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PHILIPPINE CORPORATE GOVERNANCE: ISSUES AND REFORMS

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This paper describes the macro structure for corporate governance in Philippine firms and their impact on internal corporate governance. The paper also assesses the strengths and weaknesses of corporate governance reforms initiated by regulatory agencies in the Philippines. Selected cases of corporate governance failures in some firms in the Philippine financial services sector are also presented. Weaknesses in corporate governance mechanisms in these cases were categorized into: 1) decision processes; 2) violation of regulations; 3) weaknesses of regulatory agencies; and 4) financial reporting standards. The paper ends with some recommendations addressing some of these weaknesses and other necessary reforms to improve corporate governance in Philippine firms.

I. INTRODUCTION

Corporate Governance – Defined

Corporate Governance refers to both the structure and process by which the public corporations control agency problems. Some of the issues addressed by Corporate Governance are: 1) how suppliers of finance assure themselves of getting a return on their investment (Shleifer and Vishny, 1997); 2) how to determine the uses of organizational resources and how to resolve conflicts among participants in organizations (Daily and Cannella, Jr., 2003); and 3) what mechanisms can be instituted through which outside investors protect themselves against expropriations by the insiders (La Porta, 2000). Jensen and Meckling (1976) wrote that agency problem dominates corporate governance research and quoting from Adam Smith's (1776) Wealth of Nations:

> "The directors of such (joint-stock) companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company."

Reforms in corporate governance have recently been the subject of much discussion in academic and policy making circles worldwide. This paper will discuss contemporary government structures and problems in the Philippine financial services sector. Specifically, this paper will:

1. describe the macro structure for corporate governance in Philippine firms and their impact on internal corporate governance;
2. examine cases of corporate governance failures in firms in the Philippine financial services sector;
3. determine weaknesses in corporate governance mechanisms governing the Philippine financial services sector; and
4. assess the strength and weaknesses of corporate governance reforms initiated by regulatory agencies in the Philippines.

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II. POLICY REFORMS IN ADVANCED COUNTRIES

In the US, reforms followed directly from high profile financial scandals of Enron (2001), WorldCom (2002) and Global Crossing (2002) blamed on the close relationship between these firms and their external auditors (Marlin, 2004). In 2002, the Sarbanes-Oxley Act was signed into law which revised the U.S. securities laws of 1930.

Reforms on Corporate Governance in recent years in the US and in UK focused on governance mechanisms that limit the agent's self-serving behavior for the protection of the principal as well as other minority stockholders. Initially driven by corporate collapses and financial scandals, the UK revised its Combined Code of 2003 which operates on the "comply or explain" basis (Mallin, 2004). In the US, the Sarbanes-Oxley Act was passed in 2002 triggered by a number of financial scandals e.g., Enron. The US does not have a corporate governance code like the UK. The Sarbanes-Oxley Act strengthens mainly the independence of the external auditor.

The intervention of regulatory agencies or lawmakers in the development of corporate governance mechanisms is necessary when a company is publicly-listed and has a large number of small owners. Oliver Hart (1995) cites two reasons for this: 1) dispersed shareholders have little or no incentive to monitor management and, 2) the owners are too small and numerous to exercise control on a day to day basis leading to the delegation of day to day control to a Board of Directors which in turn, delegates to management. This creates a situation where there is a separation of ownership and control and most likely, the managers, according to Hart, will pursue their own goals at the expense of shareholders.

III. REVIEW OF LITERATURE

Jensen and Meckling (1976) integrates elements from property rights, agency and finance theories to develop a theory of the ownership structure of the firm. The authors refer to ownership structure as the relative amounts of ownership claims held by insiders (management) and outsiders (investors with no direct role in the management of the firm). According to the authors, the relationship between the stockholders and manager of a corporation fit the definition of a pure agency relationship and that the issues associated with the "separation of ownership and control" are associated with the general problem of agency.

Agency theory has developed into two streams – the positivist agency theory and the principal-agent theory (Eisenhardt, 1989). According to the author, the positivist researchers focused on identifying situations in which principal and agent have conflicting goals, particularly on the principal and agent relationship between owners and managers of large, public corporations. In addition, positivist researchers describe governance mechanisms that limit the agent's self-serving behavior. On the other hand, the Principal-Agent researchers share the positivist assumptions about people, organizations and information but they follow logical deduction and mathematical proof. Research studies on the principal-agent theory focus on determining the optimal contract between the principal and the agent.

La Porta, et al. (2000) share the same view. The auditors classify the stakeholders into insiders (managers and controlling shareholders) and outsiders (minority shareholders and creditors). According to the auditors, "outsiders" face risk that the returns on their investments will never materialize because the "insiders" expropriate them. Expropriation means the "insider" use the profits of the firms to benefit themselves. Thus, outside investors must be protected by or through the legal system.

Shleifer and Vishny (1997) also pointed out that large investors may represent their own interests which need not coincide with the interests of other investors in the firm or with the interest of employees and managers. Examples cited by the authors are: 1) large investors may treat themselves preferentially at the expense of other investors and employees, and 2) force the firm to take on too much risk since he shares in the upside while other investors, who might be creditors, bear all costs of failure.

Classens, et al. (2000) found in their research that a relatively small number of families effectively control most of East Asian countries. According to the authors, a concentrated control structure of a corporation could lead to the suppression of minority rights and hold back institutional development of legal and regulatory channels to enforce these rights.

Fama and Jensen (1993) discussed in their research that decision processes of some corporation seem to be dominated by an individual manager, generally the CEO and in some cases, this signals the absence of separation of "decision management" and "decision control." The authors refer to decision management as the combined functions of initiation of proposals for resource utilization and decision control as the combined functions of ratification and monitoring. According to the authors, board members who are "outsiders" can act as arbiters in disagreements among internal managers and can carry out tasks that involve serious agency problems between internal manager and residual claimants such as setting executive compensation. The authors also recommend separation and diffusion of decision management and decision control in order to limit the power of individual agents to expropriate the interests of residual claimants.

