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Managing Corporate Distress in the Philippines: Some Policy Recommendations

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Abstract

While not widespread, the Philippine corporate sector is showing some signs of stress. The paper reviews the exposure of banks to distressed corporate borrowers, the ownership structure of the corporate sector, including the interlocking relationship of corporations and banks, and the legal framework in place for the resolution of debts of distressed companies and the protection of creditor rights. It recommends that immediate measures be taken to improve transparency and regulatory oversight, and to quickly resolve the debts of distressed companies by strengthening the policy framework and institutional capacity for suspension of debt payments by the Securities and Exchange Commission.

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SUMMARY

Philippine companies have weathered the regional financial crisis relatively well because of their smaller exposure to foreign debt and better corporate performance. However, the structure of the corporate sector and the process for dealing with distressed borrowers raise issues that need to be addressed. First, the concentrated ownership structure and the cross shareholdings between banks and corporations allow for the easy flow of credit and a high degree of leverage. Second, inadequate enforcement of rules governing disclosure implies that the true financial condition of companies may not be known until it is too late to take corrective action. Third, the weak policy framework for debt restructuring by the Securities and Exchange Commission precludes the rapid resolution of the debts of distressed companies.

To prevent problems from emerging as growth slows, it is essential that measures to deal with distressed borrowers are taken immediately. In this paper, we recommend that policies aim at improving transparency, regulatory oversight, and in the short term, the legal framework for resolution of distressed corporate debts.

In particular, the reform measures should include: (1) strengthening the risk management practices in the banking system to ensure that banks adhere to high standards for prudential lending; (2) enforcing full financial disclosure, by imposing severe penalties for noncompliance, in order to provide an early warning of corporate distress; and (3) strengthening the policy framework and institutional capacity for suspension of payments by the Securities and Exchange Commission to allow for the rapid resolution of illiquid or insolvent companies while protecting the contractual rights of creditors. However, over time the quasi-judicial function of the Securities and Exchange Commission should be transferred to a special bankruptcy court. This would necessitate an improvement in court governance and a new bankruptcy law, incorporating some of the proposals recommended in the paper.

I. INTRODUCTION

As the regional financial turmoil deepens and economic growth declines, issues concerning the health of the corporate sector in the Philippines need to be addressed. These include the impact on the corporate sector of high domestic interest rates and unhedged external borrowing, and measures to facilitate corporate debt restructuring. In addition, it is important to examine the degree of interlocking of corporations and banks given that distress in the corporate sector would spread to the banking sector. A fragile banking system erodes confidence, impedes new lending to the productive sector, and would exacerbate the contraction already taking place in the real economy.

This paper reviews the state of the corporate sector in the Philippines, focussing in particular on the exposure of banks to distressed borrowers, the interlocking relationship between the corporate and the banking sectors, and the legal framework in place for the resolution of the debts of distressed companies and the protection of creditor rights. We find that while there has been no widespread disruption of corporate activity, the existing structure of the corporate sector and the process for dealing with distressed borrowers raise issues that need to be addressed. First, the concentrated ownership structure and the cross shareholdings between banks and corporations allow for the easy flow of credit and a high degree of leverage. Second, inadequate enforcement of rules governing disclosure implies that the true financial condition of companies may not be known until it is too late to take corrective action. Third, the weak policy framework for debt restructuring by the Securities and Exchange Commission (SEC) and its lack of institutional capacity preclude the rapid resolution of the debts of distressed companies which is critical given the large increase in the number of companies filing for suspension of debt payments. As the economy comes under increasing pressure and the level of nonperforming bank loans rises, it is essential that measures are taken now to deal with distressed borrowers. In particular, reforms must aim at improving transparency, regulatory oversight and the quick resolution of the debts of distressed companies by, in the short term, strengthening the policy framework and institutional capacity for suspension of debt payments by the Securities and Exchange Commission.

While important, this paper does not address the role of tax policy in corporate debt restructuring. A comprehensive treatment of these issues is beyond the scope of this paper but clearly can be the subject of future work.

The paper is organized as follows. Section II provides some data on the level of corporate debt, including a regional comparison of corporate performance. Section III estimates the relative impact on the net worth and debt service payments of corporates of an exchange rate depreciation and an increase in interest rates. Section IV reviews corporate governance, corporate debt restructuring and enhancement of creditor rights. Section V concludes.

II. THE LEVEL OF CORPORATE DEBT

(a) *Corporate debt.* As of March 1998, the total liabilities of the top 5,000 corporations in the Philippines was $126 billion or 180 percent of GNP (Table 1). Excluding banks, total corporate liabilities was $98 billion.[2] Of this amount, foreign debt was about $12.5 billion and foreign currency denominated liabilities owed by corporations to domestic banks was an additional $10.8 billion. The rest, $74.7 billion consisted of debt denominated in local currency. The banking system accounts for the largest share of corporate liabilities, amounting to $24.2 billion (excluding foreign currency denominated liabilities), while inter-company debts, issues of commercial papers by corporations (about $1.5 billion) and other accounts payable amount to $50.5 billion .

Table 1. Selected Indicators of the Top 5,000 Corporations in the Philippines

(In billions of U.S. dollars as of March 1998)
Exchange rate: ₱40/US$

	Top 5,000	First 1,000	Second 1,000	Next 3,000
Sales	69.2	56.2	6.5	6.4
% of GNP	98.4	79.9	9.2	9.1
Profits	3.8	3.5	0.3	0.1
Assets	181.0	154.9	14.4	11.7
Liabilities	126.2	109.5	9.1	7.6
Excluding banks	98.0	...	...	...
Stockholders' equity	54.7	45.3	5.3	4.1
Excluding banks	50.6			
Debt-equity ratio	2.3	2.4	1.7	1.8
Excluding banks	1.9	...	...	...

Source: Securities Exchange Commission; Philippine Stock Exchange Investments Guide, 1997; staff estimates.

Most of the domestic debt (both peso and foreign currency denominated) was short term while on the external side, about $2.8 billion or 22.4 percent of the total corporate external debt was short term.

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[2]This is based on data for publicly listed banks as of end-June 1997.

