

CORPORATE GOVERNANCE IN MALAYSIA

by

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Abstract

The paper provides a descriptive analysis on the corporate governance mechanisms in Malaysia. The discussion relates the economic crisis in 1997 that necessitate for the corporate governance efforts on the private sector in the country. It is explained based on the reforms agenda contained in the Malaysian Code on Corporate Governance, Capital Market Master Plan and Financial Sector Master Plan. By highlighting the mechanisms that normally used in the academic research, the paper identifies some of the important mechanisms applied in the reforms of the Malaysian corporate governance. It is found that the mechanisms that have been put in place are comprehensive and covers a wide spectrum of corporate governance internally and externally.

1. INTRODUCTION

The discussion on Corporate Governance in Malaysia as well as other East Asian countries should be initiated from the event of East Asian economies collapsed in the second half of 1997. The period placed a greater concern and recognition of Corporate Governance to the public and private sector in those countries.

The financial crisis was triggered in Thailand when foreign investors lost their confidence and started to withdraw capital due to currency devaluation. The problems transmitted to other neighboring countries. The most affected countries included Indonesia, Malaysia, South Korea, and the Philippines. In Malaysia, attempts to contain further devaluation caused higher level of interest rate and credit contraction. This created severe contractions in output and corporate profitability which was reflected in massive fall of equity prices. The Kuala Lumpur Composite Index declined by 72% during the period from end-June 1997 to end-August 1998. Real estate markets declined sharply due to high interest rates and in crisis environment. Banks, which had a significant portion of their loan exposure in the construction and real estate sector; and stock purchase financing were badly affected.

There were different views on the causes of the crisis. Some viewed that the direct reason of the financial crisis was attributed to a downturn of the economy, the collapse of the property and stock markets. However, the more fundamental reasons were state-directed loan policies, lack of competition and lack of prudential regulations. Another view indicated the significant impact of too much exposure of the banking institutions on debts to accommodate the economic boom in the early 1990s as a source of the crisis.

Paul Krugman (1998) in “What Happened to Asia” and Corsetti et al (1998) in “What Caused the Asian Currency and Financial Crisis” advocated the ‘Fundamentalists View’ pertaining to the crisis. They argued that the crisis was due to structural weaknesses in the domestic financial institutions supported by unsound macroeconomic policy and moral hazard.

The ‘Financial Panic View’ was first suggested by Jeffrey Sachs and Stephen Radelet (1998) in “The Onset of East Asian Financial Crisis” who emphasized the role of expectations, panic and over adjustment. With sound economic fundamentals in the region and positive reflection by International Monetary Fund (IMF), credit rating agencies and analyst, market participants and analysts were unable to predict the crisis even though, there were actually some signs of vulnerability but in a very subtle and not at a full-blown. Investors on the other hand experienced an abrupt change in their expectations and their irrational behavior was compounded by the IMF inappropriate responses for crises originated in the public sector but proved to be for crises that originated from private sector.

According to IMF (1999), the crisis was infected by the domestic policy weaknesses. This were manifested by the large current account deficits; concentration of bank loans in real estate development and financing share purchases; weaknesses in domestic financial system; poor governance and risk management; and too much international borrowing in the corporate sector.

The World Bank (1998) regarded the vulnerability in the banking sector was attributed to poor risk management and excessive lending. Poor risk management was reflected by weak corporate governance and limited investment in risk management technology. The excessive lending was caused mainly by extensive cross-ownership of banks and companies, weak enforcement of bank regulations and government-directed lending. Combining these two categories resulted to large amount of non-performing loans and insolvent financial institutions that subsequently had to be financially supported, merged or liquidated.

Even though various factors were highlighted to explain the causes, there was a consensus among the above-mentioned ideas that the element of poor governance could not be separated in explaining the crisis. As such, like other economies in East Asia, corporate governance has been actively promoted to the Malaysian corporate sector in a period after the crisis. Measures have been taken to improve the aspects of fairness, transparency, accountability and responsibility in running the organizations.

2. WHY CORPORATE GOVERNANCE?

A definition by the Finance Committee on Corporate Governance in Malaysia in the Report on Corporate Governance (2002) stated that: “*Corporate governance is the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long term shareholder value, whilst taking account the interests of other stakeholders*”. This indicates that corporate governance is not only applied to the shareholders but the other stakeholders as well.

From the economic perspective, corporate governance is an important element of achieving an allocative efficiency in which scarce funds are moved to investment project with the highest returns. In practice, efficiency is achieved when at given level of risk, investments project offer the highest return exceeding its cost of capital. The crisis indicated how the failure to regulate good governance affected the mobilization of funds in an effective way. Corporate finance on the other hand, concerns on the effectiveness of corporate governance as an assurance in protecting the invested funds and to generate returns. As highlighted by Scheifer and Vishny (1997), corporate governance mechanisms assure investor in organizations that they will receive adequate returns in their investments. To relate this with the crisis, it is concluded that efforts on shareholders protection were inadequate during the crisis and as such contributed to the destruction of the value of their investment.

