

# FACTORS AFFECTING BANK GOVERNANCE IN MALAYSIA

**Wan Masliza, Wan Mohammad, Rapih Mohd Zaini, Haslina Hassan, Takunda Guest Charumbira \***

## Abstract

Since the financial crisis in year 1997, banks in Malaysia had undergone various issues and transformations, including stricter regulation on merger and acquisitions and greater enforcement of corporate governance. Besides that, the institutions had also gone through the transformation in terms of the risk assessment practice due to the stricter rulings under Basel II regulations. Taking into account of these changes, this study empirically examines the effects of corporate governance, risk and capital on the performance of banks in Malaysia. Based on 132 firm-year samples for the period of 2004-2009, study indicates a significant and negative relationship between bank risks and performance. It further reveals that the risk weighted capital (RRWC) improves bank performance. However none of the corporate governance variables have any associations with banks performance. The detail explanations of the findings along with the suggestions for future research are provided in the full text of the reports.

**Keywords:** Corporate Governance, Basel regulations, Risks and Performance

**Jel Classifications:** G21, G34 and G38

\* Faculty of Management (FOM), Multimedia University, Malaysia  
Email: [wan.masliza@mmu.edu.my](mailto:wan.masliza@mmu.edu.my)

## 1 Introduction

Since the financial crisis in year 1997, banks in Malaysia had undergone various issues and rapid transformations. These include stricter regulations on lending to aggressive merger and acquisitions, greater enforcement of transparency and improvement in corporate governance and the risk assessment practice of the banks in Malaysia. In fact, some of these issues have become the main agenda of the regulators like Bursa Malaysia, Securities Commission and Central banks itself.

In Malaysia particularly, banks are governed under Banking and Financial Institutions Act 1989 (BAFIA) and Central Bank of Malaysia Act 2009. Both acts ensure proper supervisory of Malaysia banks, rules on licensing and products, permissible holdings for institutions and so forth. Whilst this acts focus on the operations of the banking institutions, Malaysian Code on Corporate Governance (MCCG) has laid focus on the governance of directors and audit committees of banking institutions. These principles of corporate governance is drawn from the framework of the Organization of Economic Co-operation and Development (OECD) and are similar to frameworks proposed by the MCCG (2000, later revised to MCCG, 2007). The objectives are to assist governments in their efforts to evaluate and improve their frameworks for corporate governance and to provide guidance for the financial market regulators

and participants in financial market (Basel Committee on Banking Supervision 1999; Thillainathan 1999)

Aside from corporate governance, Malaysian banks also goes through transformations in terms of their risk assessment practice due to stricter rulings under Basel II regulations. However most of the research focuses on the relationship between capital adequacy ratios (CAR) and risk, and limited study has look into the effect of CAR on banks' performance in Malaysia (Ahmad 2008). In addition to that, based on the reported literature fewer studies were conducted on the relationship between good governance and the effectiveness of Basel regulations implementation (Laeven and Levine 2009). In extending the research, this study will look on the effect of Basel regulations and Malaysian Code of Corporate Governance in improving banks performance.

## 2 Background of the study

Corporate governance refers to the rules, process, laws and guidelines by which businesses are operated. It serves the need of the shareholders and other stakeholders by aligning the management activities towards stakeholder's interests. Hence, the results of good corporate governance might be reflected positively on the banks performance. The general overview of previous research seems to support the stance that there is a positive relationship between corporate governance and performance (Chamberlain 2010). However, Fernandes (2008) shows

nonexecutive board members do not have a strong monitoring and it is shown that firms with less non executive board members and independent directors usually have a better alignment with shareholders interests (Fernandes 2008). Other studies also found that board composition does not determine corporate performance (Bhagat and Black 2002; Khi and Bazaz 2008; Mak and Kusnadi 2005; Postma et al. 2003). Related studies were also conducted in determining the association of performance with size (Cheng 2008), Chief Executive Officer (CEO) termination (Brookman and Thistle 2009), CEO tenure rises (Walters et al. 2007), directors remuneration (Brick and Chidambaran 2010; Brick et al. 2006; Duffhues and Kabir 2008) and board activities (Brick and Chidambaran 2010; Vafeas 1999).

