

РАЗДЕЛ 3
КОРПОРАТИВНОЕ
УПРАВЛЕНИЕ
В АЗИИ

SECTION 3
CORPORATE
GOVERNANCE IN
ASIA



DIRECTOR'S MONITORING EFFECTIVENESS AND CEO
COMPENSATION

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Abstract

This paper examines the monitoring effectiveness of independent and non independent directors on a CEO pay-performance of Malaysian financial firms from 2002-2009. It is based on the agency and managerial power theory. The former states that under optimal contract pay should be aligned to performance, while the latter postulates that powerfully entrenched CEO can influence captive directors to award generous compensation package. Our empirical results show (1) a high CEO pay-dividend sensitivity while market measurement plays no part in influencing CEO pay; (2) both the independent and non independent directors have failed in their fiduciary role as internal monitor, suggesting the dominance of managerial power in the board; (3) the appointment of independent directors is merely a move to fulfill the minimum standards of the best practices of corporate governance.***

Keywords: Corporate Governance, CEO Pay-Performance, Director's Monitoring, Agency Theory

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1. Introduction

The significant increase in CEO compensation over the past two decades has made CEO compensation practices a controversial global issue. For example, in the 2010 survey done on S&P 500 US companies, average CEO compensation was reported at \$11.4 million per year. Bebchuk and Grinstein (2005) reported that CEO compensation has outstripped the

growth in firm's performance and size from 1993 till 2003. Thus, excessive CEO's compensation has certainly made CEO compensation practices an important governance issue. The most recent global financial crisis 2009 strongly suggests that CEO compensation has not being tied to performance. What remains controversial and divisive is while shareholders have lost their fortune in the stock market, CEOs were rewarded with huge severance

pay package. For example, the CEO of Merrill Lynch, Stan O'Neal reportedly walked away with \$161 million in compensation package while his company lost \$2.2 billion in 2007.

The successful implementation of a performance orientated contract is linked to an effective internal monitoring mechanism. To facilitate this objective, regulators have periodically introduced best practices of corporate governance as in the case of Cadbury (1992), Greenbury (1995), Hampel (1998) and Higgs (2003) reports. Among all, the board of director is the most important internal corporate governance mechanism in a public listed company. One of its main duties is the setting of CEO remuneration package. Greenbury Report (1995) proposed the setting up of a remuneration committee, whereby, its majority should be independent directors as they have no direct financial interest in the decision making. Nevertheless, the above recommendation should also be complemented by a proactive board as suggested by Pearce and Zahra (1991). Proactive board is the strongest form of internal monitoring mechanism as the members are motivated by shareholder activism and poses power that exceed the CEO. In addition, majority of the board members are independent and poses unique expertise and experience to complement existing effective decision making mechanism.

Board structure is represented by the ratio non independent directors and independent directors. In Malaysia, the code of corporate governance was introduced by Securities Commission in 2000 which was subsequently revised in 2007. According to Bursa Malaysia listing rules section 4.26, non independent director is defined as a person who represents the interest of significant shareholders in the company. Implicitly, they can collectively influence the appointment of CEO and independent director. However, empirical evidence seems to suggest that independent directors are not effective in discharging their monitoring duties. In fact, Fernandes (2008) finds that a firm with zero independent director has fewer agency problem and better alignment between manager and shareholder interest.

The financial sector is selected as our case study due to two main reasons. First, little attention is being focused on corporate governance research in financial institutions as pointed out by Kose and Qian (2003). Till to this date, there has yet to be any pay-performance research on Malaysian financial sector. Second, not all firms have the same level of internal monitoring mechanism. Internal monitoring mechanism should be rigorous in firms that are subjected to stringent local and international regulatory requirements. Due to its important intermediary role in the economy, financial services industry is heavily regulated by regulator as suggested by Doucouliagos et. al. (2007) and Kose and Qian (2003). In fact, a higher standard of care should be applied on bank directors compare to other industry. For the purpose of our study, we shall focus on the

internal monitoring role of independent and non independent directors in regards to pay performance in Malaysian financial sector.