(b) Debt-to-equity ratio. The debt-to-equity ratio for the top 5000 corporations, excluding banks, is 1.94. At that level, it is comparable to the ratios for Indonesia and Malaysia but significantly lower than the ratios for Thailand, Korea and Japan (Table 2). Claessens et. al., (1998) argued that the Philippines had weathered the financial crisis better than some of its neighboring countries because of its relatively low exposure to foreign debt, better corporate performance and lower debt to equity ratios. Like Malaysia and Indonesia, its corporate and banking sectors were hit more by contagion rather than by a rapidly deteriorating corporate performance as was the case in Thailand and Korea. The slight difference between the debt equity ratio estimated here and that found in Claessens et. al. (1.94 versus 1.89) is most likely due to the different sample size and observation period, as the Financial Times Extel data used by Claessens et. al. covered only 49 companies in 1997.

Nevertheless, at 1.94, the debt-equity ratio is not low and could increase. Indeed, the number of companies that filed for suspension of debt payments has risen sharply from 3 in the first quarter of 1997 to 14 in the first quarter of 1998 alone. So far this year, a total of 24 companies have filed for suspension of debt payments, with 8 subsequently dismissed by the SEC.[3] In addition, the total value of liabilities involved surged, from less than $0.3 billion for the whole of 1997 to more than $2.4 billion so far this year. In June, the financial problems of the country's major airline, the Philippines Airlines (PAL), worsened (exacerbated by a pilot strike), causing it to seek suspension of payments by the SEC. At the same time, it filed a restraining order with a bankruptcy court in California to prevent U.S. creditors from foreclosing on its loans. The total debt involved is estimated at $2 billion (2.8 percent of GNP) with some 11 percent due to local banks .[4]

III. The Relative Impact of Interest Rate Versus Exchange Rate on Corporate Balance Sheet

The relatively even distribution between foreign and local currency denominated debt—$23.3 billion versus $24.2 billion as of March 1998—indicates that the corporate sector is both affected by a sharp exchange rate depreciation and a major sustained increase in interest rates. Determining which will have the greater impact on corporate balance sheets depends on a number of factors, including factors such as the depth of the currency depreciation, the length of time in which interest rates are sustained at high levels to support the currency, the

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[3]For 1997 as a whole, 21 companies filed for suspension of debt payments compared to a total of 50 since 1982.

[4]PAL made a net loss of ₱8.08 billion in the year to March 1998, a threefold increase from its previous year's loss of ₱2.5 billion. On September 17, four days prior to submitting a rehabilitation plan, PAL announced it was shutting down due to insurmountable losses and following the breakdown of negotiations between management and the labor unions.

Table 2. A Regional Comparison of Corporate Performance

Country	Year	Observations	ROA (%)	MBA (ratio)	Int/Profit (%)	Not Repay (%)	Debt-equity (ratio)
Hong Kong	1994	310	7.6	1.47	34	2.4	1.94
	1995	347	4.2	1.38	37	3.1	2.53
	1996	343	4.1	1.44	40	4.2	3.11
	1997	159	5.1	1.42	43	4.8	3.29
Indonesia	1994	258	5.5	1.38	39	0.8	1.96
	1995	275	5.1	1.15	42	1.2	2.12
	1996	268	4.4	1.23	45	1.8	1.89
	1997	14	4.1	1.17	49	3.7	2.34
Japan	1994	678	1.0	1.53	66	5.7	3.55
	1995	494	0.7	1.42	74	7.8	3.79
	1996	489	0.7	1.54	73	8.6	3.91
	1997	388	0.9	1.42	75	10.6	4.31
Korea	1994	224	1.9	1.23	67	5.2	4.70
	1995	226	1.5	1.15	69	5.8	5.42
	1996	81	0.4	1.06	85	10.9	6.21
	1997	29	-0.9	0.97	88	31.8	6.39
Malaysia	1994	592	6.8	2.23	32	2.1	1.21
	1995	653	6.4	1.98	36	4.6	1.61
	1996	695	5.9	2.04	35	5.0	1.90
	1997	374	5.2	1.69	34	5.3	2.21
Philippines	1994	110	4.5	1.63	42	3.6	1.63
	1995	138	5.0	1.53	36	5.9	1.52
	1996	140	4.4	1.51	39	6.5	1.56
	1997	49	4.7	1.39	46	7.9	1.89
Singapore	1994	289	5.5	1.64	42	4.6	1.50
	1995	298	3.9	1.61	41	5.1	1.76
	1996	310	3.8	1.58	45	4.6	1.97
	1997	113	4.5	1.54	44	6.1	2.07
Taiwan	1994	172	6.4	2.13	36	1.5	1.16
	1995	177	6.0	1.72	35	1.3	1.12
	1996	79	6.1	1.89	39	3.6	1.26
	1997	68	5.8	1.63	40	5.1	1.38
Thailand	1994	503	5.5	1.54	39	5.0	2.82
	1995	526	4.0	1.35	40	7.6	3.16
	1996	498	1.0	1.17	46	13.6	3.39
	1997	48	-13.1	0.84	73	34.8	4.09

Source: Claessens et. al. (1998). ROA is return on assets; MBA is market to book value defined as total assets minus the book value of equity plus the market value of equity; Int/Profit is interest expenses over profits before interest, taxes and depreciation. Not Repay is the share of firms which have interest expenses higher than their profits before interest, taxes, and depreciation.

amount of maturing external and domestic debt that is rolled over, the additional revenue gain from higher export receipts and domestic prices and the extent to which external debt is hedged.

The experience of the recent Asian crisis highlights the challenge faced by policymakers. On the one hand, raising interest rates to defend the currency and protect the net worth of companies may trigger problems of illiquidity among companies, and in the worst cases, insolvency. On the other hand, not raising interest rates to defend the currency would cause a sharp decline in the net worth of companies, an attendant increase in the debt-equity ratio as well as higher debt service payments. Policymakers have to tread a fine line between these two scenarios, raising interest rates when necessary to support the currency and to "lean against the wind" but lowering interest rates once the currency has stabilized. The Philippines have generally followed this rule.[5] The central bank raised interest rates sharply at the onset of the crisis in July 1997 and subsequently when speculative pressures reemerged but reduced them once these pressure abated. Since the beginning of this year, bank prime lending rates have declined by 9 percentage points.

