

Governance in Rural Banking

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RBAP President Mr. Tomas “Mitch” Gomez

Officers and members of the Rural Bankers Association

Ladies and Gentlemen

Good morning!

Allow me to express my sincere thanks for your invitation to speak before you this morning. This is the first time I’ve had the chance to interact with your association and I must say that – given the key role that rural banks play in bringing development to the countryside – I am truly appreciative.

In preparing my remarks for today, I’ve had to ask myself whether I could say anything about the theme of your conference – corporate governance – that could possibly be of any interest to your group. As you know, I am not a banker. I have spent my career as a professional manager largely in manufacturing and lately in telecommunications. But after giving it some thought, I realized I do have some relevant credentials.

For example, I spent 4 years as a director of First eBank (formerly PDCC Bank) from _____ to _____. In fact, you could say that up to now something of that experience lingers with me. For example, I am still facing a court suit filed against the bank's directors. That case stemmed from a dispute that erupted even before I joined the bank. I just happened to be on the board when the complainant sued us. So, I know a bit about the hazards of being a bank director.

As President and CEO of PLDT, I take corporate governance very seriously. Since PLDT is listed in the U.S. Stock Exchange, we are covered by the Sarbanes Oxley Act which imposes some of the world's toughest governance regulations. For example, as PLDT President I routinely sign stacks of documents this thick [pls show with your out-stretched fingers] that make me personally liable – meaning I could be jailed – for the accuracy or inaccuracy of the Company's financial disclosures. So I know what personal accountability means in today's corporate governance environment.

But why should you in the rural banking sector really care about corporate governance? I think that is the relevant question for you here. To begin answering that question, let's start with a working definition of corporate governance.

To keep it simple, I looked it up in Wikipedia (you know, in the internet age, nobody looks at the dictionary anymore; you check Wikipedia). It says that corporate governance is the set of rules, laws and practices that defines the

proper roles and ethical conduct of the different stakeholders in a corporation. Historically, the principal concern of corporate governance practice has been to protect shareholders from the mischief of managers of the enterprise. That's because as corporations became larger and its businesses more complex, and as shareholdings become more widely dispersed, Management tended to acquire such control over the affairs of the company that it could hoodwink and take advantage of unwitting shareholders.

That's why disclosure rules are designed to keep managers from inflating company performance. That's also why boards of directors representing shareholders are given a stronger mandate to oversee the business strategies of managers, to monitor their reporting systems and to ensure that managers do not overpay or entrench themselves at the expense of shareholders.

To the layman, all this is boring stuff – until a big corporate scandal hits the headlines. Then, corporate governance becomes very sexy.

Remember Enron? This is the big U.S. energy company that collapsed in 2001 because it had wildly overstated its profits through massive accounting fraud. All the while, its managers pocketed hundreds of millions of dollars through bonuses that they paid themselves for declaring billions in fictitious profits.

Well, in reaction to that, the U.S. Congress passed the Sarbanes Oxley Act and U.S. late night talk shows made Enron the butt of vicious jokes. The latest corporate target of late-night political humor is AIG which floundered last year

because of huge losses. The company stirred a hornet's nest when it paid its executives fat bonuses after receiving some 170 billion dollars in bailout money from the U.S. government. Here are samples of the barbed jokes thrown at AIG by comedian Jay Leno of *The Tonight Show* and Jon Stewart of *The Daily Show*. [Play video]

Here in the Philippines we've had our share of scandals, the latest and most colorful being the demise of the Legacy Group of Companies which includes about a dozen banks, mostly rural banks. Such scandals demonstrate the disastrous consequences of poor corporate governance.

The Legacy controversy is especially relevant because it springs from a situation quite common in Philippine business, including the rural banking system. As I discussed earlier, the logic of conventional corporate governance practices assumes that owners and managers are on opposite sides of the table. But how do you deal with a situation when the owner is also the manager?

This is the classic dilemma faced by family-run corporations which should be quite familiar to you. A study done by the PDIC several years ago showed that about 60% of some 400 rural banks were family-owned corporations in the sense that over 50% of their equity was clearly owned by a single family. In nearly three-fourths of these banks, the positions of Chairman (which should represent shareholders) and President (which is supposed to represent management) were held by a single person.

In such settings, the potential conflict shifts from management v. shareholders to a case of majority v. minority shareholders. The question here is how can we realistically expect the controlling family to embrace good governance practices when there are powerful incentives for them to simply ignore these things.

After all, they own the business. They can run it as they see fit. Nothing illegal about that. And the widely-held view is if minority shareholders or depositors are left out a bit – well, that's life. If the purpose of corporate governance is to restrain managers and control shareholders, why should a family-run firm ever really want such a thing?

