

Corporate governance of banks in Malaysia¹



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ABSTRACT This study considers the state of corporate governance in the domestic banking system in Malaysia, and the progress and success of regulatory reforms implemented to improve the internal corporate governance mechanisms in the domestic banking institutions in the post-1997 crisis period. A unique contribution of this study is that it provides first-hand evidence on the domestic banking system's corporate governance structure. Based on the Asian Development Bank Institute questionnaire surveys of the board of directors, this study presents, for the first time, the observed perceptions of board members about their overall responsibilities, accountability and role in enhancing their board's effectiveness. These micro-level results reveal very encouraging evidence about the changes that have been made in the defining roles of CEOs/controllers and the independent directors in board committees and related party transactions, as well as in the areas of public disclosure and risk management processes. Some evidence has emerged from the survey questionnaires that the rapid enhancement of regulatory norms such as Bank Negara Malaysia's regulatory guidelines, Guidelines on Directorship in the Banking Institutions (GP1) and Guidelines on the Specimen Financial Statements for the Banking Industry (GP8), have resulted in structural changes being made in the domestic banking institutions' internal governance mechanism. Board directors are now more conscious that disclosures, transparency and board independence are prerequisites for their effectiveness in propagating governance in their banking institutions, especially in those financial conglomerates with complex and opaque ownership structures. At the public policy level, the task of striking a balance between the use of various regulatory policy instruments and market discipline to make the practice of good corporate governance a norm in the domestic banking system will become more challenging to Bank Negara Malaysia in the post-merger period. These are issues that should be of interest to the banking community in Malaysia.

THE FINANCIAL AND BANKING system in Malaysia has always been considered safe and sound, and Malaysia's central bank, Bank Negara Malaysia (BNM), is renowned for its pursuit of a high level of regulatory and supervisory standards. The practice of corporate governance in the domestic banking system is not a new phenomenon. Even before the 1997 Asian financial crisis, Malaysia had already adopted the Basel Core Principles of Effective Banking. It would be erroneous to say that both the regulators and the board of directors in the banking industry did not understand what good corporate governance entails and its importance in reducing the costs of banking crises. Yet the 1997 financial crisis occurred. The lesson of experience from this crisis is that having an enhanced corporate governance regime is a necessary but not a sufficient condition to avert a crisis.

The Asian financial crisis has revealed gaps in our understanding of the significance between an explicitly defined governance mechanism and the practice and adoption of it by agents of a firm. A troubling implication is that the existence of a clearly defined set of governance rules does not causally imply that it will be effective unless various stakeholders are convinced that their participation will bring about net benefits over their abstention or over the costs of disregarding it. Consensus is growing that both the banking and corporate leaders are buying into the process to improve corporate governance in Malaysia.

Corporate Governance and the Banking System

A good corporate governance mechanism encourages the proper management of risk and also provides a framework of disclosure that allows the market to discern the risk choices of the banking institutions. To be effective it must entail greater transparency and market discipline. It is essential that there must also be a proper balance in the prudential regulatory framework that acts as a stick as well as a carrot i.e. inflicting disincentives for departure from,

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and bequeathing incentives for conformity to prudential norms. Especially in an environment of heightened uncertainties, the 1997 crisis demonstrated that lapses in internal controls and the management of credit, market operational risks can be very costly to the individual banking institutions.

In the post-crisis period, BNM has relentlessly encouraged both the banking and the corporate sectors to minimise this gap in the practice of the governance framework. All banks have adopted strict measures in enhancing board structures and composition, i.e. by appointment of independent directors, audit, nomination, remuneration and risk management committees. There is now greater disclosure in the notes to their financial statements. Bank examination by BNM's inspectors includes the review and scrutiny of minutes and loans portfolio and financials. Board members and top management of banking institutions are incrementally enhancing their effectiveness and cognizant of their accountabilities in the decision-making process. New forms of corporate governance behaviour implanted will require time to take root. Both monitoring costs and supervisory costs of engendering accountability have increased, however, and whether there are commensurate gains and benefits has to be tested.

There are obvious gains from the costly lessons of experience from the 1997 crisis. The operational experience of BNM and other governmental regulatory authorities in rescuing banks in crisis and restructuring banking reforms in the post-crisis period have been invaluable. But there is also the unsettling implication that these lessons may not last. Despite the benefit of hindsight, crises by nature are surprises and though there may be resemblances to those encountered in the past, each new crisis still manages to spring its unique mix of surprises and unanticipated elements upon the regulatory authorities. These surprises could re-emerge out of the opaqueness in our

understanding of the underlying variance between the practice of good corporate governance and the germination of crisis in the banking sector.

The Asian Financial Crisis and Banking Sector Problems

In this section, we will highlight some of the structural weaknesses in the banking system during the crisis. One of the key issues that emerged during the crisis was that the weak institutions, particularly the banks and some large firms in the corporate sector undertook too much risk and had too many losses. These banks and firms were the main nexus of the illiquidity and foreign exchange risks and they were also the victims of the crisis when it hit.

We take advantage of the availability of a sample of annual report data of mainly the domestic banks in Malaysia to explain some of the key problems in the banking sector related to the Asian financial crisis of 1997. The data for the sample is derived from the annual reports and financial statements of the 10 large and six small domestic banks and four foreign-owned banks. Our focus here is mainly on the large amounts of non-performing loans (NPLs) that were the result of some of the banks' excessive lending and ensuing risk exposure during the crisis period.

In the period 1994-1997, loan growth in the banking sector's broad property sector averaged about 44% per annum compared to about 22% in the manufacturing sector. Loan growth for the purchase of shares and for consumption credits in the total banking system averaged about 11.5% and 13% respectively in the same period. The reason for these differences was simply the fact that lending to the broad property sector was a more lucrative business than lending to the manufacturing sector.