The following simple exercise illustrates the relative effect on the balance sheets of the corporate sector of a depreciation of the exchange rate versus an increase in the interest rate.[6,7] Assuming that 50 percent—the actual share accounted for by exporters—of the foreign currency liabilities of corporations ($10.8 billion) are hedged and another $1.3 billion are covered by forward contracts (i.e., the difference between forward sold and forward bought positions of banks as of end-1997), then $6.7 billion of the total foreign currency liabilities are hedged or $16.6 billion (23.6 percent of GNP) of foreign currency debt is unhedged. A 10 percent depreciation of the exchange rate would thus decrease the net worth of the corporate sector by 2.4 percent of GNP. Given the current dollar interest rate of 9 percent,

[5]In addition, the central bank provided cover to unhedged borrowers using the non-deliverable forward facility to ease pressures on the peso, and for a brief period last year, suspended the sale of non-deliverable forward contracts from onshore banks to offshore counterparties.

[6]Accounting standards in the Philippines which is based on the International Accounting Standards Council allow foreign exchange losses associated with loans to acquire specific assets to be added to the value of the assets or amortized over the remaining life of the loan in question. The former creates a gain from revaluation equal to the foreign exchange loss and the net worth of the borrower remains unchanged. See section IV below.

[7]Of course, a better assessment of the relative exchange rate versus interest rate effect can be obtained by looking at individual corporate balance sheets and taking into account the variance across companies. This exercise asssumes all maturing debt is rolled over.

the debt service interest payments of the corporate sector would rise by 0.2 percent of GNP.[8] In view of the cumulative depreciation of the peso-dollar rate of 38 percent since the float in July last year, the net worth of the corporate sector would in this example have declined by 9.1 percent of GNP and its cash flow by 0.8 percent of GNP. On this basis, the debt-equity ratio would have increased to 2.2.[9]

With a total peso debt of $24.2 billion (34.4 percent of GNP), most of which is short term and subject to floating rates, a 1 percentage point increase in the peso interest rate would increase the debt service payments by 0.3 percent of GNP. As of March 1998, the total increase in bank lending rates from the pre-crisis mid-1997 levels was 10 percentage points, suggesting a reduction in the cash flow (if interest rates had remained at high levels) of the corporate sector by 3 percent of GNP (on an annual basis). However, bank lending rates have since declined to some 5 percentage points above pre-crisis levels, hence reducing the additional debt service interest payments to 1.5 percent of GNP.[10]

IV. Corporate Governance

Corporate governance is a set of rules that defines the behavior of company managers while ensuring their accountability to shareholders. Good corporate governance is essential for a well functioning economy as it provides incentives for managers to act in ways that raise the firm's net present value and assure shareholders an adequate return. However, empirical evidence shows no one corporate governance mechanism can fully protect the best interests of shareholders. Instead, a mix of institutional structures—such as the transparency of corporate financial information, internationally accepted auditing and accounting standards, liberalized markets for corporate control, open capital markets, legal protection of investor rights and well functioning bankruptcy procedures—are required to ensure that markets can assess risks and impose discipline.

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[8]The 9 percent rate is the current interest rate on foreign currency deposit unit loans. Interest rates on existing short-term foreign debt are lower, at LIBOR plus 200–250 basis points (7–8.5 percent).

[9]If the total amount of hedged corporate liabilities was 17 percent of total liabilities (assuming only 25 percent of foreign currency denominated liabilities are hedged), the net worth of the corporate sector would decline by 2.7 percent of GNP and the debt service burden would rise by 0.25 percent of GNP on a 10 percent depreciation of the peso.

[10]Note that in real terms, bank prime lending rates are now close to pre-crisis levels.

A. Ownership Structure and Corporate Financing

(a) The ownership structure. The Philippine corporate sector is dominated by a relatively small number of large groups. In addition to owning and controlling major sectors of the manufacturing and services sector, these groups also control most of the major banks in the country. The Philippine Stock Exchange Investment Guide shows that 60 to 90 percent of most publicly listed companies are owned by the top 20 stockholders, with the top 5 shareholders owning more than 50 percent (Table 3).[11] In addition, the degree of cross-shareholdings is extensive (Table 4). For example, Ayala Corporation, the country's oldest business house, owns a 43 percent stake in the Bank of Philippine Islands and has concerns in real estate, insurance services, electronics and information technology, food manufacturing and telecommunications. Similarly, Benpres Holdings another large conglomerate owns 18 percent of Philippine Commercial International Bank and has diversified into broadcasting, property development, power generation and distribution, telecommunications and transportation. The high ownership concentration and the tight linkage between the corporate and banking sectors have also led to a significant concentration of loans outstanding. For instance, the top 100 corporate borrowers in the Philippines account for $10.7 billion or 30 percent of loans outstanding from the banking system.

These observations are certainly not new. Tan (1993) has argued that a number of the relatively large firms in the Philippines have characteristics similar to the Korean chaebols and Japanese zaibatsus: they are family-owned; include a bank among their component firms; very few are publicly traded on the stock exchange; they receive preferential treatment from the government and some of their directors are politically influential.

(b) Costs of high ownership concentration and extensive interlocking. A high degree of ownership concentration may not necessarily be bad. Economies of scale arguments would suggest some positive correlation between ownership concentration and the efficiency of operations as well as higher levels of profitability. However, combined with extensive cross-shareholdings, especially in relation to the banking system, large firms can easily circumvent prudential controls on commercial bank lending, leading to significantly higher leverage and

[11]Only 222 companies out of the top 1,000 corporations in the Philippines are publicly listed on the stock exchange, with a total market capitalization of ₱1,137 billion (40 percent of GNP). The relatively small size of the stock market reflects the reluctance of family owned firms to go public as most prefer to rely on internal sources of funds rather than raising equity or debt from the capital markets to finance their expansion.

