Group	Size Class[a]	Flagship Company	Affiliate Bank[b]
1.	Eduardo Cojuangco	Large	San Miguel Corporation	UCPB
2.	Lopez Family Group	Large	MERALCO	PCIBank
3.	Ayala Corp. Group	Medium	Ayala Corporation	BPI
4.	George Ty	Medium	Toyota Motors	Metrobank/Global Bank
5.	John Gokongwei	Medium	Robinson	PCIBank
6.	Henry Sy	Large	Shoe Mart	Banco de Oro
7.	Lucio Tan	Large	Philippine Airlines	Allied Bank
8.	Ramon Cojuangco Family Group	Large	Phil. Long Distance Telephone	Bank of Commerce
9.	Del Rosario/Phinma Group	Medium	Phinma	Asian Bank
10.	Zuellig Group	Large	Zuellig Pharmaceutical	
11.	First Pacific/Metro Pacific Group	Medium	Metro Pacific	PDCP Bank
12.	Aboitiz Family Group	Medium	William Gothong and Aboitiz	Union Bank
13.	Jose Concepcion/RFM Group	Medium	Swift Foods/RFM	Consumer Bank (Savings Bank)
14.	Alfonso Yuchengco	Medium	House of Investment	RCBC
15.	Andres Soriano Family Group	Medium	Anscor	Asian Bank
16.	George Go	Medium	Equitable Card Network Inc.	Equitable Banking Corp.
17.	W. Uytengsu/General Milling Group	Medium	Alaska Milk Corporation	
18.	David M. Consunji	Medium	DM Consunji, Inc.	
19.	Jollibee Foods	Medium	Jollibee Foods Corporation	
20.	Luis Lorenzo Family Group	Small	Pepsi Cola Products	
21.	Alcantara Family Group	Small	Alsons Cement	

22. Bienvenido Tantoco	Medium	Rustans	
23. Elena Lim	Medium	Solid Group	
24. Andrew Gotianum	Small	Filinvest	East-West Bank
25. Brimo Family Group	Medium	Philex Mining	International Exchange Bank
26. Andrew Tan	Medium	Megaworld Properties	
27. J. P. Enrile/JAKA Group	Small	Jaka Investment Corporation	
28. Jaime Gow	Small	Uniwide Corporation	Ecology Bank (Savings Bank)
29. Guoco Group	Small	Guoco Ceramics	Dao Heng Bank
30. Jose Go	Small	Ever Gotesco	Orient Bank
31. Jardine Davies	Medium	Republic Cement	
32. Gerardo Lanuza	Small	PhilRealty	International Exchange Bank
33. Alfredo C. Ramos	Medium	National Bookstore	International Exchange Bank
34. Gaisano Family Group	Small	Gaisano Department Store	Philbanking Corp.
35. Felipe Yap	Small	Lepanto Consolidated Mining	
36. Felipe F. Cruz	Small	F. F. Cruz & Co., Inc.	
37. Jose Luis Santiago	Small	PT&T Corp.	
38. Keppel Group	Small	Kepphil Shipyard Inc.	Keppel-Monte Bank
39. Robert John Sobrepeña/Fil-Estate Group	Small	Fil-Estate Development Inc.	

[a] Size class is measured in terms of sales: Large = greater than P4.48 billion; medium = P1.65 billion to P4.48 billion; small = less than P1.65 billion.
[b] Refers to commercial banks, unless otherwise indicated.
Sources: PSE Databank, SEC-*BusinessWorld* Annual Survey of Top 1,000 Corporations (1997), and various company annual reports.

Table 3.12
Control Structure of the Top 50 Corporate Entities, 1997

	Corporate Entity	Sales (P billion)	Control Structure	Major Industrial Orientation
1.	Eduardo Cojuangco	123.7	Business Group	Beverages, food, coconut oil, and packaging
2.	Lopez Family Group	98.8	Business Group	Power distribution, mass communications, and bank
3.	Ayala Corporation Group	84.5	Business Group	Real estate, bank, food, and car manufacturing
4.	National Power Corp.	77.1	Government-Owned	Power
5.	Petron Corporation	60.8	Publicly Listed/Foreign-Owned	Refined petroleum products
6.	Pilipinas Shell Petroleum Corporation	53.2	Foreign-owned	Refined petroleum products
7.	George Ty	49.4	Business Group	Banking, car manufacturing, and real estate
8.	John Gokongwei	48.5	Business Group	Banking, food, and telecommunications
9.	Henry Sy	47.5	Business Group	Department store and banking
10.	Lucio Tan	46.5	Business Group	Airlines, beverages, agriculture, and tobacco
11.	Ramon Cojuangco Family Group	44.0	Business Group	Telecommunications and banking
12.	Caltex (Philippines) Inc.	38.0	Foreign-Owned	Refined petroleum products
13.	Texas Instruments (Phils.), Inc.	37.6	Foreign-Owned	Radar equipment and radio remote control apparatus
14.	Del Rosario/PHINMA	26.5	Business Group	Cement and construction materials
15.	Zuellig Group	26.0	Business Group	Pharmaceutical and distribution
16.	Toshiba Information Equipment (Phils.), Inc.	24.8	Foreign-Owned	Electronic data processing equipment and accessories
17.	Fujitsu Computer Products Corp. of the Phils.	22.4	Privately-Owned	Electronic data processing equipment and accessories
18.	Philippine National Bank	19.6	Publicly Listed/Foreign-Owned	Bank
19.	Mercury Drug Corp.	18.1	Privately-Owned	Drugs and pharmaceuticals goods retailing
20.	First Pacific/Metro Pacific Group	17.5	Business Group	Real estate, telecommunication, and personal care products
21.	Aboitiz Family Group	17.2	Business Group	Shipping, power, and food
22.	Jose Concepcion/RFM Group	16.3	Business Group	Food, beverages, and dairy products
23.	Alfonso Yuchengco	15.5	Business Group	Investments, banking, construction, and mining
24.	Philippine Associated Smelting and Refining Corp.	15.2	Government- and Foreign Jointly Owned	Gold and other precious metal refining

25.	La Suerte Cigar and Cigarette Factory	14.9	Privately-Owned	Cigarettes
26.	Land Bank of the Philippines	14.7	Government-Owned	Bank
27.	Procter and Gamble Philippines	13.3	Foreign-Owned	Soap and detergents
28.	Andres Soriano Family Group	13.0	Business Group	Management, real estate, and tourism
29.	George Go	13.0	Business Group	Banking
30.	Hitachi Computer Products (Asia) Corp.	12.6	Foreign-Owned	Radar equipment and radio remote control apparatus
31.	National Steel Corporation	12.0	Government-Owned	Operation of rolling mills
32.	National Food Authority	11.5	Government-Owned	Palay, corn (unmilled), and other grains wholesaling
33.	Phil. Amusement and Gaming Corporation	10.7	Government-Owned	Other amusement and recreational activities
34.	Mitsubishi Motors Phils. Corp.	10.7	Foreign-Owned	Motor vehicles
35.	W. Uytengsu/General Milling Group	10.4	Business Group	Food and dairy products
36.	David M. Consunji	10.1	Business Group	Construction and mining
37.	Uniden Philippines Laguna, Inc.	9.8	Foreign-Owned	Television and radio transmitters, and apparatus for line telephony and line telegraphy
38.	EAC Distributors Inc.	9.8	Foreign-Owned	Tobacco products wholesaling
39.	Philip Morris Philippines, Inc.	9.6	Foreign-Owned	Cigarettes
40.	Philips Semiconductors Phils., Inc.	9.5	Foreign-Owned	Radar equipment, radio and remote control apparatus
41.	Jollibee Foods	8.5	Business Group	Fast food
42.	Citibank N.A.	8.4	Foreign-Owned	Bank
43.	Luis Lorenzo Family Group	8.3	Business Group	Beverages and distribution of agro-industrial products
44.	United Laboratories	8.2	Privately-Owned	Drugs and medicines, including biological products
45.	Development Bank of the Philippines	7.9	Government-Owned	Bank
46.	Alcantara Family Group	7.9	Business Group	Cement and wood products
47.	Bienvenido Tantoco	7.8	Business Group	Retail merchandising
48.	Elena Lim	6.9	Business Group	Electronic appliances
49.	Brimo Family Group	6.0	Business Group	Mining
50.	Andrew Tan	5.6	Business Group	Real estate
	Total	**1,290**		
	Share in Top 1,000 Companies Sales (%)	**53.6**		

Sources: SEC-*BusinessWorld* Annual Survey of Top 1,000 Corporations (1997), PSE Databank, and various company annual reports.

publicly listed commercial banks affiliated to these groups, business groups had only minority ownership. However, although public investors held a majority of shares, these were dispersed shareholdings. Actual control of the banks was still held by the groups.

3.3.2 Corporate Management and Shareholder Control

The main mechanisms by which shareholders control corporate management are the board of directors, appointment and compensation of senior executives, shareholder voting in general meetings and legal protection of their rights, accounting and auditing, and financial disclosure. This section reviews practices of corporate management and shareholder control in Philippine publicly listed companies. The review is based on an ADB survey of listed companies in the Philippines conducted in 1999 for this study.[8]

The Board of Directors

As the representative of shareholders in a company, the board of directors plays a crucial role in corporate governance. The Philippine Corporation Code mandates the board of directors to exercise its control over a corporation. Shareholders limit the broad power of the board by ratifying their decisions on critical corporate affairs, such as amendments of the articles of incorporation, issuance of corporate bonds, sale or disposition of a substantial portion of corporate assets, investments of corporate funds in other companies or purposes, issuance of stocks, corporate mergers or consolidations, voluntary dissolution, approval of management contracts, amendments in the bylaws, determination of compensation to board members, removal of directors, and declaration of cash dividends. The Corporation Code holds members of the board of directors liable, jointly and individually, to the corporation and its shareholders for damages caused if they agree to unlawful corporate acts. They are likewise liable if they pursue financial interests that conflict with their duty as directors. Shareholders have the right under the Code to file derivative suits against directors and officers and other third parties to redress any wrongdoing committed against the corporation for which the board refuses to sue or to remedy. Of course,

[8] The ADB survey of corporate governance practices was conducted in the first semester of 1999 using a questionnaire prepared by Juzhong Zhuang of the Asian Development Bank. A total of 44 companies responded to the survey (out of about 221 financial and nonfinancial listed companies).

actual practices of board functions and the role of shareholders may diverge somewhat from the legal framework.

Respondents of the ADB survey ranked the following as the most important responsibilities of the board: making strategic decisions; protecting shareholder interests; appointing senior management; ensuring that a company follows legal and regulatory requirements; and determining remuneration for board directors and senior management, in a descending order. Making day-to-day management decisions was not regarded as an important board responsibility.

The ADB survey shows that the number of board directors ranged from six to nine among the responding companies. The majority of respondents indicated that board directors and chairpersons were elected mainly on the basis of either relationship with major shareholders (31.9 percent), or percentages of shareholdings (28.7 percent). But professional expertise is also an important criterion (28.7 percent). In a few cases, board directors were the founder of a company, appointed by the Government, or representatives of creditors. More than half of respondents indicated that board directors were elected during the shareholder general meetings. But half of respondents indicated that they also had board directors directly nominated by controlling shareholders or management, or the Government without approval by shareholder general meetings.