The uniqueness of the cyclical nature of excess lending in the broad property sector in Malaysia has always been related to the



Table 1: Non-Performing Loans and Capital Adequacy Ratios: 1998-2003

	1998	1999	2000	2001	2002	2003
Total NPL (RM million)	32,644	29,770	32,453	42,812	41,409	39,138
NPL/Total Loans	6.7	5.5	5.4	7.5	6.9	6.8
CAR	8.9	10.6	10.8	11.0	11.2	11.2

Source: Bank Negara Malaysia, Monthly Statistical Bulletin, March 2004

wealth effect of an equity market boom that spilled over into the broad property markets in the subsequent years after the equity market boom. Excessive loan growth usually resulted in deterioration in the quality of the loans. This was especially so in the property market. During the crisis period, it was evident that high NPLs were also related to lower than average loan loss provisions.

Table 1 provides an aggregate view of the commercial banks' total NPLs and core capital adequacy ratios (CAR) in the period 1998-2003. The NPL figures suggest that the after effects of the excessive loan growth problems were still being felt even after the successful completion of the government's recapitalisation programme in 2002. Despite the fact that the commercial banking sector appeared well capitalised, the NPLs based on a 6-month classification had not improved significantly even after 2002. One possible source of the high level of NPLs was the sizable amount of unresolved old NPLs, especially the property-related bad loans that were still in the banks' books.

The annual report data provides evidence that some banks were indeed exposed to liquidity and market risks in the interbank markets. Liquidity risks are measured by the loan to deposit ratio and liquid assets to short-term funding ratio. Market risks are represented by the net inter-bank assets (or liabilities) to total assets ratio. If the loan-

deposit ratio is considered to represent the bank's gearing ratio, the five domestic banks with high gearing ratios – Arab-Malaysian Bank Bhd, Bank of Commerce (M) Bhd, EON Bank Bhd, Maybank Bhd and Southern Bank Bhd) also had relatively low liquid asset ratios. As shown in Table 2, Public Bank Bhd had an above average liquid assets ratio (61.7%) and a relatively lower gearing ratio (53.8%), implying relatively low vulnerability to liquidity risks. During the crisis period, with the exception of Public Bank, most banks' liquid asset ratios were between 27% to 42%.

In general, all the 10 large domestic banks held between 13% to 34% of their total assets in interbank securities, suggesting that they had some exposure to market risks, unless they had off-balance sheet hedges. In addition, four banks, namely, Arab-Malaysian Bank, EON Bank, Maybank and RHB Bank Bhd, had net interbank liabilities. These banks also had high gearing ratios, suggesting that a negative correlation exists between high gearing and exposure in net interbank liabilities. This made them more vulnerable to interest rate risks when the interbank market interest rate (KLIBOR) rose faster than lending rates during the crisis period.

Table 3 summarises the correlations between the key financial ratios of the sample of 16 domestic banks and the four foreign-owned

Table 2: Liquidity Risk and Market Risks Ratios: 10 Domestic Banks, 1997/98

	Liquidity Risk: Total Loans to Deposits	Liquid Assets to Short-term Funding	Market Risk: Interbank Asset to Total Asset	Net Interbank Asset to Total Asset
Affin Bank Bhd	86.9	34.4	17.4	10.3
Alliance Bank Malaysia Bhd	82.2	27.4	13.2	11.9
Arab-Malaysian Bank Bhd	145.4	28.1	20.2	-21.4
Bank of Commerce (M) Bhd	100.8	28.6	20.9	8.6
EON Bank Bhd	127.7	42.0	26.4	-8.9
Hong Leong Bank Bhd	90.4	28.1	13.1	9.7
Maybank Bhd	108.4	32.6	18.2	-2.5
Public Bank Bhd	53.8	61.7	34.3	19.1
RHB Bank Bhd	98.4	38.4	17.5	-0.1
Southern Bank Bhd	105.6	33.6	22.1	10.1
Mean	100.0	35.5	20.3	3.7
Standard Deviation	25.1	10.4	6.3	12.0

Sources: Annual Reports of the respective banks. Data for the Alliance Bank are for 1999.

banks during the crisis year. The evidence suggests that the banks' prudent behaviour is related to their risk exposures and profitability performance. A few key features stand out in the correlation matrix about the domestic banks' behaviour and performance during the crisis period:

- (a) Banks with large amounts of non-performing loans usually had low loan loss provisions, suggesting less than satisfactory risk management in these banks.
- (b) The more prudent banks held a large amount of liquid assets and placed aside a larger amount for loan loss provisions.
- (c) Banks that held large amounts of liquid assets also held large amounts of interbank assets, implying they were less vulnerable to liquidity risks during the crisis period.
- (d) Banks with high gearing ratios also had high net inter-bank liabilities, suggesting that they were more vulnerable to market risks during the crisis period.
- (e) There is a high correlation between the profitability and the overhead cost ratios, but the banks' profitability is negatively correlated with their gearing ratios.

The evidence from the annual report data suggests that the problems of excessive loans growth with rising NPLs and the problems of risk exposure with illiquidity in the banking institutions are related. The

high level of NPLs representing the default obligations of highly-g geared firms associated with the troubled banks showed there were also troubled and over-leveraged firms in the corporate sector. There was also the belief that the structural weaknesses and fragility in the internal corporate governance mechanism within both the banking system and the corporate sector created channels through which problems were transmitted between these sectors and throughout the economy during the crisis period.