Berger et al. (1995) provide some analysis on to the importance of capital ratios on financial institutions. The analysis reveals that there is a market requirement which is subject to each individual bank on how much capital a bank should hold (Berger et al. 1995). The safety net refers to government actions designed to enhance safety and soundness of the banking system other than the regulations and enforcement of capital requirement (Berger et al. 2005). It is found that commercial banks with a lower capital adequacy rate in order secure larger profits for banks take on higher risks. Banks with higher a capital adequacy ratio provide a stronger guarantee to customers who are depositing their funds (Lin et al. 2005).

Therefore, this study was conducted with the aim to investigate (i) the effect of corporate governance in improving bank performance, and (ii) the effect or risks and capital on bank performance. Empirical research in this area is useful for a number of reasons. To the regulatory bodies and related agencies, the findings provide an important input on the effectiveness of the regulation and the signal for the next steps to be taken in improving of the weaknesses. The findings also contribute towards better understanding of the areas of corporate governance, risk and capital in relation to the performance of financial institutions. For the regulatory agencies, the findings may be used to tighten up their rules and, perhaps they can concentrate their efforts on those companies which characteristics are identified.

### 3 Data sources and methodology

#### 3.1 Sample Selection and data

The sample consists of 132 observations between years 2004-2009, comprises Islamic, investment and commercial banks. There are a total of 22 banks selected from a total population of 68 banks, thus representing 32.4% of the population of Malaysian banks. The banks collected are those banks that publicly disclosed their annual reports either in their own websites or Bursa Malaysia. This period

comprises of banking crisis in 2008 as well as the revised Malaysian Code of Corporate Governance (2007). This is partly due to merger and acquisition process of all banks that takes place after 1997-1998 crises.

#### 3.2 Model Specification

##### Model 1

$$REVTA = a_0INTERCEPT + a_1ETHNICPER + a_2INDAC + a_3INDEP + a_4MEETAC + a_5MEETDIREC + a_6LLP + a_7NPL + a_8RRWC + a_9PERNAF + a_{10}CHAIRINDEP + a_{11}DIRECTORREM + a_{12}BOARD\_SIZE + a_{13}NETLOANASS + a_{14}TENURE + a_{15}LEVERAGE$$

##### Model 2

$$INTINCOMEASS = a_0INTERCEPT + a_1ETHNICPER + a_2INDAC + a_3INDEP + a_4MEETAC + a_5MEETDIREC + a_6LLP + a_7NPL + a_8RRWC + a_9PERNAF + a_{10}CHAIRINDEP + a_{11}DIRECTORREM + a_{12}BOARD\_SIZE + a_{13}NETLOANASS + a_{14}TENURE + a_{15}LEVERAGE$$

From Table I, revenue over total assets (REVTA) has a mean value of 0.05599 with the range of 0.01940 to 0.29017. The mean of INTINCOMEASS is 0.04225. In fact the maximum value of INTINCOMEASS is only 0.06577 whilst the minimum value is 0.0035. Loan loss provision (LLP) has a mean value of approximately RM 192 millions and varies from a maximum figure of RM 1,325 millions to under provision of RM (39,316). The BOARD\_SIZE has a mean of 8.66141 with largest board size consisting of 13 members and the smallest consisting of 5. Net loan over Assets (NETLOANASS) exhibited a mean figure of 0.46261 and with the highest is 0.91240. The percentage of Malay members on the board of directors (ETHNICPER) has a ratio of 0.5 with a range of from 0 to about 1 indicating the existence of pure Malay owned banks and other ethnics. The percentage of independent directors in the audit committees (INDAC) is 77.94% with a range from 30% to about 100%. Proportion of independent directors on the board (INDEP) exhibits a mean of 46.09% with a range from 18% to 80% showing a well distributed proportion of independent directors in Malaysian banks. The Leverage (LEVERAGE) of the bank has a mean of 1.09626 with a range of about -2.158033 to 3.1751. Remuneration paid to the board of directors (DIRECTORREM) has a mean of RM 3.622 million and a range from RM 129,000 to RM 2.5698 millions. The number of meetings held by the audit committee (MEETAC) has an average of about 8.966 and ranges from 2 to 32. In retrospect to the number of meetings held by the directors (MEETDIR) the mean is 11.22 and the range is between 3 to 24 meetings in a year. The ratios of non-audit with respect to the audit fees