According to the ADB survey, a typical chairperson owned 3 to 5 percent of outstanding shares of a company on average, with a maximum of 36 percent. Board chairpersons in a substantial number of responding companies did not own significant amounts of shares in their personal capacities. This can partly be explained by the fact that many family-based large shareholders control companies through holding companies in which they have majority ownership.

The average stipulated term of office of the chairperson and members of the board for most responding companies was one year. Such a short tenure may to some extent suggest that large shareholders want to keep their board members under close control. In practice, the average number of years of holding office was 6.6 for board chairpersons and 7.5 for board members. The longest was 27 years for board chairpersons and 14 years for board directors.

Financial compensation is another means by which shareholders can motivate boards and board members to manage companies in their interests. The ADB survey results show that a chairperson is compensated either by a fixed fee (52 percent of respondents), a fixed fee plus performance-related bonuses (30 percent), or a per diem for meetings (18 percent).

Compensation for the chairperson was determined either by the board (54 percent of respondents), the parent company or company bylaws (21 percent), or management (15 percent).

The Corporation Code prohibits the removal of any director without cause if that act would deprive minority shareholders of representation in the board. There was no case found in the ADB survey where a minority shareholder invoked such a provision of the Corporation Code. Ninety-three percent of the respondents had one or more outside directors. But the independence of these outside directors is often doubtful. It is also not clear whether the outside directors were elected before or after the financial crisis. In some companies, owners brought prominent political or civic leaders into their boards with the intention of improving the visibility of the corporation rather than improving the quality of board decisions.

Companies may set up special board committees to strengthen due diligence procedures.[9] In practice, however, large shareholder-dominated companies often view such committees as unnecessary formalities. In the ADB survey, only 35 percent of responding companies have set up board committees. About half of the active committees were audit committees and the other half nomination committees. These committees were established only recently.

Senior Executives

The Corporation Code does not specify the role and responsibilities of senior executives. The ADB survey shows that in 41 percent of the responding companies, the chairperson of the board was also the chief executive officer (CEO). A CEO that was not the chairperson of the board was selected on the basis of professional expertise (42 percent of respondents), relationship with controlling shareholders (35 percent), or amount of shareholding (15 percent). This suggests that large shareholders control CEOs by means other than shareholdings, namely, by tenure and compensation. Unlike in Western corporate models, CEOs apparently cannot increase their shareholdings because family-based owners restrict the number of shares available to management. When the CEO was not the chairperson, the CEO

[9] The three most common board subcommittees are the compensation, audit, and nomination committees. The compensation committee reviews and recommends remuneration plans of key officers and employee stock option plans. The nomination committee searches and reviews candidates for key management positions. The audit committee selects external auditors, negotiates the audit fees and scope of audits, and reviews the findings of external audits.

was not related to the chairperson by blood or marriage in all of the cases except one.

About 60 percent of respondents of the ADB survey considered maximizing shareholder values as the CEO's most important responsibility. But about 27 percent viewed it to be ensuring steady growth of the company. A substantial number of respondents also considered looking after interests of other stakeholders and the general public as among the important responsibilities of the CEO. An overwhelming 70 percent of respondents said a CEO who was not the chairperson of the board could make key decisions only after consulting the chairperson or the entire board.

The majority of responding companies compensated their CEOs by using a fixed salary plus a performance-related bonus. The "golden parachute" was apparently not a common feature of CEOs' compensation packages. Only one respondent indicated that its CEO was entitled to a substantial amount of compensation, equal to three years' pay, if the CEO's contract was preterminated. The average service length of CEOs was 5.2 years. The longest service rendered was 27 years.

Shareholder Rights and Protection

Under the Corporation Code, shareholders enjoy a number of rights and protection. Among others, first, to help ensure the representation of minority interests in the board, the Corporation Code allows cumulative voting for directors, and prohibits the removal, without cause, of directors representing minority shareholders. Second, shareholders may exercise appraisal rights, i.e., the rights to demand payment for shares of those who do not agree with the board's decisions when a company (i) amends the articles of incorporation; (ii) disposes of or mortgages a substantial portion or all of corporate properties and assets; (iii) invests in another company for a purpose different from that of the corporation; or (iv) enters into a merger or consolidation with another corporate entity. Third, shareholders have preemptive rights to maintain their proportionate ownership of a company under any financing plan that may be undertaken by the company. They can vote through proxy, including electronic means. Companies are not allowed to issue shares with different voting rights. Fourth, the Corporation Code requires that the following types of transactions involving potential conflict of interest between shareholders and management be reviewed and approved by the board: (i) dealings of a company with directors or officers; (ii) contracts with companies linked through interlocking directorship; and (iii) involvement of directors in businesses that compete with the company. Fifth,

shareholders are allowed to inspect a company's stock and transfer books. Regardless of the amount of shares held, a shareholder could file a derivative suit against a director to redress a wrongdoing. Sixth, in cases of corporate takeovers, potential buyers are required to make a tender offer to minority shareholders at a price equal to the offer it is making to controlling shareholders. Last, the Revised Securities Act has strict provisions designed to deter insider trading.

In practice, because of poor compliance and enforcement as well as some loopholes in corporate laws, minority shareholders were often vulnerable to the expropriation of their interests by controlling shareholders and management. Few minority shareholders actually exercised their appraisal rights. Those who did were usually offered below-market values for their shares. Dissenting minority shareholders did not necessarily have recourse to a third party for an objective appraisal of their shares. During annual general meetings where minority shareholders could exercise their rights, because of the dominance of large controlling shareholders, there were often no real discussions of board proposals or actions. There was little chance that a proposal from minority shareholders could ever get approved. In the case of preemptive rights, the Corporation Code allows a company to waive this in the article of incorporation upon registration or in a subsequent amendment.

Although transactions involving potential conflict of interest need to be reviewed and approved by the board, there are no requirements for disclosing such transactions to shareholders under the Corporation Code. Consequently, it is doubtful whether this legal protection for shareholders will achieve what it intends to in practice. Being appointees of controlling shareholders, board members are likely to be under pressure to approve transactions that benefit controlling shareholders to the detriment of minority shareholders. In cases of derivative suits against directors for wrongdoings or actions against insider trading, SEC proceedings were costly and time-consuming. In the past, no one has been successfully prosecuted for insider trading. There was only one case, that of Interport Resources Corporation, where SEC made substantial progress in investigation. But an action by the regular court on a petition by the company's owners/officers prevented SEC from pursuing the investigation. The company was dissolved before indictment.

An effective market for corporate control may provide some protection for minority shareholders against the expropriation of their interests by the incumbent management. However, in the Philippines, hostile takeovers are not common because in most companies ownership is concentrated

in a few controlling shareholders and families. Nevertheless, the successful hostile takeover by First Pacific Group of PLDT, a company that is widely held but has a large shareholder, demonstrates the feasibility of developing a market for corporate control if publicly listed companies were widely held.

The ADB survey provides further evidence on shareholder rights, protection, and their activism in the corporate sector. The responding companies had on average 43,522 shareholders each. Nominees held about 45 percent of the outstanding shares. An average of 327 shareholders per company attended the last annual meeting and they represented about 63 percent of total shares. About 333 shareholders per company voted by proxy, representing 3.4 percent of shareholders but 58 percent of outstanding shares. The brokers or securities companies were the most important proxy voters, followed by management and banks. An average of about 4,900 shareholders per company did not vote during the last annual general meeting, representing about 24 percent of outstanding shares. Table 3.13 summarizes rights that the shareholders of the responding companies enjoyed.

Table 3.13
ADB Survey Results on Shareholder Rights

	Percentage of Respondents	
Shareholder Rights	**Yes**	**No**
One Share One Vote	100.0	0.0
Proxy Voting by Mail	51.4	48.6
Preemptive Rights on New Share Issues	70.0	30.0
Prohibition of Loans to Directors	36.8	63.2
Mechanisms to Resolve Disputes with Company	56.8	43.2
Independent Audit	92.7	7.3
Mandatory Independent Board Committees	43.2	56.8
Severe Penalty for Insider Dealings	69.4	30.6

Source: ADB Survey of Philippines Publicly Listed Companies, 1999.

Independence of Auditing

The ADB survey revealed that all the responding companies had an independent auditor, appointed either by the board or shareholders during the annual general meetings. About 93 percent of the respondents contracted

their annual audit to an international auditing firm. On average, the responding companies have been associated with their present auditors for 13 years, with the longest being 50 years. More than 20 percent of the respondents have been dealing with their auditors for 20 years or more.

Because of such long relationships, independent auditors are likely to be quite familiar with the operations and financial aspects of their clients. Nevertheless, independent audits do not guarantee the absence of questionable accounting practices. In two celebrated cases, a preferred independent auditing firm either reported assets that did not exist (Victorias Milling Corp., a bankruptcy case) or hid a large amount of liabilities and losses (PLDT, a hostile takeover case).

Disclosure and Transparency

The disclosures required by the Corporation Code are achieved through shareholders' inspection of a company's books and an "information statement" that companies should regularly issue to shareholders. The Code grants a shareholder the right to inspect business records and minutes of board meetings. Meanwhile, the information statement transmitted to every shareholder should contain the audited financial statements, a management discussion of the business, and an analysis of financial statements.

SEC requires all registered companies to periodically submit reports for the purpose of updating their respective registration statements filed at the agency. From publicly listed companies, the agency also requires reports on important details about their operations and management, imposing penalties on violators.

In practice, financial reporting standards allow room for interpretation by independent auditors. An auditor can choose among three alternative sets of GAAP, namely, the local standard (i.e., as practiced in the Philippines), the international accounting standard, or the accounting standard of a specific developed country (for example, the US GAAP). These different versions of GAAP, although closely related, vary in their evaluation of some major accounts such as securities and other liquid assets, long-term leases, investments in subsidiaries, revaluation of fixed assets, foreign currency-denominated liabilities, intangible assets, intra-company receivables and payables, and consolidation policy.

The accounting profession in the Philippines is considered fairly developed and Manila is a known regional center for accounting expertise. Most major international auditing firms operate in the Philippines. Nevertheless, there are many cases of poor financial reporting by large companies.

Many small- and medium-sized businesses did not have quality financial statements. Publicly available financial information was often of low quality, arguably, because of the highly concentrated ownership of Philippine corporations, as large shareholders had no need for financial statements to monitor their companies and management that were under their own control. Even for widely held public companies, the authorities, namely SEC and the Philippine Institute of Certified Public Accountants (PICPA), sometimes did not penalize independent auditors for poorly prepared audited financial statements.

Corporate Control by Controlling Shareholders

As in many other Asian countries, controlling shareholders in the Philippines usually exercise their corporate control through the setting up of business groups, which are usually controlled by holding companies. Holding companies enable controlling shareholders to collectively own shares of other companies in a business group and to centralize the group's management. They allow risk pooling and can achieve economies of scale in management, marketing, and financing. However, they also make it easier for controlling shareholders to expropriate interests of minority shareholders. Such expropriation is due to gaps between control rights and cash flow rights that pyramiding structures of business groups centered on holding companies create. When control rights exceed cash flow rights, large shareholders can use their control to transfer wealth from a company in a business group where they have low cash flow rights to another where they have high cash flow rights, e.g., from a minority-controlled to a majority-owned subsidiary. The popularity of holding companies in the Philippine corporate sector is evident: with a market capitalization of P258.6 billion, they formed the largest group of corporate entities in the Philippine stock market in 1997, accounting for 27 percent of the total stock market capitalization that year.