Significance and Objectives of the Study

One of our primary concerns in this report is to consider the state of corporate governance in domestic banks in Malaysia and to explain why the Malaysian banking system's corporate governance mechanism was frayed to extremis during the 1997 Asian financial crisis. This is a puzzle to most banking analysts since Malaysia is known to have some of the strongest banks in the ASEAN region and that Bank Negara Malaysia is reputed to be one of the best regulators in terms of transparency and strict enforcement of its regulatory guidelines in the banking industry. We believe that one of the pivotal elements in this puzzle is the gap between the normative structure of the governance regime and the consistency of the application of that regime among the individual banking institutions in the domestic banking system. Our interest will also extend to analysing the changes and developments in the corporate governance regulatory norms as applied in the banking sector since 1997.



Table 3: Correlation Matrix of Banks' Financial Ratios, 1997/98

	NPL to Total Loans	Loan Loss Provisions to NPL	Loans to Deposit	Liquid Asset Ratio	Interbank Assets	Net Interbank Assets	Return on Assets
NPL to Total Loans	1						
Loan Loss Provisions to NPL	-0.585	1					
Loans to Deposit	-0.106	-0.407	1				
Liquid Asset Ratio	-0.256	0.529	-0.434	1			
Interbank Assets	-0.081	0.249	-0.112	0.797	1		
Net Interbank Assets	0.084	0.303	-0.810	0.341	0.191	1	
Return on Assets	0.360	-0.070	-0.560	0.013	-0.052	0.373	1
Overhead Cost to Total Assets	-0.039	0.230	-0.521	0.199	-0.171	0.398	0.668

Sources: Annual Reports of the respective banks

The scope of our study will be confined to the domestic banking industry where our analysis will be focused on the 10 domestic banking groups during the post-crisis period 1998-2003. An interesting and unique aspect of this study is the collation of a set of data derived from survey questionnaires about corporate governance, ownership structures, executive compensation and risk management practices in the domestic banking industry. The results of the opinion survey of the board members have provided us with some useful insights in understanding how board members consider important issues such as the board's effectiveness, board members' independence and the key elements for enhancing board effectiveness, especially in the changing domestic banking industry landscape during this period.

The significance of this study's results is the emergence of evidence showing the effects of the rapid enhancement of the regulatory norms such as BNM's regulatory guidelines GP1 (Guidelines on Directorship in the Banking Institutions) and GP8 (Guidelines on the Specimen Financial Statements for the Banking Industry). Structural changes have been made in the internal governance mechanism of domestic banking institutions. There is now a greater consciousness among board directors that disclosures and transparency are prerequisites for their effectiveness in conducting governance in the banking institutions. The importance of disclosures and transparency is a theme that will run throughout this study.

Given the richness and quality of basic corporate information in the banks' annual reports, we have attempted to construct a monitoring and disclosure index of the 10 domestic banks for the period 1998-2003. In developing this monitoring and disclosure index, our objective is to relate the implementation of BNM's regulatory guidelines GP1, GP3 (Guidelines on the Suspension of Interest on Non-Performing Loans and Provision for Bad and Doubtful Debts), GP7 (Guidelines on the Code of Conduct for Directors, Officers and Employees in the Banking Industry) and, especially, the BNM/GP8 on disclosures requirements among domestic banks. We have made use of our disclosure index to discern whether market discipline exists in the domestic banking system as an input complementary with the BNM regulatory guidelines in the production function for corporate governance and financial stability.

Finally, our interest is focused on the impact of ownership structures and performance among the domestic banks. The ownership structure in the domestic banking industry is very much influenced by the government's New Economic Policy (NEP) directives introduced over thirty years ago. The NEP's restructuring objectives have very far-reaching policy impacts on the redistribution of wealth and income in the Malaysian society in the past 30 years; and invariably these restructuring objectives set the tone for the government's ownership structure in the domestic banking industry. As a result, the ownership structure in the Malaysian domestic banking industry is quite neatly categorised into government-owned banks, family-owned banks and a couple of banks with corporate and widely-held ownership structures.

We believe that the issue of ownership structures in the banking industry is an important one, especially from the perspective of the Malaysian government policy. Our purpose here is to establish a statistical relationship between the domestic banks' performance and their ownership structure. The significance of such findings is to put into perspective both the positive and negative externalities of government-owned and family-owned banking institutions and how the different ownership structures may have a significant bearing on the performance of the different domestic banking institutions in Malaysia.

Main Findings on Corporate Governance of Banks

The main theme of this report is to consider the state of corporate governance in domestic banking institutions in Malaysia and to discern whether corporate governance has improved in these institutions in the post-crisis period. Post-1998 saw a rapid enhancement of regulatory norms, such as the GP1 and GP8 guidelines which resulted in structural changes being effected in the banking system's internal governance mechanism. In a survey conducted using questionnaires to elicit the opinions of the board of directors, some very interesting results were revealed about the emerging dynamics of corporate governance in domestic banking institutions. The survey's key elements and how it was conducted will be discussed under the section 'Internal Corporate Governance Mechanisms' (page 29). In this section we summarise only the main results.

A major concern of the survey is to discern the board of directors' roles and effectiveness in the domestic banking system. On average, over 80% of our respondents in the survey believe that the boards in the domestic banking system are effective. In particular, most board members are cognizant of the elements considered significant in engendering a more effective board. This is encouraging and reads well for the development of corporate governance practices in Malaysia, given that a major component in the diagnosis of the ailing banking system during the crisis period was that the boards were ineffective and did not play their rightful roles.

Specifically, almost all respondents in our survey believe that the board is effective in performing its responsibilities in the areas such as formulating long-term strategies, establishing risk management and internal control systems, and selecting, monitoring and ensuring that the CEO is performing his/her role in the interests of the shareholders, the depositors and other stakeholders. This strong agreement, in the main, reflects that both legislative and regulatory norms in the area of risk management and the setting up of internal control systems appear to have been very successful and the Banking and Financial Institutions Act 1989 (BAFIA) has been instrumental in this aspect.