We test our hypotheses on a sample of 168 financial firms listed in Bursa Malaysia by using fixed effect panel model. Our performance measures are expected stock return, abnormal stock return (as short term market measurement), and dividend per share (as long term accounting return). For control variables, we include firm size. Our main focus is on independent director, non independent director and their interaction effect with the performance measures to determine director's monitoring effectiveness (BIND and NIND with all of the performance measures). Our results did not conclusively support agency optimal contract theory. With the exception of significant positive dividend coefficient, all variables are insignificant. Further, the significant negative interactive coefficients suggest independent and non independent directors' failure as internal monitors.

This study is outlined as follows. In section 2, we provide our research objectives and hypotheses. In section 3, we discuss methodology and data, including specification of our empirical model of agency theory, director's monitoring, measurement of the variables and description of our sample. In section 4 we describe and discuss the empirical results, and in section 5 we conclude this paper.

2. Research Objective and Hypotheses

The main objective of this study is to investigate the empirical CEO pay-performance relationship in the Malaysian financial services industry. Just like in Australia and US, Malaysian financial institutions are viewed with great interest by the investors, regulator, financial press and government. Unfortunately, there is a dearth of empirical study on the relationship of CEO pay-performance of financial firms in Malaysia. Our findings can be utilised to design an optimal pay performance contract for CEO in Malaysian financial services sector respectively. Besides, we also investigate the effectiveness of a CEO's pay-internal monitoring mechanism in Malaysian financial industry. Previous studies on corporate governance issue only focus on the role of independent director. However, our study includes non independent director as part of the firm's internal monitoring system. To our best knowledge, there is no empirical research done on the role of non independent director as internal monitors.

This study is distinctive in two ways. First, our research examines the monitoring role of independent and non independent director as internal monitors for the Malaysian financial firms. Second, we segregate total shareholder return into stock return and dividend. Previous studies by Doucouliagos et. al. (2007) defined shareholder return as the aggregate of stock returns and dividends while Duffhues and Kabir (2008) and Merhebi et. al. (2006) use stock returns.

We believe it is essential to disaggregate both components, as stock price is considered a short term market measurement, while dividend represents a long term accounting return.

The development of our hypotheses is based on the agency theory and managerial power literature. From the public listed company's point of view, the principal and agent is represented by the shareholder and manager respectively. Jensen and Meckling (1976) and Jensen and Murphy (1990) suggest that agency costs can be reduced through the implementation of optimal contract, which states that pay should be aligned to the performance of the firm. Three widely cited empirical papers on study done in US, by Jensen and Murphy (1990), Murphy (1999) and Core et. al. (2003) suggest that the pay-performance relationship is positive. Thus, we suggest the following hypothesis:

Hypothesis 1. CEO pay is positively associated with stock returns, abnormal returns and dividend per share.

Bebchuk and Fried (2004) and Bebchuk et. al. (2002) introduced the concept of *fat cat* in their managerial power theory, which was subsequently used by the media to describe over paid top executive directors in the corporate sector. This managerial power theory suggests that an entrenched CEO manipulate its captive board of directors and remuneration committee to award huge remuneration package to him/her at the expense of shareholders. Based on the Malaysian Shareholder Watchdog Group (2008) report on corporate governance in Malaysian public listed companies, Malaysian board structure does not fall under proactive category. Cheng and Firth (2005) and Main (1991) studies found positive significant association between CEO pay and the number of directors. Based on the above evidence and reasoning, the following hypothesis is suggested:

Hypothesis 2a. There is a positive association between CEO pay with the composition of independent directors.

$$\begin{aligned} \log(CEOPay)_{i,t} = & \beta_0 + \beta_1 SR_{i,t-1} + \beta_2 ANR_{i,t-1} + \beta_3 DPS_{i,t-1} + \beta_4 \log(TA)_{i,t-1} + \beta_5 BIND_{i,t} + \beta_6 NIND_{i,t} \\ & + \beta_7 (SR_{i,t-1} * BIND_{i,t}) + \beta_8 (ANR_{i,t-1} * BIND_{i,t}) + \beta_9 (DPS_{i,t-1} * BIND_{i,t}) + \beta_{10} (SR_{i,t-1} * NIND_{i,t}) \\ & + \beta_{11} (ANR_{i,t-1} * NIND_{i,t}) + \beta_{12} (DPS_{i,t-1} * NIND_{i,t}) + \eta_i + \nu_t + \varepsilon_{it} \end{aligned} \quad (1)$$

where:

