

The Role of Corporate Governance and Ownership in Unconventional Bond Rating: Empirical Evidence from Companies Listed on Bursa Malaysia

Othman Ibrahim Altwijry¹

Abstract

Corporate governance is the system through which companies are directed and managed. The essential role of corporate governance has been an issue of late due to the global financial crisis in 2007. In addition, the Islamic finance industry has garnered attention in recent times because of its high growth. Among its instruments is unconventional bonds. This study investigates the impact of corporate governance on unconventional bond ratings. To this end, we collected data from corporations listed in the Bursa Malaysia that have issued unconventional bond from 2008 to 2011. The data was subjected to panel data analysis. The findings demonstrated that the corporate governance mechanisms of separate board leadership structure, independent non-executive directors, and smaller board size (at 10% significance) contribute to better and higher unconventional bond ratings. Meanwhile, in regards to ownership variables, a lower proportion of director ownership and higher proportion of institutional ownership (at 5% significance) lead to higher unconventional bond ratings. Whereas regarding control variables, the bigger the size of the issued unconventional bond (at 1% significance), the less years it takes to achieve maturity, with bigger firm size (at 10% significance), lower proportion of leverage, and less net income, all of which contribute to better unconventional bond ratings. Lastly, all of these variables were found to be in line with the theoretical framework except for net income variable, which could be due to the nature of unconventional bonds as a partnership and debt-based element contrary to the nature of bonds as a debt instrument. These findings are expected to contribute significantly in fields that concern regulators, issuers, investors, academicians as well as the public.

Keywords: *Corporate governance, Unconventional bonds, Bond rating*

1.0 Introduction

¹ Institute of Islamic Banking and Finance, Malaysia, Sheila Nu Nu Htay, Institute of Islamic Banking and Finance, Malaysia

Corporate governance is one of the most important and significant pillars of the economic structure for any organisation. The 1997/98 Asian financial crisis alarmed regulators, industry players, and investors and highlighted the importance of corporate governance. In addition, recent corporate failures such as Enron, Global Crossing Ltd., Healthsouth, Pamalat, Jinro Ltd and Tyco exert additional pressures on regulators to tighten rules and regulation on corporate governance. It is hypothesised that when corporations are governed very well, it will positively affect the market. Investors are always looking for good corporate governance to extend their investment and boost sustainable growth (Allen, 2005). Corporate governance is essential for companies that need access to capital, and for governments to stimulate private sector investment (Faulkner, 2000).

Corporate governance plays an equally significant role in the capital market. The capital market plays an essential role in the financial market since it provides financing facilities to companies. Bonds are the most popular capital market instrument. Given its importance for stimulating growth and Malaysia's keen drive to grow, Malaysia is one of the leading countries to issue unconventional bonds (Abdullah, 2009). According to the Securities Commission Malaysia (2009), Malaysia is going to lead global unconventional bond growth. However, there are many defaults in the unconventional bonds issued by Malaysian companies (Hafizi Ab Majid et al., 2011). This highlights the importance of researching the role of corporate governance and ownership in unconventional bond rating.

There are limited studies that examine the impact of corporate governance on bond ratings (Hollis Ashbaugh, 2004; Mark S. Klock, 2004; Sameh Ouni, 2010). To date, no study has examined the impact of corporate governance and ownership on unconventional bond ratings. To address the lacuna, this study examines whether corporate governance variables have affect unconventional bond ratings.

This paper is discussed in five sections. The second section highlights the theoretical framework, relevant literature, and the development of hypotheses. The third section

articulated the empirical model, variables, and sample. The fourth section elaborates on the findings of this research and the last section concludes the study.

2.0 Agency Theory, Findings of Prior Researchers, and Development of Hypotheses

Agency theory is among the prominent theories in corporate governance research. According to Jensen and Meckling (1976), agency cost will occur due to the separation of ownership and control. Hence, good corporate governance is necessary to reduce the conflict of interests. Many countries and organisations have introduced corporate governance guidelines based on the agency theory to ensure that the board of directors acts in line with the interest of shareholders.

Dong Chuhl Oh (2011) demonstrated that good corporate governance has a positive impact on credit ratings in South Korea. Similarly, Sameh Ouni, and Abdelwahed Omri (2010) found that the relationship between corporate governance and targeting credit rate is positive. Hillis Ashbaugh, Daniel W. Collins, and Ryan LaFond (2006) found that firm credit ratings are positively related to overall board independence, board stock ownership, and board expertise, and negatively related to CEO power on the board. Sanjeev Bhojraj (2003) found a positive relationship between institutional ownership and bond ratings. In Indonesia, Mafudi (2012) found that the number of independent commissioners had a positive effect on bond ratings.