Most respondents view the board as effective in ensuring the integrity of the bank's financial reporting, especially towards greater public disclosure of relevant information to the investing public. Though a small percentage disagrees, the fact that there is some dissent on this issue is noteworthy. Given that bank auditors are in the main very cognizant of their strict duties, the small dissent could appear to imply that the board's effectiveness in ensuring the integrity of bank's financial reporting is still an issue to reckon with.

The survey results also reveal an interesting insight about board members' perspectives on the issue of conflict of interests and related party transactions. Of those surveyed, a large majority agree that their boards are effective in overseeing this crucial area of governance abuse. It is noteworthy that a small percentage holds the view that the board is ineffective in this area. It is difficult to surmise the reason for this disagreement.

In the spirit of the GP1 Guidelines, the power of the controlling owners and CEO/executive chairperson has been counterbalanced by

the strengthening of the various committees responsible for the effective implementation of corporate governance policy in the domestic banking institutions. Besides the audit committees, all domestic banks have established nominations, remunerations and risk management committees to oversee governance operations in their organisations.

An interesting element of the survey findings is that by way of such structuring of various committees, there is also an enhancement of the important roles of the independent directors in the boardroom. In all the banks, the chairpersons of the audit and the risk management committees are independent directors. We think that this trend augurs well for the conduct of governance in the banking sector. However, there is still a concern in a few banks where the chairpersons of the nomination and compensation committees are still not independent directors.

Over 84% of those surveyed believe there are some common ingredients to enhancing board effectiveness. For example, selecting qualified and truly independent directors and promoting constructive criticism and alternative views in boardroom discussions will enhance board effectiveness.

The survey results reveal that the variety of recent central bank regulatory reforms has been significant, in that, they mirror and encourage the value and role of independent directors. About 71.5% of those surveyed agree that independent directors are truly independent from the CEO or the controlling shareholders. However, 24% believe that independent directors are not fully independent. Their main concern may have arisen because the CEO/controlling owners either selected them or could decide on the extension or termination of their directorship. More disturbing is that a small percentage of the respondents do not even have an opinion on this important issue of board independence. This signals that more needs to be done to ensure that board independence is a prerequisite for board members to play their role effectively.

All respondents believe that the chairperson's and CEO's roles should be separated but there is no mandatory requirement that this should be so. All board members believe board effectiveness can be enhanced with better disclosure of board activities. This is important in the light of BNM's efforts to encourage greater and better disclosure of bank activities, which is at the heart





of the governance issue in the domestic banking industry, facilitating the role of market discipline in monitoring banks' risk choices.

EVOLUTION AND RESTRUCTURING OF THE BANKING SECTOR

In 1998, the Malaysian government established three institutions to resolve the banking sector's growing NPLs problem. These institutions were Danaharta, Danamodal and the Corporate Debt Restructuring Committee (CDRC). As the asset management company, Danaharta's responsibility was to purchase NPLs from banking institutions and manage these NPLs in order to maximise their recovery value. Danamodal's complementary role was to recapitalise ailing domestic banking institutions to a healthy level. The CDRC's role was to facilitate corporate debt restructuring among creditors and debtors by mediation without resorting to legal proceedings.

Bank Negara Malaysia's banking sector restructuring efforts is substantially completed. Five years after its establishment in 1998, Danamodal, the capital injection vehicle for the central bank, wound down its operations on the last day of December 2003, following the closure of the CDRC in August 2002. Danaharta also completed its task of acquiring NPLs from the financial sector in 2001 and is making significant progress in its recovery operations. In the crisis period, Danaharta had been very successful in containing the rise of the NPLs in order for

the banking system to function efficiently during the intermediation process.

Overview of the Banking Sector Restructuring after the Crisis

Danamodal's accomplishments are quite impressive. Its success in recapitalising ailing banking institutions had enabled these banking institutions enhance their ability to resume and generate new lending activities at the most critical time when the economy was slowing down. During its operation, Danamodal injected a total of RM7.6 billion into 10 banking institutions affected by the 1997 banking crisis. This capital injection is significantly below the initial budget of RM16 billion allocated for this purpose. Danamodal's success can be explained by the prudent nature of its operations. The main criterion for capital injection is based on market principles and commercially viable terms, supported also by due diligence reviews of the banking institutions' viability by international investment bankers. In its capital injection operations, Danamodal would adhere strictly to the 'first loss' principle where the existing shareholders were required to absorb all losses before recapitalisation. In the final analysis, Danamodal was able to keep the total recapitalisation cost at a low level of about 2.5% of GDP.

Danamodal's task did not stop after its recapitalisation of the weak but viable banking institutions. As a strategic shareholder in these recapitalised banking institutions, It was also responsible for

Table 4: Danaharta Loan Recovery: End of 2003

	Adjusted Loan Rights Acquired and Managed (RM billion)		Expected Recovery Rate (%)	
	Acquired NPL	Managed NPL	Acquired NPL	Managed NPL
Plain Loan Restructuring	2.2	5.5	62	87
Settlement	2.7	6.7	89	78
Schemes of Arrangement	2.9	6.9	66	77
Schemes under Special Administrators	2.5	2.9	51	35
Foreclosure	9.9	4.5	28	46
Others	1.7	3.0	60	53
Legal Actions	0.2	1.0	-	-
Total	21.9	30.5	49	66

Source: Bank Negara Malaysia Annual Report 2003

Table 5: Status of CDRC Cases: End of 2002

	Total Debt Outstanding (RM million)	Number of Account
Total Referred to CDRC	67,644	87
Cases Withdrawn/Rejected	12,615	28
Transferred to Danaharta	2,470	11
Cases Accepted	52,559	48
Resolved	52,559	48
Implemented	35,969	32
Pending Implementation	16,590	16

Source: Bank Negara Malaysia Annual Report 2002

initiating and carrying out micro reforms such as proper risk management practices, good corporate governance and higher operational efficiencies in the restructured institutions. Their improved capital position, coupled with the operational and efficient restructuring, meant these banking institutions could resume their business of bank lending activities without unnecessary lag time. Danamodal, in its role as a strategic shareholder or bondholder, had the opportunity to facilitate BNM's bank merger and consolidation exercise in the post-crisis period.

