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Corporate Governance and Bond Ratings in Malaysia

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Abstract

This paper examines the effects of corporate governance mechanisms on bond ratings of banking firms in Malaysia. This study scrutinises the link between institutional ownership, and independent directorship with bond ratings of Malaysian local banks, while holding the debt to equity and size of the firm as control variables. Our sample consists of Malaysian local banks from 2005 to 2017. This study employed the panel ordered logistic regression and found that independent directors and blockholders show an insignificant relationship with bond ratings. Leveraging debt to equity ratio also showed an insignificant relationship with bond ratings. However, a significant positive relationship has been found between firm size and bond ratings. Our insignificant result for corporate governance mechanism and bond ratings may be due to banking firms work closely with rating agencies as they are also part of the key underwriters of debt securities issuing and Sukuk for other cooperations; hence their bond ratings may be less influenced by their independent directors and blockholders. The study from this paper can be used as a guideline for bank management, current and potential investors, and policymakers in Malaysia by providing additional evidence of bond ratings in the Malaysian market.

Key words Corporate Governance, Bond Ratings, Institutional Ownership, independent Directorship

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1. Introduction

Managing business and company affairs require a process and structure in which generally known as corporate governance. Good corporate governance is known as the key to enhance business prosperity while taking into consideration of other stakeholders interests, and ensuring corporate accountability with the goal of realising long term shareholder wealth, as stated in the Report on Corporate Governance in Malaysia by the Finance Committee (2000). In Malaysia, after the Asian Financial Crisis back in 1997, corporate governance was introduced and started to gain attention. Amendment of the listing requirement by Bursa Malaysia in 2001 represents the evidence of corporate governance forte.

In Malaysia, the foundation of the development of the bond market involves the inclusive controlling framework and resilient groundwork, along with clear vision and mission, political stability, and comprehensive macroeconomic policies. Since the early days of bond introduction in Malaysia, Bank Negara Malaysia (BNM), a government agency is responsible for the compliance of corporate bond issuance. Two government agencies, namely the Malaysian Rating Corporation Berhad (MARC) and Rating Agency Malaysia Berhad (RAM) provide sovereign estimations and opinions on how a potential debt issuer

might experience default risk. Both agencies attempt to circulate all relevant information to current and potential stakeholders.

Shleifer & Vishny (1997) express corporate governance as a mechanism for investors to assure their investment returns that could be acquired by the end of the day. Bond grades are represented by their credit ratings. In which the quality of bond issuer monetary forte or its capability to pay back principal and interest promptly. Dey (2008) discovered that firms with greater agency conflicts, especially those related to the board, auditor and audit committee tend to have a better governance mechanism. Company with better governance are less likely to have a chance of default, thus has a better rating.

Ouni and Omri (2010) find that financial attributes and corporate governance mechanisms can be used to achieve target ratings. Better governance is said to help corporate in improving their performance and to protect investors' interests. Based on previous studies, higher rating associates with a lower yield. This is because the company with better ratings is associated with low default risk. In contrast, lower rating bonds will try to attract potential investors by providing a higher yield. The main purpose of this study is to investigate the effects of corporate governance mechanisms on bond ratings in Malaysia.

1.1. The bond market, Bond Rating Agencies and Corporate Governance in Malaysia

In Malaysia, the popularity towards the bond market has established expressively in terms of market capitalisation, the efficiency and the variety of bond instruments. Malaysia, as a bond market hub provides a well-diversified financial base; a wide range of debt securities products such as fixed coupon-interest bearing bonds, convertible bonds, callable bonds, asset-backed securities and floaters. Strenuous engagements were taken by the government to mark the Malaysian bond market as one of the star rising bond markets in Asia. The size of the bond market at the end of 2010 was reported to reach RM763.4 billion, which consisted of 45 % of public and 55% of private-sector bonds (Bond Info Hub, 2017).

Additionally, this study intends to examine the importance of institutional owners and independent board members in reducing agency risk, which this argument is still under debate. How the management of the company may abuse their authority to benefit themselves rather than taking care of the interest of shareholder and bondholder can be illustrated as agency risk. In this case, management or managers might boost overhead, for instance, by increasing their salaries rather than allocate excess profit to pay more dividends, making low-risk investment decisions, nor performance in the best interest of its shareholders. Such behaviour may penalise the company profitability, stockholders return, and company performance; thus, these actions will affect the bond ratings. According to Bhojraj and Sengupta (2003), other risks involved, such as inflation, financial status and other economic conditions are the conventional determinants of corporate bond ratings and the bond yields.