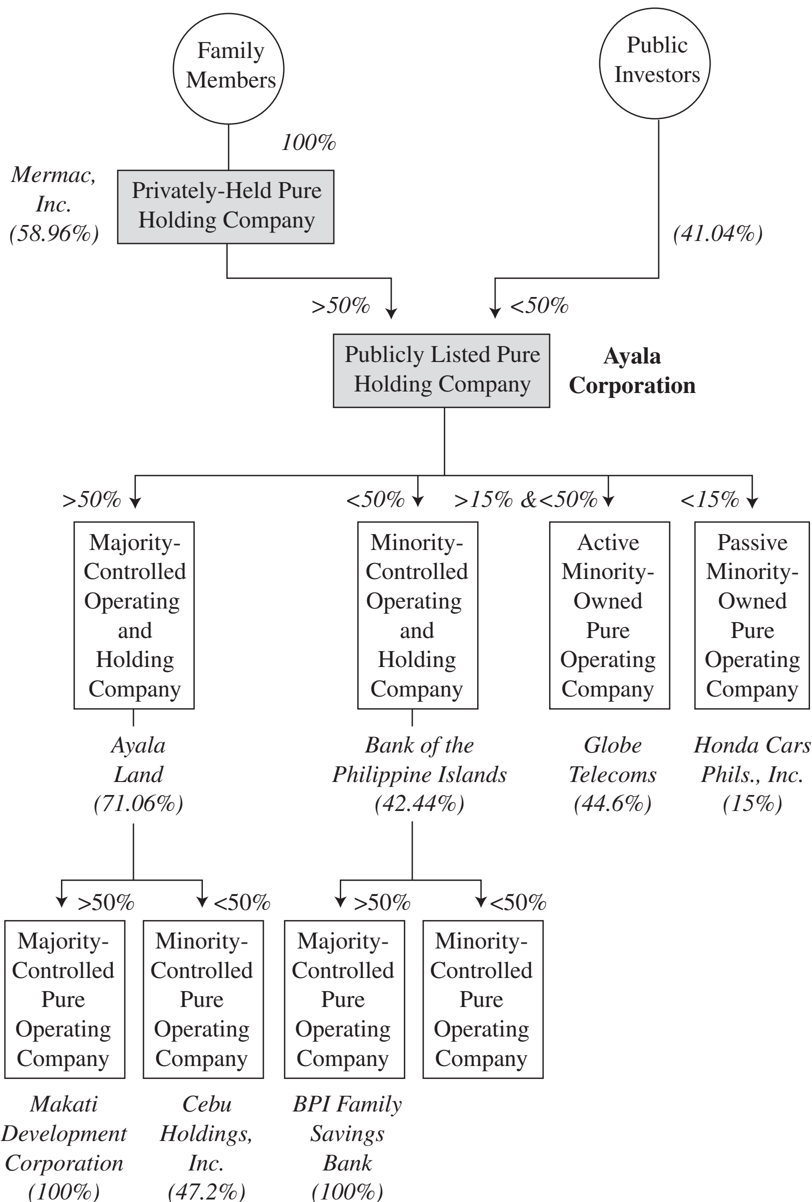
Laws of many Southeast Asian countries allow the establishment of pure holding companies (with the exception of Korea up to 1999). Family-based controlling shareholders use them as vehicles for controlling business groups. Pure holding companies can be privately owned, which are closely held by large shareholders and family members, and publicly listed, which are controlled by large shareholders with public investors in a minority position. "Selective public listing" is a strategy of many business groups for channeling funds from public investors to member companies. Controlling shareholders usually select member companies that require large

equity investment for public listing. Selective public listing combined with use of pure holding companies to own and control member companies lead to various organizational structures of business groups.

Some holding companies are not pure holding companies. They are operating companies but at the same time have majority or minority share ownership in other operating companies. In cases of minority ownership, controlling shareholders of a parent company hold these shares as "strategic investments" that they could increase or reduce depending on business opportunities. These investments can be classified according to the role of the controlling shareholders in the management of the invested company, namely, active minority or passive minority holdings. In an active minority-owned operating company, the parent company plays an active role in management. Depending on the performance of the company, controlling shareholders of the parent company may eventually increase their shares to a majority position. In a passive minority-owned operating company, controlling shareholders of the parent company do not participate in management. They may have a representative in the board. Controlling shareholders gain additional leverage in management control over minority-owed companies. This is most evident when a minority-owned company transacts with other members of the group where the controlling shareholders hold majority control. Minority-owned companies may also need access to resources of the group, especially its management, financing, and customers.

The stylized features of control structure of business groups in the Philippines can be illustrated by using a leading Philippine family-based conglomerate, Ayala Corporation, as an example (Figure 3.1). Ayala Corporation is a publicly listed pure holding company. It is majority-owned by Mermac, Inc., a family-owned pure holding company, with 59 percent of shares. Public investors collectively hold a minority of 41 percent. Ayala Corporation then holds a sufficient number of shares to achieve various degrees of control in two types of holding companies and two types of operating companies. It has a majority control at 71.1 percent of Ayala Land, minority control at 42.4 percent of Bank of the Philippine Islands, an active minority share at 44.6 percent of Globe Telecom, and a passive minority investment at 15 percent in Honda Cars (Philippines). The first three companies are publicly listed while the fourth, Honda Cars (Philippines), is privately owned. Ayala Corporation's majority- and minority-controlled operating companies are also holding companies. Ayala Land fully owns Makati Development Corporation and holds a minority stake, at 47.2 percent, of Cebu Holdings (a publicly listed government-owned company).

Figure 3.1
Corporate Control Structure: The Case of Ayala Corporation



Note: Data as of 31 December 1998.

Bank of the Philippine Islands owns 100 percent of the BPI-Family Savings Bank, a privately owned company.

The control of companies through indirect corporate shareholdings, defined as control by large shareholders of an operating company through minority ownership by several companies, is illustrated in the Lopez Group (Figure 3.2). Being in the public utilities sector, companies in the Lopez Group are large and minority-controlled. MERALCO, Rockwell Land, and First Philippine Industrial Corporation are indirectly held by a majority-controlled holding company, Benpres Holdings, and a minority-controlled holding company, First Philippine Holdings Corporation. The Lopez Family owns a significant portion of shares of these companies if these indirect shareholdings are summed up and attributed to the beneficial owners. Generally, however, indirect shareholdings do not appear to be a prevalent practice in the Philippine corporate sector.[10]

The Ayala family's control rights over BPI was 1.7 times its cash flow rights by virtue of the double layer pyramid structure of the Ayala group.[11] The Lopez family's control rights over MERALCO was 5.7 times its cash flow rights by virtue of its cross-holdings via Benpres and First Holdings.[12] These examples show that even when large shareholder groups are minority shareholders, they exercise far greater control (two to five times more) than they are entitled to by virtue of their ownership rights. The situation offers large shareholders tremendous incentive to move resources

---

[10] For details, see the World Bank research papers by Stijn Claessens, Simeon Djankov, and Larry H. P. Lang: 1999a, The Separation of Ownership and Control in East Asian Corporations; 1999b, Expropriation of Minority Shareholders: Evidence from East Asia; and 1999c, Diversification and Efficiency of Investment by East Asian Corporations. See also Stijn Claessens, Simeon Djankov, Joseph P. H. Fan, and Larry H. P. Lang, 1998, Who Owns and Controls East Asian Corporations?

[11] Ibid.

$$\frac{\text{[control right]}}{\text{[cash flow right]}} = \frac{\text{[control rights via Ayala Corporation]}}{\text{[cash flow rights via Ayala Corporation]}}$$

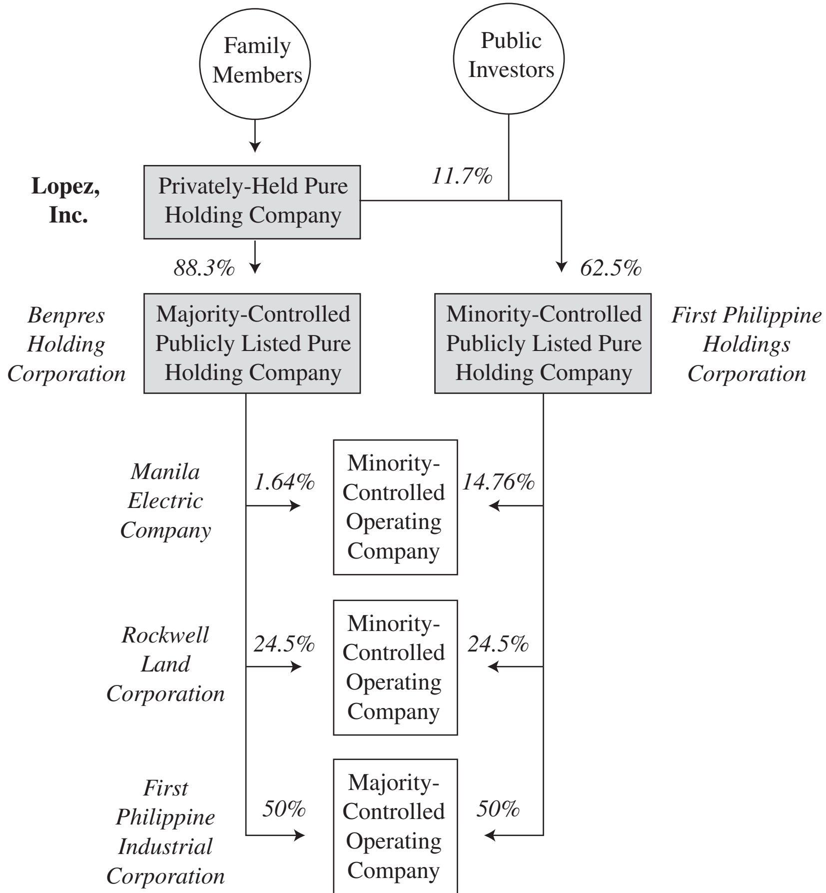
$$= [42.44\%] / [58.98\% \times 42.44\%]$$
$$= [42.44\%] / [25\%]$$
$$= 1.7 \text{ times}$$

[12] Ibid.

$$\frac{\text{[control right]}}{\text{[cash flow right]}} = \frac{\text{[sum of control rights via Benpres and First Holdings]}}{\text{[sum of cash flow rights via Benpres and First Holdings]}}$$

$$= [1.64\% + 37.5\%] / [(88.3\% \times 1.64\%) + (37.5\% \times 14.76\%)]$$
$$= [39.14\%] / [1.3\% \times 5.5\%]$$
$$= [39.14\%] / [6.8\%]$$
$$= 5.7 \text{ times}$$

Figure 3.2
Corporate Control Structure: The Case of Lopez Group



Note: Data as of 31 December 1998.

from their subsidiaries to their majority-owned publicly listed holding company or elsewhere up the pyramid. The controlling shareholders could also use the resources of minority-owned subsidiaries to engage in overexpansion and empire building investments.

3.3.3 The Role of Creditors in Corporate Control

This study examines the role of creditors in corporate control by looking at (i) how corporate borrowers perceive the control power of their creditors, and (ii) how the legal framework protects creditor interests and rights.