Danaharta's accomplishments are equally impressive. Of the RM52 billion adjusted loan rights acquired in its portfolio, Danaharta had expected to recover about 58% or RM30.6 billion over the duration of its operations. At the end of 2003, about 73% or RM22.4 billion of the expected RM30.6 billion had already been collected. In 2003, Danaharta had distributed recoveries that amounted to a cumulative total of RM13.4 billion in cash and securities to the government and 36 financial institutions. The distribution to the financial institutions was based on the 80:20 surplus recovery sharing agreement between Danaharta and the financial institutions. In 2003, Danaharta repaid its loan of RM1.3 billion to Khazanah Nasional Berhad and the Employees Provident Fund and redeemed the first two tranches of zero coupon bonds at the principal sum of RM2.6 billion. At the end of 2003, Danaharta had in its holding both cash and cash equivalents of RM5.9 billion. With its cash holding and the remaining assets to be recovered, it is expected that Danaharta will be able to redeem the remaining value of RM8.5 billion of its bonds that are expected to mature in every subsequent quarter until March 2005, without requiring any government guarantee. Table 4 shows the distribution

of the RM52 billion loan rights acquired by Danaharta at the end of 2003.

At the end of its term in August 2002, the CDRC completed the debt restructuring efforts undertaken since 1998. In the 4 years of its operation, the CDRC successfully resolved 48 cases involving a total debt of RM52.6 billion. Out of this total, 32 cases with total debts of RM36 billion had been fully restructured. As shown in Table 5, a total of 87 cases were referred to the CDRC of which 11 cases were transferred to Danaharta and 28 cases were rejected or withdrawn.

Ownership Structure of Banks Before and After the Crisis

Consolidation of the banking industry usually changes the merged banking groups' composition of ownership structure and the banking industry's market structure. In the post-crisis years, the Malaysian government's strategy to consolidate the banking industry resulted in the reduction of the number of domestic commercial banks from 20 in 1999 to 10 in 2001 when the bank merger programme was completed. While the consolidation programme resulted in larger and better capitalised domestic banking institutions, it does not seem to have any significant effect on the composition of ownership structure in the banking industry.

The government's sudden decision to initiate a bank merger programme in 1999 to consolidate the banking industry may have been prompted by the worsening situation in some of the banking institutions in early 1998. As some banking institutions' difficulties became apparent because of their substantial losses and high NPL ratios,



Table 6: Ownership Structure of the Domestic Banking Groups

Domestic Banking Groups	Ownership Control Structure
Affin Bank Bhd	Government connected ownership
Alliance Bank Malaysia Bhd	Corporate ownership and widely held
AmBank (M) Bhd – former Arab-Malaysian Bank Bhd	Family and corporate ownership
Bumiputra-Commerce Bank Bhd	Government connected ownership
EON Bank Bhd	Government connected ownership
Hong Leong Bank Bhd	Family and corporate ownership
Maybank Bhd	Government connected ownership
Public Bank Bhd	Family and corporate ownership
RHB Bank Bhd	Family and corporate ownership
Southern Bank Bhd	Corporate ownership and widely held

Sources: Annual reports of the respective banks in 2002/2003.

the central bank acknowledged that two banks and three finance companies were in need of recapitalisation. Two of the larger domestic banks, Sime Bank Bhd and Bank Bumiputra Malaysia Bhd, which had losses of about USD420 million and USD200 million respectively, were eventually taken over by RHB Bank Bhd and Bank of Commerce (M) Bhd.

In July 1999, the government initiated a robust bank merger programme to restructure all domestic banking institutions into six banking groups. It was apparent that this initial merger plan (with the government's choice of six lead anchor banks) was aggressive and fragmentary in its purpose. Criticisms resulted, that the plan was predominantly politically motivated rather than targeted at resuscitating the ailing banking industry from the crisis or to promoting efficiency in the banking system. Moreover, the merger plan did not seem to improve the the merging groups' asset quality, especially when some of the chosen lead anchor banks themselves were suspected to be burdened by their own NPL problems. In response to the criticisms, the government announced a new merger plan with ten lead anchor banks, each with minimum shareholder funds of RM2 billion and an asset base of at least RM25 billion. This new merger programme, which allowed all domestic banking groups to choose their own lead anchor bank, was finally completed in 2001.

Table 6 reflects the 10 lead anchor bank groupings' legal shareholdings and ownership control structure after the merger. The banking regulations on ownership

structure are quite effective given legal ownership is clearly seen in terms of share ownership in the banks. However, discerning the beneficial ownership structure is more difficult since nominee directors and nominee shareholdings are normal vehicles to masquerade the true ownership structure in the banking institutions. The almost status quo position in the ownership and control structure in the banking industry after the merger reflects very much the influence of the government's New Economic Policy (NEP) established 30 years ago in 1970. Over the years, banks were encouraged to restructure their ownership profile to reflect the requirements of the NEP that there should be 30% Bumiputra participation in commerce and industry.