Walsh and Seward (1990) argue for more independent outside representation in the Board of Directors noting some evidences that suggest that their presence improve corporate governance. According to the authors, concentrated ownership also motivates close monitoring of managers. Studies cited by the authors revealed that: 1) pay for performance relationships were much stronger in companies with concentrated as opposed to diffused, ownership profiles, and 2) large stockholders were directly involved in firm management rather than serving a purely monitoring role.

Daily, et al (2003) cited the more notable corporate governance reforms in the US including election of independent directors, separation of Board Chair and CEO positions, imposing age and turn limits of directors, providing compensation packages that include contingent forms of pay and the integration of the financial aspects in corporate governance. These reforms were adopted to insulate shareholders from managerial self-interest.

IV. METHODOLOGY

To portray the issues in corporate governance in the Philippine financial sector, the following activities were undertaken for this study:

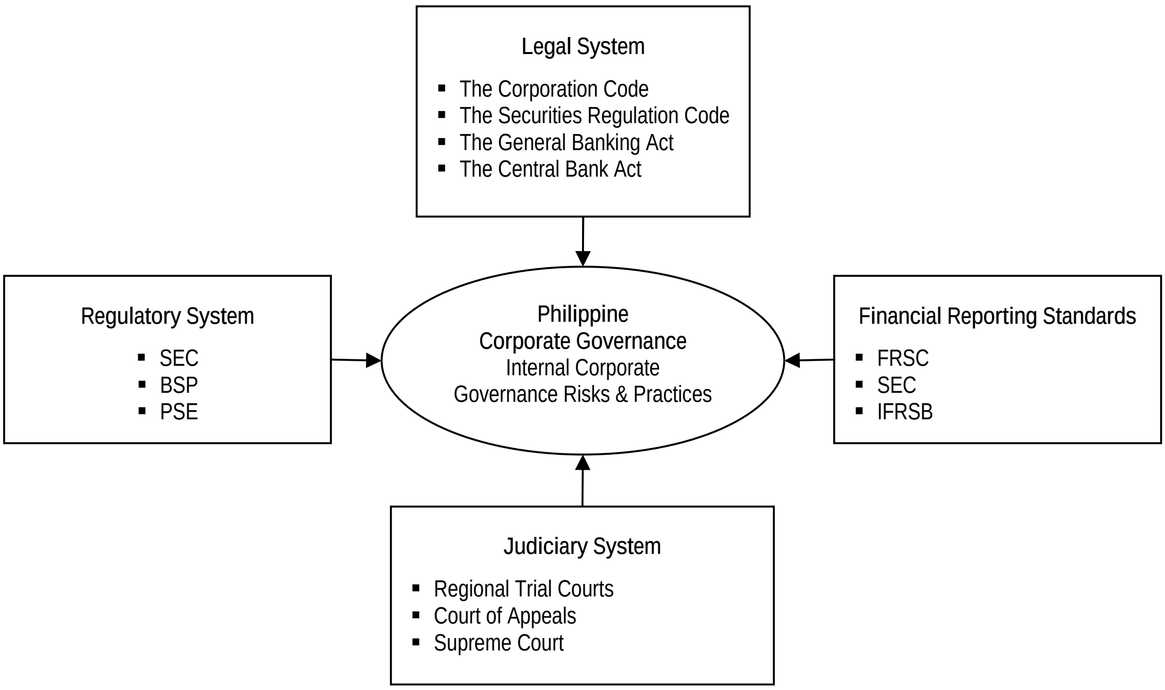
1. Review previous studies assessing the compliance of Philippine firms to financial reporting standards;
2. Review selected bank failures related to corporate governance in the Philippines;
3. Review of laws and regulations that provide the legal basis for the protection of stakeholders; and
4. Review of existing Philippine regulatory agencies and structures and assess their effectiveness in protecting stakeholders.

V. EXTERNAL INFLUENCES ON PHILIPPINE CORPORATE GOVERNANCE

This section discusses a framework for visualizing the factors which influence corporate governance in the Philippines.

The four external influences are grouped as follows: 1) the legal system, 2) the regulatory system, 3) the judiciary system and, 4) financial reporting standards (see Figure 1)

Figure 1
External Influences on Philippine Corporate Governance



Legend:
SEC – Securities and Exchange Commission
BSP – Bangko Sentral ng Pilipinas (the Central Monetary Authority)
PSE – Philippine Stock Exchange
FRSC – Financial Reporting Standards Council
IFRSB – International Financial Reporting Standards Board

Legal and Regulatory Systems

The legal system as an external influence on Philippine corporate governance include such laws as – the Corporation Code, the Securities Regulation Code, the General Banking Law and the Central Bank Act. The regulatory system encompasses rules and regulations issued by agencies that regulate corporate entities (the Securities and Exchange Commission), publicly-listed firms (the Philippine Stock Exchange), and financial institutions (the Bangko Sentral ng

Pilipinas). These rules and regulations have influenced corporate governance reforms in publicly-listed firms.

Under Republic Act 7653 (the New Central Bank Act, June 10, 1993), the Bangko Sentral, the independent central monetary authority shall have supervision over the operations of banks and exercise such regulatory powers as provided in RA 7653 and other pertinent laws over the operations of finance companies and non-bank financial institutions performing quasi-banking functions (see Table 1). On April 12, 2000, RA 8791 was passed into law to regulate the organization and operations of banks, quasi-banks and trust entities. Some of the provisions of RA 8791 related to corporate governance are the following (see Table 1):

1. Restriction on bank exposure to directors, officers, stockholders and their related interests (DOSRI);
2. Review by the Monetary Board of the qualifications and disqualifications of individuals elected or appointed bank directors or officers;
3. Prescribe at least five (5) and maximum of fifteen (15) directors, two (2) of whom shall be independent directors; and
4. Disclosure of transactions with the bank by family groups and related interests.

