THE EFFECTS OF CORPORATE GOVERNANCE, BANK RISKS AND CAPITAL ON BANK PERFORMANCE IN MALAYSIA (2004-2009)

Wan Masliza Wan Mohammad*, Takunda Guest Charumbira

Abstract

This study seeks to investigate the effects of corporate governance, risk and capital on the performance of Malaysian banks. This gives incremental insights on the effects of new regulations; revised Malaysian Code on Corporate Governance (MCCG, 2007) and the implications of this code on the performance of Malaysian banks. This is by addressing the level of boards and audit committees independence, risks and the level of risks weighted capital (RWC) on banks performance. In particular, this study aims to investigate whether regulations improves banks performance.

Keywords: Corporate Governance, Basel regulations and Risks

JEL Classification: G21, G34, G38

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

1. Introduction

The importance of corporate governance in this region has been placed under the microscope since the outbreak of the Asian financial crisis. It is a generally believed in economic theory that competition in an industry acts as a substitute mechanism for corporate governance. So under this idea firms are obliged to explicitly cater to the interests of their stakeholders or lose out to competition. Banking industry with respect to the US and Europe has undergone a rapid process of asset consolidation becoming one of the most active industries for mergers and acquisitions over the past two decades. Looking at the performance of banks in South-East Asian economies we can see an increase in performance between from 1992-1997 due to a reduction in operating costs and financial liberation resulting from an increase in competition (Kwan 2003; Williams and Nguyen 2005).

Since the financial crisis in 1997, banks in Malaysia have undergone rapid transformations from stricter regulations on lending to aggressive merger and acquisitions. In fact after the crisis enforcement of greater transparency and improvement in corporate governance are in the main agenda of regulators i.e. Bursa Malaysia, Securities Commission and Central banks itself. Corporate governance is a broad term that refers to the rules, process, laws and guidelines by which businesses are operated. This serves the need of the shareholders and other stakeholders by aligning the management activities towards stakeholder's interests. 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 assists 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. Overview of Corporate Governance, risks and capital on performance

Because the role of corporate governance is to monitor the management of a firm and align its interest with that of the shareholders, this should be reflected positively on banks performance. 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). However the general overview of research seems to further support the stance that there is a positive relationship between corporate governance and performance(Chamberlain 2010). In facts many studies has associated 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).

Contrastingly no evidence is found to suggest gender and ethnicity influence board performance (Carter et al. 2010).However, Haniffa and Cooke(2002) find that the Chinese to be more individualistic and more secretive in their disclosure partly due to their entrepreneurial skills. They, however, found Malaysian firms dominated by Malay directors have a higher level of voluntary disclosure, which is consistent with the Islamic business ethics that encourages transparency in business(Haniffa and Hudaib 2006)

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).

2. Corporate Governance in Malaysian banks

The Questions for the study of this paper are as follows.
1. How applicable is corporate governance in improving bank performance?
2. What are the effect or risks and capital on bank performance?

3. Data sources and methodology

3.1 Sample Selection and data

The sample consists of 132 observations between years 2004-2009. These banks consist of 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. We have included all the banks that have publicly disclosed their annual reports from the year 2004-2009. This period comprise 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. Central Bank objective of reducing the number of banks are due to higher capital requirement of local financial institutions under Basel regulations.

3.2 Model Specification

3.2.1 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

3.2.2 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 the Table 1, 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 0.46261and 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. The highest meeting of 32 was during a merger between RHB bank with Bank Utama Berhad in 2003. 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) has 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.

4.1 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 postestimation tests also show the presence of heteroskedasticity (Modified wald test, Prob>chi2 = 0.000). Since all tests have p-value which is less than 10%, pooled regression is inappropriate for the test as pooled regression techniques may distort the exact relationship of the variables under this study due to the correlation between errors component.

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). By using this model, the results will be more robust as Cross Sectional SUR corrects for both autocorrelation and heteroskedasticy, thus correcting for the correlation across time periods and cross sectional units. 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 (refer Table II).

4.2 The Relationship between Corporate Governance and Performance

Based on the analysis, 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; Krivogorsky 2006; Yermack 1996). 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).

4.3 The Relationship between Risk and Performance.

The examination of results provides strong evidence that there is 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. The highest NPL for the banks under this study is over RM 13 billion which may lead to potential collapse in the economy if the situation persists. Malaysian government under Ministry of Finance has set up Khazanah Nasional as

an investment holding arms to help manage 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. Across the world there has been sudden surge in the level of bailouts of banks which are due to excessive risk taking to improves banks' performance and shareholders values.