Control by Creditors

According to the ADB survey, a publicly listed company dealt with an average of eight banks and six nonbank financial institutions. Most responding companies had dealt with their commercial bank creditors for more than five years and nonbank creditors for only about two years. The average company, the data suggest, accessed nonbank creditors for specific purposes but dealt with commercial banks on a long-term basis.

Sixty-one percent of respondents indicated that creditors usually asked for collateral for all types of loans, whether for working capital or capital expenditure. However, it was not common for creditors to take legal action against debtors or foreclose on those assets held as collateral in cases of default. Only a minority of respondents (18 percent) indicated that they had faced adverse creditor actions such as a collection lawsuit or foreclosure of collateral. Most respondents (81 percent) indicated that they had renegotiated with their creditors on loan repayment when they faced liquidity problems.

The survey results also revealed that creditors did not intervene in the management of borrowing companies and wanted to maintain business relationships with corporate borrowers even when they were in trouble. Some 85 percent of respondents believed that creditors had no influence or only weak influence on corporate management, while 80 percent reported that creditors with which they had renegotiated loans were still willing to lend to them.

Suspension of Payments of Debts

Under PD 902-A, SEC could suspend the rights of a creditor to demand payment from a borrower in accordance with the terms of the loan

agreement. PD 902-A granted SEC blanket powers to intervene and adjudicate claims. This explains why creditors invariably oppose any move by borrowers to file for suspension of payments at SEC.

There are two modes of suspension of payments under PD 902-A. The first mode is for simple suspension of payments, under which, a company's assets are of sufficient value to cover all of its debts; the borrower requests to defer payments for a certain period to enable it to generate the necessary liquidity. The second mode is for suspension of payments with the appointment of a management committee (Mancom) or rehabilitation receiver. Under this mode, it is not clear whether the corporate borrower's assets are of sufficient value to cover its liabilities. An impending conflict between the two parties could result in dissipation of assets of the company due to creditors' action to liquidate the company's assets they hold as collateral. Under such circumstances, SEC could intervene to avoid asset dissipation. The borrower will propose a rehabilitation plan to SEC, which determines the viability of the rehabilitation plan and appoints a Mancom or a rehabilitation receiver to implement the proposal if approved.

There are no legal or practical limits to the time period of suspension of payments. The law on suspension of payments envisions resetting the corporation's business for a temporary period to prevent its irreversible collapse. In practice, the litigation process, including the rehabilitation of the corporation, could take an indefinite period. For example, SEC and the court required that the creditors of BF Homes, Inc., a real estate-based business group, wait for 14 years from the time the company petitioned for suspension of payments in 1984. The corporation continued to be under rehabilitation receivership as of June 1999.

3.4 Corporate Financing

3.4.1 The Financial Market and Instruments

The Philippine financial market has remained underdeveloped compared with other countries in the region. Commercial banks hold about three fourths of the resources of the financial system. Consequently, bank credit is the main source of corporate financing. Markets for equity and debt instruments are small and there are serious structural problems that discourage large, profitable companies from going public. Publicly listed companies do not represent a cross section of the Philippine corporate

sector. Of the 221 companies listed in the Philippine Stock Exchange in 1997, only 84 had sales large enough to be placed in the top 1,000 companies. Most publicly listed companies issue only up to 20 percent of total shares to the public, the minimum required to qualify as a public corporation. As a result, most listed companies are controlled by their five largest shareholders.

The Philippine stock market is not a liquid market. Table 3.14 shows that the average volume of daily trading in 1997 stood at P2.4 billion (or $59 million using the average exchange rate). Foreign funds were wary of the Philippine stock market because of its limited liquidity. They invested in only a few large companies whose shares were relatively liquid. The market capitalization of the Philippine stock market in August 1997, about the size of Thailand's, was one of the smallest in the region at $47.7 billion, compared with Malaysia ($186 billion), the Republic of Korea (henceforth, Korea) ($143 billion), and Indonesia ($61.5 billion). The ratio of market capitalization to GDP over the last 15 years put the development of the Philippine stock market at par with other developing markets in the region (e.g., Korea and Thailand). Malaysia, however, is far ahead of the flock.

Interest rates, inflation, and fiscal management were among interrelated factors explaining the underdeveloped state of the Philippine financial market. From the 1970s up to the early 1990s, the country experienced double-digit inflation. The Government financed its chronic fiscal deficits by issuing short-term Treasury bills, while interest rates were at high levels and volatile. The stock market was depressed up to the early 1990s.

Rising stock prices during the Ramos administration reflected to some extent the business optimism. The period 1993-1997 was one of lower inflation and declining lending rates. Equity financing through IPOs was active. However, the collapse of the stock market during the Asian financial crisis suggested that the earlier stock price surge in part reflected the "bubbles" common to other stock markets in the region.

The crisis affected the Philippine corporate sector, but not to the same extent as it did in other Asian economies. In part, this is because, compared with other economies, Philippine companies were less leveraged, less exposed to foreign debt, especially short-term debt, and less engaged in risky investments. Most companies invested only in projects that met hurdle rates as high as 20 to 30 percent and had short payback periods. Foreign portfolio investments also remained small. Even in the real estate sector, companies expanded only at a moderate pace.

Equity instruments include common stocks, preferred stocks, and convertible securities. The corporate sector raised a substantial amount of

Table 3.14
Philippine Stock Market Performance, 1983-1997

Year	Market Capitalization (year end, P billion)	Gross Domestic Product (current prices, P billion)	Ratio of Market Capitalization to GDP	Daily Trading Volume	
				(P million)	($ million)
1983	19.5	369.1	0.1	—	—
1984	16.5	524.5	0.0	—	—
1985	12.7	571.9	0.0	—	—
1986	41.2	608.9	0.1	—	—
1987	61.1	682.8	0.1	129.5	6.2
1988	88.6	799.2	0.1	72.7	3.4
1989	261.0	925.4	0.3	207.9	9.3
1990	161.2	1,077.2	0.2	114.3	4.1
1991	297.7	1,248.0	0.2	158.3	5.9
1992	391.2	1,351.6	0.3	314.4	12.5
1993	1,088.8	1,474.5	0.7	728.7	26.3
1994	1,386.5	1,692.9	0.8	1,445.6	59.2
1995	1,545.7	1,906.3	0.8	1,515.9	57.8
1996	2,121.8	2,171.9	1.0	2,686.0	102.2
1997	1,251.3	2,421.3	0.5	2,373.2	59.4

— = not available.
Note: Combined transactions of Makati and Manila Stock Exchanges are not available for the years 1983 to 1986.
Source: PSE databank.

equity capital through IPOs during the stock market boom from 1993 to the first half of 1997. From 1988 to 1997, about 127 companies went public with a total value of offerings of about P134.6 billion, of which 85 percent was raised from 1993 to the first half of 1997. Because existing shareholders wanted to retain their proportionate control over their companies, the rights issue was a popular way of raising equity capital. Few companies offer preferred stocks because the Philippine tax system does not allow tax deductibility of dividends on preferred stocks.

Debt instruments include negotiated credits and debt securities. Negotiated credits, which were the principal source of corporate financing in the Philippines, include bank credits, asset-backed credits, leases, discounting of receivables, and inventory financing.

Debt securities include commercial papers and corporate bonds. Only a few large companies floated commercial papers because of the limited market, tight regulations, and high transaction costs. Under SEC regulations, issuing companies had to undergo a process of review and credit rating by the Credit Information Bureau Inc., which ultimately influences the pricing of commercial paper issues. The underwriter, which in most cases is an affiliate of the issuing company, sells these commercial papers through brokers. The largest buyers have been commercial banks, which buy commercial papers either for their own account or for their clients.

Corporate bonds are another type of debt securities. However, corporate bond issuing was even more limited. This is because only companies with strong capitalization and predictable cash flows such as public utility companies can issue bonds. The corporate bond market was stunted, moreover, by volatile interest rates and the absence of a secondary market.

The picture of the financial system that emerges is thus one of limited capital markets, lack of competition among financial institutions, and the dominance of large commercial banks. Capital markets cannot provide the market discipline that corporate investors need. Only the commercial banks, by virtue of their large stakes in the financial system, are in a position to provide such discipline. However, because business groups often own large commercial banks, a strong regulatory system for bank supervision is imperative.

3.4.2 Patterns of Corporate Financing

The study looked at retained earnings, new equity, and debt as sources of corporate financing by using flow of funds analysis. The measures used in the analysis are:

(i) Self-financing ratio of fixed assets (SFRF): ratio of changes in retained earnings to changes in fixed assets. It measures a company's capacity to finance growth in fixed assets by internally generated funds;

(ii) Self-financing ratio of total assets (SFRT): ratio of changes in retained earnings to changes in total assets. It measures a company's capacity to finance asset growth by internally generated funds;

(iii) New equity financing ratio (NEFR): ratio of changes in stockholders' equity (excluding retained earnings) to changes in total assets;

(iv) Incremental debt financing ratio (IDFR): ratio of changes in total liabilities to changes in total assets. It measures a company's reliance on borrowings in financing asset growth;

(v) Incremental equity financing ratio (IEFR): ratio of changes in shareholders' equity inclusive of retained earnings to changes in total assets. It measures a company's capacity to finance asset growth by equity capital. By definition, it is one minus IDFR.

All Companies

Financial flows data were derived from the SEC-*BusinessWorld* Annual Survey of Top 1,000 Corporations in the Philippines from 1988 to 1997. As shown in Table 3.15, during this period, the average SFRF was high at 109 percent. Retained earnings were sufficient to finance the entire growth of fixed assets in the corporate sector. On the other hand, the SFRT was low at

Table 3.15
Financing Patterns of the Corporate Sector, 1989-1997

Financing Indicators	1989	1990	1991	1992	1993	1994	1995	1996	1997	Average
SFRF	1.1	0.4	1.4	0.9	0.5	0.9	0.9	0.8	2.8	1.1
SFRT	0.1	0.2	0.5	0.3	0.2	0.3	0.1	0.0	0.0	0.2
NEFR	0.4	0.2	0.4	0.4	0.3	0.3	0.3	0.4	0.1	0.3
IDFR	0.5	0.6	0.2	0.3	0.5	0.4	0.6	0.5	0.9	0.5
IEFR	0.5	0.4	0.8	0.7	0.5	0.6	0.5	0.5	0.1	0.5

Source: SEC-*BusinessWorld* Annual Survey of Top 1,000 Corporations in the Philippines, 1988-1997.

only 19 percent, implying that internal funds were far from sufficient to finance growth in total assets. The corporate sector used new equity to finance 32 percent and new debts to finance 49 percent of growth in total assets.

There were significant year-to-year variations. In periods of an economic crunch such as in 1989, 1991, and 1997, the SFRF was higher. Companies financed fixed assets from internal sources in hard times. In all the years, internal funds were not a significant source of financing growth in total assets, except in 1991, when it financed 45 percent of it. The corporate sector consistently relied on debt and new equity to finance asset growth throughout the period. In 1997, retained earnings declined and few new equity investments flowed into the corporate sector. Total assets grew by 23 percent that year, with debt providing 93 percent of the financing requirements. As a result, the level of corporate leverage increased. It can also be observed that the relative importance of stockholders' equity (including retained earnings and new equity investment) was declining and that of debts increasing in financing the growth of the corporate sector from 1991 to 1997. This was mainly caused by the declining contribution from retained earnings, suggesting that there was a deterioration of financial performance in the Philippine corporate sector in the years running up to the crisis.