Table 3: Ownership Concentration by Selected Industries, as of December 31, 1997

(% of total shares held)

Industry Classification	Top 20 Stockholders	Top 5 Stockholders
Banks		
• Bank of the Philippine Islands (3)	90.7	75.9
• Far East Bank and Trust Company (5)	81.4	58.2
• Metropolitan Bank and Trust Company (1)	69.1	57.3
• Philippine Commercial International Bank (6)	80.8	63.3
• Philippine National Bank (2)	66.2	53.8
• Rizal Commercial Bank (11)	85.3	76.8
• Union Bank of the Philippines (17)	81.5	59.3
Communication		
• ABS-CBN Broadcasting Corporation	84.6	79.9
• Philippine Long Distance Telephone Co.	75.4	66.0
Power and energy		
• Manila Electric Company	68.2	46.2
• Petron Corporation	82.8	80.8
Transportation		
• Kepphil Shipyard, Inc.	83.6	73.6
• Asian Terminals, Inc.	78.8	47.8
Construction		
• Alsons Cement Corporation	88.1	68.3
• Mariwasa Manufacturing Corporation	99.1	83.9
Food, beverage, and tobacco		
• Jollibee Foods Corporation	92.7	61.0
• San Miguel Corporation	59.0	28.8
Manufacturing, distribution, and trading		
• Atlas Fertilizer Corporation	81.3	72.5
• Pryce Corporation	74.8	50.6
Property sector		
• Ayala Land Inc.	66.3	63.9
• C&P Homes	83.1	79.3
• Filinvest Land, Inc.	66.8	62.1
• Megaworld Properties and Holdings, Inc.	90.5	82.2
Oil sector		
• Sinophil Corporation	68.9	38.5
• Oriental Petroleum & Mineral Corporation	61.3	52.1

Source: Philippine Stock Exchange Investments Guide, 1997; number in parenthesis indicate the ranking of banks by size.

Table 4. Interlocking Ownership as of December 31, 1997: A Selected Sample

(In percent of ownership of companies in concerned industries)

Subsidiaries/Affiliates	Holding Companies			
	Ayala Corporation	Aboitiz Equity Ventures	Benpres Holdings Corporation	JG Summit Holdings Inc.
Banking/Financial	40.6	34.0	17.7	100.0
Food Manufacturing	100.0	92.0		100.0
Transportation	15.0	49.5	50.0	
Telecommunications	40.3		9.6	59.3
Broadcasting			70.9	
Real Estate	78.5	100.0	24.5	100.0
Electronics	76.1			
Power Generation and Distribution/Electricity		100.0	28.3	
Insurance	100.0			
Textiles and Garments				100.0
Construction		11.5		

Source: Philippine Stock Exchange Investments Guide, 1997.

increased vulnerability to a downturn in the economy.[12] Moreover, controlling shareholders could become so important that they expropriate wealth from minority shareholders. Morck, Shleifer and Vishny (1988) show that as ownership becomes more concentrated in U.S. firms, the value of the firm declines, suggesting that wealth is diverted from minority shareholders through various means. In the Philippines, buyers in takeovers can deal only with the owners of controlling share blocks and are under no obligation to offer the same purchase price to minority shareholders.

[12]In Korea, large corporate groups (known as chaebols) are prohibited from acquiring commercial banks but are allowed to acquire controlling stakes in nonbank financial institutions. Chaebols used their affiliated nonbank financial companies (merchant banks, finance companies and insurance companies) to finance their activities within the group (see Republic of Korea: Selected Issues, SM/98/99).

The close relationship between the banks and corporates has also encouraged both parties to exploit the arbitrage opportunities presented by the considerable distortion in the tax treatment across institutions and currency (Table 5). This process, known as "engineered swaps" allows banks to profit more from dollar intermediation through foreign currency deposit units (FCDUs) than from peso intermediation.[13] The arbitrage profit arises because while banks incur a 10 percent tax liability on the interest income on dollar loans to residents, they can claim tax savings equal to 35 percent of the FCDU deposit interest expense. In addition, until recently, dollar deposits were not subject to withholding tax nor reserve requirements, hence allowing depositors to accept a lower yield and banks to fully extend dollar denominated loans. Arbitrage activities in response to these incentives lead to increases in exchange rate risk, credit risk and market risk in the banking system.[14]

(c) Prudential limits on bank lending. In order to ensure that firms face proper incentives to prevent a build-up of excessive short-term and unhedged foreign borrowing, the risk and liquidity management practices in the banking system must be strengthened; distortions that have led to widespread regulatory and tax arbitrage across institutions, currency and investors must be reduced; and the supervisory oversight of the central bank (BSP) and the SEC must be improved to encourage transparency and enforce compliance with prudential regulations.

Until recently, the main prudential measures in place governing bank lending to corporate sector were limits on the exposure of banks to a single borrower. In particular, the total liabilities of a borrower to a bank were not allowed to exceed 25 percent of the unimpaired capital of the bank; and the direct and indirect lending of banks to directors, officers or stockholders and other related interests (DOSRI loans) were limited to 15 percent of the total loan portfolio of the bank or 100 percent of the adjusted capital accounts of the bank. Furthermore, the unsecured direct or indirect lending to DOSRIs could not exceed 30 percent of the aggregate ceiling or the outstanding direct and indirect loans, whichever was lower. However, since the onset of the financial crisis, the BSP has taken additional measures to regulate bank lending to corporate borrowers and to level the playing field between dollar and

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[13]Engineered swaps work as follows: (i) bank customer A exchanges pesos for dollars at the bank's forex subsidiary at the current spot exchange rate, and deposits dollars in FCDU account; (ii) FCDU makes dollar loan to bank customer B, who if requiring peso loan, would sell dollars to forex subsidiary for pesos; (iii) in order for bank customer A to gain at least the equivalent of a peso-denominated investment, the bank offers bank customer A a forward contract that would promise to deliver the equivalent yield of a peso investment. Alternatively, the bank can enter into a non-deliverable forward contract (NDF) with bank customer A. This allows the dollars to remain in the bank and for the bank to benefit from continued dollar intermediation.

[14]The exchange rate risk is borne by the corporate borrower (unless hedged) who earns in pesos but borrows in dollars; and the market risk may arise when banks conceal their mark-to-market trading losses by rolling over NDFs at off-market rates.

Table 5. The Bias in Favor of Foreign Currency Intermediation 1/

	Peso		**Foreign currency**	
Policy	Previous	Current	Previous	Current
1. Statutory reserve requirement	14 percent	8 percent	None	None
2. Liquidity reserve requirement	2 percent	7 percent	None	None
3. Liquid asset requirement	None	None	None	30 percent
4. Depositors	Tax payable on interest income from deposits at 20 percent.	Tax payable on interest income from deposits at 20 percent.	Not taxed on interest income from deposits.	Tax payable on interest income from deposits at 7.5 percent.
5. Banks	Tax payable on interest income on loans at 35 percent; on interest income from treasury bills and other qualifying assets at 20 percent. Tax saved on interest expense at 35 percent.	Tax saved on interest expense limited to 20 percent to the extent interest income is subject to final withholding.	Tax payable on interest income on loans to residents at 10 percent. Not taxed on interest income on loans to nonresidents. Tax saved on interest expense at 35 percent.	Taxed saved on interest expense limited to 20 percent to the extent interest income is subject to final withholding.