Following the Asian financial crisis in the '90s, Malaysia corporate governance practices have enhanced their foundations by including the introduction of the Code on Corporate Governance in 2000, the construction of a 10-year Capital Market Master Plan in 2001, the demutualisation of the Bursa Malaysia Stock Exchange, and changes in the role and composition of the Board of Directors (BOD). Those foundations provide guidelines on the standards and best practices in corporate governance, the implementation direction, along with outlining the future prospects of corporate governance in Malaysia (Zulkufly & Hafiz 2010). Bursa Malaysia established the corporate governance department in 2008 to monitor the implementation of corporate governance policies in Malaysian listed companies.

Bond ratings are the reference used by the investors to identify the relative risks involved when investing in bonds. Prior to July 2000 all corporate bonds issued in Malaysia were subjected to a minimum requirement rating of BBB or above. However, the minimum rating requirement was then lifted. Market customs dictate that bond issuers should still convey credit ratings despite the lifting of rating requirements. In addition, experience has shown that both investors and issuers endorse better approval for fixed income securities such as bonds as ratings allow them to measure returns and evaluate the cost of raising funds. It is argued that all bonds expose to the potential risk of default except for federal issued bonds. Nonetheless, firms benefit from resilient credit ratings will remain to hit the bond market at viable rates because of constant strong demand by investors.

Rating Agency Malaysia (RAM) was established in 1990 and has grown into the largest credit rating agency in South-East Asia. Rating Agency Malaysia (RAM) products are highly considered in domestic,

regional, as well as international markets. RAM provides independent and insightful views to its credit ratings and assessments. RAM covers rating assessment for domestic and international bond markets, public and private finance, financial institutions and insurance, project finance, including structured obligations and loans. It also accredited by the Tokyo Stock Exchange, showing a great triumph in global rating scales. RAM is also the world prominent rating agency for Sukuk or Islamic bond and won the Best Islamic Rating Agency by Islamic Finance News (IFN) in 2016 (RAM, 2017).

Malaysian Rating Corporation Berhad (MARC) was established in 1996 and has grown as one of the two biggest domestic credit rating institutions in Malaysia. MARC offers quality rating coverage extends to public and private finance, financial institutions, and insurance, project finance including bank loans, commercial papers, and hybrid debt instruments as well as credit analysis reports for online purchases. All assessments and ratings finalised by MARC are preserved under continuous observation. MARC received appreciation and acknowledgement as a credit rating agency by the Securities Commission (SC) upon its fulfilment of requirements in 2011 (MARC, 2017).

Rating Agency Malaysia (RAM) joined the credit rating agency as a pioneer line-up to the United Nations in 2016. In the following year, Rating Agency Malaysia (RAM) received the Best Rating Agency award by CPI Financial 2017 for their immense understanding, experience, and contributions in the fast-growing Islamic bond or Sukuk market (RAM, 2017).

1.2. Problem Statement and Research Questions

The corporate bond market in Asia has expended expressively in market size, variety of bond instruments, and efficiency, especially in Malaysia. A company with better governance is likely to have less chance of default, hence has a better rating, and thus conclusively offer a lower yield. In contrast, lower rating bonds will tend to attract potential investors with a higher yield. Better governance is said to help in improving corporate performance and to protect investors' interests. This study examines how various governance mechanisms from internal to external are projected to govern agency conflicts between the management and their stakeholders (executives, non-executives, and institutional investors) and the effects on bond ratings.

We hypothesise that the firm dissemination of future cash flows will tend to shift descending resulted from weak governance compare to more effective governance. This will raise the probability of default, and resulting in lower credit ratings. Governance mechanisms are aimed to diminish the agency conflict between the management team and its stakeholders. Consequently, to the degree that control and authority also generally said as governance is an important determining factor of credit ratings, and it may take a weighty influence on firms' external financing costs. A company with superior ownership and stronger independent control of the board will be more likely to enjoy the developed governance monitoring. The reduction in information will lower the cost of debt capital by reducing agency problems, subsequently lower the bond yield and obtained higher ratings on their new issuing bonds (Bhojraj & Sengupta, 2003).