3. DEVELOPMENT OF CORPORATE GOVERNANCE IN MALAYSIA

The main sources of the Corporate Governance reforms agenda in Malaysia are from the Malaysian Code on Corporate Governance by Finance Committee on Corporate Governance, Capital Market Master Plan (CMP) by Securities Commission and Financial Sector Master Plan (FSMP) by Bank Negara Malaysia on the financial sector. It provides guidelines on the principles and best practices in corporate governance and the direction for the implementation as well as charts the future prospects of corporate governance in Malaysia.

3.1 Malaysian Code on Corporate Governance

The initiative started with the establishment of Finance Committee on Corporate Governance in 1998 that consists of both government and industry. Recognition of corporate governance in Malaysia was significantly evidenced by the released of the Malaysian Code on Corporate Governance by the Committee in March 2000. The principles underlying the report focus on four areas including: board of directors, director's remuneration, shareholders and accountability and audit. The code is hybrid in nature, which is similar to the Combined Code on Corporate Governance (United Kingdom). Under the approach, the companies in Malaysia should apply the broad principles of good corporate governance sets out by the code flexibly and with common sense to the varying circumstances of individual companies.

3.2 Capital Market Master Plan (CMP)

Complementing the reforms is the introduction of Capital Market Master Plan by the Securities Commission to chart the direction of the Malaysian capital market for the next ten years. It was initially announced by the Second Finance Minister and Chairman of Securities Commission in August 6, 1999 and subsequently approved by the Minister of Finance in December 2000 before it's launching in February 2001. The efficient mobilization and allocation of funds together with high degree of confidence to market participants are the visions outline by the CMP. Corporate governance is a key strategic thrust of the CMP as the Securities Commission considers good corporate governance among public listed companies is vital to achieve the objective of promoting a more conducive environment for investors in the Malaysian capital market. One of the recommendations by the CMP is a mandatory disclosure on the state of compliance with the Malaysian Code on Corporate Governance which were issued in the revamped exchange listing requirements on January 22, 2001 to listed companies.

3.3 Financial Sector Master Plan (FSMP)

Financial Sector Master Plan (FSMP) was launched in March 2001 by the Bank Negara Malaysia to chart the future direction of the financial sector over the next ten years. It has the objective of developing a more resilient, competitive and dynamic financial systems that contributes to the economic growth and technology driven. Elements of corporate governance that are recommended by the master plan would include promoting shareholders' and consumers' activisms, regulatory control and priority sector financing. Some of the specific

recommendations to the banking sector indicated the requirement of having board committees to further improve corporate governance, the implementation of a transparent and clearly structured early warning system for weak banking institutions, encourage mergers between banking institutions and establish a deposit insurance funds.

3.4 Institutional Development

The development of corporate governance in Malaysia is also complemented by the institutional development. The establishment includes the Malaysian Institute of Corporate Governance (MICG) and the Minority Shareholders Watchdog Group (MSWG).

The Inception of Malaysian Institute of Corporate Governance (MICG)

MICG was established in March 1998 by the High Level Finance Committee on Corporate Governance. It is a non-profit public company limited by guarantee, with founding members consisting of the Federation of Public Listed Companies (FPLC), Malaysian institute of Accountants (MIA), Malaysian Association of Certified Public Accountants (MICPA), Malaysian institute of Chartered Secretaries and Administrators (MAICSA), and Malaysian Institute of Directors (MID).

MICG's mandate was to raise the awareness and practice of good corporate governance in Malaysia. MICG was given a start-up capital of RM50,000 and later in 1999 was given a contribution of RM79,000 from the Registrar of Companies. Other than these monies, MICG had been operating on revenues from its programmes and private donations ever since. MICG usually runs a balanced budget every year, thus there are usually very little surplus funds to bring forward to the next year.

The Report on Corporate Governance published by the High Level Finance Committee on March 1999 has stipulated MICG as 'The Recognized Corporate Governance Training Centre' (CGTC). Bursa Malaysia Berhad (formerly known as Kuala Lumpur Stock Exchange) also partake in the effort of enhancing corporate governance in Malaysia by revamping its' Listing Requirements. For instance, Chapter 15 of the Revamped Listing Requirements address issues on corporate governance and one of the paramount requirement spells out that a listed issuer must ensure that its board of directors make the following statements in relation to its compliance with the Malaysian Code on Corporate Governance in its annual report:-

- (i) a narrative statement of how the listed issuer has applied the principles set out in Part 1 of the Malaysian Code on Corporate Governance to their particular circumstances; and
- (ii) a statement on the extent of compliance with the Best Practices in Corporate Governance set out in Part 2 of the Malaysian Code on Corporate Governance which statement shall specifically identify and give reasons for any areas of non-compliance with Part 2 and the alternatives to the Best Practices adopted by the listed issuer, if any.