4.4 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 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 I. Descriptive Statistics

	Mean	Median	Maximum	Minimum	Std. Dev.
Panel A – Continuous Variables					
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
Panel B –Dichotomous Variables					
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 II. Correlation matrix for sample firms (2004 – 2009)

	LLP	BOARD_SIZE	CHAIRMAN INDEP	DIRECTO-RREM	ETHNIC-PER	INDAC	INDEP	LEVER-AGE	MEETAC	MEET-DIR	NETLOAN-ASS	PER-NAF	RRWC	TENURE	NPL
LLP	1	0.390	-0.092	0.291	0.239	0.104	0.103	-0.073	0.582	0.449	0.404	0.087	-0.101	0.170	0.740
BOARD_SIZE	0.390	1	-0.046	0.211	0.099	0.145	0.104	0.168	0.259	0.286	0.328	0.045	0.032	0.202	0.372
CHAIRMANDEP	-0.092	-0.046	1	0.304	-0.145	-0.089	0.382	-0.100	-0.012	0.110	0.182	0.024	0.114	0.245	-0.133
DIRECTORREM	0.291	0.211	0.304	1	-0.075	0.288	0.634	-0.273	0.325	0.175	0.224	-0.012	-0.133	0.103	0.328
ETHNIC-PER	0.239	0.099	-0.145	-0.075	1	0.122	-0.068	0.181	0.285	0.370	-0.168	0.116	0.111	-0.166	0.141
INDAC	0.104	0.145	-0.089	0.288	0.122	1	0.163	-0.165	0.315	0.077	0.087	0.001	-0.178	-0.193	0.112
INDEP	0.103	0.104	0.382	0.634	-0.068	0.163	1	-0.159	0.263	0.319	0.106	-0.021	0.047	0.012	0.059
LEVERAGE	-0.073	0.168	-0.100	-0.273	0.181	0.165	-0.159	1	-0.044	0.170	0.029	-0.008	0.048	0.003	-0.075
MEETAC	0.582	0.259	-0.012	0.325	0.285	0.315	0.263	-0.044	1	0.610	0.242	0.074	-0.200	0.092	0.498
MEETDIR	0.449	0.286	0.110	0.175	0.370	0.077	0.319	0.170	0.610	1	0.267	0.025	-0.264	0.241	0.355
NETLOANASS	0.404	0.328	0.182	0.224	-0.168	0.087	0.106	0.029	0.242	0.267	1	0.042	-0.098	0.286	0.321
PERNAF	0.087	0.045	0.024	-0.012	0.116	0.001	-0.021	-0.008	0.074	0.025	0.042	1	-0.050	0.161	0.131
RRWC	-0.101	0.032	0.114	-0.133	0.111	-0.178	0.047	0.048	-0.200	-0.264	-0.098	-0.050	1	0.100	-0.064
TENURE	0.170	0.202	0.245	0.103	-0.166	-0.193	0.012	0.003	0.092	0.241	0.286	-0.161	0.100	1	0.316
NPL	0.740	0.372	-0.133	0.328	0.141	0.112	0.059	-0.075	0.498	0.355	0.321	0.131	-0.064	0.316	1

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

		Model 1		Model 2	
Independent Variables	Expected Direction	t-Statistic	Prob.	t-Statistic	Prob.
Corporate Governance Variables					
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
Bank Risks Variables					
LLP	_	5.292609	0.0000	1.841314	0.0758
NPL	-	-3.121884	0.0040	-2.102226	0.0443
Bank Capital Variable					
RRWC	+	4.115155	0.0003	1.775672	0.0863
Control Variables					
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 Fixed (dummy variables)	+/-	Yes		Yes	
R-squared		0.725367		0.509265	
Adjusted R-squared		0.526495		0.153905	

5. Conclusions

The findings of this study have several implications towards regulators as well as literature in the areas of corporate governance. 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 third findings of the study 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.

Further research studies should 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.

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Appendix 1

	Name	Types
1	Maybank	L
2	UOB	F
3	Affin	L
4	Public Bank	L
5	Hong Leong	L
6	Bankof China	F
7	Bank Islam	L
8	RHB Investment bank	L
9	OCBC bank	F
10	Bank Muamalat	L
11	Standard Chartered bank	F
12	Kuwait Finance House	F
13	Asian Finance bank	F
14	Hong Leong Islamic	L
15	Kenanga investment bank	L
16	Cimb bank	L
17	HSBC Bank	F
18	Royal Bank of Scotland	F
19	RHB bank	L
20	RHB Islamic	L
21	Cimb Islamic	L
22	Citibank	F

Notes:
L : Local Bank
F : Foreign Bank