Corporate Governance and Executive Remuneration in Malaysia

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Abstract: It is explained based on the reforms agenda contained in the Malaysian Code on Corporate Governance, Capital Market Master Plan and Financial Sector Master Plan. By highlighting the mechanisms that normally used in the academic research, the paper identifies some of the important mechanisms applied in the reforms of the Malaysian corporate governance. It is found that the mechanisms that have been put in place are comprehensive and covers a wide spectrum of corporate governance internally and externally. The paper also examines some arising pertinent and puts forth some recommendations on how the future direction of the development of corporate governance in ASEAN countries with respect to directors’ remuneration shall take shape.

Keywords: Corporate Governance, Executive , Director’s Remuneration, CEO, BOD.

Introduction:

The financial crisis was triggered in Thailand when foreign investors lost their confidence and started to withdraw capital due to currency devaluation. The problems transmitted to other neighboring countries. The most affected countries included Indonesia, Malaysia, South Korea, and the Philippines. In Malaysia, attempts to contain further devaluation caused higher level of interest rate and credit contraction. This created severe contractions in output and corporate profitability which was reflected in massive fall of equity prices. The Kuala Lumpur Composite Index declined by 72% during the period from end-June 1997 to end-August 1998. Real estate markets declined sharply due to high interest rates and in crisis environment. Banks, which had a significant portion of their loan exposure in the construction and real estate sector; and stock purchase financing were badly affected. Paul Krugman (1998) in “What Happened to Asia” and Corsetti et al (1998) in “What Caused the Asian Currency and Financial Crisis” advocated the ‘Fundamentalists View’ pertaining to the crisis. They argued that the crisis was due to structural weaknesses in the domestic financial institutions supported by unsound macroeconomic policy and moral hazard. According to IMF (1999), the crisis was infected by the domestic policy weaknesses. This were manifested by the large current account deficits; concentration of bank loans in real estate development and financing share purchases; weaknesses in domestic financial system; poor governance and risk management; and too much international borrowing in the corporate sector.

Reforms that took place after the 1997 financial crisis

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<th>Year</th>
<th>Reform</th>
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<tr>
<td>1998</td>
<td>The formation of the High Level Finance Committee to conduct a detailed study on corporate governance and to make recommendations for improvements.</td>
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<td>1998</td>
<td>Amendments were made to the SICDA with the view to enhance transparency in share ownership amidst other improvements.</td>
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<td>1998</td>
<td>The Malaysian Institute of Corporate Governance was established to look into the improvements for corporate governance practices in Malaysia.</td>
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<td>1999</td>
<td>A new Malaysian Code on Takeovers and Mergers was introduced.</td>
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<td>1999</td>
<td>Directors and CEOs were required to disclose their interests in Public Listed Companies (PLCs)</td>
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<td>1999</td>
<td>PLCs were required to submit Quarterly Reports (Available to the investing public) on their results and financial position.</td>
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<td>2000</td>
<td>The establishment of the Malaysian Code on Corporate Governance.</td>
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<td>2000</td>
<td>Amendments were made to the SCA further streamlining the regulatory by making SC the sole regulator for fund raising activities and the corporate bond market.</td>
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<td>2001</td>
<td>The KLSE issued its revamped listing requirements which included new sections on corporate governance and continuing disclosure requirements.</td>
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<td>2001</td>
<td>Establishment of the Minority Shareholders Watchdog Group to further protect minority shareholders’ interests and to promote shareholder activism.</td>
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<td>2001</td>
<td>Directors of PLCs were required to undergo training – Mandatory Accreditation Program</td>
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<td>2001</td>
<td>The Audit Committee must have a member who is financially trained.</td>
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To further improve on the effectiveness of the enforcement, the masterplan also provides to reinforce the SC’s enforcement capacity on a continuous basis. Those that perform enforcement duties will be continuously equipped with up-to-date knowledge and information on financial transgressions which increasingly are becoming more complex and dynamic. To complement the enforcement role, SC will identify and develop front line regulators (FLR) like the KLSE and self-regulatory organizations (SRO) such as professional bodies. They are expected to play an increasing role in policing their respective segments of the market. This will enable increased surveillance and effective and efficient enforcement be carried out at the vanguard of the market activity itself. It is hope that enforcement can then be applied in a timely and consistent manner so as to instill assurance among market participants of the fairness, efficiency and integrity of the capital market. (Prof. Romulo Neri, 2001, “Financial Indicators of Good Governance”, Asian Institute of Management, Philippines)