In order to mitigate the agency risk, there should be a separate board leadership structure (Florackis & Ozkan, 2008; Htay, 2011), higher proportion of independent directors (Nicholson, 2003; Ozkan, 2008), smaller board size (Kim & Nofsinger, 2007), and higher ownership proportion of institutions (Htay, 2011; Mafudi, 2012) and directors (JIA Weiyang, 2008; Htay, 2012). Based on the concept of agency theory, the following hypotheses are developed in an alternative form:

- H_{a1}: Unconventional bond ratings are positively related to the separate board leadership structure.
- H_{a2}: Unconventional bond ratings are positively related to higher proportion of independent non-executive directors.
- H_{a3}: Unconventional bond ratings are negatively related to board size.

H_{a4}: Unconventional bond ratings are negatively related to higher proportion of director ownership.

H_{a5}: Unconventional bond ratings are positively correlated to higher proportion of institutional ownership.

3.0 Sample, Empirical Model, and Variables

Sample companies are selected if they are public companies listed on Bursa Malaysia which issue unconventional bonds rated by two rating agencies such as RAM and the Malaysian Rating Corporation Berhad. The final sample includes 12 listed companies from 2008 to 2011.

In order to test the above stated hypotheses, the following empirical model is developed:

$$\text{UNCONVENTIONAL BOND RATING} = \beta_0 + \beta_1 \text{BLS}_{it} + \beta_2 \text{INE_BZ}_{it} - \beta_3 \text{BZ}_{it} - \beta_4 \text{DOWN}_{it} + \beta_5 \text{IOWN}_{it} + \beta_6 \text{BOWN}_{it} + \beta_7 \text{LNLSIZE}_{it} - \beta_8 \text{MATUR}_{it} + \beta_9 \text{LNNTA}_{it} - \beta_{10} \text{TD_TE}_{it} + \text{NETI}_{it} + \mu_{it}$$

Where, the dependent variable is proxies by unconventional bond rating and measured as: B = 1, BB = 2, BBB = 3, A = 4, AA = 5, and AAA = 6.

Independent variables used are as follow:

BLS = Board leadership structure

INE_BZ = Proportion of independent non-executive directors on the board.

BZ = Board size

DOWN = Proportion of director ownership

IOWN = Proportion of institutional ownership

BOWN = Proportion of block ownership

Control variables:

LNLSIZE = Size of issue.

MATUR = Number of years to maturity.

LNNTA = Firm size, measured by Log of total assets.

TD_TE = Leverage, measured by total debt over total equity.

NETI = Net income.

i = 1,2,3,4,5,6,7,8,9,10..12

t = 1, 2, 3, 4

4.0 Findings

4.1 Findings of Descriptive Statistics

Table 1 Descriptive Statistics Result

Variable	Mean	Std. Dev	Min	Median
Unconventional bond rating	4.81	0.67	3.00	5.00
BLS	0.83	0.38	0.00	1.00
INE_BZ	3.71	1.01	2.00	4.00
BZ	8.79	2.35	6.00	8.00
DOWN	4.92	11.64	0.00	0.22
IOWN	58.34	12.47	30.97	58.92
SIZE	1,187,979,167	1,639,924,914	20,000,000	500,000,000
LNLsize	20.01	1.45	16.81	20.03
MATUR	10.75	5.00	5.00	10.00
TA	8,785,755,059	18,540,364,214	140,990,286	1,330,615,500
LNTA	21.33	1.65	18.76	21.01
TD_TE	2.15	0.77	1.04	1.89
NETI	272 000 000	765 000 000	-1 290 000	35 400 000
			000	

4.1.1 Descriptive Statistics Result for Independent Variables

4.1.1.1 Corporate Governance Variables

Table 1 shows that the mean of the sample for the board leadership structure is about 80% (0.80), which means the majority of corporations have a separate leadership structure. This result is in line with the theory of corporate governance whereby the CEO of the company should not be the chairman at the same time (Jensen, 1976). This is supported by the Malaysia Code on Corporate Governance (2007). However, the minimum sample of the BLS is zero, which means few corporations do not have a separate leadership structure. As a result, approximately 20% of the sampled companies combine the CEO and chairman positions.

In another variable, the mean of the independent non-executive directors' variable shows that the average number of independent directors is almost four. This figure can be interpreted as being in line with the recommendation of the theory and code of corporate governance to have independent directors on the board to monitor any self-interested action by managers and minimise agency costs (Ozkan, 2008). Moreover, this figure contains approximately 40% of the average number of board members, as illustrated in the next figure. This is a good sign that corporations are following and adopting the corporate governance suggestions and recommendation by having a sufficient percentage of independent directors on the board.