The requirement was aimed towards regulating companies to be more transparent and accountable in their actions in order to gain investors' confidence. It is hoped that this would

reduce the effects of the agency theory and signaling theory, thus paving the way for a more efficient capital market. Indirectly, it also envisaged that these efforts would in turn boost the country's economic growth as well as encouraging inflow of foreign direct investments. In other words, good corporate governance is the key to a robust and competitive corporate sector, which serves as a source for sustainable economic growth.

a) The Mission of MICG

MICG is dedicated to facilitating businesses and corporate development in the country through improved corporate governance best practices. Corporate governance has succeeded in attracting a good deal of public interest because of its apparent importance for the economic health of corporations and society in general. However, the concept of corporate governance should be defined to suit the needs of our own nation because it potentially covers a large number of distinct economic phenomenon of which we are different from other developing nations. Corporate governance is not a one size that fits all.

Although, the regulators have created a commendable framework for corporate governance, Malaysian corporations have yet to achieve a satisfactory level of corporate governance practices and compliance. This is evident from a joint study conducted by the emerging market investment bank CLSA and Asian Corporate Governance 2003 in which the country was ranked number one (9 out of 10) in terms of rules and regulation but only managed to obtain an average score of 5.5 out of 10 for overall corporate governance practice. In fact, the rules in the code are only recommendations, and there is much skepticism that best-practice recommendation and/or principle-based approaches are effective substitutes for more rule-based approaches, such as the US Sarbanes Oxley Act. This raises the question on whether corporate governance disclosure should be made mandatory instead of voluntary.

Nevertheless, it should be noted that corporate governance at its core, is about the interaction of human beings – the relationships in a boardroom, or the ability of a non-executive to stand up to a dominant chief executive. Thus, making corporate governance disclosure mandatory may hamper the spirit or the very objective of the code whereby companies disclose not with the aim to strengthen corporate governance principles but more as a compliance effort.

There have been evidences suggesting that companies who opted for voluntary disclosure deemed to have gained more benefits compared to those who disclosed in adherence to mandatory requirement. In light of the above argument, one could arrive at an assumption that in order to promote voluntary disclosure of corporate governance practice, companies should be made aware of the benefits they could attain especially in terms of higher corporate performance. Although it has been accepted as a rule of thumb that better corporate governance practices leads to higher corporate performance, empirical researches has shown contradicting results. Consequently, a clear link between corporate governance and corporate performance could not be established.

b) Principal Objectives of MICG

The principal objectives of MICG can be outlined as follows:

- To be a leading organization for enhancement of corporate governance development and best practices through continuing education programme for company directors, chief executive officers, company secretaries, company advisers, company auditors, accountants, lawyers, members of audit committees and investors in Malaysia;
- To be a recognized organization for corporate governance issues through roundtable forums and dialogues, public seminars and conferences, and lecture series for corporations, institutional investors, business and professional bodies, educational institutions;
- To establish linkages and networking with the leading corporate governance references and research organizations.
- To be an authoritative facilitator and the organization for advisory, technical and support services on implementation of corporate governance best practices and to work in collaboration with relevant authorities and regulatory agencies to pursue this objective.
- To work closely with various stakeholders as well as company directors, private investors, institutional investors, business and professional bodies, educational institutions, relevant authorities and regulatory agencies.
- To complement the regulators: Security Commission, Company Commission Malaysia and Bursa Malaysia with regards to Corporate Governance matters. MICG to the best of its ability work closely and reciprocate with the said organizations, other related bodies and Malaysian Institute of Integrity in the uplifting of integrity and Governance in the corporate sector.
- To act as an independent body to conduct Corporate Governance Ratings and ensuring the ratings credibility, especially for Public Listed entities.
- To be able to be independent, fair and truthful in providing input or information to enhance the performance of PLCs companies to intended investors, from within and outside Malaysia.
- To publicize the country's effort and commitments in emphasizing corporate governance.
- To conduct further research with local and foreign organizations on topics: Corporate governance and investors; Corporate governance and financial gain.
- The ultimate objectives of MICG are to inspire companies in creating longer term shareholder value and to bring business prosperity in nation building and to contribute to sound economic system for the well being of the society at large.