1/ Previous indicates ruling as of June 1997. Current indicates ruling as of June 1998. Liquidity reserves are remunerated at 91-day treasury bill rate minus 0.5 percentage points. Since March 20 1998, up to 40 percent of the deposits maintained under the statutory reserve requirement earn 4 percent interest. Previously, only 25 percent of the deposits earn 4 percent interest.

peso intermediation. These measures include, inter alia: (i) preventing over-exposure to the real estate sector by reducing the limit on property loans from 30 percent to 20 percent of a bank's total loan portfolio; (ii) reducing the ratio of loans against acceptable collateral from 70 percent to 60 percent of the appraised value; (iii) reducing the statutory reserve requirement on peso deposits to 8 percent from 15 percent and imposing a 7.5 percent withholding tax on foreign currency deposits; (iv) requiring that FCDUs maintain 100 percent cover on liabilities with at least 30 percent of the cover required to be in the form of liquid assets; and (v) reducing tax arbitrage opportunities by requiring that interest expense savings be limited to 20 percent (the Tax Reform Act of 1997). While these measures are in the right direction, more can still be done. In particular, the tax on peso intermediation remains relatively high while enforcement of prudential regulations can be made stricter by imposing stiffer penalties for noncompliance.

B. Accounting-Disclosure Standards and the Accounting Profession

(a) Regulatory framework for accounting standards. The SEC, based on recommendations from the Accounting Standards Council, drafts accounting standards and submits them to the Board of Accountancy (BOA). When BOA approves them, they are published in the official gazette, thus giving them legal status.

The Accounting Standards Council, which was established in 1981, has 8 members including 4 persons from the Institute of Chartered Public Accountants, a Commissioner or Assistant Commissioner of the SEC, a representative of the BSP and a member of the Board of Accountancy.

(b) Accounting standards and audits. Until the early 1990's, Philippine accounting standards (PAS) were based on U.S. Generally Accepted Accounting Principles (USGAAP) as they existed in the 1970s. Rather than updating the PAS in line with changes in USGAAP, which were considered to be too complex or too arcane for the Philippine situation, it was decided to adopt the standards established by the International Accounting Standards Committee (IASC). At present, for all intent and purpose PAS, as defined by the SEC/BOA's statutory "Rules and Regulations Covering Form and Content of Financial Statements," is based on IASC.

Statutory financial statements include the balance sheet and statements of income and cash flows along with the general notes to the financial statements. Philippine accounting standards, including those dealing with consolidation, are comprehensive and appear to adequately cover all basic accounting principles. Also the rules require disclosure of all matters which might affect the decision of an investor to buy or sell the securities of the company. All companies with quarterly sales in excess of ₱100,000 must have their financial statements audited and signed by a Certified Public Accountant.

However, there are important differences between PAS/IAS and USGAAP which are relevant, given the large depreciation of the peso since mid-1997. For example, under USGAAP, an increase in unhedged foreign currency liabilities, caused by a devaluation of the local currency, creates an equivalent loss when reporting income for the year. Under PAS/IASC increases in such liabilities can be capitalized (i.e. offset by revaluation gains) if they are related to the acquisition of fixed assets, or, alternatively, they can be amortized over the remaining life of the debt in question. Most companies have opted for capitalization or amortization of increases in foreign debt.[15]

(c) Accounting profession. There are around 80,000 Chartered Public Accountants in the Phillippines. Each year around 10,000 aspirants write examinations organized by the Institute of Chartered Accountants. Only about 20 percent of them pass the examination. The BOA has the power to suspend or revoke an accountant's certification. In actual fact these powers are seldom exercised and, when they are, the reasons are usually related to unprofessional conduct rather the failure to properly execute the duties and responsibilities of an auditor.

(d) Other sources of financial information. In addition to published audited financial statements, banks can obtain credit information from a credit bureau operated by the Bankers Association of the Philippines (BAP). There is also Credit Information Bureau Inc. (CIBI) which was established in 1982 by the BSP, the SEC and the Financial Executives Institute of the Philippines. Currently CIBI rates about 12 issuers of short term commercial paper lines and about 31 issuers of long term commercial papers. It also prepares credit information reports on companies. Banks, which once accounted for about 60 percent of the demand for CIBI's credit reports, now account for only about 30 percent, with the remainder coming from industrial and commercial clients. CIBI has access to all the statutory financial statements filed with the SEC as well as information concerning non performing loans filed with BSP.

(e) Issues and recommended actions. According to users of financial statements, including banks and investment banks, accounting and disclosure regulations/standards in the Philippines compare favorably with those in many Asian countries. However, the same users report that enforcement by regulators is weak and that auditors seldom issue caveats which might raise questions about the reliability of the information contained in client financial statements. Also, there is no tradition of legal actions by investors and lenders against company officers or auditors in connection with cases of deficient or misleading financial reporting. Hence, the true financial state of the companies may not be known sufficiently in advance to arrest a potentially serious deterioration in performance.

Eventually, investors and shareholders may become more aggressive in seeking compensation, through the courts, from companies and their auditors for losses resulting from violations of disclosure rules and misleading financial statements. However, in the meantime the SEC needs

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[15]In addition, while USGAAP requires that all fixed assets be valued at their historic cost, net of depreciation, PAS/IASC permits enterprises to reappraise their fixed assets, a feature that allows inflation to be taken into account periodically. Thus, with the approval of the SEC, companies with negative retained earnings can improve the appearance of their balance sheets by using the gains created by the revaluation of fixed assets to wipe out a retained earnings deficit. This practice, known as "Quasi Reorganization," is used to create the appearance of "creditworthiness."

to add teeth to its regulations by imposing fines large enough to deter noncompliance. The SEC could also facilitate class actions by providing lawyers willing to represent investors, on a contingency fee basis, with access to any evidence of non compliance by the defendants in such actions.