The Philippine Stock Exchange (PSE) provides the market for the trading of securities. In June 1998, the SEC granted PSE a Self-Regulatory Organization (SRO) status, authorizing it to impose rules and penalties on erring trading participants and listed companies. The Securities Regulation Code (SRC) follows the US model whereby the regulatory authority is divided between the SEC and the Stock Exchange. The PSE requires periodic financial reports to be submitted by publicly-listed firms. However, continuing review of financial statements require a large staff of accountants and the cost of maintaining the staff is quite high. Thus, it is doubtful that these financial reports are reviewed.

The SRC was enacted into law on August 8, 2000. One of the objectives of the SRC is to encourage the widest participation of ownership in enterprises. The SRC incorporates and modifies certain provisions of the Revised Securities Act (RSA) of 1982 and revised the earlier Securities Act of 1937. The SRC of 2000, the RSA (1982) and the 1937 Securities Act were all patterned after the 1933 US Securities Act and the 1934 US Securities Exchange Act. For the protection of investors, SRC requires the filing of annual reports and periodic reports which are necessary to update investors on the operation of the issuer's business. Reports include financial statements, auditor's certification, and a management discussion/analysis of results of operations.

Table 1
Banking Laws and Corporate Governance Issues

AN ACT PROVIDING FOR THE REGULATION OF THE ORGANIZATION AND OPERATIONS OF BANKS, QUASI-BANKS, TRUST ENTITIES AND FOR OTHER PURPOSES*	THE NEW CENTRAL BANK ACT**
▪ **Sec. 12.** *Stockholdings of Family Groups or Related Interests*. Stockholdings of individuals related to each other within the fourth degree of consanguinity or affinity, legitimate or common-law, shall be considered family groups or related interests and must be fully disclosed in all transactions by such an individual with the bank. ▪ **Sec. 13.** *Corporate Stockholdings*. Two or more corporations owned or controlled by the same family group or same group of persons shall be considered related interests and must be fully disclosed in all transactions by such corporations or related groups of persons with the bank. ▪ **Sec. 15.** *Board of Directors*. The provisions of the Corporation Code to the contrary notwithstanding, there shall be at least five (5), and a maximum of fifteen (15) members of the board of directors of bank, two (2) of whom shall be independent directors. ▪ **Sec. 16.** *Fit and Proper Rule*. To maintain the quality of bank management and afford better protection to depositors and the public in general, the Monetary Board shall prescribe, pass upon and review the qualifications and disqualifications of individuals elected or appointed bank directors or officers and disqualify those found unfit. ▪ **SECTION 36.** *Restriction on Bank Exposure to Directors, Officers, Stockholders and Their Related Interests*. No director or officer of any bank shall, directly or indirectly, for himself or as the representative or agent of others, borrow from such bank nor shall he become a guarantor, indorser or surety for loans from such bank to others, or in any manner be an obligor or incur any contractual liability to the bank except with the written approval of the majority of all the directors of the bank, excluding the director concerned: Provided, That such written approval shall not be required for loans, other credit accommodations and advances granted to officers under a fringe benefit plan approved by the Bangko Sentral.	▪ **Sec. 25.** *Supervision and Examination*. The Bangko Sentral shall have supervision over, and conduct periodic or special examinations of, banking institutions and quasi-banks, including their subsidiaries and affiliates engaged in allied activities. ▪ **Sec. 29.** *Appointment of Conservator*. Whenever, on the basis of a report submitted by the appropriate supervising or examining department, the Monetary Board finds that a bank or a quasi-bank is in a state of continuing inability or unwillingness to maintain a condition of liquidity deemed adequate to protect the interest of depositors and creditors, the Monetary Board may appoint a conservator with such powers as the Monetary Board shall deem necessary to take charge of the assets, liabilities, and the management thereof, reorganize the management, collect all monies and debts due said institution, and exercise all powers necessary to restore its viability. ▪ **Sec. 130.** *Phase-out of Regulatory Powers Over the Operations of Finance Corporations and Other Institutions Performing Similar Functions*. The Bangko Sentral shall, within a period of five (5) years from the effectivity of this Act, phase out its regulatory powers over finance companies without quasi-banking functions and other institutions performing similar functions as provided in existing laws, the same to be assumed by the Securities and Exchange Commission.

* *Source: Republic Act No. 8791*
** *Source: Republic Act No. 7653*

Judiciary System

Under RA 8799 or the Securities Regulation Code of 2000, the Philippine judiciary is now vested with original jurisdiction to hear cases that were used to be resolved by the SEC. Decisions by the Regional Trial Courts are appealable to the Court of Appeals and all cases decided by the Court of Appeals can be brought to the Supreme Court for final review. Following are the cases covered by the Philippine judiciary (See Table 2):

1. Acts of the board of directors or officers which are detrimental to the interest of the public or stockholder such as fraud and misrepresentation.
2. Controversies between and among stockholders.
3. Controversies in the election or appointments of directors, officers or managers of corporations.
4. Claims for profits on transactions of directors, officers and principal stockholders who own more than 10% of any class of equity security realized from unfair use of information obtained as owner/director within any period of less than six months.