Malaysian Institute of Corporate Governance will provide an independent and neutral platform for all stakeholders for the exchange of ideas, opinions and debates to bring about continuous improvement in corporate governance best practices among corporations, private investors and institutional investors, business and professional bodies, and educational institutions as well as relevant authorities and regulatory agencies.

c) Membership and Services

Membership of MICG includes corporate members and ordinary members. The activities of MICG are managed by a Secretariat under the direction and guidance of the President, assisted by the Management Committee.

MICG actively engages in various strategic co-relations by networking with international organizations such as the Institute of Directors in East Asian region (IDEA.net), Asian Pacific and Development, United Nations Development Programme, the Pacific Economic Cooperation Council Peer Assistance and Review Network (PECC PARNET), the Asia Pacific Economic Cooperation (APEC), the Pacific Basin Economic Council (PBEC) and PECC forums, C.V. STARR Chair for Corporate Governance in Asia under the Asian Institute of Management-Ramon V. del Rosario Sr. Centre for Corporate Responsibility (AIM-RVR Centre for Corporate Responsibility). MICG is also a core member in OECD's Annual Roundtable on Corporate Governance.

4. GOVERNANCE MECHANISMS IN MALAYSIAN CORPORATE SECTOR

Corporate governance mechanisms can be viewed from the internal and external perspective. The internal perspective often sees the board of directors and equity ownership as the primary internal mechanism while takeovers and market for corporate controls and legal/regulatory system are the primary external mechanism (Denis and Mc Connell, 2002; Cremers and Naim, 2004). The combination of these two mechanisms affects the corporate governance of a firm. Bai et al. (2003) however, highlighted the corporate governance mechanisms according to its model. The market-based governance model or Anglo American models has the characteristics of an independent board, dispersed ownership, transparent disclosure, active takeover markets and well-developed legal infrastructure. On the other hand, the control model or Franco-Germany emphasizes the values of insider board; concentrate ownership structure; limited disclosure; and reliance on family finance and the banking system.

The external governance mechanisms can be implemented as a result of the failure of internal governance mechanisms. According to Jensen (1986, 1988, 1989, 1993), the U.S takeovers in 1980s were ultimately caused by a failure in the internal governance mechanisms of U.S corporations. The failure was attributed to weaker management incentives during which the corporations had become larger, management ownership had shrunk and shareholders had become more widely dispersed. The boards on the other hand which were supposed to protect the shareholder rights, mostly sided with the management and were ineffective in carrying out their duties. There was also the act of subsidizing poorly performing divisions using cash from successful divisions instead of returning the free cash flow to the investors.

The practices of governance mechanisms in the Malaysian corporate sector can be analyzed from the directions contain in the master plans as well as orders from the regulatory bodies. Based on the Malaysian Code on Corporate Governance 2000, the issues are on the composition of board, recruitment of new directors, remuneration of directors, the use of board committees, their mandates and their activities.

The presence of corporate governance is significantly explained by the inclusion of 10 recommendations which focus specifically on corporate governance in the CMP. The dimensions of corporate governance contain in the CMP among others include the strengthening of minority shareholder's right, enhancing the quality and independence of auditors of public listed companies, improving the channels of communication between companies and the shareholders, enhancing disclosures in annual reports, requiring shareholder value disclosures for securities issuance, restructuring, takeovers and merger exercises, introducing measures to enhance regulatory, transparency, accountability and independence.

The following discussions will focus on the widely used governance mechanisms in academic research and the extent to which these are applied by the Malaysian corporate sector as suggested by the governance reform agenda.

4.1 Ownership Structure

The inclusion of this mechanism is necessary to explain the corporate control of particular firms at a different level. Study on ownership can be explained by type of ownership and the ownership concentration. The type of ownership can be explained by individual, institution, state, foreign and managerial ownership. The importance of ownership concentration was recommended by Schleifer and Vishny (1997) as one of the key determinants of corporate governance. Large shareholders often referred as block shareholders can benefit the minority shareholders because of their power and incentive to prevent expropriation (Mitton, 2002). However, these controlling shareholders may also pursue objectives that are inconsistent with those of minority shareholders (Morck et. al, 2000 and Bebchuk et. al, 2000). Mitton (2002) reported that a higher ownership concentration is associated with a higher stock price return of an average of 2.6% for every increase of 10% in the ownership of the largest shareholders. However, it was claimed that the return premium is largely attributable to large blockholders that are not involved with management.

Managerial ownership is a mechanism that firms can implement to increase the incentive for board members to monitor managers. With the proportions of ownership, board members will have personal wealth incentive to monitor managers in addition to their fiduciary responsibility (Coles et. al, 2002). There is a vast literature which argues that the percentage of Chief Executive Officer (CEO) ownership is correlated with Tobin's Q (e.g. Morck, Schleifer, Vishny: 1998, Demsetz and Villalonga: 2001). Some studies have found a positive relation between CEO shareholding and both Tobin's Q and ROA (Mehran: 1995). Between the financial and non-financial firms, consistent with studies by Houston and James (2002) and Booth, Cornett and Tehranian (2002), Adam and Mehran (2003) identified that CEO ownership in bank holdings companies was lower than the manufacturing firms (i.e., 2.3% and 2.9% respectively). Empirical

evidence was also documented by Demsetz and Lehn (1985) where size typically measured by book value of assets has an inverse relationship with the percentage of equity held by the CEO.