The banking institutions involved in the merger programme are shown in Table 7. The bank merger programme has resulted in a banking landscape that involves financial conglomerates with increasingly complex group structures. While the basic ownership structure of the 10 domestic banking groups (in terms of government ownership, corporate ownership, family ownership and being widely held) has not changed significantly, the true beneficial ownerships within the financial conglomerates have grown more complex and pervasive. This has made the identification of true beneficial ownerships more difficult despite the disclosures of legal shareholdings ownership structures now given in the annual reports.

As a result of the NEP restructuring policy, the share of government ownership in a few of the larger domestic banking groups is substantial with major controlling rights.

Table 7: Bank Mergers of Domestic Banking Institutions

Lead Anchor Bank	Original Merging Commercial Banks	Other Merging Financial Institutions
Affin Bank Group	Perwira Affin Merchant Bank BSN Commercial Bank (Malaysia) Bhd	Asia Commercial Finance Bhd Perwira Affin Bank BSN Finance Bhd BSN Merchant Bankers Bhd
Alliance Bank Group	Multi-Purpose Bank Bhd International Bank Malaysia Sabah Bank Bhd	Sabah Finance Bhd Bolton Finance Bhd Amanah Merchant Bank Bhd Bumiputra Merchant Bankers Bhd
Arab-Malaysian Bank Group	Arab-Malaysian Bank Bhd Bank Utama (Malaysia) Bhd	Arab-Malaysian Finance Bhd Arab-Malaysian Merchant Bank MBf Finance Bhd Utama Merchant Bank Bhd
Bumiputra-Commerce Bank Group	Bank of Commerce (M) Bhd Bank Bumiputra Malaysia Bhd	Bumiputra Commerce Finance Bhd Commerce International Merchant Bankers Bhd
EON Bank Group	EON Bank Bhd Oriental Bank Bhd	EON Finance Bhd City Finance Bhd Perkasa Finance Bhd Malaysian International Merchant Bankers Bhd
Hong Leong Bank Group	Hong Leong Bank Bhd Wah Tat Bank Bhd	Hong Leong Finance Bhd Credit Corporation (Malaysia) Bhd
Malayan Banking Group	Maybank Bhd Pacific Bank Bhd PhileoAllied Bank	Mayban Finance Bhd Aseambankers Malaysia Bhd Sime Finance Bhd Kewangan Bersatu Bhd
Public Bank Group	Public Bank Bhd Hock Hua Bank Bhd	Public Finance Bhd Advance Finance Bhd Sime Merchant Bankers Bhd
RHB Bank Group		RHB Sakura Merchant Bankers Bhd Delta Finance Bhd Interfinance BhdRHB Bank Bhd
Southern Bank Group	Southern Bank Bhd Ban Hin Lee Bank Bhd	United Merchant Finance Bhd Perdana Finance Bhd Cempaka Finance Bhd Perdana Merchant Bankers Bhd

Source: Bank Negara Malaysia Annual Report 2001

For example, in 2003, Maybank's three substantial shareholders were Skim Amanah Saham Bumiputra (33.95%), Permodalan Nasional Berhad (13.81%) and the Employees Provident Fund Board (9.81%). As for Bumiputra-Commerce Bank, the Employees Provident Fund Board (26.61%), Khazanah Nasional Berhad (11.26%) and Kumpulan Wang Amanah Pencen (7.62%) were its three largest shareholders.

Table 8 shows government ownership structure in the domestic banking system in 2003. There are five main government agencies with large shareholdings in the domestic banking institutions. These five government agencies are Permodalan Nasional Berhad (PNB), The Employees Provident Fund Board (EPF), Khazanah

Nasional Berhad, Pertubuhan Keselamatan Sosial (PKS) and Kumpulan Wang Amanah Pencen (KWAP). PNB is the government's national capital corporation and Khazanah the Ministry of Finance's investment arm. EPF, PKS and KWAP are the government agencies 'social security and pension funds.

The columns in Table 8 show the percentage of each government agency's shareholdings in each of the domestic banking institutions. For example in 2003, PNB held about 50.9% of Maybank's total shareholdings; and this included its unit trusts' shareholdings which PNB used as its vehicle to control the banking institutions. These unit trusts include Skim Amanah Saham Bumiputra (SASB), Skim Amanah Saham Nasional (SASN), Amanah Saham Malaysia (ASM) and Amanah Saham Wawasan 2020 (ASW).

Historically, the EPF has been an important source of funds the government taps to promote its economic development objectives. Now it is also a major vehicle through which the government can have shareholding ownership control of domestic banking institutions. In 2003, EPF owned 26.6% of Bumiputra-Commerce Bank and 31.8% of RHB Bank total shareholdings respectively.

The rows of Table 8 show the total shareholdings of all government agencies in an individual domestic bank in 2003. For example, the row totals for Maybank and Bumiputra-Commerce Bank show that 64.6% of the Maybank shareholdings and 52.7% of the Bumiputra-Commerce Bank shareholdings respectively being owned by various government agencies or investment vehicles, with EPF and Khazanah being the largest government controlling shareholders.

There are two exceptions here. The Lembaga Tabung Angkatan Tentera (LTAT), which is the armed forces pension board, is the largest controlling shareholder of Affin Bank. LTAT held 39.5% of the Affin Bank shareholdings. The other exception is EON Bank. In 2003, Edaran Otomobil Nasional Berhad (EON), the government's national car corporation and also the bank's parent company, owned the majority shareholding of 50.1%.