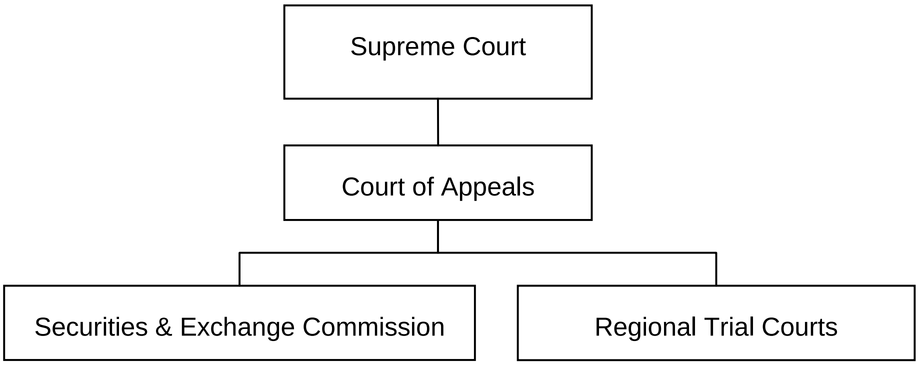
Table 2
Cases Covered by the Philippines Judiciary*

▪ Devices or schemes employed by or any acts, of the board of directors, business associates, its officers or partnership, amounting to fraud and misrepresentation which may be detrimental to the interest of the public and/or of the stockholder, partners, members of associations or organizations registered with the SEC;
▪ Controversies arising out of intra-corporate or partnership relations, between and among stockholders, members, or associates; between any or all of them and the corporation, partnership or association of which they are stockholders, members or associates, respectively; and between such corporation, partnership or association and the state insofar as it concerns their individual franchise or right to exist as such entity;
▪ Controversies in the election or appointments of directors, trustees, officers or managers of such corporations, partnerships or associations.
▪ The RTC also have jurisdiction over claims for profits on transactions of directors, officers and principal stockholders who are directly or indirectly the beneficial owner of more than ten per centum (10%) of any class of any registered equity security, or who is a director or an officer of the issuer of such security, for which profits were realized from an unfair use of information obtained as such beneficial owner, director, or officer by reason of the relationship to issuer, within any period of less than six (6) months, unless such security was acquired in good faith in connection with a debt previously contracted, irrespective of any intention of holding the security purchased or of not repurchasing the security sold for a period exceeding six (6) months.

** Source: Presidential Decree 902-A*

All other cases are vested in the SEC (see Figure 2).

Figure 2
Jurisdiction over Cases involving Corporations and Partnerships



Financial Reporting Standards

Financial Reporting Standards in the Philippines are set by Philippine Generally Accepted Accounting Principles (GAAP). In the Philippines, according to SEC Rule 68, GAAP represents accounting principles that are promulgated by the following, listed in the order of priority:

1. Philippine Securities and Exchange Commission
2. Financial Reporting Standards Council
3. Standards issued by the International Financial Reporting Standards Board (IFRSB)
4. Accounting Principles and Practices for which there is a long history of acceptance and usage.

The Financial Reporting Standards Council (FRSC) has fifteen (15) members, composed of the chair, who had been or presently a senior practitioner in public accountancy and fourteen (14) members representing the following:

1. Board of Accountancy	1
2. SEC	1
3. BSP	1
4. Bureau of Internal Revenue	1
5. A major organization composed of preparers and users of financial statements	1
6. Commission on Audit	1
7. Accredited National Organizations of CPAs	8
	14

The chair and members of the FRSC shall be appointed by the Professional Regulatory Commission.

Reliable financial reports are important control mechanisms used by stockholders in monitoring the performance of management.

The Code of Corporate Governance requires that the external auditor should be rotated every five (5) years or the handling partner shall be changed. BSP Circular 410 requires that only BSP accredited external auditors shall be engaged by banks and other financial institutions. Sanctions are imposed on erring accredited external auditors.

VI. IMPACT OF EXTERNAL INFLUENCES ON CORPORATE GOVERNANCE

Board Structure

Unitary Board. The corporation code defines the type of board structure for Philippine corporations which is the unitary board type, similar to the UK and the US. A board structure maybe unitary or dual. A unitary board is characterized by one single board comprising of both executive and non-executive directors. The shareholders elect these directors at the company's annual meeting. On the other hand, a dual board consists of a supervisory board and an executive board of management. The supervisory board oversees the direction of business. Shareholders appoint the members of the supervisory board (other than the employee members) while the supervisory board appoints the members of the management board. There can be no dual membership in the supervisory board and in the management board in order to have a clear distinction between management and control.

Following are the relevant sections of the corporation code that defines the board structure of Philippine Corporations:

1. Section 23. …the [members of the] board of directors [are] elected from among the holders of stocks who shall hold office for one (1) year and until their successors are elected and qualified.
   Every director must own at least one share of the capital stock of the corporation of which he is a director.
2. Section 25. Immediately after the election, the directors elect a president who shall be a director.

These sections of the Corporation Code define who should be members of the highest governing body of a public corporation.

The board of directors shall exercise all powers that are necessary to carry out its purposes as stated in its articles of incorporation subject to the required votes of the board and/or the stockholders. Table 3 shows decisions that could be made by the board and the necessary votes in the board required to authorize the action. Table 3 also shows the necessary votes required for stockholders to authorize the Board for the following specific actions:

1. Power to fix salaries of directors
2. Power to increase or decrease bonded indebtedness
3. Sale or other disposition of assets
4. Power to invest corporate funds in another corporation or business of for any other purpose.
5. Power to declare cash or stock dividends
6. Power to enter into management contract
7. Plan of merger or consolidation
8. Voluntary dissolution where no creditors are affected.

In April 2002, the SEC issued the Code of Governance which is applicable to: 1) corporations whose securities are listed or registered, 2) corporations which are grantees of permits/licenses and secondary franchise for the commission and, 3) public companies prescribe the following:

1. The Board shall be composed of at least five (5) but not more than fifteen (15) members elected by shareholders.
2. Public companies shall have at least 2 independent directors or such independent directors shall constitute at least 20% of the members of such Board, which ever is the lesser.