**Development of Corporate Governance in Malaysia**

The main sources of the Corporate Governance reforms agenda in Malaysia are from the Malaysian Code on Corporate Governance by Finance Committee on Corporate Governance, Capital Market Master Plan (CMP) by Securities Commission and Financial Sector Master Plan (FSMP) by Bank Negara Malaysia on the financial sector. It provides guidelines on the principles and best practices in corporate governance and the direction for the implementation as well as charts the future prospects of corporate governance in Malaysia.

**Malaysian Code on Corporate Governance**

The initiative started with the establishment of Finance Committee on Corporate Governance in 1998 that consists of both government and industry. Recognition of corporate governance in Malaysia was significantly evidenced by the released of the Malaysian Code on Corporate Governance by the Committee in March 2000.

**Shareholders’ Role in Corporate Governance**

In Malaysia, as in other East Asian countries, a large proportion of the public listed companies are owned and managed by families. In a survey carried out by Claessens et al., (2000)10 in nine East Asian countries (Malaysia included), the following results were reported:

i) more than two thirds of the firms are controlled by a single shareholder

ii) separation of management from ownership control is rare

iii) the top management of about 60% of the firms that are not widely held is related to the family of the controlling shareholder

iv) there is extensive family control in more than half of East Asian corporations.

Similar findings was found in the 1998 analysis carried out by the World Bank in its Reports on the Observance of Standards and Codes (ROSC) on Malaysia, where it was found, from a sample comprising fifty percent of the KLSE market capitalization in 1998, that 67.2% of the shares were in family hands, 37.4% had only one dominant shareholder and 13.4% were state controlled.

About 85% of the public listed companies had owner-managers and the post of CEO, chairman of the board or vice-chairman belonged to a member of the controlling family or a nominee.

**Effectiveness of the Board of Directors**

The governance of companies has been the subject of increasing interest following the East Asian financial crisis in 1997. Central to this governance mechanism is the board of directors. Concerns have been expressed on the levels of responsibility, accountability and transparency of the boards of the public listed companies in Malaysia. Most corporate governance studies; Cadbury (1992), Greenbury (1995) and Hampel (1998); called for greater transparency and accountability in areas such as board structure and process, board independence and the role of independent directors and the establishment of board monitoring committees. The Malaysian Code on Corporate Governance was drafted to address these issues. The governance structures recommended by the Code should provide more effective monitoring of the board and the decision making process, enhance the effectiveness of the board which in turn will improve performance as these governance mechanisms will ensure that shareholder interests are being promoted. This is of particular importance as a large proportion of the boards in KLSE listed companies are family/owner controlled. The boards tend to be dominated by the
owner or directors who are handpicked by the controlling owner with high tendencies to serve only the interests of the controlling owners.

**Board Structure and Procedures**

The Code recommends as a matter of best practice the appointment of committees with clearly spelt out authorities, to assist the board. One such committee is the Remuneration Committee. Remuneration Committee should comprise wholly or mainly of non-executive directors. Its function is to recommend to the board the remuneration of the executive directors in all its forms, drawing from outside advice if necessary. The determination of remuneration of non-executive directors should be a matter for the board as a whole.28 The director should abstain from discussing his own remuneration. Sixty four percent of the survey respondents have complied with this and have set up a remuneration committee.