Family ownership structure in the domestic banking system is more straightforward. Table 9 provides the direct shareholdings of the four main family groups: Tan Sri Azman Hashim (Amcorp Group), Tan Sri Quek Leng Chan (Hong Leong Group), Tan Sri Teh Hong Piow (Public Bank Group) and the family that owns the Utama Banking Group, now the largest controlling shareholder of the RHB Bank Group.

**Table 8: Government Ownership Structure in the Domestic Banking Institutions
Shareholdings by Government Agencies in 2003 (%)**

	PNB	EPF	Khazanah	PKS	KWAP	LTAT	EON	Row Total
Affin Bank Bhd	1.18	8.53		0.52		39.46		49.69
Alliance Bank Malaysia Bhd	0.39	0.88		0.41				1.68
AmBank (M) Bhd	0.91	10.78		1.22	0.37			13.28
Bumiputra-Commerce Bank Bhd	6.09	26.61	11.26		8.77			52.73
EON Bank Bhd		0.93		0.22			50.1	51.25
Hong Leong Bank Bhd		0.19						0.19
Maybank Bhd	50.93	9.81	1.35	0.62	1.89			64.60
Public Bank Bhd		4.91						4.91
RHB Bank Bhd	0.10	31.77		0.56	11.01			43.44
Southern Bank Bhd	0.60	2.67						3.27

Sources: Shareholding analysis of data in the banks' annual reports

**Table 9: Family Ownership Structure in the Domestic Banking Institutions
Shareholdings by Family Groups in 2003**

Financial Institution	Family Ownership Share (%)
AmBank (M) Bhd	35.2
Hong Leong Bank Bhd	60.9
Public Bank Bhd	32.6
RHB Bank Bhd	32.0

Sources: Shareholding analysis from data in the annual reports of the banks

Table 10: Bank Negara Malaysia Regulatory Guidelines

BNM/GP1	Guidelines on Directorship in the Banking Institutions
BNM/GP2	Guidelines on Submission of Annual Accounts
BNM/GP3	Guidelines on the Suspension of Interest on-Non Performing Loans and Provision for Bad and Doubtful Debts
BNM/GP4	Guidelines on Staff Training Fund
BNM/GP5	Guidelines on the Credit Limit to a Single Customer
BNM/GP6	Guidelines on Section 26A of Banking Act 1973: Prohibition of Loans to Directors, Staff and their Interested Corporations
BNM/GP7	Part 1: Code of Ethics Guidelines on the Code of Conduct for Directors, Officers and Employees in the Banking Industry
BNM/GP8	Guidelines on the Specimen Financial Statements for the Banking Industry
BNM/GP9	Guidelines on Money Laundering and “Know Your Customer Policy”
BNM/GP11	Guidelines on Consumer Protection on Electronic Fund Transfers
BNM/GP10	Guidelines on Minimum Audit Standards for Internal Auditors of Financial Institutions

Source: Bank Negara Malaysia Guidelines

The ownership structures shown in Tables 8 and 9 imply a high concentration of shareholding by ownership types. Interestingly enough, Section 46 of the BAFIA 1989 requires that all banks institutionalise their shareholding structure by restricting ownership in a bank to no more than 20% for each institution and no more than 10% for individuals. Although the restriction of ownership under Section 46 has been in place for a long time, it appears that BNM has not strictly enforced this regulation. This is because the regulation does not apply retrospectively to bank ownership structure already been in place before 1989.

Recent Policy Efforts to Enhance Corporate Governance of Banks

Banking crises have significant externalities for the economy, many, of which, are negative in nature and related to the effects of the direct and indirect costs of crisis resolution. Ironically, one of the beneficial externalities of the 1997 banking crisis was the acceleration of the government’s programme to institute measures to enhance corporate governance in the banking system.

In this section we consider a brief review of Bank Negara Malaysia’s policy efforts to enhance corporate governance in the banking industry. The main elements of corporate governance practices in the banking sector are usually instilled and embedded by way of statutory provisions which can be broadly classified into three categories:

- Statutory provisions that govern entry, ownership and appointment of key officers;

- Regulatory guidelines that govern the control of the composition of board of directors and the setting up of the audit, nomination, remuneration and risk management subcommittees; and
- Regulatory directives to set up internal control systems within the banking institutions.

Since the crisis period, BNM has revised and issued a number of regulatory guidelines; and in terms of classification of these BNM guidelines, there is now a set of 11 GPs (Garis Paduan is the Malay term for guidelines). Table 10 provides a list of these Central Bank regulatory guidelines.

In the post-crisis period, the central bank’s policy focus, in enhancing corporate governance in the banking system, has been mainly directed at the second and third categories. We consider the central bank’s two most important regulatory guidelines, GP1 (Guidelines on Directorship in the Banking Institutions) and GP8 (Guidelines on the Specimen Financial Statements for the Banking Industry), that will have far reaching policy implications on the banking industry.

GP1: Guidelines on Directorship in the Banking Institutions

GP1, which were issued in May 2003, involve the establishment of board committees, minimum qualifications and training requirements for directors, and the definition and responsibilities of independent directors. According to BNM, the intent of these guidelines is to enhance the board’s effectiveness through greater responsibility,





accountability and professionalism of board members and senior management in the banking institutions. The guidelines also set requirements on the establishment and responsibilities of three board committees: the nominating, remuneration and risk management committees.

We believe that GP1 provides the implied countervailing force to balance the concentration of power of the controlling owners and CEO/Executive chairperson in the domestic banking system. By way of structuring the various committees with the most competent individuals elected and appointed as independent directors to the board committees, GP1 encourages the formulation of transparent procedures in the conduct of governance policies. We like to believe that the issue of GP1 was also in response to one of the major concerns that the boards in the banking industry were ineffective and did not play their rightful roles during the pre-crisis period.