Table 3
Powers of the Board and Stockholders*

Corporate Decision	Needs Approval by Majority of the Board Members	Needs Approval by the vote of Stockholders: Representing AT LEAST 2/3 of outstanding capital stock**	Needs Approval by the vote of Stockholders: Representing MAJORITY of outstanding capital stock
1. Sec. 30. Power to fix salaries of Directors			✓
2. Sec. 38. Power to increase or decrease capital stock; incur, create or increase bonded indebtedness.	✓	✓	
3. Sec. 40. Sale or other disposition of assets. A corporation may sell, lease, exchange, mortgage, pledge or otherwise dispose of all or substantially all of its assets including goodwill.	✓	✓	
4. Sec. 42. Power to invest corporate funds in another corporation or business or for any other purpose. A private corporation may invest its funds in any other corporation or business or for any other purpose other than the primary purpose for which it was organized.	✓	✓	
5. Sec. 43. Power to declare cash dividends out of the unrestricted retained earnings	✓	n.a.	n.a.
Sec. 43. Power to declare stock dividends	✓	✓ in a regular or special meeting called for this purpose	
6. Sec. 44. Power to enter into management contract.	✓		✓
7. Sec. 77. Plan of merger or consolidation	✓	✓	
8. Sec. 118. Voluntary dissolution where no creditors are affected.	✓	✓	

* *Source: Batas Pambansa Blg. 68*
** At a stockholder's meeting duly called for the purpose.

Independent Directors. Independence generally means there are no relationship or circumstances which could affect director's judgment. In the UK, the Combined Code (2003)[1] requires Board balance and independence (Mallin, 2004). The board should include a balance of executive and independent non-executive directors such that no individual or small group of individuals can dominate the board's decision-making. In the US, the Sarbanes-Oxley Act of 2002 requires listed companies to have a board audit committee comprised only of independent members. The OECD (1999) also echoes this issue on independent non-executive directors requiring a sufficient number of board members not be employed by the company and not be closely related to the company or its management thru significant economic, family or other ties[2]. In the Philippines, the SEC Code of Governance requires public firms to have at least two (2) independent directors or such independent directors shall constitute at least 20% of the members of such Board, whichever is lesser.

Board Committees. The SEC Code of Corporate Governance requires an audit committee which shall be composed of at least three (3) Board members, preferably with accounting – finance background, one of whom shall be an independent director and another should have related audit experience.

The Board may also form the following committees:

1. Nomination Committee – may be composed of at least three (3) members, one of whom should be an independent director. The committee among other duties, may review or evaluate qualifications of all persons nominated to the board as well as those nominated to other positions that require Board approval.
2. Compensation or Remuneration Committee – may be composed of at least three (3) members, one of whom should be an independent auditor.

The Chairman and the Chief Executive Officer. One of the principles in the Combined Code (2003) is that there should be a clear discussion of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business (Mallin, 2004). In the US, the Commission on Public Trust and Private Enterprise 2003[3] states the following:

1. the chairman should be an independent director
2. if companies choose not to separate the two roles, a Presiding Director should be appointed.

In the Philippines, the SEC code of corporate governance states that the roles of the Chairman and the CEO may be separate.

Compensation to Members of the Board and Officers

The Corporation Code and the Code of Corporate Governance prescribe some limitations and disclosure requirements regarding compensation of directors and officers. Table 4 shows the pertinent provisions.

Table 4
Compensation to Members of the Board and Officers

Section 30. Corporate Code*	Code of Corporate Governance**
▪ In the absence of any provision in the by- laws fixing their compensation, the directors shall not receive any compensation, as such directors, except for reasonable per diems. ▪ Provided, however, that any such compensation (other than per diems) may be granted to directors by the vote of stockholders representing at least a majority of the outstanding capital stock at a regular or special stockholder's meeting. ▪ In no case shall the total yearly compensation of directors exceed 10% of net income before income tax of the corporation of the preceding year.	▪ The corporation's annual reports, information and proxy statements shall include a clear, concise and understandable disclosure of all plan and non-plan compensation awarded to, earned by, paid to or at least to be paid to, directly or indirectly to all individuals serving as the CEO… ▪ To protect the funds of the corporation, the commission may regulate the payment by the corporation to directors and officers of compensation, allowances, fees and fringe benefits in very exceptional cases, e.g. when a corporation is under receivership or rehabilitation.

* *Source: Sec. 30, Corporation Code*
** *Source: SEC Code of Corporate Governance*

Audited Financial Statements and Statement of Management's Responsibility

Rule 68.1 issued by the SEC on October 25, 2005 requires the Statement of Management's Responsibility signed by the Chair of the Board, the President, and the Chief Financial Officer.

The Statement of Management's Responsibility certifies that:

1. Management is responsible for all information and representations contained in the financial statements;
2. Financial statements have been prepared in conformity with accounting principles generally accepted in the Philippines; and
3. The Board of Directors reviewed the financial statements before such statements are approved and submitted to the stockholders of the company.

The U.S. Sarbanes – Oxley Act (2002) also requires this certification by CEOs and CFOs.[4]

Regulatory Powers Over Finance Operations and Other Institutions Performing Similar Functions

Republic Act 7653 (The New Central Bank Act, June 10, 1993) explicitly stated in Section 130 that within five (5) years from 1993, the BSP shall phase out its regulatory powers over finance companies without quasi-banking functions and other institutions performing similar functions as provided in existing laws. The regulatory functions for these institutions will be assumed by the SEC.