Governance mechanisms may control self-opportunistic management behaviour by offering sovereign monitoring of supervision, endorsing effective corporate decision making, thus enhance the firm value and benefit all stakeholders. According to the empirical result shown in Bhojraj & Sengupta (2003) study, firms with a higher percentage of outside directors tend to have greater credit rating, while greater institutional ownership (blockholding) having a lower credit rating.

Different countries have been examined by previous researchers, which may possess different corporate governance issues and bond ratings mechanisms compared to Malaysia. Consequently, this study focuses only on local banks listed in Bursa Malaysia. Our study intends to response the following research questions:

i. Is there any significant relationship between blockholder ownership and bond ratings in Malaysia?

ii. Is there any significant relationship between Independent directorship and bond ratings in Malaysia?

2. Literature review

Over the past few decades, corporate governance impacts have been widely studied. The studies have been conducted in different countries such as the United States, Thailand, India, and Malaysia. In Malaysia, Corporate governance was first presented in 1998 and set as a listing requirement in 2001 by Bursa Malaysia. As the previous study engrossed on the corporation performance, researchers draw variables such as CEO power, CEO remuneration, and CEO duality. Koehn & Ueng (2005), Ponnu (2008), and Sulong & Nor (2010) putting attention on company financial performance, such as the connection between the yields and ratings towards corporate governance. On the contrary, Ziebart & Reiter (1992); Liu & Jiraporn (2010) equated the effects of company front-runner or CEO power on creating judgment as well as decision towards yields and bond ratings. The commencement of corporate governance mechanisms is to control the structure of the corporate board, its working procedures and maximise the firm performance. Bhojraj & Sengupta (2003) study shown that firms that succeeded in controlling other potential determinants of ratings enjoy the advantage of higher bond ratings. The advantages of strong governance mechanisms include default risk minimisation, rating enhancement, and deliberate return by reducing agency costs. Strong governance is believed to be able to monitor management performance and reduce the information asymmetry gap between the coporation and the stakeholders (Bhojraj & Sengupta, 2003; Loh & Ragayah, 2007).

For bond rating classification, Klock *et al.* (2005) used an adaptation process in compute bond ratings, which D-rated bonds denoted as the value of 1 and AAA-rated bonds have dispersed a value of 22. For example, A+ rating from S&P would be assigned with a score of 18; Liu andJiraporn (2010) used S&P credit ratings because previous research claims that the S&P ratings most reflecting on the overall creditworthiness of the company. Sulong & Nor (2010) inspired to deliver a substantiation on the effectiveness of governance mechanism existence to defence and improve the interests of shareholders, besides, to defend the interests of minority shareholders. Sulong & Nor examined the control mechanisms governance on Malaysian firm value (dividend) during the post-reform period. Though their study did not examine bonds ratings, yet their research offers a shred of evidence in which concentrated ownership and size of independent directors help to improve the firm value and performance.

Ponnu (2008) stated that good governance mechanism could help in creating investors goodwill and confidence. In addition, Liu & Jiraporn (2010) found that CEO pay share has shown a negative influence on credit ratings, whereas positively impact on yield spreads. Their results showed that institutional ownership is the most significant factor in affecting the bond credit ratings, and bond yield spread. Inclusively, CEO power has a substantial effect in increasing the cost of bond financing, thus lower the ratings. According to Bhojraj & Sengupta (2003), the consequence of a larger percentage of institutional ownership (blockholding) is a lower rating. Oppositely, firms with a superior percentage of outside directors offer better governance of management engagements and have a higher bond rating (Bhojraj & Sengupta, 2003; Skaife *et al*., 2006).

2.1. Institutional and Financial Sustainability Approaches

Institutional investor, also known as blockholder possess a key role in shaping the potential of a firm. Generally viewed from a public standpoint, a firm that has good corporate governance has a wide dispersion of shareholders who demand a governance mechanism to protect their right on residual claims. According to Skaife *et al.* (2006), credit ratings are negatively associated with the number of blockholders (own at least 5% ownership in the firm). The higher number of blockholders in a firm indicates lower credit ratings, which offer a higher yield. Blockholders as one of the external governance mechanisms; that supervise manager activities and limit their self-opportunistic behaviour to look after the welfares of shareholders and bondholders. The prospect of investors using their influence when there is an increase in the number of shares held by institutional investors or as the percentage of blockholders surges will result in the wealth transfers from bondholders rises, signifying an inverse relation between institutional ownership and credit ratings (Burshman, 2009).