Corporate Financing by Ownership Type

As shown in Table 3.16, for all three types of companies—publicly listed, privately- and foreign-owned, debts were the most important source of financing. Retained earnings were the least important, except for foreign-owned companies that had a negative new equity financing ratio, reflecting the capital flight caused by political instability in the early 1990s. On

Table 3.16
Corporate Financing Patterns by Ownership Type, 1989-1997

Financing Indicators	Publicly Listed	Privately-Owned	Foreign-Owned
SFRF[a]	1.3	0.8	1.7
SFRT[a]	0.3	0.2	0.2
NEFR	0.3	0.3	(0.0)
IDFR[a]	0.5	0.6	0.9
IEFR[a]	0.5	0.5	0.1

[a] Excludes negative balances.
Source: SEC-*BusinessWorld* Annual Survey of Top 1,000 Corporations in the Philippines, 1988-1997.

average, publicly listed companies relied more on new equity financing than privately- and foreign-owned companies. Foreign-owned companies relied more heavily on debt financing, contributing 90 percent of growth in total assets, compared with 47 percent for publicly listed companies and 55 percent for privately-held firms. This financing pattern supports the earlier finding that foreign-owned companies had the highest leverage among the three types of companies.

A breakdown of the financial structure of publicly listed companies measured in balance sheet items is shown in Table 3.17. It presents a composition analysis of assets and financing sources for the period 1992-1996. The sector built up its short-term debts, especially bank loans, significantly

Table 3.17
Composition of Assets and Financing of the Publicly Listed Sector, 1992-1996
(percent)

	1992	1993	1994	1995	1996
Assets					
Cash and Temporary Investment	14.7	14.0	19.3	13.7	13.3
Accounts Receivable	13.5	13.3	12.0	12.1	13.0
Inventory	12.7	11.7	9.4	10.5	9.8
Other Current Assets	2.4	2.4	2.6	3.4	2.8
Total Current Assets	43.3	41.3	43.4	39.8	38.9
Investment	10.2	12.5	12.9	16.9	16.0
Fixed Assets	42.3	41.8	38.9	38.6	37.7
Other Assets	4.2	4.4	4.8	4.7	7.4
Total Assets	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Liabilities and Equity					
Accounts Payable	12.2	10.9	9.4	9.3	9.3
Short-Term Loans	12.2	12.2	10.4	10.9	13.8
Other Current Liabilities	3.5	3.6	3.7	3.9	3.8
Total Current Liabilities	27.9	26.8	23.5	24.1	26.8
Long-Term Debt	16.8	17.6	16.5	15.8	16.9
Other Long-Term Debt	0.0	0.1	0.0	0.1	0.1
Other Long-Term Liabilities	6.8	7.2	8.3	9.1	10.0
Total Liabilities	51.6	51.6	48.3	49.1	53.8
Stockholders' Equity	48.4	48.4	51.7	50.9	46.2
Total Liabilities and Stockholders' Equity	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: SEC-*BusinessWorld* Annual Survey of Top 1,000 Corporations in the Philippines, 1988-1997.

in 1996 and became more vulnerable to the financial crisis in 1997. The traditional measure of liquidity, the current ratio,[13] was at 1.45 in 1996, indicating that many publicly listed companies were likely to be in a tight liquidity position.

Corporate Financing by Control Structure

Conglomerates have certain advantages in financing because of the opportunities offered by the internal capital markets, their inherent ability to pool risks, the easier access to external credit, and economies of scale in fund raising. As shown in Table 3.18, the average SFRF of business groups was higher compared with that of independent companies. On average, retained earnings financed 113 percent of growth in fixed assets and 23 percent of growth in total assets from 1989 to 1997 for business groups, as opposed to 94 and 30 percent, respectively, for independent companies. The SFRF for independent companies would have been even lower if the highly profitable foreign-owned companies were excluded.

Table 3.18
Financing Patterns by Control Structure, 1989-1997

Financing Indicators	Group Member	Independent Company
SFRF[a]	1.1	0.9
SFRT[a]	0.2	0.3
NEFR	0.3	0.3
IDFR[a]	0.5	0.5
IEFR[a]	0.6	0.5

[a] Excludes negative balances
Source: SEC-*BusinessWorld* Annual Survey of Top 1,000 Corporations in the Philippines, 1988-1997.

Group companies financed an average of 45 percent of growth in total assets by debt, compared with an average of 54 percent for independent companies. Group companies were generally more profitable than independent companies. Further, group companies usually financed their investment in member companies by equity rather than debt. For these two reasons, group companies were less reliant on debt financing than

[13] Defined as total current assets divided by total current liabilities. The normal standard liquid position is a current ratio of 2 or higher.

independent companies. These results support the earlier finding that the leverage of business groups was lower than that of the independent companies from 1988 to 1997.

Corporate Financing by Firm Size

SFRF was highest for medium-sized companies, with an average of 3.06. The corresponding ratio was 0.76 for small companies and 0.88 for large companies (Table 3.19). The lower SFRF for large companies may be caused by their larger outlays for growth in fixed assets. With assets growing at a fast pace during this period, medium-sized companies used more debts, averaging 61 percent of growth in total assets, compared with 55 percent for large companies and 47 percent for small ones.

Table 3.19
Financing Patterns by Firm Size, 1989-1997

Financing Indicators	Large	Medium	Small
SFRF[a]	0.9	3.1	0.8
SFRT[a]	0.2	0.3	0.2
NEFR	0.3	0.2	0.3
IDFR[a]	0.6	0.6	0.5
IEFR[a]	0.5	0.4	0.5

[a] Excludes negative balances.
Source: SEC-*BusinessWorld* Annual Survey of Top 1,000 Corporations in the Philippines, 1988-1997.

The medium-sized companies' high debt financing ratio was due mainly to three years of complete reliance on debt to finance growth. These years were 1991 with 110 percent, 1993 with 96 percent, and 1997 with 131 percent. Large companies' IDFR of 0.55 was substantially higher than the small companies' 0.47. Large firms consistently increased their reliance on debts from 1994 to 1997.

Corporate Financing by Industry

The manufacturing sector had an average SFRF of 1.08 and SFRT of 0.50 (Table 3.20). On average, equity financed 42 percent of incremental asset growth. There was also increased reliance on debt financing. Excluding

1991, when debts declined, the manufacturing industry financed 57 percent of its total asset growth by debt. While this level is considered prudent, the total debt ratio was much higher in 1996 at 0.79 and in 1997 at 0.91. Low incomes diminished the equity financing position of the manufacturing industry toward the crisis year.

Table 3.20
Financing Patterns by Industry, 1989-1997

Financing Indicators	Manufacturing	Construction	Utilities and Services	Real Estate and Property
SFRF[a]	1.1	0.5	0.3	3.6
SFRT[a]	0.5	(0.2)	0.3	0.3
NEFR	0.4	0.7	0.3	0.4
IDFR[a]	0.6	0.5	0.6	0.4
IEFR[a]	0.4	0.5	0.4	0.6

[a] Excludes negative balances.
Source: SEC-*BusinessWorld* Annual Survey of Top 1,000 Corporations in the Philippines, 1988-1997.

The real estate industry financed its growth by substantial equity funds. Up to 1997, the industry generated internal funds, achieving an average SFRF of 3.58 and SFRT of 0.27. Equity financed an average of 62 percent of total asset growth. During the crisis year, debt financed about 78 percent of asset growth in real estate. In the eight years preceding the crisis, the incremental equity ratios of the industry were high, ranging from 41 to 118 percent. Equity financed the rapid expansion in the industry's assets in the period 1994 to 1997. Since the real estate boom coincided with that of the stock market, many of the leading real estate companies successfully went public during that time.

The construction sector was a heavy user of debt financing. Its SFRF and SFRT were volatile because of chronic losses and reduction in fixed and total assets. The utilities sector showed weaknesses in internal fund generation in 1989-1994, with an SFRF as low as 0.04. The situation improved beginning 1994, increasing to 0.47 two years later. Excluding 1997 when fixed assets declined, SFRF for the sector averaged 0.32, while SFRT averaged only 0.29. The effects of the crisis of 1997 were adverse. Total liabilities increased partly as a result of the local currency devaluation and financed all of asset growth for the year. Incremental equity financing amounted to an average of 44 percent of total asset growth. The sector had the highest leverage among all industries that year.

3.4.3 Ownership Concentration, Financial Leverage, and Performance

Previous studies on corporate governance have often associated ownership concentration with heightened risk-taking by companies.[14] Large shareholders may borrow excessively to undertake risky projects, knowing that if an investment turns out to be successful they could capture most of the gain; while if it fails, creditors bear the consequences. Large shareholders may also overuse financial leverage to avoid diluting ownership and control.

Using the PSE database, the degree of ownership concentration, measured by the percentage of shareholdings of the largest five shareholders, was regressed against measures of profitability and of financial leverage. Three regressions were run with the shareholding of the largest five shareholders as an independent variable and ROA, ROE, and leverage, alternatively, as the dependent variable. As shown in Table 3.21, the coefficient of the ownership concentration measure in all the three regressions is positive and statistically significant. ROE, ROA, and financial leverage are all positively and significantly related to the degree of ownership concentration. These results suggest that companies with higher ownership concentration tend to be more highly leveraged and, at the same time, more profitable.

Table 3.21
Ownership Concentration, Profitability, and Financial Leverage

	Dependent Variable		
Item	**ROE**	**ROA**	**Leverage**
Coefficient of Ownership Concentration	0.00056	0.00036	0.00125
T-statistics	1.769	2.287	2.421
Adjusted R-squared	0.004	0.008	0.009
F-statistics	3.130	5.230	5.860

Leverage = the ratio of total assets to total equity, ownership concentration = the total shareholdings of the top five shareholders, ROA = return on assets, ROE = return on equity.
Source: Author's estimates based on the PSE databank, 1992-1996.

[14] See for example Michael Jensen (1993), The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems, *Journal of Finance* 48: 831-880.

3.5 The Corporate Sector in the Financial Crisis

3.5.1 The Financial Crisis: Causes and Manifestations

A devaluation of the local currency signaled the arrival of the financial crisis in 1997. The Government explained that the country had "sound economic fundamentals" but that the problems were caused by "contagion." The Government's judgment that economic fundamentals were strong was based on stable growth rates, which averaged 4.5 percent per year from 1992 to 1997. Although much lower than those of other Asian countries, the country's GDP growth pace indicated that it did not have a "bubble economy," that is, an overexpansion of capacities. The costs of an economic correction brought about by the regional financial crisis were thought probably to be low due to the sound structure of the real economy and the strong position of the financial sector.

The structure of the economy may be understood by looking at its sectoral composition and export competitiveness. The largest contributors to GDP were services at 43 percent, industry at 34 percent, and agriculture at 21 percent. Exports were growing at about 20 percent per year in the three years preceding the crisis. Manufactures accounted for about 85 percent of exports, with commodities accounting for the balance. The export sector had a very narrow breadth. In 1997, more than half (52 percent) of exports were semiconductors. Garments was the second largest export sector at about 9 percent, but its share had been declining by 4 percent per year since 1995. Commercial and industrial activities in the country were largely oriented to domestic markets. About 80 percent of imports were capital goods (particularly power generating and telecommunications equipment), raw materials, and intermediate goods. Net trades in goods and services averaged a deficit of 4.8 percent of GDP from 1995 to 1997. The country experienced balance of payments surpluses but these were due to transfers, notably remittances of overseas workers. In sum, the economy still showed vestiges of its import-dependent and substituting character, with a narrow exporting industry base.