ratio (PERNAF) had a median of 0.3247 and the highest being 2.79949. The risk weighted cost of capital (RRWC) for the sample of banks has a mean of 23.192% and ranging from 2.84% to 2.1192%. Tenure of CEO's (TENURE) has a mean of 4.78571 and the highest tenure is 24 years. The nonperforming loans (NPL) have a mean of RM 1,222 million and ranging from RM 67,000 to RM 13,037 million. The dichotomous variable of the chairman independence (CHAIRMANDEP) had a median value of 0 and had a range from 0 to 1.

### **3.3 Robustness Checks**

The data was run initially using pooled regression techniques. The data revealed that there is autocorrelation using Lagrange multiplier (LM) test (p-value is 0.000). Further analysis also revealed that there is heterocedasticity problems using Breusch-Pagan-Godfrey (BPG) test (p-value is 0.000) (Baltagi 2005; Gujarati 2003). Another post estimation tests also show the presence of heteroskedasticity (Modified Wald test, Prob>chi2 = 0.000). Thus, a Cross Sectional Seemingly Unrelated regressions (SUR) panel data regression analysis estimator is used to correct for the problems of heteroscedasticity, autocorrelation and contemporaneous correlation (Beck and Katz 1995; Magalhaes and Africano 2007). This will improve the efficiency of the coefficients of each variable under this study. Further analysis on the correlation matrix reveals that there is no correlation between variables under this study.

## **4 Results of the study**

### **4.1 The Relationship between Corporate Governance and Performance**

Based on the analysis (Table II), none of the corporate governance variables indicate any association with bank's performance. The percentage of ethnic member in the board (ETHNICPER), percentage of independent directors in audit committees (INDAC) and percentage of independent directors in the board (INDEP), audit committees meeting (MEETAC) and directors meeting (MEETDIREC) also have no implications towards banks' performance. Board size (BOARD\_SIZE) is the only control variable that has a positive significant relationship with performance at a 10% significance level. This is inconsistent with some other studies who found negative association between board size and performance (Bhagat and Black 2002; Connel and Cramer 2010; Eisenberg et al. 1998; Hossain et al. 2001; Kim and Rasia 2010). The

argument made by Eisenberg et al (2008) is that greater problems in regards to communications and coordination when there exist greater number of board members. In Malaysia with diverse ethnic group, larger boards, with politically connected and family firms may be a sign of greater influence of board members over local economic activity (Jaggi et al. 2009; Wahab et al. 2007).

### **4.2 The Relationship between Risk and Performance**

Result indicates of a strong relationship between risk and performance. For both Model 1 and Model 2 there is a significant relationship between the Non Performing Loan (NPL), Loan Loss Provision (LLP) and performance. Regulations in regards to the level of credit risks needs to be further strengthened as the potential risks increases as firms engaged in profit seeking alternatives. Malaysian government under the Ministry of Finance has set up Khazanah Nasional as an investment holding arms to help managing the government assets and undertake strategic investment in areas that may generate the economy. This also includes bailouts on financial institutions that represent public interest. The importance of this findings is for the government to take stricter ruling on highly profitable banks who may be indulge in offering products that generates higher NPL and LLP.