When institutional possessions are relatively intense, blockholders and institutions tend to support the proposal sponsor. On the contrary, insiders and outside directors who own substantial shares of the firm will have a tendency to support the management team, who habitually has a clash with the

shareholder-sponsored proposals. Gordon & Pound (1993) pointed out that shareholder-sponsored proposals will modify corporate governance structures through voting. Consistent with this view, Koehn & Ueng (2005) and Ouni & Omri (2010) expressed that institutional investors or blockholders, who own a large proportion of equity have the financial interest and freedom to interfere the company management and corporate policies in an unprejudiced way. Such investors are needed in a company for a well-functioning governance system to eliminate the management's self-serving behaviour by putting pressure on them with their voting right. Better legal environments in institutional frameworks provide better governance due to the increase of enticements in corporations. Therefore, good corporate governance mechanisms are being emphasised all over the world (Koehn & Ueng, 2005). Different countries serve different governance codes as templates for practices in their particular country, where the set of norms and rules governing the auditing procedures and information disclosure, shareholding relations and accountability, the arrangement and role of directors of the board, hiring, rewarding, and firing of directors and top management (Nanka-Bruce, 2011). The arrangement of board structure is vital because of the presence of non-executive directors in monitoring the activities of the executive directors to ensure the executive directors follow the policies and acting in line with shareholders interests (Fama, 1980).

Furthermore, Nanka-Bruce (2011) suggested complementing the agency theory with the institutional approach. It was explained that the determined ownership panels, an unrestrictedly rising problem within the agency theoretical framework, where private benefits are occasionally surrendered for corporate competence to harm the minority investors. Hence, ownership attentiveness does not automatically provide good governance or promote performance growth (Nanka-Bruce, 2011).

From a financial sustainability perspective, Bhojraj & Sengupta (2003) stated that debt yield and ratings are principally determined by the capability of the company to meet its obligations. The future cash flow of the firm holds a significant role in determining bond ratings. According to Chebbi & Hellara (2010), rating agencies assess the bond issuers' distribution of future cash flows to determine the debt rating; by taking account the firm solvency or creditworthiness to ensure that its future cash flows will be sufficient to cover its coupon interest and the principal payments. According to Zulkufly & Hafiz (2010) increased in the management monitoring actions can limit managers opportunistic behaviour. As a part of corporate governance, it also improves the quality of firm information flows, as well as lessens other agency risks. Strong independent board or board of outside directors limit management self-opportunistic engagements. Managers would perform business transactions carefully, thus boost firm value. Where the firm value increases, the performance may lead to an increase in its credit rating.

The decline in firm expected future cash flows will tend to increase the default risk. Correspondingly, bondholders will face greater default risk if blockholders influence the managers to commence in more risky investments that increase the uncertainty of firm future cash flows. Here, the outside directors are expected to take part and to come with opinions and decisions. As the riskiness of its future cash flows upsurge or the higher probability of the firm's future cash flow distribution shifts downward, the likelihood of default risk rises, hence may lower the credit rating (Bhojraj & Sengupta, 2003).

Nanka-Bruce (2011) stated that a larger company would encounter more conflicts of interest to arrive at a decision. The empirical studies suggested that there is an ideal board size; which with the maximum of firm value. According to Tantivanichanon (2015), larger boards tend to have a lower cost of debt, as larger boards possess more effective monitoring of the company's accounting processes. Fama & Jensen (1985) stated that outside directorships are perceived to have significant monitoring role than insider directors, this is due to their independence and reputation in the corporate world. Nanka-Bruce believed that from the agency theory point of view, there is a positive effect of board independence on corporate performance, thus may raise its credit ratings.