Compared to other East Asian crisis-affected countries, the country was less dependent on foreign private capital. Net investment inflows were $3.5 billion in 1996 and grew at an average of 48 percent per annum from 1992 to 1996. Historically, foreign investments in the country have been low, their growth gathering momentum only beginning in 1992. Because of limited local capital, the growth in foreign investments fueled that of the manufacturing and services sectors in the years preceding the crisis. After a

long period of debt moratorium and restructuring that started in 1983 and ended in 1991, the Government sought stability and achieved this in 1992-1997. Prudent fiscal management and controls on foreign borrowings were part of the adjustments required by IMF and foreign creditors. Eventually, the Government restructured its debts into longer tenors with a maximum of 25 years. During this time, the country and the corporate sector had no access to foreign currency debts from the international financial market, unlike their counterparts in the region.

The lessons from debt restructuring became the basis for the Government's economic policies. Economic performance during 1992-1997 was characterized by an average growth rate of real gross national product (GNP) at 3.5 percent, an average inflation rate of 7.8 percent, an average Treasury bill rate of 13.1 percent, a government fiscal surplus from 1994 to 1997, a positive balance of payments from 1992 to 1996, and a relatively healthy banking system. Since the regional financial crisis was triggered by the loss of confidence in some East Asian economies by foreign creditors and investors, adjustments were focused on the quantity and quality of the banking system's corporate loans, which, in turn, depended on the quality of the corporate sector's investments. Financial institutions called on their short-term loans and shortened the maturity of existing loans.

Five years of stable growth before the crisis enabled the country to build its net international reserves to $10.6 billion as of March 1997. The adverse impact of the crisis in most Asian countries was proportional to the amount of short-term foreign debts relative to net international reserves. In the Philippines, the discipline of the loan moratorium and the restructuring of the country's loans to long-term maturity kept this ratio below 100 percent up to September 1997. After hovering in the range of 100 to 127 percent, the ratio of short-term debts to international reserves dipped below 100 percent beginning June 1998. The Central Bank conserved international reserves by allowing the local currency to float within a wider trading margin, resulting in stability in the short-term debt to reserves ratio.

The corporate sector was in a relatively stable financial condition around the time of the crisis. Profitable operations since 1992 had allowed it to build equity, fueled also by successful IPOs during the stock market boom of 1993-1996. Total debts were only 52 percent of assets or 108 percent of equity. From 1988 to 1996, average ROE was 13.3 percent. Closer analysis, however, shows that investments of the corporate sector were growing at a faster rate than sales revenues in the years immediately preceding the crisis. From 1993 to 1997, assets grew at a compound annual rate of about 31 percent, while sales grew by only 20 percent per year.

The corporate sector indeed overexpanded after 1993 like its counterparts in the region, but to a lesser degree. Debts financed a large part of this expansion, growing by about 34 percent per year from 1994 to 1997. The debt level of the Philippine corporate sector in 1997 was low by Asian standards but still high by developed country standards. Most of this leverage happened during the boom years in the region. These patterns in investment and financing are similar to those of other countries in the region. In sum, the country's economic and corporate sector growth in 1994 to 1997 appeared to have been part of a positive "contagion" effect of optimism by investors and creditors about the region. It is understandable then that the effect of the Asian financial crisis on the Philippines was correspondingly that of a negative "contagion."

3.5.2 Impact of the Crisis on the Corporate Sector

Aside from the foreign exchange adjustment, the other immediate impact of the crisis was that on foreign investment flows. Net foreign investments more than doubled from 1995 to 1996 but declined by 78 percent in 1997 (Table 3.22). Foreign investments in the Philippines have not been as high as the inflows to other Asian countries—and this, precisely, mitigated the effects of the pullout and liquidation of investments in the aftermath.

Net foreign portfolio investment amounted to $1.5 billion in 1995, or 114 percent of net foreign direct investment (FDI). It rose to $2.101 billion or 196 percent of net FDI in 1996. In 1997, net FDI remained stable at more than $1 billion. It financed 26 percent of corporate capital growth. But portfolio investment amounting to $406 million flew out of the Philippines.

Table 3.22
Foreign Investment Flows, 1995-1998

Item	1995	1996	1997	1998
Net Foreign Investments ($ million)	1,609	3,517	762	739
Foreign Direct Investment (FDI)	1,300	1,074	1,073	555
Foreign Portfolio Investment	1,485	2,101	(406)	328
Net Capital Increase by Corporations (P million)	145,303	92,718	121,749	69,650
Net FDI as a Percentage of Corporate Net Capital Increase (%)	23.0	30.4	26.0	32.7

Note: Peso-dollar exchange rates used are: 1995 = 25.71; 1996 = 26.22; 1997 = 29.47; 1998 = 41.06. Data for 1998 cover only January-August.
Sources: Bangko Sentral ng Pilipinas and SEC.

Corporate financial performances and conditions deteriorated during 1997. Net profit margins were at a 10-year low at 4.9 percent, ROE at 6.2 percent was barely above inflation rate, and leverage increased to 149 percent compared with 109 percent in 1996. Companies deferred investments in new fixed assets. Because of weak internal fund generation, new borrowings financed asset growth. With the increase in borrowings and reduced liquidity, the corporate sector became vulnerable to loan calls and high interest rates. Loan calls, in turn, depended on the liquidity and capital position of commercial banks, which held about 75 percent of the assets of the financial system in 1997. The resources of the financial system that year totaled P3,369 billion, with commercial banks holding P2,513 billion.

The banking system was able to absorb the impact of the crisis primarily because of its strong capital position. By March 1988, the commercial banking sector's capital remained strong at 17.3 percent of assets. A number of small banks closed but they represented less than 1 percent of the financial system's total resources.

The real problem of the corporate sector during the crisis was the rise in interest rates. Because commercial banks were strongly capitalized, they were willing to restructure and renegotiate existing loans by corporate borrowers, albeit at current market interest rates. Bank loan pricing was based on the bellwether 91-day Treasury bill rates rather than inflation. The interest rates on Treasury bills, meanwhile, ranged from 11 to 13 percent from 1993 to July 1997, then rose to a high of 22.7 percent in January 1998, sparking a rise in interest rates on corporate loans. Average bank lending rates climbed to their peak of 25.2 to 28.2 percent in November 1997. Lending rates were well above the 20 percent level from July 1997 to March 1998. Although corporate borrowers were not highly leveraged, they could not initiate a large reduction of their loans because these in part financed long-term growth in assets.

When the Treasury bill rates eased in March 1998, lending rates also came down, suggesting that commercial banks required a higher premium at about the height of the crisis but not beyond. Bank spreads over Treasury bill rates increased in 1997 but were within the range experienced in the past.

The combined effects of shrinking demand and high interest rates reduced the corporate sector's demand for loans. Loans outstanding of commercial banks declined by the first quarter of 1998, in varying degrees for each sector. By October 1998, the sectors with the highest outstanding loans had reduced their credit exposures. Manufacturing reduced its loans outstanding by 11 percent from October 1997 levels; and the wholesale and

retail trade sector, by 12 percent. However, loans outstanding of the real estate sector increased by 11 percent from June 1997 to June 1998. These figures show that adjustment problems were industry-specific and that the real estate industry, as with its counterparts in other Asian countries, was a problem sector. In March 1997, real estate loans averaged 11.9 percent of bank loan portfolios. These peaked at 14.3 percent in December 1997, and subsequently went down to 13.6 percent in June 1998. The pattern indicates that real estate loans were of substandard quality but banks had contained the problem by mid-1998.

As for nonperforming loans (NPLs), the ratio increased to a high of 11.5 percent by September 1998. But the Philippine banking system had gone through worse crises in the past, and its experience of low, single-digit NPL ratios began only since 1989. Still, the aggregate effect of the crisis on NPLs was of a magnitude comparable only to the country's last major banking crisis in 1984-1986.

3.5.3 Responses to the Crisis

Government Responses

The Government's policy and regulatory responses to the crisis focused on monetary and credit issues, the fiscal position, and the financial system. The Central Bank introduced regulations on foreign exchange trading to control speculation and nondeliverable forward contracts, set limits on overbought/oversold foreign exchange positions of banks, and set up a hedging facility for borrowers with foreign currency-denominated loans. The latter measure was especially beneficial to companies with unhedged foreign currency loans from commercial banks.

The Central Bank also moved to control inflation and bring down domestic interest rates by reducing the statutory reserve requirement by 3 percentage points and raising the liquidity reserve ratio by the same amount. The move retained the liquidity position of banks but lowered their cost of reserves, thereby reducing overall intermediation costs. This allowed the Central Bank to convince the banks, through the Bankers' Association of the Philippines, to reduce their lending spreads over the 91-day Treasury bill rates from 3-8 percent to 1.5-6 percent. This "voluntary agreement" partly explains why the loan spreads of banks were within the range of recent experience.

The Central Bank adopted other measures to strengthen the financial system, including (i) a regulatory limit of 20 percent on banks' loans to the

real estate sector; (ii) shortening the period for classifying unpaid loans as past due from three months to one month; (iii) fixing loan loss provisions of 2 percent of the gross amount of loan portfolio on top of individually rated bad loan accounts; (iv) increasing banks' capital requirement by 20 percent for universal banks (banks with expanded licenses) and 40 percent for ordinary commercial banks; (v) improving disclosure requirements on the financial position of banks; and (vi) issuing guidelines on duties and responsibilities of banks' boards of directors for improved quality of bank management.

The policy directions and actions taken by the Government appear to have ushered in recovery. The economy avoided a recession in 1998 and achieved 3.6 percent growth in 1999. With prudent monetary management, the Government kept inflation below 10 percent. Average Treasury bill rates have cooled since mid-1998. In response to calls for lower bank intermediation costs, bank loan rates have also come down. The real estate portfolio of commercial banks also declined and was well below the Central Bank's regulatory ceiling by March 1998.

Responses of the Corporate Sector

The corporate sector's financial position, its accessibility to foreign capital, and the legal framework for reorganization and liquidation conditioned its response to the crisis. With its weakened financial position, the corporate sector dealt with the crisis as any company facing a recession and drying up of credit would—companies cut costs by reducing staff, changing technologies, subcontracting and outsourcing, consolidating business units, and giving up noncore businesses. Financially strong companies were able to survive the crisis by effecting such internal restructuring. Large companies with heavy loan exposures such as Philippine Airlines Inc. (PAL), the country's flag carrier, took more action. PAL, which was privatized with the Lucio Tan group gaining control and the Government retaining minority ownership, came up with a rehabilitation plan by May 1999 that was found acceptable to all parties.