VII. SELECTED CASES IN THE PHILIPPINE FINANCIAL SERVICES SECTOR

Below are summary accounts of the five recent corporate failures in the Philippine financial services sector as reported in the business media which raise governance issues:

Orient Commercial Banking Corporation

This bank acquired its commercial banking license in February 1996. At the end of 1996 and 1997, total assets of Orient Commercial Banking Corporation amounted to P2.8 billion and P7.8 billion.[5] As of 1997, it had 52 branches. On February 14, 1997, Orient Bank declared a bank holiday due to liquidity problems. The BSP discovered some P5.44 billion of the bank's total loan portfolio of P6.1 billion in unrecorded loans to the bank's directors, officers, shareholders and other related interests (DOSRI) including loans of P50,000.00 each to eight newly-founded companies. Disbursements were made to these eight companies even before their registration was approved by the SEC. The last examination of the bank's records by the BSP was in 1996, when it was still a thrift bank. Books of banking institutions are subject to an annual examination by monetary authorities.

Monte de Piedad and Savings Bank

The bank had 30 branches and a deposit base of P6 billion from 80,000 individuals and corporate depositors at the time of its closure. The bank suspended its operation on April 23, 1997, 115 years after it was established. At the end of 1996 and 1997, total assets of the bank amounted to P6.69 billion and P5.98 billion.[6] Through a conduit lending investor firm, the bank incurred P1.8 billion of bad loans to public utility operators and drivers. This conduit firm, with only P100,000.00 capitalization was able to discount its papers with the bank from 1991 to 1995. BSP did not discover this arrangement during its regular examinations. Anomalous loans and irregularities were also not reflected in the audited reports. In 1995, 70% of MPSB's equity was acquired by the Vicente Tan group. The former owners reportedly paid themselves some P87 million in cash dividends between 1990 and 1994.

An audit of MPSB ordered by BSP after operations were suspended also revealed that the bank's ledgers of individual accounts were not properly maintained and that BSP had to rely on the records of MPSB's primary conduit, Strategic Lending Investors, Inc. (SLI), for the outstanding loan balances. At this point, the management of MPSB led by Vicente Tan, blamed BSP for its late discovery of "anomalous loans and irregularities" committed since 1992.

Westmont Investment Corporation WINCORP)

Wincorp collapsed in the year 2000. Wincorp violated on a large scale the DOSRI policy in financial institutions. The biggest borrower was also the second largest stockholder of Wincorp – the Sta. Lucia Realty and Development Inc. Sta. Lucia owned 20.3% of the total outstanding shares and cornered P943 million loans. Furthermore, stockholders of Unioil Resources & Holdings Company Inc., a major stockholder of Wincorp, were also borrowers of Wincorp in over 50% of the pooled investment accounts. Wincorp skirted the "19 lender rule" of the Revised Securities Act – prohibiting nonbanks from collecting deposits or investments from more than 19 clients – by collecting investments from its 2200 lenders or investors and combining them to less than 20 accounts.[7]

Wincorp also entered into a few large loan transactions related to the government privatization program. (Wincorp and Westmont Bank were linked to the Secretary of Finance during the years 1998-1999.) Wincorp loaned P1.5 billion to Malaysian Hottick Holdings Corp. at 17% interest over a one year repayment period. Hottick was to buy the government-owned National Steel Corp. However, the deal of NSC and Hottick was the subject of a legal battle and consequently, Hottick was unable to pay Wincorp. Another big borrower of Wincorp is Power Merge which had P2.5 billion debts to the firm. Other borrowing firms related to directors/owners amounted to P3.7 billion. Most of the borrowers were also shareholders of Unioil Resources and Holdings Co., Inc. which owns 100% of Wincorp.

Urban Bank

On April 26, 2000, Urban Bank closed. Total assets of bank as of the end of 1999 was P12.2 billion.[8] According to the regulators, deposits held by Urban Bank had been used to service the heavy withdrawals from its sister company, Urbancorp Investment Inc. (UII). UII sold to Urban Bank P2.8 billion worth of receivables described by regulators as "trash" or "doubtful and substandard" real estate projects. Urbancorp operated as an investment house without quasi-banking functions and engaged in trust operations pursuant to its trust license issued by the BSP. UII also carried between P5 billion and P10 billion in off-balance sheet items or transactions mostly in the form of marketable securities – managed and brokered by the firm but not reflected in its books. As of April 27, 2000, Urban Bank's deposit base stood at P9.1 billion. It had 24 branches.

The Philippine National Bank (PNB)

PNB had the largest amount of NPLs as of the end of the first quarter of CY 2000 at P36.8 billion representing 33% of its total loan portfolio. PNB is partly government-owned. Based on published data, the bulk of its non-performing loans have been granted to only a small number of big corporations which included government-related firms owned by individuals close to government officials and property firms[9]. In a special audit by Price Waterhouse Coopers (December 1991), it was found that 10 business groups have exceeded the BSP's single borrower lending limit which is 25% of a bank's unimpaired capital. It was also disclosed in the audit report that many of PNB's creditors were adversely affected by the significant deterioration of the peso due to the Asian crisis.

In 1997, when the Asian crisis occurred, PNB had total assets of P242.3 billion (as of the end of December 1997) and was ranked the No. 2 commercial bank in terms of total assets.[10]

VIII. WEAKNESSES IN CORPORATE GOVERNANCE MECHANISMS

The cases discussed in the previous section are clearly indicative of weaknesses in government regulatory structures and corporate governance mechanisms of financial institutions. These weaknesses allowed the expropriation of small investors by a few stockholders and management. These weaknesses may be categorized as follows:

1. Decision Processes;
2. Violation of Regulations;
3. Weaknesses of Regulatory Agencies; and
4. Financial Reporting Standards

Each of the above will be discussed in turn.