With respect to Malaysian governance reform, FSMP for instance stressed on the importance of institutional ownership and foreign ownership while limiting the individual or family ownership in banking business. It is recommended in the CMP that the equity ownership requirements of futures broking firms to be liberalized to allow foreign majority ownership and this is followed by subsequent announcement that foreign participants would be allowed to own 100% equity in broking companies. On March 2005, it was announced that five foreign brokers and one foreign fund manager have received the nod to operate in Malaysia. The five brokers are Credit Suisse First Boston, JPMorgan Chase & Co, Macquarie, UBS and CLSA, and the sole fund manager is Aberdeen Asset Management. FSMP on the other hand encourages the ownership of banking institutions by institutional investor. It was highlighted that historically majority of the institutions were either family-owned business or controlled by prominent individuals. The recommendation is based on the fact that institutional investors are able to commit their resources in creating strong and dynamic banking institutions. As such, the maximum limit of 20% for corporation and 10% for individuals is strictly enforced to ensure the accomplishment of this objective.

4.2 Board Structure

Board of directors is designated for the purpose of ensuring the alignment of the firm activities and its specified objectives. The board has the duty for making sure that the top managers are behaving in a way that will provide the optimal value for shareholders (Coles et. al, 2001). There is no maximum number of directorships prescribed by the Malaysian Code of Corporate Governance. However, Bursa Malaysia in its listing requirements in 2002 adopts restriction in the number of directorship of a person. Under the restriction, a director may only hold not more than 10 directorship of a public listed companies and not more than 15 directorships in non-listed companies. The rational is for the director to perform his/her duties effectively with less commitments, resources and time available.

There are different characteristics of board of directors practiced by the firms all over the world that specified the corporate governance framework of each firm.

4.2.1. CEO is Chairman of Board of Director (CEO Duality)

Leadership structure of a firm can be divided into combined leadership structure and separated structure (Coles et. al, 2001). Efficiency in monitoring management could be enhanced through CEO-Chairman duality, where a single person assumes the position of Chairman and CEO simultaneously because less contracting is needed and information asymmetry is reduced (Haniffa and Cooke, 2000). However, it was found that cost-efficiency and return on assets are lower when the CEO is also the chair. (Pi and Timme, 1983). It is also supported by Jensen (1993) that the combined structure is inappropriate to design one of the most critical power relationships in the firm. The argument is that the CEO who is also a board chair will have a concentrated power base that will allow the CEO to make decisions in their own-self interest and

at the expense of shareholders. As such, the views support the use of separate leadership structure where the titles are separated into two positions held by two separate individuals and the power spreads out in a way that allows the board to more completely perform its fiduciary duties. However, Rechner and Dalton (1989) in a study over five-year shareholders returns find no significant distinction between the performance of separated and combined structure.

In relation to Malaysian Code on Corporate Governance (2000), there is a requirement of balance of power and authority between Chairman and Chief Executive Officer so that no one individual has unfettered powers of decision. It is recommended that strong independent element should be induced and publicly explained in the event of CEO duality.

4.2.2. Board Size

There are conflicting ideas about the appropriate size of a board of directors in both financial and non-financial firms. It was identified that financial firms have an average larger board than manufacturing firms (Hayes et al, 2000 and Booth et al, 2002). While Vafeas (1999) documented a board size of 12, Shivdasani and Yermack (1999) reported a size of 11.

There are different reasons that explain for a larger board. Board size is said to increase prior to the increase in activism by institutional shareholders. The size may also increase following a merger or acquisition to incorporate some of the target directors (e.g. Wulf 2000). Adams and Mehran (2003) in their study on bank holdings company argued that an active level of consolidation in the banking industry make up a larger board for the bank holding companies. A complex organizational structure of bank holding companies where the bank holding companies controlling many subsidiary banks and the need to include these different boards in the bank holding companies board also contributed to a bigger board size. In addition, larger boards are formed due to positive correlation of board size with firm size (Hermalin and Weisbach, 2001; Yermack, 1996; and Baker and Gompers, 2000).