$CEOPay_{i,t}$ = log of CEO Pay for firm i, time t;
 $TA_{i,t-1}$ = log total asset for firm i, time t-1;
 $R_{i,t-1}$ = stock return for firm i, time t-1;
 $ANR_{i,t-1}$ = abnormal stock return for firm i, time t-1;
 $DPS_{i,t-1}$ = gross dividend per share for firm i, time t-1;
 $BIND_{i,t}$ = ratio of independent director for firm i, time t;
 $NIND_{i,t}$ = ratio of non independent director for firm i, time t;
 $SR_{i,t-1} * BIND_{i,t}$ = the interaction between SR and BIND;

Hypothesis 2b. There is a positive association between CEO pay with the composition of non independent directors.

The effective internal monitoring role by director is crucial in ensuring creation of shareholder value. For example, the board can ingeniously design a compensation contract that rewards the CEO for his/her superior performance. Thus, it is essential to analyse the director's influence on CEO pay-performance. However, to differentiate our study with the rest, we incorporate the monitoring role of non independent as part of the internal monitoring mechanism. This is because non independent directors represent the interest of the significant or controlling shareholders. We also assume that significant shareholder interest is aligned to minority interest. Based on this reasoning, we suggest the following hypothesis:

Hypothesis 3. The interaction coefficient between performance measurement and independent and non independent director composition is predicted to be significantly positive if independent directors and non independent directors are discharging their monitoring role effectively, *vice versa*.

3. Methodology and Data

We adopt panel regression technique to test the above hypotheses. In the presence of unobservable firm-specific variable, fixed effect panel model is robust, whereas simply pooling time series data under OLS framework would have resulted in biased estimates (Cornett et. al., 2008 and Fernandes, 2008). In addition, Fernandes (2008) is of the opinion that fixed model is appropriate for pay-performance regression as the relevant issue is whether compensation fluctuates with the firm's performance.

Our fixed-effect baseline model (1) is presented as follows:

$ANR_{i,t-1} * BIND_{i,t}$ = the interaction between ANR and BIND;
 $DPS_{i,t-1} * BIND_{i,t}$ = the interaction between DPS and BIND;
 $SR_{i,t-1} * NIND_{i,t}$ = the interaction between SR and NIND;
 $ANR_{i,t-1} * NIND_{i,t}$ = the interaction between ANR and NIND;
 $DPS_{i,t-1} * NIND_{i,t}$ = the interaction between DPS and NIND;

The coefficients β_1 , β_2 and β_3 test hypothesis 1, while β_5 and β_6 test hypothesis 2. In order to study the effectiveness of independent and non independent directors as internal monitors, performance variables are interacted with the ratio of independent and non independent directors in the firm. A significantly positive coefficient implies that these directors are effectively discharging their monitoring role while a significantly negative coefficient suggests that these directors have failed in

$$\begin{aligned} \log(CEO_{i,t}) = & \beta_0 + \beta_1 SR_{i,t-1} + \beta_2 ANR_{i,t-1} + \beta_3 DPS_{i,t-1} + \beta_4 \log(TA)_{i,t-1} + \beta_5 (SR_{i,t-1} * D33_{i,t}) \\ & + \beta_6 (ANR_{i,t-1} * D33_{i,t}) + \beta_7 (DPS_{i,t-1} * D33_{i,t}) + \beta_8 (SR_{i,t-1} * D50_{i,t}) + \beta_9 (ANR_{i,t-1} * D50_{i,t}) \\ & + \beta_{10} (DPS_{i,t-1} * D50_{i,t}) + \eta_i + \nu_t + \varepsilon_{it} \end{aligned} \quad (2)$$

where *D33* is the dummy variable with value 1 if the firm has minimum 33% but less than 50% are independent director, and 0 otherwise; and *D50* is the dummy variable with value 1 if minimum 50% are independent director, and 0 otherwise.