**Analysis of the relationship between Corporate Governance Practices and Firm Performance**

One of the causes of the corporate failures in 1997 financial crisis was attributed to weak corporate governance practices. Conversely having strong corporate governance practices should improve financial performance. Many studies have been done to establish this link. Although there are studies that have found positive linkage between the two (Romulo N.,2001), there is equally a growing number which have found no direct linkage between the two (David L. and Charles W., 1999; Charles W. and David L., 2001). Possible reasons for the difference in the findings could be due to differences in the measurement of performance, theoretical perspectives applied and the contextual nature of the individual firms. However the results from most studies concur that investors are prepared to pay a premium for companies that are perceived to have good governance practices. McKinsey & Co. found in their survey in 2000 that “over 80% of investors say that they would be prepared to pay more for the shares of well-governed companies than those of poorly governed companies.” In the same survey it was found that “three quarters of investors surveyed say board practices are at least as important to them as financial performance when evaluating companies for investment, especially in emerging markets.” The same findings were found in the KLSE Price water house Coopers Corporate Governance Survey 2002 carried out in Malaysia recently. Good governance is undeniably a contributing factor to the firm performance. However there are many other contributing factors to firm performance such economic and market situation, the industry the firm operates in, the size of the firm and its market share, innovativeness and financial strength of the firm. Unfortunately insufficient number of survey responses were received and hence the relationship between corporate governance practices and firm performance in Malaysia could not be tested.

In place of this, a simple analysis was done on 32 firms selected from the listed companies in the KLSE to provide a general inference of the relationship and perhaps an idea of the actual scenario.

15 firms were selected from the list of firms that made up the KLSE Composite Index. There are altogether 100 firms that made up the KLSE Composite Index list. These firms were selected by the KLSE to form the Composite Index based on among other factors, their sound management, financial health, good track record and consistent dividend payouts. Generally these firms are known as the blue chips to the stock broking industry. Being blue chips, they are generally perceived to have better corporate governance practices. Another 15 firms of the same industry were selected from the second liners. Second liners as known in the stock broking industry, are firms with share prices trading in the RM1 and RM2 per share category and are mostly bought by investors and fund managers with smaller funds. These firms are generally perceived to be second graders and tendency for weaker corporate governance practices. These 30 samples were selected from the same industry to reduce the number of variables to have a better comparison.

**Conclusion**

Malaysia has certainly come a long way since the financial crisis to promote corporate governance. Legal, institutional and regulatory frameworks have undergone reforms and are still being further improved to institute a sound and effective corporate governance structure to protect investors. In terms of rules and regulations, Malaysia has been in the forefront introducing many regional firsts. This has been attested by the joint study between the emerging market investment bank CLSA and Asian Corporate Governance Association in 2003 where they ranked Malaysia the highest at a score of 9 out of 10 in terms of rules and regulations amongst the emerging markets.

Financial and non-financial disclosures by the public listed companies have also improved. Essentially these companies have diligently complied with the requirements of the Code and the KLSE listing rules. Directors have successfully undergone their mandatory training and have been made more aware of their responsibilities, duties, the need to be transparent and to enhance corporate governance practices. Overall corporate governance practices
have improved in Malaysia. In the same study mentioned in the preceding paragraph, Malaysia was ranked an overall 5th position at an average score of 5.5 out of 10, an improvement from the 18th position at an average score of 3.7 two years ago.¹

The laws and listing rules have been changed to promote corporate governance. That was the easy part. Mindsets too have to change to embrace the true spirit of corporate governance otherwise, compliance will just be mere paper compliance. It is true that morality and ethical conduct cannot be prescribed by black letter law. Perhaps we should heed the call by Tun Dr. Mahathir, the former Prime Minister of Malaysia, to the Organization of Islamic Conference (OIC) in his keynote address at the OIC Business Forum on October 15, 2003, to set up Muslim business schools where Muslim business ethics can be developed, expanded and taught systematically. Perhaps instead of only Muslim schools all business schools should develop, expand and teach systematically general business ethics. As he said “there is too much greed, profiteering and usurious practices are rampant. Business is about making profits but it should not be such that others would suffer.”

Lastly, we need to follow the cliché “walk the talk” and diligently implement the changes in the true spirit of corporate governance by all players in the industry. The regulatory needs to ensure and be seen to take visible and timely enforcement actions against those that deviate.

REFERENCES


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