### **4.3 The Relationship between Risk Weighted Capital (RRWC) and Performance**

The role of capital adequacy is significant; that is to improve banks' stability, through adequate provisioning against adverse economic effects (Blum 1999; Ghosh 2009; Nachane et al. 2000; Rime 2001). , Previous studies shown that there is a positive relationship between capital adequacy and risk (Milne and Jokipii 2008; Rime 2001; Stolz and Wedow 2009). This reflects the ability of capital to buffer against risk in time of recession. In this study we have found that RRWC improves banks performance. This is partly due to greater risk taking as evidence from the level of NPL and LLP and requirement impose under Basel II regulations. On another perspective regulations has ensure banks safety net to increase and provide greater confidence for stakeholders. This finding provides a positive note on steps taken by Central Bank of Malaysia to pursue banks to adhere to this capital standard.

**Table 1.** Descriptive Statistics

	Mean	Median	Maximum	Minimum	Std. Dev.
<i>Panel A – Continuous Variables</i>					
REVTA	0.05599	0.05292	0.29017	0.01940	0.02609
INTINCOMEASS	0.04225	0.04303	0.06577	0.00351	0.00985
LLP (000's)	191949.27	106812	1325478	-39216	269259.96
BOARD_SIZE	8.66141	8	13	5	1.90329
NET LOANASS	0.46261	0.52166	0.91240	0	0.19493
ETHNICPER	0.51940	0.5	1	0	0.29593
INDAC	0.77949	0.75	1	0.3	0.16411
INDEP	0.46094	0.42857	0.80	0.18	0.34530
LEVERAGE	1.09626	1.06298	3.31751	-2.15803	0.56528
DIRECTORREM(000's)	3621.68	2761	25698	129	327.540
MEETAC	8.96638	0.58049	32	2	6.3325
MEETDIR	11.22222	0.49091	24	3	5.51055
PERNAF	0.32479	0.06571	2.79949	0	0.52622
RRWC	0.23192	0.1423	2.1192	0.0284	0.29038
TENURE	4.78571	2	24	0	5.85505
NPL(000's)	1222647.07	529561	13037159	67	1869764.31
<i>Panel B – Dichotomous Variables</i>					
CHAIRINDEP	0.244094488	0	1	0	0.431250221

REVTA is the revenue to total asset ratio. The INTINCOMEASS is the interest income divided by total assets ratio. INDEP is the number of independent directors on the board. CHAIRINDEP is a nominal data of 1 if the chairman is independent and 0 if otherwise. DIRECTORREM is the remuneration paid out to the directors on the board. MEETDIREC is the number of meeting held by the directors. INDAC is the proportion of independent directors over board size. MEETAC is the number of meetings held by audit committees. ETHNICPER is the percentage of board of directors that are Malays. NPL is the amount of nonperforming loans. RRWC is the risk weighted capital for the bank. BOARD\_SIZE is the number of directors. PERNAF is the ratio of the non-audit fee divided by audit fees. LLP is the loan loss provision for the bank. LEVERAGE is the current liabilities over current assets. TENURE is the total number of years of service of the CEO. NETLOANSASSETS is net loans divided by the total assets.

**Table 2.** Results of panel data regression (Model 1 and 2)

		Model 1		Model 2	
<b>Independent Variables</b>	Expected Direction	t-Statistic	Prob.	t-Statistic	Prob.
<b>Corporate Governance Variables</b>					
ETNICPER	+	0.395231	0.6956	-0.119937	0.9054
INDAC	+	-1.528095	0.1373	-1.237833	0.2257
INDEP	+	0.245720	0.8076	1.147545	0.2605
MEETAC	+	-0.889655	0.3810	0.403218	0.6897
MEETDIREC	+	-1.355430	0.1857	0.841113	0.4072
<b>Bank Risks Variables</b>					
LLP	-	5.292609	0.0000	1.841314	0.0758
NPL	-	-3.121884	0.0040	-2.102226	0.0443
<b>Bank Capital Variable</b>					
RRWC	+	4.115155	0.0003	1.775672	0.0863
<b>Control Variables</b>					
PERNAF	-	-0.189041	0.8514	-0.287116	0.7761
CHAIRINDEP	-	0.371297	0.7131	-0.239612	0.8123
DIRECTORREM	+	0.999976	0.3256	-0.648744	0.5216
BOARD_SIZE	-	8.461834	0.0000	3.249358	0.0029
NETLOANASS	+	0.201442	0.8418	2.085201	0.0460
TENURE	+	1.007671	0.3219	-0.894075	0.3786
LEVERAGE	-	-0.002260	0.9982	0.774921	0.4447
Period (dummy variables)	Fixed +/-	Yes		Yes	
R-squared		0.725367		0.509265	
Adjusted R-squared		0.526495		0.153905	