In accordance with the approach underline by Merhebi et. al. (2006) and Firth et. al. (2006), the CEO pay package includes only cash remuneration (basic salary, bonus, allowances, fees, pensions and monetary benefits). Stock options are excluded due to unavailability of data in Malaysian public listed companies. Stock return is used as a market measurement by Duffhues and Kabir (2008) and Merhebi et. al. (2006). The former failed to find significant positive relationship between pay-performance in Netherlands while the latter reported significant positive relationship based on Australian data. The difference in results could be attributed to the different level of shareholder activism in both countries.

Stock return *SR* is computed based on the average movement in daily stock price and is a proxy for short term market measurement. Abnormal return *ANR* represents short term return to shareholder after discounting the effect of overall market movement. Thus, it reflects the true CEO management skills rather than being subjected to overall market fluctuation (Main, 1991). While Kerr and Bettis (1987) supported Main's view, their study found no significant influence of abnormal returns on CEO's compensation. Their results differ from Main (1991) studies which reported positive significant relationship.

The importance of dividend to shareholders in finance literature is discussed from sustainability perspective (Litner, 1956), protection of minority shareholder's rights (La Porta et al., 2000) and enforcement of agency theory (Gugler, 2003). In our study, gross dividend per share comprises of cash dividend declaration by the firm. We prefer gross dividend per share over Battacharrya et. al. (2008)

their monitoring role. Thus β_7 to β_{12} test hypothesis 3.

We also carried out a robustness checking by incorporating dummy variable to see if the CEO pay is significant if regressed with different group of independent directors. The dummy variable is interacted with performance variable as shown below. Under the Malaysian code of corporate governance 2000, board of director should consists of minimum 33% independent director. However, Higgs (2003) propose a minimum ratio of 50%. Our fixed-effect robustness model (2) is presented as follow:

dividend payout ratio and Fenn and Liang (2001) dividend yield approach. First, adopting the dividend payout approach would exclude firms with negative payout ratio. Second, there are firms who pay out dividend from its retained earnings even though it reported negative earnings per share. In addition, dividend yield approach does not project the managerial skills and competence of a CEO as it is subjected to the daily fluctuation of stock prices.

Doucoulagos et. al. (2007) predicts that a CEO's compensation for year t is based on the company's performance of prior years based on two factors. First, lag year approach will produce relatively accurate results as the current CEO's pay in year t will be based on the company's performance in the previous financial reporting year. Empirical studies that do not lag their independent variables assume that pay is based on the expectation of corporate performance for year t. Thus, it is unlikely to capture accurate relationship between pay and performance (Cornett et. al, 2008 and Kerr and Bettis, 1987). Second, there would be delay in adjusting pay to performance if consultant compensation is employed by the financial institution. The practice to engage the services of compensation consultant is common in Malaysian financial sector. Due to the variability of financial firms in Malaysia, we include total asset as control variable.

The data is collected from all public listed financial institution in Bursa Malaysia from 2002 till 2009. To ensure compliance with homogeneity factor, as suggested by Banz (1981), all the selected firms have year-end reporting period 31 December. In addition, the selected firms did not undergo any corporate restructuring exercise during the research period. Using the above stated criteria, 168 public listed financial firms were selected. The data on CEO pay, independent and non independent director is hand collected from the annual report of each of the selected financial firms, while daily stock price, annual cash dividend and total assets are extracted

from Datastream. Since there are no missing values, a balanced sample is presented for analysis.

4. Empirical results

4.1 Descriptive statistics

The summary statistics of all the variables are presented in Table 1. The means (medians) of CEO pay in the financial services sector is RM 1,625,375 (RM 925,500). The highest paid CEO received RM 15.22 million per year while the lowest paid CEO is only compensated with a meager sum of RM 88,400 per year. Financial services firm record poor return in terms of abnormal return and stock return. Abnormal return means (medians) recorded a loss of 0.37% (0.35%) while stock return means (medians) recorded only 0.08% (0.09%). The main reason is attributed to the bearish performance of Bursa Malaysia stock

market during the period of study 2002-2009. Nevertheless, the means (medians) of 0.09 (0.004) dividend per share indicate that a large proportion of financial services total shareholder return is contributed by dividend payout. The means (medians) of total asset are RM 27 billion and RM 2.36 billion respectively. In regards to board independence, the means (medians) 0.44 (0.42) suggest that most financial firms met the threshold standard of 33% independent directors in the board. Some boards can have as high as 66% independent directors and as low as 22%. In addition, the composition of independent directors equally matched non independent directors in the board. This is to ensure that minority shareholder's rights are protected. We perform preliminary correlation test (not reported here) among the variables and result shows no multicollinearity issue in our model.