Publicly listed Philippine companies could also be restructured through takeovers by local and foreign investors. Takeovers in the past involved cooperative negotiations between purchasers of a target company and family-based large shareholders. In the case of PLDT, the largest telecommunications setup in the Philippines, the Asian crisis opened a unique opportunity for foreign investors. A 40 percent devaluation of the Philippine peso lowered the purchase price of PLDT to foreign investors. The acquiring company, First Pacific Corporation, was known to have a policy

of investing to control companies that are dominant players in their industries. First Pacific could have acquired sufficient shares to take control of PLDT in three ways. One mode was the outright purchase of shares in the open market. Consequently, the stock price of PLDT was buoyant during the takeover period. A second method was to purchase the shares of other large minority shareholders. PLDT's large minority shareholders such as the SSS and First Philippine Fund publicly announced their willingness to offer their entire holdings in a block sale at a premium. A third method was to make a formal tender offer to PLDT's controlling minority shareholders, the Cojuangcos, at a premium over the market price to reflect the value of management control. First Pacific, using some or all of these means, eventually took over PLDT and announced a restructuring plan for the entire group of companies.

SMC is another widely-held company managed by a minority shareholder, the Soriano family. In a legal process that ended in his takeover of management, Eduardo Cojuangco was able to assert his ownership of shares taken over by the Government during the transition of power in 1986. Although considered the prime industrial company in the Philippines, SMC had lagged behind other groups of companies such as Ayala Corporation in financial performance for some years. Its stock price and returns to shareholders had stagnated. When Cojuangco took over, he restructured the company toward its core brewery business and sold off local and foreign subsidiaries.

3.6 Summary, Conclusions, and Recommendations

3.6.1 Summary and Conclusions

The Philippine corporate sector has been shaped by the country's economic and industrial development policies. Ownership is highly concentrated and a few dominant players control major industries. Corporate governance is conditioned by the high ownership concentration of these large companies. When companies are highly profitable, controlling shareholders can capture these profits by excluding public investors from ownership. By itself, concentrated ownership of companies is not equivalent to weakness in corporate governance. It may even solve agency problems that a separation of control and ownership could precipitate because large shareholders have an incentive to closely oversee management. The question, however, is whether there are sufficient safeguards to prevent controlling shareholders from

expropriating the wealth of minority shareholders through aggressive and risky investment. With large shareholders in control, minority shareholders need to be protected by external control mechanisms. This study points out weaknesses in external control mechanisms such as weak legal protection for minority shareholders, oligopolistic market structures, an underdeveloped capital market, ownership of banks by business groups, an ineffective insolvency system, passive independent auditing, and the lack of market for corporate control. The result is that corporate governance depends only on internal controls.

This study analyzed trends in corporate performance and financing in relation to corporate governance from 1988 to 1997. The Philippine corporate sector was relatively efficient in investing and financing compared with other countries affected by the Asian crisis. Returns to capital exceeded inflation rates. Leverage was within Asian norms but above developed country standards. By ownership structure, foreign companies were the most profitable but highly leveraged. Privately-owned companies, the most numerous in the corporate sector, were the least profitable. Publicly listed companies had the highest profit margins and lowest leverage among the local companies.

By control structure, companies that are members of family-based conglomerates had higher returns and lower leverage than independent companies. By size, medium companies showed higher profitability than large and small ones. Performance was, to some extent, influenced by industry characteristics, with the real estate and public utilities industries standing out for their pronounced cyclical patterns.

Corporate governance should be viewed in the context of an increasing presence and growth of large shareholders-centered conglomerate business organizations. Ownership of publicly listed companies is highly concentrated. The five largest shareholders have majority control of an average publicly listed company, while the largest 20 shareholders control more than 75 percent of shares. Financial institutions are not significant shareholders. Forming business groups appears to be a viable means of competing because this allows for more efficient organization and utilization of resources of large controlling shareholders. Business groups occupied seven of the top 10 and 25 of the top 50 largest corporate entities in the Philippines in 1997.

The financing pattern of the corporate sector was influenced by the tight financial conditions prevailing in the country up to 1992. The corporate sector consistently relied on internally generated funds and equity before resorting to borrowings. Analysis of corporate financing by ownership

type gave similar results, with the foreign-owned companies found to rely more on borrowed funds.

After controlling for industry effects, statistical analysis of company-level data revealed significant relationships between corporate performance and corporate governance. ROA, ROE, and leverage were all positively related to the degree of ownership concentration. The positive relationship between financial leverage and ownership concentration is consistent with the hypothesis that controlling shareholders prefer to use debt financing in order to avoid ownership dilution.

Internal financial markets operated by business groups allowed them to optimize their financial resources at lower external debt levels. Publicly listed companies were responsive to investors' requirements for prudent use of debts. Ownership concentration was positively related to both returns and leverage. Companies whose large shareholders have higher degree of control tend to borrow more but generate better returns.

Family-based business groups have focused their investments in industries where their superior financing capacities and political/social influence give them unique advantages. Large companies owned or controlled by business groups tend to dominate their industries. A business group is an effective business organizational model for achieving leadership in industries, superior profitability, and sustained growth. A commercial bank is an important part of most business groups. Even in cases where the group owned only a minority share of a commercial bank, the bank usually accounted for a large share of each group's net profits. Large, family-based shareholders gain control by such means as the setting up of holding companies, selective public listing of companies in the group, and centralized management and financing. The pyramid model is useful for centrally managing smaller companies, as typified by the Ayala Group.

Business groups with pyramiding structures heighten the issue of corporate governance. Such structures result in control by large shareholders through disproportionately smaller investments in equity ownership. The difference between management control and ownership rights is usually substantial. Larger disparities in control over cash flow rights imply higher incentives for large shareholders to (i) expropriate wealth of shareholders not belonging to the controlling group and (ii) invest in empire-building and high-risk projects. The extent of governance problems depends on internal control policies of the controlling shareholders, the amount of pressure from stock market investors and PSE (for publicly listed companies in the group), and the extent of supervision of outside institutions such as independent auditors and SEC.

The financial crisis came when the Philippine economy was in a relatively strong financial position, with recently restructured public debt, a strong international reserves position, low inflation, the government budget in surplus, and a market-oriented policy environment. The corporate sector was also in good financial condition with rich internal cash flows accumulated from a number of profitable years, strong capital position built on IPOs in a buoyant stock market, and sound overall creditworthiness. The corporate sector accessed the foreign debt market only in the mid-1990s because of the country's long-drawn debt moratorium. Still, there was a sharp rise in borrowings and decreasing productivity of investments a few years before the crisis in a pattern similar to that of Asian crisis countries. The crisis caused a tightening of credit to the corporate sector and a spike in interest rates, adversely affecting companies' operations and financial position.

The Central Bank responded by improving the liquidity of the system and by establishing conditions for bringing down interest rates on bank loans. As the crisis wore on in 1998, there were sharp rises in the number of bankruptcies and petitions for debt relief, mostly by highly leveraged companies and speculative investors in real estate. The Central Bank imposed strict limits on real estate lending, resulting in the banks' accelerated restructuring of troubled debts in this sector. A number of large debtors petitioned SEC for rehabilitation under procedures set by PD 902-A. This law is flawed in concept because it supplants a market-based credit agreement with a political process. That is, SEC officials, rather than the banks that lent millions of pesos, decide on the financial future of a troubled debtor. Under the new Securities Regulation Code enacted in 2000, SEC's quasi-judicial functions, including suspension of payments, are to be removed and transferred to courts.

3.6.2 Policy Recommendations

The Government should address weaknesses in corporate governance identified in this study by introducing reforms in the policy and regulatory framework and promoting the development of markets. Specific actions recommended are described below.

Promoting a Broader Ownership of the Corporate Sector

The highly concentrated ownership of the publicly listed corporate sector should be a concern of SEC and PSE. There are systemic risks involved in highly concentrated ownership. For example, decisions by large sharehold-

ers often cause wide volatility in stock prices and invite reaction from creditors. The following recommendations involve amendments to the Corporation Code that will improve transparency of ownership and address the current high level of ownership concentration in Philippine business:

(i) require disclosures of underlying ownership of shares held by nominees and holding companies;

(ii) require disclosure of material changes in ownership; and

(iii) increase the minimum required percentage of outstanding shares for public listing in the stock exchange from the present 10-20 percent, depending on the size of the company, to 25 percent. The adjustment should be made over a fixed period of time.

Increasing the Statutory Accountability of Directors and Strengthening the Board System

The Government should clarify statutory fiduciary responsibilities of the board of directors. This will enable SEC to enforce prudential requirements on management of companies and enable minority shareholders to pursue grievances against their boards. Clear legal accountability is a precondition for successful shareholder activism.

Another measure would be to impose a statutory limit on the number of directorships that one can accept. This may limit current practices of appointing prominent individuals and family members as directors.

To strengthen the board, the PSE Listing Rules require the appointment of a minimum number of independent directors in the board of publicly listed companies. Because independent directors tend to adopt the perspective of minority shareholders in board decisions, they serve to curb the powers of controlling shareholders. To help ensure this, PSE Listing Rules should specify criteria and a selection process that will help ensure that the nominees for the position are truly independent and qualified.

Strengthening Minority Shareholder Rights

An issue that concerns minority shareholders is whether they have instruments—legal or ethical—that can prevent controlling shareholders from expropriating their wealth through risky investment and financing, inadequate disclosures, insider information, and self-dealing. SEC should strengthen disclosure requirements by issuing specific guidelines on minimum disclosures required for related party transactions. It has suffi-

cient case history that can be used as a basis for tightening its disclosure requirements.

Minority shareholders have failed to use traditional venues such as the annual general shareholders' meetings to discipline controlling shareholders that expropriate their wealth. They need legal empowerment such as higher majority voting requirements, e.g., raising the current two-thirds majority to a three-fourths majority. For example, current rules allow boards of directors to approve own-dealings or related party transactions by simple majority. Because ownership is generally concentrated in five shareholders, the board can easily muster the needed majority to approve the deal. By requiring sufficient disclosure and a 75 percent majority vote on such decisions, the board will be compelled to initiate a thorough discussion of the merits of the proposed related-party deals that will require the participation of minority shareholders. Finally, the Corporation Code should be amended to impose sufficiently stiff penalties for self-dealings that patently expropriate the wealth of other shareholders.

Improving Financial Regulation and Strengthening Implementation

The Asian crisis demonstrated the need to strengthen banking regulation. The Government should improve its prudential supervision system to ensure that banks perform their role as external control agents of their corporate debtors. The following recommendations aim to further improve banking regulations and supervision in the Philippines:

- (i) limit shareholdings of nonfinancial companies in banks, and of banks in nonfinancial companies in order to avoid connected lending;
- (ii) set strict limits on lending by banks to affiliated companies, officers, directors, and related interests. Impose severe penalties for any attempt by banks to circumvent this regulation;
- (iii) adopt international standards of capital adequacy and ensure that banks comply with these standards;
- (iv) require banks to follow international financial accounting, reporting, and disclosure standards; and
- (v) closely monitor, limit, or prohibit cross-guarantees by companies belonging to affiliated groups.

It is encouraging that the newly enacted 2000 Banking Laws have introduced changes along these lines, in particular, in areas of supervisory functions of the central bank, prudential measures and regulations, fit and

proper rule, foreign ownership of banks, transparency, and lending to DOSRI.

Reforming the Legal and Regulatory Framework for Investment Funds and Venture Capital

Owners of Philippine publicly listed companies consist of controlling shareholders and investors that hold trading portfolios. This investor profile has a "missing middle"—long-term investors who intend to participate in long-term growth of a company and who also trade shares depending on company performance. Investment and venture capital funds meet this description. In developed capital markets, institutional investors lead public investors in providing market signals to companies. This way, institutional investors can be a driving force in providing market discipline to management.