## 5 Conclusions

This study reports the results of a study, which examined the effects of corporate governance, risk and capital on the performance of Malaysian banks. Based on this study we fail to establish the relationship between corporate governance mechanism and banks performance. This however does not in necessity indicate the lack of importance of corporate governance mechanism discussed in this paper. Although the research conducted here does not indicate a significant relationship, the roles of corporate governance in protecting the interest of stakeholders are plausible.

The second findings of the study are the effects of risks on performance. It seems that higher risks banks have larger profits. However the added performance that comes from increasing risk carries its own burdens as the associated risk reflects the heavy burden carries by banks excessive risk taking. The study also reveals that risk weighted capital (RRWC)

improve banks performance. This in part may be due to stricter regulations imposed under Basel II regulations and its effects on banks stability. On another perspective, the higher RRWC was a consequence of the high level of risks that commensurate with banks performance.

It is suggested that future research studies may be constructed to investigate and compare the impacts and effectiveness of corporate governance mechanisms in the banking industry. A comprehensive study analysing the corporate governance on the different types of bank categories such as Islamic, commercial, and investment banks should be done to gain an insight on how these mechanism differ among the banking groups. Issues of financial distress amongst banks need to be further explored to see how regulations mechanism may helps to alleviate the burden of financial distress and improves banks performance through greater awareness on the value of corporate governance and their effects to the welfare of other stakeholders.