C. Corporate Debt Restructuring and Enforcement of Creditors Rights

As noted above, given that most domestic debt is short-term many companies will have large obligations to banks and other lenders maturing within one year. Based on a thorough review of a large sample of 1997 financial statements, it is concluded that a number of these companies might find it difficult to honor their maturing obligations.[16] In similar situations in the past, default was avoided when banks passively restructured loans by simply rolling over the current portion of loans due from distressed borrowers. However, in many cases, such forbearance, only increased the problem and eventually led to greater losses for the banks. To deal with this problem the BSP adopted stricter rules for loan provisioning. However, recently, these rules were somewhat relaxed in order to give the banks a strong incentive to play an active role in restructuring or collecting the debts of distressed corporate borrowers.[17] Debt restructuring is usually done on an informal basis, or, when this not possible, it is carried out formally according to procedures dictated by the existing legal framework for insolvency. However, both approaches can be problematic.

(i) Informal debt restructuring

Banks are working with their distressed borrowers to restructure loans. For a number of borrowers, with sound core businesses, financial distress was due to investments in non core activities such as real estate development or speculation. Thus, recently many borrowers have sold non-core business or transferred real estate assets to banks in order to repay or reduce their debts. As holding real estate does little to improve the liquidity of the banks, they are required to maintain in their provisions for loan losses an amount equal to 25 percent of the transfer value of such real estate assets. This gives them a significant incentive to sell such assets. However, a possible disincentive to such transactions is the need to pay, in cash, at the time of the asset transfer, a 6 percent transfer tax and a 1.5 percent documentary stamp tax.

Debt restructuring negotiations can fail for a number of reasons: (i) the parties to the negotiation might simply refuse to act in good faith; (ii) the borrower is so distressed that

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[16]The analysis was based on evaluating if total cash available for debt service over the next 12 months was sufficient to cover bank loans shown as current liabilities and the current portion of long term debt.

[17]Provisions on nonperforming short-term loans can be reversed if such debt can be restructured into longer maturities, or alternatively loans can be recovered through foreclosure actions.

liquidation is the only solution; (iii) banks may decide that continuance of the debtor company's operations, under current ownership/management, would be detrimental to the interests of the lenders; or (iii) one of the lending banks refuses to support a restructuring plan supported by the other banks. In the Philippines, the outcome of debt negotiations can be influenced by the fact that a lender and a borrower might belong to the same holding group. This conflict of interest might prevent the liquidation of an otherwise non viable business.

(ii) The formal framework for debt restructuring

Creditor-debtor relations are regulated/arbitrated by the courts, under the Civil Code and the Insolvency Law (Act No. 1956), enacted in 1909, or by the SEC which was given quasi-judicial powers in 1976 by Presidential Decree No. 902-A, which was proclaimed under Martial Law. As a result of the 1976 Decree and two important court decisions, in 1994 and 1998, the SEC, rather than the courts, decides on petitions from illiquid companies seeking a suspension of payments (debt- service moratorium) as well as proposals for rehabilitation and debt restructuring.

(a) Civil Code. In the Philippines, contractual rights and obligations are governed by the Civil Code. When debtors default, the Civil Code provides for the enforcement of creditors' contractual rights through foreclosure actions. However, following a foreclosure the debtor has one year to recover the foreclosed asset. The creditor is required to immediately pay the transfer tax and the documentary stamp tax even though he is required to hold the asset in question for one year pending a possible recovery action by the debtor.

In many countries—Canada and the United Kingdom, among others—lenders are permitted to take a charge on all of the borrower's assets including inventories and accounts receivable. In cases of default and presentation of the necessary evidence, the courts have no choice but to issue an order permitting the lender to appoint a receiver and manager who immediately assume control of the debtor company and all of its assets. While a debtor retains the right to appeal the decision of the court, the receivership stands until it is confirmed or revoked by the court hearing the appeal. If it is in his best interests, the lender can opt to continue the operations of the debtor enterprise. However, in the Philippines, this type of security is not available. Thus, in cases of default, if it is not possible to reach agreement on debt restructuring, the lender's only option is foreclosure. This is also why banks in the Philippines are sometimes likened to pawn shops. Of equal significance, the inability to collateralize certain assets, such as inventories and receivables, represents a major constraint on the ability of small and medium sized enterprises to obtain bank loans.

In cases of insolvency, Articles 2241 and 2242 of the Civil Code, dealing with movables and immovables, respectively, infringe on secured creditor's rights. They give a supplier the right to trace and claim possession of items which have not been paid for as well as the debtor's accounts receivable arising from the resale of such items. Therefore, such items or receivables cannot be liquidated to pay the claims of secured creditors, and secured creditors, with registered claims, may find that they have become subordinated to other creditors, who are normally considered to be unsecured.

(b) The Insolvency Law. The 1909 Insolvency Law governs the liquidation of insolvent companies (companies whose debts exceeded their assets). The law permitted the court to grant a solvent, but illiquid, company, a suspension of payments (debt-service moratorium) for up to three months. During this period, the debtor company would try to reach agreement with its creditors on a debt restructuring plan. Such an agreement would have to be approved by at least two-thirds of the creditors representing at least 60 percent of the total claims by all creditors. However, the suspension of payments did not prevent secured creditors, with security, such as mortgages, from foreclosing. In many cases this would make it impossible to rehabilitate a distressed company.

(c) Presidential Decree No. 902-A. To facilitate rehabilitation of companies with temporary liquidity problems, Decree No. 902-A was proclaimed. Under the Decree, the SEC can decide on petitions for suspension of payments as well as petitions for rehabilitation of distressed companies. Its powers have been upheld by several important court decisions. Ruling in January 1994, on an application by a bank to seize its collateral from a company which had been granted a suspension of payments, the Supreme Court decided that "whenever a distressed corporation asks for rehabilitation and suspension of payments, preferred creditors may no longer assert such preference, but shall stand on equal footing with other creditors." Also, when a bank tried to pursue its claim against a debtor company through the courts under the Insolvency Law, the court threw out the case and ruled (in June 1998) that only the SEC could deal with such cases.