Decision Processes

When a significant portion of the outstanding shares is owned by a few individuals, such as the Wincorp, Orient Bank and Urban Bank, it is likely that there is no separation of decision management and decision control which is of utmost importance in banks particularly in the loan approval process and in the determination of the loan portfolio. It could be seen in the cases discussed, that the owners and directors effectively centralized and combined these functions at the board level. For example, Wincorp extended a few large loans to Hotlick and Power Merge totaling P4 billion. These two loans were both unpaid by the borrowers. PNB, likewise, granted big loans to only small number of big corporations. Thus, as of the first quarter of CY 2000 (a few years after the Asian financial crisis), it had the largest NPLs at P36.8 billion.

Violation of Regulations and Weaknesses of Regulatory Agencies

The cases also illustrated various ways of violating the Restriction on Bank Exposure to Directors, Officers, Stockholders and their Related Interests (DOSRI) rule in the Philippine General Banking Act (see Table 1). The case of Urban Bank demonstrated a weakness in of the regulators and/or Philippine laws. For example, in the Urban Bank case, it was not clear which agency, BSP or SEC should supervise investment banks like Urbancorp. While Urbancorp had a trust license to engage in trust banking activities and operate common trust funds, it was not under BSP supervision but under SEC.

Financial Reporting Standards

Wincorp violated the “19 lender rule” of the revised Securities Act and violated prudential limits on lending to DOSRI despite audits by the firm’s external auditors and audits by the BSP. In 1997, a study conducted by the UP College of Business Administration of 122 publicly-listed firms found violations by these publicly-listed firms such as: 1) overstatement of earnings per share; 2) failure to consolidate subsidiaries; 3) non-disclosures or inadequate disclosures as required by financial reporting standards; and 4) overstatement of assets and income.

Agustin reviewed 239 financial statements in the years 2001 and 2002 of 163 companies listed with the Philippine Stock Exchange. The study revealed that: 1) external auditors gave qualified opinions to 14% of the financial statements reviewed, and 2) only 7% of the statements were found to be compliant with all the prescribed rules issued by SEC and the ASC.

Dyball and Valcarcel (1999) concluded in their study that accounting regulation in the country (Philippines) is still more of the "tradionalist" and not a "corporatist". The latter means that the profession must be able to modify self-interested behavior and to uphold public interest. The authors noted that the biggest accounting firm has the biggest representation in Philippine Institute of Certified Public Accountants (PICPA) which in turn has the largest representation in the body that formulates the accounting standards in the country, the Financial Reporting Standards Council.

Cayanan (2006) in his study of 152 annual reports of 79 companies (17 banks and 62 holding companies) for the years 2002-2003 concluded that the monitoring systems of Philippine regulatory agencies such as the SEC, the BSP and PSE are weak and must be strengthened. Cayanan also observed that there is a high concentration of financial reports being audited by one accounting firm. Industry practice may be dictated by one firm and may become part of GAAP. Cayanan also noted that eight (8) out of 14 members of the Financial Reporting Standards Council (FRSC) come from the PICPA whose membership is composed of top accounting firms. This can clearly give rise to conflict of interest and lack of independence on the part of some FRSC members.

IX. CONCLUSIONS AND RECOMMENDATIONS

Weaknesses in corporate governance mechanisms in selected Philippine firms discussed in this paper have been partly addressed by regulations issued by government and other agencies, and by laws recently enacted by Congress such as banking laws and the securities regulation code. SEC also issued a code of corporate governance for publicly-listed firms.

These reforms have focused mainly on the board structure – the inclusion of independent directors as well as the choice of directors in the case of financial services firms supervised by the BSP. Reforms in the preparation of financial statements were also prescribed by the Financial Reporting Standards Council.

These reforms, however, are not sufficient to protect the "outsiders" for the following reasons:

1. The market share of just one dominant accounting firm still concerns investors and other foreign credit watchdogs because of the possibility of limiting the rotation of the handling partner within the dominant accounting firm every five years as prescribed by the Code of Governance. Furthermore, the independence of FRSC is affected by the dominance of one accounting firm;
2. Enforceability of laws is also weak. Philippine courts take years to resolve cases and violators are aware of this. Thus, some firms prefer the resolution of financial reporting cases by international arbitrators to Philippine courts. However, international arbitration is very expensive and may not be affordable by many;
3. More diversified ownership in banks is also lacking, ownership in banks is concentrated in few individuals and families and the industry is dominated by few banks controlling 71.2% of system-wide assets as of 2005 (see Table 5). In 2005, top 10 commercial banks accounted for 71.21% of the total assets of the commercial banking system. Of these top 10 banks, more than 50% are controlled by families and their affiliates, and two are wholly owned by the government. The concentration of ownership in banks in few individuals or families makes possible the violation of the DOSRI

banking rule which is a common cause of bank failure in the Philippines. This can also lead to decisions that are centralized at the board level that are not properly evaluated at various decision levels in the organization;

4. It seems that the monitoring system by regulatory/ supervisory bodies should be strengthened. Regulatory agencies should have more frequent examinations of firms that are most likely to violate rules/regulations due to ownership structure.
5. The regulators (SEC and BSP), the Philippine Stock Exchange, the Credit Rating Agencies and the Accounting Standards Council must play a stronger role to improve financial reporting practice for the protection of the investing public.