## 6 References

1. Ahmad R, Ariff.M., Skully,M.J. 2008. The Determinants of Bank Capital Ratios in a Developing Economy. *Asia-Pacific Finan Markets* 15:255-272.
2. Baltagi BH. 2005. *Econometrics Analysis of Panel Data*: John Wiley & Sons. 265 p.
3. Basel Committee on Banking Supervision. 1999. *Enhancing Corporate Governance for Banking Organisations*. Bank for International Settlements September(Available at [www.bis.org](http://www.bis.org)).
4. Berger AN, Clarke GRG, Cull R, Klapper L, and Udell GF. 2005. Corporate governance and bank performance: A joint analysis of the static selection and dynamic effects of domestic, foreign and state ownership. *Journal of Banking & Finance* 29(8-9):2179-2221.
5. Berger AN, Herring RJ, and Szego GP. 1995. The role of capital in financial institutions. *Journal of Banking & Finance* 19:393-430.
6. Bhagat S, and Black B. 2002. Board independence and Long term Firm performance. *Journal of Corporate Law* 27(271-273).
7. Brick IE, and Chidambaran NK. 2010. Board meetings, committee structure and firm value. *Journal of Corporate Finance* 16(4):533-553.
8. Brick IE, Palmon O, and Wald JK. 2006. CEO compensation, director compensation, and firm performance: Evidence of cryonism? *Journal of Corporate Finance* 12(3):403-423.
9. Brookman J, and Thistle PD. 2009. CEO tenure, the risk of termination and firm value. *Journal of Corporate finance* 15(3):331-344.
10. Carter DA, D'Souza F, Simkims BJ, and Simpson WG. 2010. Gender and Ethnic Diversity of US Boards and Board Committees and Firm Financial Performance. *Corporate Governance: An International Review* 18(5):396-414.
11. Chamberlain TW. 2010. Board Composition and Firm Performance: Some Canadian Evidence. *International Advances in Economic Research* 16(4):421-422.
12. Cheng S. 2008. Board size and variability of corporate performance. *Journal of Financial Economics* 87(1):157-176.
13. Connel VO, and Cramer N. 2010. The relationship between firm performance and board characteristics in Ireland. *European Management Journal* 28(5):387-399.
14. Duffhues P, and Kabir R. 2008. Is the pay-performance relationship always positive? Evidence from the Netherlands. *Journal of Multinational Financial Management* 18(1):45-60.
15. Eisenberg T, Sundgren S, and Wells MT. 1998. Larger board size and decreasing firm value in small firms. *Journal of Financial Economics* 48(1):35-54.
16. Fernandes N. 2008. EC: Board compensation and firm performance: The role of "independent" board members' *Journal of Multinational Financial Management* 18(1):30-44.
17. Haniffa R, and Hudaib M. 2006. Corporate Governance Structure and Performance of Malaysian Listed Companies. *Journal of Business Finance & Accounting* 33(7-8):1034-1062.
18. Hossain M, Pestov A, and Rao RP. 2001. Corporate governance in New Zealand: The effect of the 1993 Companies Act on the relation between board composition and firm performance. *Pacific-Basin Finance Journal* 9(2):119-145.
19. Jaggi B, Leung S, and Gul F. 2009. Family control, board independence and earnings management: Evidence based on Hong Kong firms. *Journal of Accounting and Public Policy* 28(4):281-300.
20. Khi BM, and Bazaz MS. 2008. Corporate Governance and Firm Performance in Iran. *Journal of Contemporary Accounting and Economic* 4(2):156-172.
21. Kim PK, and Rasia D. 2010. Relationship between corporate governance and bank Performance in Malaysia during the Pre and Post Asian crisis. *The European Journal of Economics Finance and Administrative Finance* 2(1):39-64.
22. Kwan SH. 2003. Operating Performance of banks among Asian economies: An international and time series comparison. *Journal of Banking and Finance* 27(3):471-489.
23. Laeven L, and Levine R. 2009. Bank governance, regulation and risk taking. *Journal of Financial Economics* 93(2):259-275.
24. Lin SL, Penn JHW, Gong S-C, Gong C-S, and Chang C-S. 2005. Risk-based capital adequacy in assessing on insolvency-risk and financial performance in Taiwan's banking industry. *Research in International Business and Finance* 19(1):111-153.
25. Mak YT, and Kusnadi Y. 2005. Size really matters: Further evidence on the negative relationship between board size and firm value. *Pacific-Basin Finance Journal* 13(3):301-318.
26. Milne A, and Jokipii T. 2008. The Cyclical Behaviour of European bank capital buffers. *Journal of Banking & Finance* 32(1).
27. Postma TJB, Ees HV, and Sterken E. 2003. Board composition and performance in the Netherlands. *Eastern Economic Journal* 29:41-48.
28. Rime B. 2001. Capital requirements and bank behaviour: Empirical evidence for Switzerland. *Journal of Banking & Finance* 25(4):789-805.
29. Stolz S, and Wedow M. 2009. Banks' regulatory capital buffer and the business cycle: Evidence for Germany. *Journal of Financial Stability* In Press, Corrected Proof.
30. Thillainathan R. 1999. Corporate Governance and restructuring in Malaysia-A review of Markets, Mechanisms, agents and the legal infrastructure. Paper prepared for the joint World Bank and OECD Survey of Corporate Governance Retrieved June 22, 2011 (from <http://www.oecd.org/dataoecd/7/24/1931380>).
31. Vafeas N. 1999. Board meeting frequency and firm performance. *Journal of FinancialEconomics* 53:113-143.
32. Wahab EAA, How JCY, and Verhoeven P. 2007. The Impact of the Malaysian Code on Corporate Governance: Compliance, Institutional Investors and Stock Performance. *Journal of Contemporary Accounting & Economics* 3(2):106-129.
33. Walters BA, Kroll MJ, and Wright P. 2007. CEO tenure, boards of Directors, and acquisition performance. *Journal of Business Research* 60(4):331-338.
34. Williams J, and Nguyen N. 2005. Financial liberalization, crisis, and restructuring: a comparative study of bank performance and bank governance in South East Asia. *Journal of Banking and Finance* 29(8-9):2119-2154.