The Decree provides for the appointment of a rehabilitation receiver or the creation of a management committee to oversee the rehabilitation of a distressed company. However, it does not specify any procedural rules or define the rights of creditors to vote on rehabilitation or debt restructuring plans. While some have taken the position that these should be in accordance with the procedural rules contained in the Insolvency Law, SEC has taken the position that it will determine the policies and procedures which govern suspension of payments and rehabilitation. For example, in some cases, it has created a provisional management committee to prepare a rehabilitation plan. This committee usually includes an outside business consultant and 2 representatives each of secured and unsecured creditors. As a matter of policy the SEC usually bases its decisions on the wishes of a majority of the members of a management committee. Other policy guidelines, contained in a October 1997 memorandum from the Chairman of the SEC, require that:

- the Hearing Panel be composed of an Associate Commissioner and two Hearing Officers, one of whom will be a Certified Public Accountant-Lawyer;

- on receipt of a petition for suspension of payments from a solvent company, the Hearing Panel **shall** issue a provisional suspension order effective for a period of 30 days;

- on receipt of a petition for suspension of payments from an insolvent company, the Hearing Panel **may** appoint an interim receiver and issue a suspension order stopping all actions for claims against the company;

- various supporting documents must be attached to the petition including,

  – a debt repayment schedule which shall indicate the period of suspension sought, which shall not exceed six months (however, this is extendable to such a period as may be warranted under the prevailing circumstances as determined by the SEC); and

  – certification by the Bureau of Internal Revenue as to the petitioner's tax liability (failure to provide this shall be a ground for the dismissal of the petition);

- creditors comment on the petition within 20 days of its receipt by the SEC; and

- an order be issued which would either grant the suspension of payments and appoint a permanent receiver/management committee, or deny the petition and lift the suspension order.

During the period January 1997 and August 1998, around 45 companies petitioned for suspension of payments, of which 24 were received since the end of 1997, including one from the national airlines, PAL. When compared to previous years, this represents an unprecedented increase in the number of petitions.

Of the 24 petitions received in 1998, eight have been either dismissed or withdrawn. In assessing whether the existing procedures will eventually lead to the successful rehabilitation of the companies concerned, a review of past attempts at rehabilitation is not very encouraging. Of six companies that have been granted permission by SEC to attempt rehabilitation, five have ended up in liquidation and the sixth is still in rehabilitation. In the latter case, suspension of payments and a stay on actions by secured creditors have been in effect for 14 years as a result of, among other things, a dispute between the majority shareholder group and the minority group over whose rehabilitation plan should be approved. There is little indication that the SEC has found ways of minimizing procedural delays in more recent cases. In one case, the interim suspension of payments granted to a company, in mid January 1998, has now been extended five times and a definitive hearing has been postponed until September 20, 1998. In contrast, in the case of PAL, the most complex to date, an unreasonably short time, 10 days, was given for creditors to study the interim management committee's rehabilitation proposal before a hearing is convened by SEC.

(iii) Issues and recommended actions

With respect to informal out of court agreements on corporate debt restructuring, the main issues that need to be addressed and the actions recommended to deal with each issue are presented in Table 6 below.

Table 6. Informal Debt Restructuring by Banks

Issue	Recommended Actions
The taxes associated with swapping debts for assets unnecessarily increases the cost of corporate business and debt restructuring.	*Exempt from taxes, the asset transfers to banks and other lenders associated with debt restructuring actions.*

With respect to protection of creditors' rights under the Civil Code and the taxes associated with foreclosures, the main issues that need to be addressed and the actions recommended to deal with each issue are presented in Table 7 below.

Table 7. Civil Code

Issue	Recommended Actions
1. The taxes associated with foreclosure actions unnecessarily increase the cost of corporate business and debt restructuring.	*A. Exempt from taxes, the asset transfers to banks and other lenders associated with foreclosure actions*
2. The one year period given for debtors to recover foreclosed assets is too long.	*B. Reduce the period allowed for recovery of foreclosed assets to 60 days.*
3. The subordination of secured creditor claims to those of suppliers under Articles 2241 and 2242 of the Commercial Code is a major issue in connection with the enforcement of creditors rights	C. Amend Articles 2241 and 2242 of the Civil Code. Amendments would subordinate claims under the two articles to the claims of secured creditors.
4. Certain assets such as inventories and receivables are difficult to collateralize.	*D. Facilitate the collateralization of all assets.* 1. Amend the Civil Code to permit the collateralization of all types of assets. 2. Issue regulations that all pledges of assets as collateral must be registered and create the necessary registries.
5. Even if the above issue is resolved, it is not clear if a creditor, with a fixed and floating charge covering all of a borrower's assets, could, in the event of default, appoint a receiver to take control of the debtor company.	*E. Strengthen the rights of creditors to establish receiverships.* Concurrent with measures to permit collateralization of all assets, amend the Civil Code so that a creditor with a charge on all of the assets of a defaulting debtor has the possibility to immediately obtain a court order empowering him to create a receivership.

Finally, on suspension of payments under Decree 902-A, the main issues that need to be addressed and the actions recommended to deal with each issue are presented in Table 8 below.

Table 8. Suspension of Payments

Issue	Recommended Actions
1. The statement of policy issued by the Chairman of the SEC in October 1997 helps to clarify some of the policies, procedures and deadlines governing decisions concerning suspensions of payments and rehabilitation. However, the grounds for considering a suspension of payments need to be more restrictive both in general terms and for specific cases.	*A. Establish general grounds for considering suspension of payments which would include all of the following criteria:* 1. a debtor enterprise with viable core business(es) becomes illiquid/insolvent, or faces imminent illiquidity; and 2. the present value of future payments to secured creditors arising from the financial and business restructuring of the debtor enterprises would exceed the present value of the amounts which could be recovered by the secured creditors in the event that the debtor enterprise was liquidated.
2. The grounds for ordering a suspension of payments need to be more narrowly defined.	*B. Establish specific (case by case) grounds for declaring an interim suspension of payments which would require credible evidence that:* 1. above mentioned general grounds exist; 2. that imminence of illiquidity/ insolvency could not be ascertained early enough to permit sufficient time to present credible evidence; 3. a court is about to rule on a claim filed by a creditor; 4. a serious attempt to reach agreement with secured creditors has failed; and 5. the petition for suspension of payments is supported by secured creditor(s), representing at least 30 percent of total secured debt but excluding creditors connected to the debtor enterprise by a common ownership interest.