There were different findings on the board-size-performance relationship for non-financial and financial firms. For non-financial firms, board size has a negative relationship to performance. Jensen (1993) and Lipton and Lorsh (1992) argued that increases in board size make them less effective at monitoring management because of free-riding problems amongst directors and increased decision-making time. Contrary to the evidence for non-financial firms, there is a positive relationship between board size and Tobin's Q (Adams and Mehran 2002). Additionally, Brewer III et al. (2000) found that there was no effect or target bank board size on bid premiums in the event of mergers and acquisitions.

In explaining the board size requirement in Malaysia, the Governance Code recommended that the impact of size should be examined on the board effectiveness. However there is no specified numbers of the board recommended. It is in line with the above-mentioned arguments that a board should not be too big nor too small. However, the companies should allow a board with active participation and has the ability to make effective decisions and performing their functions.

4.2.3 Independent Board of Directors

The board independence is associated with the entry of outsiders into the board. The literature suggested that increases in the proportion of outside directors on the board should increase firm performance as they are more effective monitors of managers (Adams and Mehran, 2003). The proportions of the outside directors can be measured in terms of the ratio of outside directors to board size. The positive aspect of having board independence was evidenced in a study by Byrd et al (2001) that highlighted the survival of firms in the thrift crisis due greater proportion of independent directors in the board. However certain regulations may affect the number of outsiders sitting on the board. Brickley and James (1987) revealed that banks from state with takeover restrictions in US have fewer outside directors than banks from other states. In terms of proportions, bank holding companies have a higher proportion of outsiders on the board than non-financial firms with 69% in Vafeas (1999) and 46% in Shivdasani and Yermack (1999). Findings on board independence-performance studies indicated that there is no significant relationship between the proportion of outsiders on the board and Tobin's Q, although they found some evidence of a positive correlation between Tobin's Q and majority-outside boards (Adams and Mehran 2002). It was further argued that higher proportions of outside directors are not associated with superior firm performance but are associated with better decisions concerning such as acquisitions, executive compensation and CEO turnover (Hermalin and Wesbach 2001). However, it was found that bid premiums increase with the independence of the target's board in the event of mergers and acquisitions. (Brewer III et. al., 2000).

In the Malaysian context, Bursa Malaysia (formerly known as Kuala Lumpur Stock Exchange (KLSE) listing requirements amendments released January 2001 require at least one third of the board to comprise of independent directors. The term independent as prescribed by the listing requirement and the Malaysian Governance Code refers to independence from management and independence from the significant shareholders.

4.2.4 Professionalism/ Qualifications

Having educated managers will increase the likelihood of firms adopting innovative activities and accept ambiguity (Hambrick and Mason, 1984). According to Wallace and Cooke (1990), an increase in the level of education may increase political awareness and demand for corporate accountability.

As part of the governance enhancing effort, Bursa Malaysia in its listing requirements requires all directors of listed companies to undergo continuous training prescribed by the exchange. It aims at influencing corporate thinking on governance issues among the directors. Two programmes namely, Mandatory Accreditation Programme (effective 2001) and Continuing Education Programme (effective 2003) are designed so that they can effectively understand and perform their duties as directors.

4.3 Board Activity

4.3.1 Board Meeting

Board meeting has also been studied in relation to effective governance. Coger et. al (1998) suggested that board meeting time is an important resource in improving the effectiveness of a board. Study by Adams and Mehran, (2002) on board meeting of financial and non-financial firms suggested that bank holding companies meet slightly more frequently than manufacturing firms. The average number of board meeting per year is 8.45 (Adams and Mehran, 2002) which is close to 7.45 meetings a year reported by Vafeas (1999). Though it is difficult to explain such differences, it can be argued that regulations on the number of meetings may influence the bank's choice of directors; thus, regulations can potentially affect the quality of directors willing to serve these boards. Vafeas (1999) finds a negative correlation between the number of board meeting and performance. It means that boards that meet more frequently are valued less by the market. This is due to the notion that higher board meetings follow poor performance. Further tests indicated that operating performance rises following years of abnormally high meeting frequency. Such result concluded that boards respond to poor performance by raising their level of board activity is associated with improved operating performance.

A response on the importance of meeting however was highlighted with the issuance of guidelines by Malaysian Association of the Institute of Chartered Secretaries and Administrators (MAICSA). In November 2000 and November 2002, the Institute released the best practice guide entitled "A Guide to Annual General Meetings" and "The Company Secretary: A Reference Kit". The Malaysian Code on Corporate Governance on the other hand recommended that board should meet regularly and the number of meeting in a year together with director's attendance should be disclosed. Even though there is no stipulation on the number of meetings, the recommendation felt that it is difficult to positively explain the board control of company which has less than four meetings a year.