3. Methodology of research

This study is a panel study involving the financial service sector's Malaysian local banks that have been listed on the Bursa Malaysia main board. The study period covers from 2005 to 2017. All the data was gathered from companies' annual reports and Thomson Reuters DataStream databases. This research aims to examine the relationship between corporate governance and bond ratings in Malaysia. For bond ratings, we took RAM's bond rating A3, A2, A1, AA3, AA2, AA1, and AAA and created the value from 1 to 7 to

denote the bond ratings. Since our dependent variable- bond rating is in categorical form; hence we employed panel ordered logistic regression analysis to examine the dataset. All the test was run by using Stata version 14 software.

The selected independent variables are the percentage of institutions that hold five per cent or more of the firm common stock is indicated as blockholder (BLOCK), and percentage of Independent Directors (INDDIR). Additionally, debt to equity ratio (DE) and firm size (FSIZE) also have been included as control variables; these variables are used in a prior study by Ziebart and Reiter (1992) and Bhojraj and Sengupta (2003). A higher debt to equity ratio (DE) of firms is expected to lower its bond ratings. Meanwhile, larger firms with high total assets (ASSET) are expected to provide lower bond yields, thus benefit to higher ratings compared to small firms (Bhojraj & Sengupta, 2003).

3.1. Estimation models and analysis

This study intends to examine the relationship between corporate governance with bond ratings in the Malaysia banking sector. Descriptive statistics analysis, Pearson correlation coefficient, and panel ordered logistic regression are employed to assess the relationship between corporate governance and bond ratings in Malaysia bank institutions. Hence our estimation model can be express as:

Bond Ratings = f (governance variables, control variables)

Baseline Model: $$RAT_{i,t} = \alpha + \beta_1 DE_{i,t} + \beta_2 FSIZE_{i,t} + \varepsilon \quad (1)$$

Model I: $$RAT_{i,t} = \alpha + \beta_1 INDDIR_{i,t} + \beta_2 DE_{i,t} + \beta_3 FSIZE_{i,t} + \varepsilon \quad (2)$$

Model II: $$RAT_{i,t} = \alpha + \beta_1 BLOCK_{i,t} + \beta_2 DE_{i,t} + \beta_3 FSIZE_{i,t} + \varepsilon \quad (3)$$

Full Model: $$RAT_{i,t} = \alpha + \beta_1 INDDIR_{i,t} + \beta_2 BLOCK_{i,t} + \beta_3 DE_{i,t} + \beta_4 FSIZE_{i,t} + \varepsilon \quad (4)$$

Whereby;

INDDIR = Independent board of directors
BLOCK = Blockholders (hold more than five percent of the company's common stock)
DE = Debt to Equity ratio (book value of long term debt over the market value of common equity at the end of year *t*)
FSIZE = Firm Size (measured by the natural logarithm of total assets at the end of year *t)*

4. Empirical results and discussions

Panel A in Table 1 shows a summary of the descriptive statistic of the variables specifically Bond Rating (RAT), Independent Directorship (INDDIR), Institutional Ownership (BLOCK) and two control variables namely Debt- Equity Ratio (DE) and Firm Size (FSIZE) for eight Malaysian local banks from 2005 to 2017. From the table, the average of long term bond rating is 5.36, which indicates, on average, the bonds issued by Malaysia banks were rated at AA2 to AA1. On average, our sample's board of directors consists of 52.2% of independent directors. For Blockholding, local banks show high blockholding in their ownership which up to a maximum of 87.2% with an average of 52.96%. While Panel B in Table 1 exhibits the correlations among dependent and independent variables, bond ratings show a positive relationship with independent directors, blockholder and firm size, yet showing a negative relationship with firm leveraging (Debt to Equity ratio).

Table 1. Summary Statistics and correlation coefficients

Panel A: Descriptive statistics					
Variable	**Obs**	**Mean**	**Std. Dev.**	**Min**	**Max**
RAT	104	5.365385	1.695555	1	7
INDDIR	104	0.522001	0.121608	0.2857	0.75
BLOCK	104	0.529626	0.209603	0.0623	0.872
DE	104	2.1545	0.211158	1.613419	2.794788
FSIZE	104	18.6949	0.878673	16.97094	20.45466
Panel B: Correlations matrix					
	RAT	**OUTDIR**	**BLOCK**	**DE**	**FSIZE**
RAT	1				
INDDIR	0.1251	1			
BLOCK	0.1159	-0.3532	1		
DE	-0.0464	-0.097	-0.1085	1	
FSIZE	0.5912	0.2249	-0.1333	0.179	1