Table 8. Suspension of Payments (continued)

Issue	Recommended Actions
3. To the detriment of all parties, payment suspensions, both interim and definitive, can be extended indefinitely at the discretion of SEC or as the result of legal maneuverings.	C. *Fix maximum duration of interim suspension of payments*: 1. in the case of B1, above, a suspension of 30 days would be given for the receiver or management committee to finalize a rehabilitation plan; or 2. in the case of B2, above, an interim suspension of up to 60 days would be given for the receiver or management committee to attempt to develop a rehabilitation plan which meets all of the criteria of the general grounds for suspension; and 3. an additional 30 days would be allowed for consideration of the plan by creditors.
4. The limitations placed on the rights of secured creditors to enforce their claims or vote on rehabilitation plans run counter to the principles applied in most countries with modern legal frameworks dealing with insolvency.	D. *Establish voting rules which protect the rights of secured creditors:* 1. creditors would be classified as secured or unsecured. 2. each class of creditors would vote separately on the rehabilitation plan. 3. the plan would be accepted only if approved by: (a) at least a two-thirds of the secured creditor representing at least 60 percent of the total claims by the group; and (b) at least two-thirds of the unsecured creditors representing 60 percent of total claims of the group.
5. The duration of the definitive suspension of payments is based on a cash flow projection submitted by the petitioner and cannot exceed six months but can be extended by the commission	E. *Extension of duration of suspension of payments*: the interim suspension of payments by the debtor enterprise could be extended as proposed in the rehabilitation plan approved by the creditors.
6. There are no clear rules covering the grounds for lifting suspension of payments and stays of action by secured creditors	F. *Grounds for termination of suspension of payments*: 1. creditors reject proposed rehabilitation plan; or, 2. arrival of date for termination of suspension as specified in the agreed rehabilitation plan.

Table 8. Suspension of Payments (concluded)

Issue	Recommended Actions
7. Fresh funds may be required in order to implement the rehabilitation plan. However, there is no provision for providing seniority to lenders who advance funds to the rehabilitation receiver or management committee.	G. *Provide for seniority of new debts incurred for the implementation of the rehabilitation plan:* If implementation of the agreed rehabilitation plan requires the debtor enterprise to obtain additional debt financing, such debt would have seniority over all other claims and would retain that status even in the case of an eventual liquidation of the debtor enterprise.
8. Given the large increase in the number of petitions received by SEC, it is not clear that it has the capacity to deal with all of them in a timely manner as suggested by the number of extensions granted in the case of interim payment suspensions	*H. Restrict access to SEC venue:* Access to suspension of payments under Decree 902-A could be restricted to illiquid companies with total liabilities exceeding ₱100 million (the threshold may be adjusted to reflect changes in the incidence of cases of illiquidity/insolvency and capacity of SEC to deal with them).
9. The quasi-judicial proceedings under Decree 902-A seem to be driven by lawyers and litigation. This often makes it difficult to reach agreement and drags out the process.	*I. Replace lawyers with business analysts and accountants as the main players*: Adopting clear rules as recommended above should promote a process based on commercial considerations rather than legalistic ones.
10. It is not clear that the SEC administered process leads to the type of fundamental business restructuring that many distressed companies require and this may explain the high failure rate	*J. Focus on business restructuring issues as well as financial issues:* Many distressed companies may have sound core businesses but scarce financial and management resources are dissipated by non-core activities such as real estate development.
11. SEC will require technical assistance to adapt to a new way of doing things.	*K. Make use of technical assistance (TA) already provided and obtain additional TA from local and international consultants with the support of the World Bank:* In early 1997, a locally based international expert on insolvency provided SEC with policy/procedural framework based on best international practices. If such a framework were adopted, additional TA should be obtained for implementing it.

(iv) Actions recommended for longer term

Given the recent increase in the number of filings for suspension of payments and the lack of other effective avenues for debt restructuring, as a short term measure, it is necessary to strengthen the policy framework and institutional capacity for suspension of payments under Decree 902-A. As recommended above, the rules of procedures governing suspension of payments and rehabilitation should be clearly spelt out in order to reduce procedural delays, and at the same time allow for the protection of the rights of secured creditors. On the latter, the petition for suspension of payments should be supported by secured creditors, representing at least 30 percent of the total secured debt but excluding creditors connected to the debtor enterprise by a common ownership interest. This might help mitigate problems associated with conflicts of interest that would otherwise prevent the liquidation of a non viable business.

Unlike the SEC in most other countries, the Philippine SEC is tasked with the unique responsibility of performing a quasi-judicial function, in addition to the regular responsibilities of licensing, registering and regulating corporations and securities markets. However, the SEC presently faces serious staffing and institutional constraints. Thus, the quasi-judicial function of the SEC should be transferred to a specialized bankruptcy court as soon as possible. For this to happen, certain conditions must be in place to ensure that the court system is able to effectively undertake this responsibility. These include improving court governance and replacing the 1909 bankruptcy law with a more modern law based on international best practices. The new bankruptcy law could provide for, inter alia, stay of foreclosure proceedings as well as suspension of payments (along the lines of the proposals in Table 8).

V. Concluding Remarks

The financial and economic distress which has recently affected the corporate sector in the Philippines is much less severe than in other countries in the region. To ensure the continued health of the corporate sector, pre-emptive measures should aim at reducing its vulnerability to external shocks and unfavourable developments in the domestic economy.

The recent stabilization of the peso and reduction in the level of interest rates has helped buy time to deal with the debt problem in the corporate sector. The Philippines can also profit from the lessons learned from the recent experiences of other countries in the region. These lessons clearly suggest that financial distress in the corporate sectors can be mitigated and corrective actions facilitated when:

- banks adhere to high standards for prudential lending, particularly with respect to DOSRI limits and loans to related corporate borrowers;

- high standards for financial disclosure are established and enforced in order to provide an early warning of corporate distress;

- corporates respond to adverse conditions by cutting costs, shedding non core businesses, shedding surplus labor and focusing on core business activities;
- lenders work in good faith with their distressed borrowers to restructure their debts and maintain their viable business activities;
- an adequate legal framework and institutional capacity exists for rapidly dealing with illiquid or insolvent companies while protecting the contractual rights of creditors;

As the paper explains, there is still much to be done before it can be considered that all of the above conditions exist in the Philippines. However, there are encouraging signs that both banks and corporates understand the need to move rapidly to put the above conditions in place.

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