4.3.2 Board Committee

The board committee has an important role in corporate governance by improving the decision-making by the board and enhancing the monitoring of management and accountability to shareholders. Klein (1998) documented that aspects of the board related to committee may affect performance. Specifically, it was argued that having the proportion of insiders on the finance committee is positively related to firm value. However, Weir et. al. (2001) argued that neither the independence of committee membership and caliber of committee members has an effect on performance. A study by Vafeas and Theodorou (1998) also found no evidence to support the view that the structure of board sub committees significantly affected performance. Findings from Adams and Mehran (2002) indicated that each board on average has 4.42 committees and each committee member sits on 1.87 committees.

In industry specific governance, Bank Negara with its FSMP and guidelines highlighted the governance issue of banking sector as well as other financial institutions in Malaysia. In enhancing corporate governance in the long term, the plan requires banking institutions to establish additional committees in addition to the existing committees. Initially there are Audit Committee, Credit Committee and Asset-Liability Committee. The additions would include

Nominating Committee, Management Development and Compensation Committee and Risk Management Committee. Malaysian Code on Corporate Governance and Bursa Malaysia listing requirements however require committees to handle the matters pertaining to nomination of directors, compensation and remuneration of directors and internal control and integrity of the external audit.

4.4 Remuneration

The incentives of top management have been characterized as an important mechanism of corporate governance as it ensures the alignment of the management and the shareholders interest (John et al 2004). In other words, it serves as a mechanism for resolving the conflict of interest among the managers and shareholders. Brick, Palmon and Wald (2002) highlighted that director compensation should also affect performance of a firm. With regards to banking institutions, Anderson and Campbell (2000) suggested that failure to specify meaningful incentives by Japanese banks led to the extension of credit to smaller, less well-known borrowers and increasingly secured such loans with overpriced real estate in the 1980s. The compensation is in the form of cash and stock and is termed as Deferred Compensation or Deferred Stock. According to Adams and Mehran (2002), nearly 95% of the firms have deferred compensation plans for their directors. However, only 31% of the firms offer a choice of stock and/ or cash to their directors. Studies have been conducted to analyze the implication of having different level of both type of compensation on the firm performance. Using a measure of Ratio of Value of Granted Options to Salary plus Bonuses, Adams and Mehran (2003) indicated that manufacturing companies possessed a mean that the value of granted options was 60 percent larger than the sum of base salary and bonuses. Financial firms as represented by bank holdings were said relied on lower stock options (Houston and James, 1995). The difference was attributed to growth status of the industry. It was recommended by Smith and Watts (1992) and Mehran (1992) that low growth industries proxies by Tobin's Q ratio rely less on stock based compensation. It happened because the board of a low growth industries can observe, monitor and evaluate the actions of CEOs easily thus rely more on fixed rather than stock based compensation. The study by Adams and Mehran (2003) classified the bank holdings companies into a low growth industries due lower Tobin's Q of 1.0 compare to the manufacturing with 1.9. Additionally, they argued that smaller stock return volatility in the bank holdings companies sample might make it easier for the board to monitor CEO actions.

The Malaysian Code on Corporate Governance requires that director's remuneration should be appreciable and should reflect the responsibility and commitment of the directors. In the case of executive director, remuneration should link rewards to corporate and individual performance while in the case of non-executive directors, it should link rewards to experience and level of responsibilities. The level of remuneration for the executive directors should be decided by the remuneration committee consisting wholly and mainly of non-executive directors. On the other hand, remuneration of the non-executive directors should be determined by the board as a whole. The companies is also required to disclose the details of the remuneration of each director in its annual reports.

4.5 Transparency and Disclosure

The financial transparency is an important mechanism that provides depositors, creditors and shareholders with credible assurances that they will refrain from fraudulent activities. Financial reporting or disclosure quality had been measured as one of the mechanism in assessing the corporate governance of a firm [e.g. Mitton (2002) and Coles et. al (2002)]. LLSV (1998) argue that accounting standards play a critical role in corporate governance by making contracts more verifiable. There are different ways in explaining disclosure quality. Higher disclosure quality may be achieved by appointing reputable external auditors which is normally referred to one of the big 5 international accounting firms (Reed et. al, 2000; Mitton, 2002; Titman and Trueman, 1986). The big 5 firms are said to be more likely to ensure transparency and eliminating mistakes in firm's financial statements because they have a reputation to uphold (Michaely and Shaw, 1995), may be more independent than local firms; face greater legal liability for making errors (Dye, 1993) and may offer higher perceived disclosure quality (in the case in which actual disclosure quality is not higher) due to their prominent and recognizable names (Rahman, 1998). Mitton (2002) has also suggested that higher disclosure quality to be associated with a firm that has a listed American Depository Receipt (ADR). The higher disclosure quality can be formally exercised through the meeting of mandated disclosure requirements of the listing exchange. In informal way, higher demand for disclosure from the investors and increased scrutiny of the firms report would enhance the disclosure quality of a firm. Using a sample of 398 firms from the five East Asian countries, it was reported that both proxies of disclosure quality were associated with significantly better stock price performance during the crisis period. By having an ADR and a Big Six Auditor, there were higher returns of 10.85% and 8.1% over the crisis period.