TABLE 5
TOP 10 COMMERCIAL BANKS - CY 2005
OWNERSHIP PROFILE

Name of Bank	Rank	Total Assets (in thousand PhP) Q4 '05	% To Total Assets[1]	Family Ownership[2]	Company Affiliates[3]	GOV'T[4]	PCD Nominee[5] (Fil/Non-Fil)	Other Companies	Unnamed Accounts	OTHERS (Ind)	TOTAL
Metropolitan Bank & Trust Co.	1	586,492,434	14.16%	30.25%	31.35%		17.66%	4.01%	1.11%	1.09%	85.47%
Bank of the Philippine Islands	2	529,963,253	12.80%	49.81%			35.29%	10.13%		0.06%	95.29%
Equitable PCI Bank	3	326,224,873	7.88%		32.52%	38.31%	13.35%	9.00%		1.36%	94.54%
Land Bank of the Philippines	4	310,927,244	7.51%			100%					100.00%
Banco de Oro	5	234,001,153	5.65%	0.86%	34.45%		57.73%	5.30%		0.48%	98.82%
Philippine National Bank	6	224,395,488	5.42%	NO DATA AVAILABLE							0.00%
Development Bank of the Philippines	7	210,588,768	5.09%			100%					100.00%
Citibank, N.A.	8	198,704,428	4.80%	NO DATA AVAILABLE							0.00%
Rizal Commercial Banking Corporation	9	189,262,088	4.57%	64.47%			6.23%	25.13%	0.34%	2.56%	98.73%
Allied Banking Corporation	10	138,441,515	3.34%	14.85%				46.29%[6]		38.86%	53.71%
TOP 10 (% Total Assets)		**2,949,001,244**	**71.21%**								
TOTAL ASSETS (40 banks)		**4,141,220,278**									

Based on Top 20 Stockholders indicated by banks in their GIS submitted to SEC.

[1] % to Total Assets = $\frac{\text{Total Assets Firm i}}{\text{Total Assets (40 banks)}}$

[2] Ownership based on Subscribed and paid up capital stock. Includes Bank as Trustee for retirement funds.

[3] Companies identified as owned by the family based on submitted stockholders list.

[4] Includes government offices like Social Securities System (SSS) and Government Service Insurance System (GSIS)

[5] PCD Nominee Corporation, a wholly-owned subsidiary of Philippine Central Depository, Inc. (PCD), is the registered owner of the shares in the books of the Company's transfer agents in the Philippines. The beneficial owners of such shares are PCD's participants, who hold the shares on their behalf or in behalf of their clients. PCD is a private company organized by the major institutions activitely participating in the Philippine capital markets to implement an automated book-entry system of handling securities transactions in the Philippines. Participants to PCD are all PSE member brokers, custodian banks, institutional investors and other corporations or institutions that are active players in the Philippine equity market.

[6] Representing four companies, namely: Virgo Holdings & Dev't Corporation, Iris Holdings & Dev't Corporation, Jewel Holdings, Inc. and King's Investment Dev't Corporation

TABLE 6
TOP 10 COMMERCIAL BANKS
CAPITAL STRUCTURE

Name of Bank	Rank	Total Assets (in thousand PhP) Q4 '05	Total Deposits (in thousand PhP) Q4 '05	Bank Borrowings (in thousands PhP) Q4 '05	Capital Accounts (in thousands PhP) Q4 '05
Metropolitan Bank & Trust Co.	1	586,492,434	424,345,371	61,708,347	49,510,600
Bank of the Philippine Islands	2	529,963,253	419,895,004	13,433,858	55,144,468
Equitable PCI Bank	3	326,224,873	207,995,500	29,931,513	43,880,103
Land Bank of the Philippines	4	310,927,244	242,779,681	29,104,294	24,707,124
Banco de Oro	5	234,001,153	159,084,809	37,022,945	20,186,453
Philippine National Bank	6	224,395,488	167,777,311	12,935,616	23,461,964
Development Bank of the Philippines	7	210,588,768	50,738,248	130,001,416	22,930,889
Citibank, N.A.	8	198,704,428	130,611,422	2,536,225	7,647,303
Rizal Commercial Banking Corporation	9	189,262,088	133,283,044	14,913,166	14,648,310
Allied Banking Corporation	10	138,441,515	111,018,350	3,945,658	12,078,016
TOP 10 (% Total Assets)		2,949,001,244	2,047,528,740	335,533,038	274,195,230
TOTAL (40 banks)		4,141,220,278	2,782,562,002	471,411,956	390,025,142
% to Total		*71.21%*	*73.58%*	*71.18%*	*70.30%*

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NOTES

[1] The Combined Code is appended to Listing Rules which companies on the LSE must abide by. Companies must conform to the provisions of the Combined Code on a 'comply or explain' basis which means that if the company is unable to comply with a particular provision, then it should explain why it is unable to comply (Mallin, 2004).

[2] The Organization for Economic Co-operation and Development (OECD) published its Principles of Corporate Governance in 1999. The principles focus on publicly-traded companies.

[3] The Commission on Public Trust and Private Enterprise 2003 was formed by the Conference Board, a non-profit organization to look at the circumstances which gave rise to corporate scandals which resulted in a loss of confidence in the US markets (Mallin, 2004).

[4] Under the US Sarbanes-Oxley Act, penalties are severe if CEOs and CFOs certify when in fact there is no compliance to requirements: US$1 million and 10 years improvement or both; under RA 8799 (Philippine Regulation Code penalties are: 1) supervisor/revocation of any registration for the offering of securities and 2) fine of not less than P10,000 but no more than P1,000,000 plus not more than P2,000 per day for each day of continuing violation

[5] Bangko Sentral ng Pilipinas Factbook, 1996 and 1997.

[6] Id.

[7] The BSP Manual of Regulations for Non-Bank Financial institutions cites the "19-lender rule" which states that financial instruments without quasi-banking license are not allowed to accept funds from more than 19 lenders (20 is construed to be sourcing from the "public").

[8] Bangko Sentral Factbook, 1999.

[9] "Asset Appraisal Report," PriceWaterhouseCoopers, December 1999

[10] Businessworld