Table 1. Pay, performance and board structure descriptive statistics

Variable	Mean	Median	Maximum	Minimum	Standard Deviation	Number of Observations
CEOPay	1,625,375	925,500	15,221,200	88,400	2,001,702	168
ANR	-0.37	-0.35	1.13	-2.05	0.49	168
SR	0.08	0.09	1.54	-1.29	0.43	168
DPS	0.09	0.04	0.80	0.00	0.16	168
TA	27,148,085	2,361,045	257,000,000	160,0000	4,8109,410	168
BIND	0.44	0.42	0.66	0.22	0.10	168
NIND	0.41	0.42	0.66	0.16	0.12	168

Note: The variable listed in the first column are: CEO pay in cash terms RM; abnormal return *ANR* and stock return *SR* are proxy for market measurement in percentage; dividend per share *DPS* are gross dividend paid in cash RM; total asset *TA* is proxy for firm size RM ('000); *BIND* which is a proxy of board independence is the ratio of independent director in the board of director in % and *NIND* is the ratio of non independent director in the board of director in %.

4.2 Pay-performance, board structure and director's monitoring effectiveness

Table 2 reports the fixed effect panel estimates for our baseline model 2 and robustness model 2. The estimate for model 1 implies that with the exception of *DPS*, all performance, board composition and firm size variables are insignificant. The CEO pay is predicted to increase by 31% for every cent increase in dividend, suggesting a high degree of sensitivity. However, our study suggests that top manager interest is not align to shareholder from the perspective of stock return and abnormal return. The coefficients of independent and non independent directors are

insignificant at either 5% or 10% level. Further, we find that insignificant coefficient of independent and non independent director predicts a negative relationship between the level of CEO pay and ratio of independent director and non independent director. The coefficients of interactive variables between stock return, abnormal return, firm size and independent and non independent directors are insignificant while dividend interaction coefficient is significant but negative. Overall results indicate failure of independent and non independent directors' monitoring role as components of internal monitoring mechanism.

Table 2. Regression results of independent variables on CEO compensation

Coefficients for	Model 1	Model 2
Constant	33.12 (1.71)	19.17 (6.13)
SR(-1)	1.75 (0.69)	0.02 (0.03)
ANR(-1)	-1.93 (-0.71)	0.59 (1.01)
DPS(-1)	31.42 (2.12)*	21.67 (2.98)**
TA(-1)	-1.53 (-1.26)	-0.41 (-1.91)*
BIND	-12.33 (-0.55)	
NIND	-25.63 (-1.17)	
DUM33		-1.03 (-0.43)
DUM50		-1.49 (-0.53)
SR(-1)*BIND	-2.84 (-0.88)	
ANR(-1)*BIND	1.69 (0.49)	
DPS(-1)*BIND	-36.69 (-2.19)**	
SR(-1)*NIND	-1.42 (-0.54)	
ANR(-1)*NIND	2.27 (0.77)	
DPS(-1)*NIND	-36.72 (-1.93)*	
SR(-1)*DUM33		-0.06 (-0.12)
ANR(-1)*DUM33		-1.01 (-1.77)*
DPS(-1)*DUM33		-25.63 (-3.52)***
SR(-1)*DUM50		-0.26 (-0.54)
ANR(-1)*DUM50		-0.73 (-1.25)
DPS(-1)*DUM50		-21.59 (-2.97)**
Adjusted R square	0.87818	0.8933
Observations	168	168