Table 2 presents the panel ordered logistic regression results of the impacts of corporate governance mechanisms (independent directors and blockholder) on bond ratings. The results indicate that independent directorship and blockholding shows an insignificant relationship with bond ratings. Our result is inconsistent with Bhojraj & Sengupta (2003) and Nanka-Bruce (2011), which they found a positive relationship between outside directorship and ratings. While Bhojraj & Sengupta (2003), Burshman (2009), Tantivanichanon (2015) found a negative relationship between blockholding ownership and bond ratings. Our insignificant result may be due to the sample selection, whereby banking firms naturally work closely with rating agencies. Commercial banks ab d investment banks are also part of the primary underwriters of Sukuk and debt securities for cooperations (Malaysian Bond Market Guide, 2011). As mentioned in Halim, How, Verhoeven and Hassan (2019), banks are the underwriter for bonds in the Malaysia capital market. Hence bond ratings in banking firms may be less influenced by independent directors and blockholding.

Besides, we also obtain insignificant results for debt to equity ratio with bond ratings. The negative relationship has been found in Ziebart & Reiter (1992); Bhojraj & Sengupta (2003); Koehn & Ueng (2005). In addition, our results show a significant positive relationship between firm size and bond rating; the larger the bank, the higher the bond ratings. This is consistent with the Bhojraj and Sengupta results (2003).

Table 2. Panel Ordered Logistic Regression Results of the impacts of Corporate Governance Mechanisms on Bond Ratings

	Baseline Model	**Model I**	**Model II**	**Full Model**
DE	-1.2718	-1.2792	-0.9954	-1.0008
	(1.3289)	*(1.3299)*	*(1.3819)*	*(1.3819)*
FSIZE	3.3770***	3.4026***	3.3291***	3.3696***
	(0.7717)	*(0.8051)*	*(0.7699)*	*(0.8050)*
INDDIR		-0.3395		-0.5328
		(2.9935)		*(3.0172)*
BLOCK			2.9281	2.9879
			(3.8992)	*(3.9199)*
Number of obs	104			

Note: *Standard errors are reported in parentheses, and *** indicate significance at 1% levels.*

5. Conclusions

This research scrutinizes the effects of corporate governance mechanisms toward bond ratings for eight local commercial banks in Malaysia from the year 2005 to 2017. The results indicate that, on average, the bond ratings for Malaysian local banks are rated at AA2 to AA1 follow the RAM rating scales. The panel ordered logistic regression results show that the variables used as corporate governance mechanisms in this study (independent directors and blockholders) have an insignificant relationship with bond ratings. Leveraging debt to equity ratio also showed an insignificant relationship with bond ratings. However, a significant positive relationship has been found between firm size and bond ratings. In conclusion,

corporate governance mechanisms do not influence the bank's bond rating. As mentioned earlier, the Malaysian Bond Market Guide (2011) stated that commercial banks and investment banks are the primary underwriters of Sukuk and debt securities in Malaysia. Nevertheless, we only found that the bigger the size of the bank, the higher the bond ratings.

6. Implication and Limitation of the Study

This study provides an extended review of the impact of corporate governance mechanisms on bond ratings in Malaysian local banks. We present empirical results that may be benefited the potential investors, portfolio manager, shareholders, bondholders, management, and policymakers, whereby factors such as the board independence and blockholder might not influence bank's bond rating. Yet, the size of the firm matters in bond ratings. This may also imply that the banking industry in Malaysia is highly monitoring and regulated by Bank Negara Malaysia (BNM). The conduct of this study thus provides an insight into the consequences of actions from authority policy for enhancing the future bond market.

Although this research provides the innovation to the previous analysis of the conventional long term bond rating, however, a more conducive study can be carried out to cover wider aspects of bonds such as short term bonds, subordinated bonds, and many more. This would require an extensive panel series analysis and adequate information about the data. Hence, several limitations of the study are demonstrated for further improvement of research. Firstly, the time frame of 13 years is considered short to aggregate the influence of the variables on the long term bond rating. In addition, this research only employed two corporate governance mechanisms, namely independent directors and blockholding as independent variables. Other important factors, such as ownership concentration, can be used to complement this study. Furthermore, this study only focused on eight local commercial banks in Malaysia, whereby a larger sample size or different industries may yield different findings.

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