The absence of institutional investors indicates that the legal and regulatory basis 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, SEC and PSE can help ensure that these external control agents provide market discipline even in companies controlled by large investors. Institutional investors impose market discipline by voting on strategic corporate decisions. If institutional investors are present, an active financial analyst community can begin to form. Other investors benefit from the information that analysts produce for these institutional investors as information technology makes their output a public good. Managements find that their investment and financing decisions affect stock prices and become aware of their responsibility to create shareholder value.

Promoting Shareholder Activism

Promoting shareholder activism to encourage small shareholders to actively monitor management is an approach that has not been tried out in the Philippines. Two measures should be adopted to promote shareholder activism. One is improved transparency and disclosure on specific items that potentially involve expropriation of wealth of minority shareholders. The other is the addition of provisions in the Corporation Code to facilitate class action suits against corporate directors, management, and external auditors. The current law should expand class action suits to include management and

auditors. Placing the means for prosecuting in the hands of minority shareholders may instill more discipline in controlling shareholders, their directors and management, and the external auditors.

Legal provisions for class action suits should cover self-dealing by directors, compensation contracts, information disclosures, and dividend decisions. SEC should allow minority shareholders to be represented by activist groups. These groups have an incentive to gather technical expertise, leadership, and broad-based political and popular support to pursue possible cases involving expropriation of minority shareholders' wealth. The present provision on class action suits is inadequate because shareholders view the process as ineffective and expensive. SEC should take steps to simplify the process of class action suits and provide an avenue for out-of-court settlements similar to practices in the US, where the threat of class action suits alone is sufficient to encourage quality decisions and behavior from management.

Expanding Debt Securities Financing

The Philippine corporate sector relies on bank loans because controlling shareholders do not want to dilute their control by issuing equities. The Government should enhance the securities markets as an alternative source of corporate financing and pursue aggressive development of the local debt securities markets. It should develop a medium-term yield curve for the corporate debt market by strengthening the Government bond market. And by issuing Government Treasury securities in longer tenors, the Government could develop the market for future issues of corporate bonds. Philippine Government Treasury bonds should provide bellwether rates for corporate bonds in the way that they have for short-term bank debts. Promoting the corporate bond market requires that the Government develop trading systems and services of credit risk rating of corporate issuers. There are existing institutions such as Dun and Bradsreet, and Credit Information Bureau that can be the starting point of this effort. Securities market development efforts should coincide with strict regulation of the commercial banking sector. Companies are likely to remain dependent on bank financing if the authorities do not strictly enforce prudential lending regulations.

Promoting Competition in Product Markets

The Government should pursue industrial development policies that promote competition through the elimination of subsidies, guarantees, entry

and exit barriers, and various other forms of protection. The Government's competition policies should aim to facilitate the free entry and exit of domestic and foreign companies and regulation of anticompetitive practices. The Government should also continue to improve infrastructure, so that small- and medium-scale companies can become more competitive relative to large companies. Efforts to reduce graft and corruption, improve enforcement of the rule of law, and provide quality basic services should also be heightened.

Increasing the Supply of Quality Equities in the Stock Market

To promote the capital market as an external control agent in corporate governance, there is a need to increase the supply of quality securities from top-tier local companies in the Philippine stock market. Many large companies remain privately owned, and publicly listed companies trade barely the minimum number of shares required for public listing. Lack of liquidity deters institutional investors. The resulting absence of a strong investor base makes share prices vulnerable to manipulation or insider trading by large shareholders.

PSE and SEC need to build a liquid and efficient market. PSE should campaign for top-tier companies to go public and work with SEC in encouraging publicly listed companies to expand their share offerings to the public. SEC should require that a larger percentage of publicly listed companies' shares be sold to the public. The increase in percentage of public holdings may be gradually implemented to enable the companies to adjust.

Improving External Audit Standards and Information Disclosure

Effective external control in corporate governance requires accurate and timely information about companies. Audited financial statements contain basic information about a company's financial position and performance. Many of the problems associated with auditing and disclosure stem from the tendency of SEC and PICPA to be satisfied with replicating what their counterparts in the US require by way of audit standards and disclosures. Little attention is given to the conditions that make those regulations effective in the US corporate sector but not present in the Philippines. Another problem is the orientation of external auditors to the interest of large shareholders rather than public investors.

Current disclosure requirements of SEC are not rigorous enough for public investors. Penalties for poor conduct of auditing by independent

auditors and the mechanism for imposing them are weak. In spite of the many well-known cases of poorly audited financial statements that resulted in losses for investors, SEC and PICPA have not publicly penalized any auditor company that violated disclosure requirements or failed to submit audited financial statements. Instead, violators were made to pay only nominal penalties. SEC and PICPA need to formulate more specific disclosure standards, review the system of penalties on professionals involved in a company's violation of disclosure rules, and implement those standards and penalties rigorously.

Improving the Legal Framework for Suspension of Payments, Reorganization, and Liquidation.

Reforming the legal framework for suspension of payments, reorganization, and liquidation of troubled companies should be made a priority of the Government. PD 902-A has not accomplished any successful rehabilitation of a petitioning company since its implementation. The law is obviously not in line with the 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. For that matter, it creates a moral hazard problem. Although the new Securities Regulation Code enacted in 2000 has removed some of SEC's quasi-judicial functions, including the resolution of intracorporate disputes, suspension of payments and private damage actions, and transferred these to courts, the new law needs to be effectively implemented and enforced.

References

Abonyi, George. 1999. Thailand: From Financial Crisis to Economic Renewal. Institute of Southeast Asian Studies, March.

Alba, Pedro, Stijn Claessens, and Simeon Djankov. 1988. Thailand's Corporate Financing and Governance Structures: Impact on Firms' Competitiveness. Conference on Thailand's Dynamic Economic Recovery and Competitiveness, May.

Antonio, Emilio, Jr. 1997. Philippine Macroeconomic Prospects: The Next Ten Years. *Asian Industrializing Region in 2005*, edited by Toida Mitusuru and Daisuke Hiratsuka. Tokyo: Institute of Developing Economies.

Asian Development Bank. 1998. *Key Indicators of Developing Asian and Pacific Countries 1998*, Vol. XXIX. Manila: Asian Development Bank.

Barclay, Michael, and Clifford Holderness. 1989. Private Benefits from Control of Public Corporations. *Journal of Financial Economics* 25: 371-395.

Bangko Sentral ng Pilipinas. 1998. The Philippines: Onward to Recovery, July.

Burkart, M., Dennis Gromb, and Fausto Panunzi. 1994. Large Shareholders, Monitoring and the Value of the Firm. *Quarterly Journal of Economics*, 693-728.

Claessens, Stijn, Simeon Djankov, and Larry H. P. Lang. 1999. The Separation of Ownership and Control in East Asian Corporations. Discussion Paper, World Bank.

Claessens, Stijn, Simeon Djankov, Joseph P. H. Fan, and Larry H. P. Lang. 1998a. Diversification and Efficiency of Investment by East Asian Corporations. Working Paper, World Bank.

Claessens, Stijn, Simeon Djankov, Joseph P. H. Fan, and Larry H. P. Lang. 1998b. Ownership Structure and Corporate Performance in East Asia. Working Paper, World Bank, October.

Claessens, Stijn, Simeon Djankov, Joseph P. H. Fan, and Larry H. P. Lang, 1998c. Who Owns and Controls East Asian Corporations? Discussion Paper 2054, World Bank.

Claessens, Stijn, Simeon Djankov, Joseph Fan, and Larry H. P. Lang. 1999. Expropriation of Minority Shareholders in East Asia. Working Paper 2088, World Bank.

Demsetz, Harold, and Kenneth Lehn. 1985. The Structure of Corporate Ownership: Causes and Consequences. *Journal of Political Economy* 93 (6).

Dennis, David J., Diane K. Denis, and Atulya Sarin. 1997. Agency Problems, Equity Ownership, and Corporate Diversification. *Journal of Finance* 2 (1).

Diamond, Douglas. 1984. Financial Intermediation and Delegated Monitoring. *Review of Economic Studies* 51: 393-414.

Gestner, Robert H., David S. Scharfstein, and Jeremy C. Stein. 1994. Internal versus External Capital Markets. *The Quarterly Journal of Economics*, November.

Harris, Milton, and Artur Raviv. 1990. Capital Structure and the Information Role of Debt. *Journal of Finance* 45: 321-350.

Hart, Oliver, and John Moore. 1995. Debt and Seniority: An Analysis of the Role of Hard Claims in Constraining Management. *American Economic Review* 85: 567-85.

Hoshi, Takeo, Anil Kashyap, and David Scharfstein. 1991. Corporate Structure, Liquidity and Investment: Evidence from Japanese Industrial Groups. *Quarterly Journal of Economics* 106: 33-60.

Jensen, Michael. 1986. Agency Costs of Free Cash Flow, Corporate Finance and Takeovers. *American Economic Review* 76: 323-29.

Jensen, Michael. 1993. The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems. *Journal of Finance* 48: 831-80.

Jensen, Michael, and William Meckling. 1976. Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure. *Journal of Financial Economics* 3: 305-360.

Jensen, Michael, and Richard Ruback. 1983. The Market for Corporate Control: A Scientific Evidence. *Journal of Financial Economics* 11: 5-50.

Lufkin, Joseph C. F., and David Gallagher (eds.). 1990. *International Corporate Governance*. Euromoney Books.

Modigliani, Franco, and Merton Miller. 1958. The Cost of Capital, Corporation Finance, and the Theory of Investment. *American Economic Review* 48 (3): 261-297.

Myers, Stuart. 1977. Determinants of Corporate Borrowing. *Journal of Financial Economics* 5: 147-175.

Philippine Stock Exchange Fact Book 1997; 1995; 1994 and *Investment Guide* 1997.

Prowse, Stephen. 1998. Corporate Governance: Emerging Issues and Lessons from East Asia. World Bank.

Prowse, Stephen. 1990. Institutional Investment Patterns and Corporate Financial Behavior in the United States and Japan. *Journal of Financial Economics* 27: 43-66.

Prowse, Stephen. 1991. The Structure of Ownership in Japan. *Journal of Finance* 91: 1121-1139.

Shleifer, Andrei, and Robert W. Vishny. 1996. Large Shareholders and Corporate Control. *Journal of Political Economy* 94: 461-88.

Shleifer, Andrei, and Robert W. Vishny. 1997. A Survey of Corporate Governance. *Journal of Finance* L11: 737-783.

Singh, Ajit. 1992. How Do Large Corporations in Developing Countries Finance their Growth? Corporate Financial Structures in Developing Countries, Technical paper No. 1, IFC/WB, Washington, DC.

Stein, Jeremy C. 1997. Internal Capital Markets and the Competition for Corporate Resources. *Journal of Finance* LII, No. 1, March.

Stiglitz, Joseph E. 1985. Credit Markets and the Control of Capital. *Journal of Money, Credit, and Banking Lecture* 17, No. 2, May.

Webb, David. 1998. Some Conceptual Issues in Corporate Governance and Finance. Mimeograph. Asian Development Bank, November.

World Bank. 1998. *East Asia: The Road to Recovery*. Washington, DC.