Note: The dependent variable is CEO compensation in cash terms. Three firm performance variables lag one year are represented by stock return *SR* in percentage, abnormal stock return *ANR* in percentage and dividend per share *DPS* in RM. The control variable is total asset *TA* in RM. Board structure variables are represented by ratio of independent director *BIND* and ratio of non independent director *NIND* in percentage. Two dummy variables are included; *DUM33*, coded as 1 to represent board independence ratio more than 33% but less than 50% and 0 otherwise and *DUM50*, coded as 1 to represent board independence ratio more than 50% and 0 otherwise. The monitoring effectiveness of independent and non independent director result is obtained by interacting the performance variables with *BIND* and *NIND* variables respectively. As a robustness measurement; these performance variables are interacted again with dummy variable *DUM33* and *DUM50*. The t statistics are computed using the White (1980) heteroscedasticity robust standard error and are given in parentheses. Figure in the parenthesis is t-statistic, while *, **, *** indicates significance at the 10%, 5% and 1% level.

To ensure the robustness of our modeling, we include the dummy variables with the minimum 33% to 50% and minimum 50% and in model 2. From the estimates of model 2, we find a positive strong significant relationship between *DPS* and CEO pay ($t = 2.98$, $p < 0.0038$), suggesting an increase of nearly 22% in CEO pay for every 1 cent rise in dividend. However, stock return and abnormal return are insignificant determinants for CEO pay. Based on this mixed bag of results, we cannot totally reject the presence of agency theory in model 2. In respect to total asset (*TA*) as proxy of firm size, the coefficient is strongly significant but negative ($t = -1.91$, $p < 0.0601$), suggesting a decline of 0.4% in CEO pay for every percentage rise in total asset. In regards to director's monitoring effectiveness, model 1 results are almost identical to model 2, with the exception of dividend in minimum 50% board independence ratio. Nevertheless the interactive coefficient is negatively significant ($t = -2.91$, $p < 0.0039$).

5. Conclusion

The determinants of a CEO's pay have received a lot of attention but previous empirical studies have yet to establish a significant compensation method which meets both the objectives of top managers and shareholders. The optimal contracting theory by Jensen and Meckling (1976) and Jensen and Murphy (1990) suggest that the CEO's pay should be aligned to the firm's performance and deviation should be corrected by internal monitoring mechanism. However, little research has been done on the monitoring effectiveness of the directors. Hence, this research contributes to the field of CEO pay by linking agency theory with the monitoring effectiveness of directors.

Our statistical result shows that an increase of 31% and 21% respectively on CEO pay for every 1 cent increase in firm's dividend, suggesting high pay-dividend sensitivity. However, market measurement is not significant determinant of CEO pay. This is not surprising as financial firms tend to record low

variability in stock return due to strict statutory financial regulatory requirement and stable business environment. Additionally, based on the obtained empirical evidence, we conclude that independent and non independent directors are ineffective internal monitors. Subsequently, we assess the impact of implementing the best practices of corporate governance by the firms. The obtained results indicate that independent directors do not play any positive significant monitoring role, regardless whether it is 33% or 50% ratio. Therefore, overall results suggest that the directors did not play an effective monitoring role to enforce optimal contracting principles in Malaysian financial firms during the period of study. Further, based on the obtained results, managerial power seems to influence the setting of CEO pay in Malaysian financial firms.

There are limitations in this study. First, stock based incentives have yet to be implemented by Malaysian financial firms during the period of study. As such, this study has to rely on component of cash compensation. It would be fruitful academic exercise in future research to incorporate stock options as part of the CEO pay performance analysis, when a sizable firms starts to reward them with stock options. Such research enhances the understanding of market discipline influence on CEO pay-performance and risk appetite in Malaysia. Second, independent and non independent directors monitoring incentives and capabilities are quite subjective to observe. Our results seem to suggest that directors have been ineffective in their monitoring role. Taking cue from this, future research should look into the possibility that directors might have certain preference of pay-performance variable and criteria for setting these preferences. Third, our approach did not incorporate the entrenchment power of a CEO. Thus, incorporating managerial power approach as proposed by Bebchuk and Fried (2004) and Bebchuk et. al. (2002) might explain why independent and non independent directors have not been effective in discharging their fiduciary role, despite complying with the minimum board independence ratio. Finally, our study is only based on Malaysian financial firms. To ensure a more conclusive and inclusive result, future research should include firms from other sector in Malaysia.

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