The average number of total board members for the sample is around nine (9). This is a reasonable figure for the board size, which is recommended to not more exceed eight members in order to have an effective board (Jensen, 1983).

4.1.1.2 Ownership Variables

The mean value of director ownership (4.9) illustrates that the proportion of director ownership in the sampled corporations is lower than 5%, which is considered significantly low. This result explains that most of the corporations' directors do not have shares in the companies, which is not encouraged by the agency theory in order to reduce the agency costs by being amongst the owners of the corporations (Jensen, 1983).

The mean value of institutional ownership is approximately 58% of the total ownership. 58% indicates that the largest percentage of the companies' shareholders and owners is the institutional ownership. Similar to other ownership variables, institutional ownership is recommended to be higher in order for the corporations to perform well and have better governance (Nofsinger, 2007).

4.1.2 Descriptive Statistical Result for Dependent Variable

In another category of variables, the unconventional bond rating variable shows a significant result throughout its mean of almost (5). This result is considered to be significantly high and accurate since in this research (5) represents an AA level of unconventional bond rating. In addition, the minimum figure of the unconventional bond rating variable shows how the rating of the sampled companies is fairly good, since the minimum unconventional bond rating is (3), which represents a BBB rating.

4.1.3 Descriptive Statistical Result for Control Variables

Two control variables represent the issue characteristics (such as issue size, maturity), whereas the remaining variables represent the firm-specific characteristics (firm size, leverage, and net income).

The mean of issue size (20) shows the average of the total unconventional bond issued size for the sample is almost RM 1,200 million. The mean of the maturity variable is almost 11 years, which shows that the maturity of the unconventional bond issued by the sample corporations is quite long (Frederic S. Michkin, 2009).

Firm size is represented by the total assets with a mean value of approximately RM 8,800 million. In another variable, the mean value of the leverage is 2.2, which is the proportion of total debt to total equity. Lastly, the average net income of the sampled companies is RM 272,000,000, which illustrates that the net income of issued unconventional bond corporations is almost one-third of one billion, which might be due to financing via unconventional bonds.

4.2 Correlation

Table 2 Correlation

	<i>Bls</i>	<i>Ine_B</i>	<i>Bz</i>	<i>Down</i>	<i>Bown</i>	<i>Iown</i>	<i>Lnsiz</i>	<i>Matu</i>	<i>Lnta</i>	<i>Td_T</i>	<i>Neti</i>
	<i>z</i>						<i>e</i>	<i>r</i>		<i>e</i>	
BLS	1										
INE_BZ	0.54	1									
BZ	0.32	0.65	1								
DOWN	-0.01	0.02	-0.08	1							
IOWN	-0.01	0.00	-0.14	0.03	-0.89	1					
LNLSIZE	0.64	0.46	0.08	0.37	0.05	0.17	1				
MATUR	0.34	0.25	0.10	0.18	0.01	0.02	0.55	1			
LNTA	0.48	0.57	0.2	-0.40	0.20	0.09	0.52	0.37	1		

			5								
<i>TD_TE</i>	0.28	0.08	0.5	0.03	0.27	-	0.08	0.22	-	1	
			5			0.29			0.01		
<i>NETI</i>	0.15	0.34	0.1	-0.15	0.19	-	0.24	0.36	0.61	-0.02	1
			4			0.01					

Table 2 shows the correlation among independent and control variables. There is no multi-co linearity since the values of all correlations is less than 0.80 (Kennedy, 2008).

4.3 Findings on Generalised Least Square Regression

Table 3 GLS Results on Unconventional Bond Rating

Unconventional bond rating	Coefficients	Z Statistics	P Value
BLS	0.09	0.45	0.65
INE_BZ	0.13	1.39	0.16
BZ	-0.07	-1.86*	0.06
DOWN	-0.00	-1.24	0.21
LNLsize	0.27	3.56***	0.00
IOWN	0.00	1.96*	0.05
MATUR	-0.01	-1.40	0.16
LNTA	0.11	1.65*	0.09
<i>TD_TE</i>	-0.01	-0.11	0.91
<i>NETI</i>	-3.96	-0.46	0.64
Chi2			134.83***
P value			0.00

*** Significant at the 1% level

** Significant at the 5% level

* Significant at the 10% level

4.3.1 Findings of Corporate Governance and Ownership Variables

Board size has a negative significant relationship with the unconventional bond rating at 10% level of significance. This means that corporations with lower board size would have higher unconventional bond ratings. Therefore, it is recommended for

corporation that intend to issue unconventional bonds to consider this point in order to have higher and better ratings. This finding is consistent with the findings of Yermack (1996), Hugh Grove (2011), and Larcker et al. (2007).