One text book answer to that question is this: better access to capital. This argument says companies that follow better governance practices will have better access to lower-cost capital. The argument has nice ring to it. And studies do show that the stronger a country's corporate governance practices are, the more robust its capital markets and the more willing investors are to risk their money in that country. But the evidence at the level of individual family firms is less convincing. The idea that family firms should embrace corporate governance in order to raise more capital is still a tough sell.

My own thinking is that family-run companies should care about corporate governance because they need it to grow their business. Let me put this way. For all of you here in this room who have put up your own businesses, you know that you cannot run the enterprise by yourself. Perhaps at the start, you may think that you can do everything. But after a while, especially as the business grows, as

you put up more branches, you are compelled to delegate work to more and more people in your growing organization. And when you delegate, you need to empower your people. You have to give them the authority and the means to do their work. As you do that, you need to put in place policies and procedures that will govern the exercise of such authority and that will be applied evenly and fairly to everyone in the organization – whether the persons concerned are relatives or not.

It is easy to forget. But the development of a rules-based corporate culture – where the roles of people within the organization are clearly defined, where rewards and punishment are spelled out – is essential to the growth of the organization. Its importance becomes more apparent the more you try to expand the business.

For rural banks, for example, the application of digital computing and communications technologies is a powerful way to grow your business. This includes computerizing your operations, building an ATM network, applying mobile banking and mobile commerce systems. All these enable you to serve more customers more efficiently in more areas.

I know for example that a number of you have been talking with people at Smart so that your banks can become conversion centers for mobile money. As your customers' needs become more sophisticated and they look for services similar to those of larger banks, perhaps, convenient banking through automated systems and through their mobile phones become things you would like to do. Since many

of your customers are probably Smart subscribers, collaborating with Smart will be a good step towards addressing these new aspirations. People will be able to walk into your offices and turn electronic money in their Smart Money wallets into physical cash and vice versa. This is a new fee-based revenue stream that can open up more new opportunities for you in the space of mobile commerce. The participation of rural banks in the m-commerce ecosystem will help bring the benefits of such services to rural folk using Smart's leading m-commerce platform. Smart's role here is to be the "enabler", by providing the technology you need to serve your customers in more innovative and convenient ways.

All these are very exciting possibilities and I assure you that my people are ready to work with you to turn them into real businesses. But there is a catch to all this that bring us back to the subject of corporate governance. Those of you who are already applying such innovations know from experience that these digital services require you to develop clearly-defined and rigorous business processes that must be religiously practiced. To offer such services, you need to run your organization with clockwork precision and with a rigor that comes with a rules-based culture that reduces arbitrariness and ambiguity. Indeed, you need to practice good corporate governance in order to build your business for the future.

There is another related compelling case for corporate governance that applies to rural banks, especially those that are family-run. This is the need to develop a good management succession process. Some business owners may think they don't need good corporate governance to raise capital or to grow their business.

But they cannot escape the fact that soon or later they will pass away. As they say, in the long run, we will all be dead.

Therefore, business founders have to grapple with the inescapable question: who will take over? Will his or her children be interested in running the business?

Baka naman they'd rather be lawyers or run a restaurant. In case they are interested in taking over, are they capable? Will they get up as early, stay as late and work as hard as the founder of the business did in his or her time?

These are the sort of questions that keep business owners awake at night. And considering that many rural banks are 20, 30 or more years old, I'm certain that many of you have already faced these questions in real life.

So, you know first hand that keeping a business going across generations is hard. Very hard. Studies in the United States show for example that only about one in six family-run firms survive to the third generation. Only one in six.

Family-run firms fail for many reasons. Many sound very familiar. For one reason or another, divisions arise between family members. Jealousies emerge as some family employees rise higher and faster than others, or, work less hard for the same pay. Managers or supervisors in the business find that they cannot fire or discipline an under-performing or misbehaving subordinate who happens to be a daughter or nephew or whatever of the owner.

As the business evolves, finding good managerial talent and experience within the family becomes more difficult. When the family decides at last to hire a professional manager from the outside, they don't give him the authority to succeed, or, fail to motivate or monitor him.

Corporate governance goes to the heart of these issues, though many family-run firms don't usually think of them in these terms. Families need corporate governance not only to operate and grow their businesses, but also to maintain family harmony. This means that they have to put in place decision-making processes that are open and fair. They need to develop systems for monitoring performance and promoting people that are objective and transparent. It makes a lot of sense for them to hire non-family members as managers, advisors and directors.

Second generation leaders of the family are usually the agents for this process of change. But even in the best of circumstances, this is a delicate process that requires a lot of hard work and good sense among all the parties involved. The challenge is to make these changes in a timely manner. What you don't want is by the time need for corporate governance has been recognized, family relationships or prospects of the business may have been damaged beyond repair.

Let me end with the observation of a European management adviser Mr. Robert Zafft: Family-run businesses can represent the work – and the wealth – of several generations. If business owners want to preserve, enlarge and pass on this legacy, they need to make corporate governance a family affair.

Thank you and good day.