Malaysia in its efforts to enhance disclosure quality has adopted quarterly reporting of financial information to the public listed companies effective in August 1999. It includes reports on income statement, balance sheet and cash flow statement prepared in accordance with approved Financial Reporting Standards (FRS) of the Malaysian Accounting Standards Board (MASB). Listed companies are also required to include a narrative statement of how they apply the governance principles in their annual report. Financial transparency is also applied in the process of M&A where an amended Malaysian Code on Takeovers and Mergers in 1st January 1999 requires higher standard equivalent to international best practice of corporate disclosure and behavior from the involved parties. In May 2000, Bursa Malaysia through its Taskforce in Internal Controls formulate and issued the guidelines in assisting the public limited companies to report on the state of internal controls in their annual report. To complement the measures, Institute of Internal Auditors in August 2002 released the Guidelines on the internal audit functions to assist the boards of directors on matters pertaining to internal audit functions as well as to facilitate the benchmarking of audit standards of our listed companies with the international standards. The Code is also highlighted the task of company's audit committee to reinforce the independence of the external auditor. In addition, the Taskforce on Corporate Disclosures Best Practice of the Bursa Malaysia was also issued "Best Practices in Corporate Disclosure" as a means of guiding the listed companies to perform its disclosure obligations in accordance with the Listing Requirements and securities Law.

4.6 Alliances and Mergers

Improvement on corporate governance at the firm level can also be achieved by having foreign ownership or joint ventures or strategic alliances with reputable locals and foreign firms. Joint ventures and strategic alliances may be the least costly form of governance and therefore the most favorable coordination mechanism Coase (1937, 1960) and Williamson (1985). This is due to the inclusion of new and different standards that has been practiced by one of the firm. According to Peek and Rosengren (2000), the entrance of foreign bank forces the domestic bank to adopt with the new management technique, mechanisms and information technology brought by the foreign bank It is even positively reacted by the market. Gleason et. al (2003) indicated that a significant positive annual returns for holding periods of 6, 12 and 18 months after the announcement on participation in joint venture or strategic alliance. In exploiting the above-mentioned benefits, one of the recommendations in the FSMP is for the banking institutions for them to involve in strategic alliances either with other banking and non-banking institutions especially in the form of equity alliances. This is in line with the increasing use of mergers and equity alliances in other countries.

Another way of seizing the benefits is through mergers and acquisitions. It was concluded that the industry performance measured by Tobin's Q increases when the firms within the industry acquired by foreign firms coming from countries with better shareholder protection and better accounting standard (Bris and Cabois, 2003). It is also recommended in the FSMP that mergers among the financial institutions should be expedited to extract the benefits of efficiency and synergy. It is stated that mergers between merchant banks and stockbroking companies or discount houses of the same group should be encouraged to create a full-fledged investment banks. In March 2005, the Central Bank of Malaysia (Bank Negara) unveiled plan for the investment banks. The plan stated that foreign banking group could own up to 49% of domestic investment banks. Under the plan, a discount house that did not have merchant bank could merge with another discount house to become a merchant bank and subsequently be transformed into an investment bank subject to the merger of the entity with another stockbroking company. It is also stated in the recommendation of CMP to promote consolidation of the stockbroking industry that reduced the number of stockbroking companies from 66 to 35. The effort is to form well-capitalized universal brokers which would allow to offer a full range of capital market services. It is also recommended that the insurance industry to be consolidated as well. However, effort to merge the banking institutions started as early as mid 80's as a result of economic crisis. The institutions failed to consolidate until 1997 when the country experienced financial crisis. The government led mergers materialized after the crisis with the formation of 10 anchor banks. Apart from crisis resolution, the proactive role was taken to prepare for challenges by the opening up of the financial services in the upcoming World Trade Organization (WTO) round of multilateral trade negotiations. During the crisis, Malaysia protected its domestic banks by maintaining the regulation of 30% limit on foreign ownership of the banks.

5. CONCLUSIONS

The paper provides a descriptive analysis on the corporate governance mechanisms in Malaysia. The discussion relates the economic crisis in 1997 that necessitate for the corporate governance efforts on the private sector in the country. It is explained based on the reforms agenda contained in the Malaysian Code on Corporate Governance, Capital Market Master Plan and Financial Sector Master Plan. By highlighting the mechanisms that normally used in the academic research, the paper identifies some of the important mechanisms applied in the reforms of the Malaysian corporate governance. It is found that the mechanisms that have been put in place are comprehensive and covers a wide spectrum of corporate governance internally and externally.

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