Similarly, at 10 percent significance level, the higher proportion of institutional ownership, the higher the unconventional bond rating. This demonstrated value can be interpreted as institutional ownership has positively influenced the rating of unconventional bonds. Moreover, the rating of unconventional bonds increases as long as the percentage of institutional ownership increases. As such, it is suggested for corporations that plan to issue unconventional bonds to have a bigger proportion of institutional ownership in order to have higher ratings. As a result, the unconventional bond issuers will need to pay less to the holders of unconventional bond since the risk is lowered, and the corporation will gain more trust. The positive and significant relationship between unconventional bond ratings and institutional ownership is in line with the findings of previous researchers such as Sanjeev Bhojraj (2003), Bolton (2006), Ergin (2012), and Juan Manuel San Martín Reyna (2012).

Other corporate governance variables such as board leadership structure, the proportion of independent directors and director ownership are not significant but in line with the research hypothesis. This means separate board leadership structure, a higher proportion of independent directors and lower proportion of director ownership will lead to higher unconventional bond ratings.

4.3.2 Findings of Control Variables

The size of the issued unconventional bond correlates positively and significantly with the unconventional bond rating sat 1% level of significance. This shows that there is a significant impact of the size of issued unconventional bonds on the unconventional bond rating. When the size of unconventional bonds increase, the rate of unconventional bonds would consequently and simultaneously increase. The unconventional bond issuers should recognise this fact when intending to issue unconventional bonds by raising the unconventional bond size in order to obtain higher ratings.

At the 10% significance level, total assets have a positive relationship with unconventional bond ratings. This finding is in line with the findings of Akmalia Mohamad Ariff (2007). Hence, total assets, have a significant and positive impact on unconventional bond ratings, and as such corporations that want to issue

unconventional bonds are recommended to have a large portion of total assets in order to obtain and enjoy higher and better ratings.

Other control variables such as maturity period and leverage are in line with expectations, i.e. shorter maturity period and lower leverage values will contribute to higher unconventional bond ratings. However, the ratio of net income is not in line with our hypothesis because unconventional bond differ significantly from conventional bonds. For instance, the nature of unconventional bonds concerns partnerships while that of conventional bonds serve as a debt instrument. Therefore, the return and revenue of the company that issues unconventional bonds might not be the main concern of the unconventional bond investors because they are not creditors to the company, yet they are partners. Thus, they are mainly concerned with the projects that they and the company are sharing.

5.0 Conclusion, Limitation, Significance, and Future Research

The research examined the impact of corporate governance on unconventional bond ratings. This research focused on Malaysia where most of the global unconventional bonds are issued. Twelve (12) companies listed on Bursa Malaysia that issued unconventional bonds over the 2008 to 2011 period were examined by using Generalized Least Square regression. The findings show that smaller board size and higher proportion of institutional ownership will contribute to better unconventional bond ratings at 10% significance level. In the case of board leadership structure and the proportion of independent directors and director ownership, the findings are in line with the research hypotheses although they are not significant. The control variables such as size of issue, maturity period, firm size, and leverage are in line with the expectations while the ratio of net income is not.

This research does not include private companies in Malaysia due to the unavailability of the required data. This is the first research to investigate the relationship between corporate governance and unconventional bond ratings. As such, these preliminary findings will be of interest to regulators, unconventional bond issuers, and investors. Future research should expand on the sample size by including private companies.

References:

- Abdullah, M. R. Regulatory Issues: Innovations and Application in Sukuk. In S. C. Malaysia, *Sukuk* (pp. 65-91). Kuala Lumpur: Sweet & Maxwell Asia. 2009.
- Akmalia Mohamad Ariff, M. K. Determinants of firm level governance: Malaysian evidence. *Corporate Governance*, Vol. 7, Iss: 5, (2007). pp.562 - 573.
- Allen, F. Corporate governance in emerging economies. *Oxford Review of Economic Policy*, 21(2), (2005). 164-177.
- Bolton, B. J. *Corporate Governance and Firm Performance*. Colorado: University of Colorado. 2006.
- Ergin, E. Corporate Governance Ratings and Market-based Financial Performance: Evidence from Turkey. *International Journal of Economics and Finance*; Vol. 4, No. 9, (2012). 61-68.
- Faulkner, M. C. *Securities Lending and Corporate Governance*. London: International Securities Lending Association. 2000.
- Frederic S. Michkin, S. G. *Financial Markets and Institutions*. New York: Pearson. 2009.
- Hafizi Ab Majid, S. S. Sukuk Defaults and Its Implication: A Case Study of Malaysian Capital Market. *8th International Conference on Islamic Economics and Finance* (pp. 1-37). Doha: Center for Islamic Economics and Finance, Qatar Faculty of Islamic Studies, Qatar Foundation. 2011.
- Hillis Ashbaugh, D. W. The Effects of Corporate Governance on Firms' Credit Rating. *Journal of Accounting and Economics*, (2006). 203-243.
- Hollis Ashbaugh, D. W. The Effects of Corporate Governance on Firms' Credit Ratings. *Journal of Accounting and Economics*, (2004). 1-57.
- Hugh Grove, L. P. Corporate Governance and Performance in the Wake of the Financial Crisis: Evidence from US Commercial Banks. *An International Review*, 19(5): (2011). 418–436.
- Jensen, M. &. Theory of the firm: Managerial Behavior, Agency Cost and Ownership Structure. *Journal of Financial Economics*, (1976). 305-360.
- Jensen, M. Organization Theory and Methodology. *The Accounting Review*, (1983). 319-339.
- JIA Weiyong, C. B. Corporate Governance and its Effects on Firm Value. *Industry Cluster and Meta-Studies- Proceedings of International Conference on Industry Cluster Development and Management* (pp. 436-440). Changzhou, China: ISSHP, SEI. 2008.
- Juan Manuel San Martín Reyna, R. D. Corporate Governance, Ownership Structure and Performance in Mexico. *International Business Research*; Vol. 5, No. 11, (2012). 12-27.

- Larcker, D. R. Corporate governance accounting outcomes, and organizational performance. *The Accounting Review*, 82: (2007). 963–1008.
- Mafudi, N. K. The Impact of Corporate Governance Implementation on Public Company Bond Ratings and Yield: a Case of Indonesia. *Acta Universitatis Danubius. Economica*, Vol. 8, No. 6, (2012). pp. 89-99.
- Malaysia, S. C. Malaysia and Hong Kong in Landmark Pact to Develop Islamic Capital Market. *Malaysian Islamic Capital Market*, (2009, December). pp. 9-10.
- Mark S. Klock, S. A. Does Corporate Governance Matter to Bondholders? *Journal of Financial and Quantitative Analysis*, (2004). 1-38.
- Nicholson, G. C. Board Composition and Corporate Performance: how the Australian experience informs contrasting theories of corporate governance. *Corporate Governance: An International Review*, (2003). 189-205.
- Nofsinger, K. A. *Corporate Governance*. New Jersey: Pearson Education. 2007.
- Oh, D. C. *Contagion of a Crisis, Corporate Governance, and Credit*. Saint Louis, Missouri: UMI Dissertation Publishing. (2011).
- Ozkan, C. F. Agency Cost and Corporate Governance Mechanisms: Evidence for UK Firms. *International Journal of Managerial Finance.*, (2008). 37-59.
- Sameh Ouni, A. Financial Attributes, Corporate Governance and Target Credit. *International Research Journal of Finance and Economics*, (2010). 123-135.
- Sameh Ouni, a. A. Financial Attributes, Corporate Governance and Target Credit Rating. *International Research Journal of Finance and Economics*, (2010). 123-135.
- Sanjeev Bhojraj, A. P. Effect of Corporate Governance on Bond Ratings and Yields: The Role of Institutional Investors and Outside Directors. *The Journal of Business*, (2003). 1-35.
- SCM. *The Islamic Securities (Sukuk) Market*. Kuala Lumpur: LexisNexis Malaysia Sdn Bhd. 2009.
- Sheila Nu Nu Htay, H. M. Corporate Governance and Risk Management Information Disclosure in Malaysian Listed Banks: Panel Data Analysis. *International Review of Business Research Papers*, (2011). 159-176.
- Sheila Nu Nu Htay, H. M. Impact of Corporate Governance on Social and Environmental Information Disclosure of Malaysian Listed Banks: Panel Data Analysis. *Asian Journal of Finance & Accounting*, (2012). 1-24.
- Yermack, D. Higher market valuation of companies with a small board of directors. *Journal of Financial Economics*, (1996). 185-211.

The Role of Corporate Governance and Ownership in Unconventional Bond Rating 117

Author name. Browsing title available at <http://www.theborneopost.com/2013/02/24/malaysia-to-continue-leading-global-sukuk-market-growth/>

Author name. Browsing title available at
http://www.academia.edu/1217021/Sukuk_Defaults_and_Its_Implication_A_Case_Study_of_Malaysian_Capital_Market