The nominating committee is required to formulate a formal and transparent procedure to ensure that the most competent individuals are appointed to the board and key management positions. There is also the application of a strict 'fit and proper' test and the prior consent of BNM for the appointment of the CEO and other directors. This test operates as an effective sieve for appointment of only acceptable and competent individuals to the boards.

The remuneration committee's responsibility is to oversee remuneration matters including developing transparent procedures and a competitive remuneration framework for directors and senior management officers, consistent with the banking institutions' corporate cultures, objectives and strategies. A perusal of the banks' annual reports provides the impression, that, in some banks the controlling owner could still exercise considerable influence on the committee's procedures by acting as its chairperson.

The GP1 Guidelines allow for the setting up of a risk management committee, whose task is to ensure that a risk management infrastructure is in place and functioning effectively as a means to monitor senior management activities in managing credit, liquidity and operational risks. In this respect, GP1 is really a reiteration and an extension of the legislative and regulatory norms in the area of risk management and setting up of internal control systems in the domestic banks. For example, the provisions

in the BAFIA that a director will be held to be in default of duties unless it can be demonstrated that they have responsibly instituted and monitored the functioning of an effective internal control system is a case in point.

The GP1 also defines the role of independent directors: the primary responsibility of each independent director is to protect the interests of minority shareholders and the general public. To complement these measures, the central bank also issued 'Guidelines on the Appointment of External Auditors' in August 2003 to reduce potential conflicts of interest emanating from the relationship with external auditors. The Guidelines relating to the appointment of external auditors have three salient features:

- Mandatory rotation of engagement partner of the external auditors: after relinquishing the assignment with banking institution, the engagement partner is not permitted to resume the role of audit engagement partner with the same institution until after a lapse of 5 years.
- The banking institution's audit committee is required to give prior approval to any provision of non-audit services by the same audit firm before the latter can provide such services to the banking institution.
- Re-appointment of external auditors on an annual basis requires approval by Bank Negara Malaysia. The re-appointment decision should not compromise the auditor's independence in the interim period before the 5-year rotation requirement takes effect.

GP8: Specimen Financial Statements for the Banking Industry

The GP8, first introduced in 1988, was primarily to ensure that financial institutions complied with the provisions of the Companies Act 1965 and required accounting standards. GP8 places the primary responsibility for the preparation of financial statements on the board, which is expected to develop a sound financial reporting structure to ensure the integrity and reliability of its accounts. GP8 recognises a self-regulatory stance and is also less prescriptive, thus enabling banking institution to have some flexibility in their disclosure policies and in reporting their financial performance and business operations according to the institution's specific circumstances

The GP8 is a very important set of regulatory guidelines pertaining to disclosure requirements. It requires financial institutions to disclose material and exceptional facts to facilitate users in their assessments of the financial institution's financial position and performance. We consider GP8 as the regulatory bridge for the central bank to encourage the development and enhancement of effective market discipline in the domestic banking system.

The recent revisions made in GP8 relate mainly to improvements in the Malaysian Accounting Standards Board's (MASB) accounting standards and the emphasis upon the concept of fair value based on the criteria used by the International Accounting Standard (IAS). In addition, GP8 focuses on the board of directors' role in the preparation of financial statements, assessment of the banking institution's operations in the previous and upcoming year; and also in corporate governance matters involving responsibility of the board, committees and risk management practices consistent with international best practices. The rationale for the revisions to GP8 was to take account of the recent developments in the Interest-Free Islamic Banking Scheme operations, the MASB's updating of accounting standards and the increasing requirements for greater public disclosure to foster market discipline.

Guidelines on Risk Exposures and Capital Adequacy

After the crisis period, BNM made revisions to the Guidelines on Financing the Broad Property Sector (BPS) and Share Financing. In 1997, prior to the onset of the financial crisis, BNM imposed caps on lending to the broad property sectors and on share financing. The caps were based on the respective institution's total loan outstanding and were put in place to ensure that these sectors' risk exposures were within manageable limits without posing any excessive risks to the banking system. The revised guidelines remove these limits and the banking institution's risk exposure to these sectors will now be based on the respective institution's risk assessment. The board of directors of banking institutions will be responsible to ensure that appropriate policies and procedures are in place to measure and manage the risk exposures in these sectors.

The revised guidelines also require banking institutions to increase their capital requirements to support their exposure

to these sectors, should the risk exposure exceed a predetermined threshold. This is in line with the Basel II's objective of capital adequacy and the need to attain greater risk sensitivity in measuring capital requirements. The revised guidelines' intent is to encourage prudent risk management and provide greater flexibility in managing risk exposures in these sectors. To a certain extent, these guidelines have addressed the problem of concentration risks by sector perpetuated during the crisis period.

Risk exposures now include the holding of shares, debt securities and off balance sheet items. By introducing GP5 Guidelines, BNM expanded the coverage of the rule on exposures to a single customer to also include exposures other than credit facilities. This expansion of GP5 would entail streamlining several existing regulations pertaining to exposures to large customers into a single comprehensive guideline for ease of compliance and reference. In addition under the BAFIA, financial institutions are prohibited from giving any credit facility or incur any liability on behalf of any single person which will exceed 25% of their capital funds, unimpaired by losses or otherwise.

In relation to the issue of capital adequacy under Basel II, the central bank issued a concept paper on the incorporation of market risk into the risk weighted capital ratio (RWCR) framework in January 2004 that considered the following issues:

- Classification of securities in the trading and banking book;
- Holding of securities resulting from debt/loan restructuring;
- Hedging policy of banking institutions; and
- Underwriting positions and valuation of illiquid papers by the banking institutions.

The intent of the concept paper is to gauge the banking institutions' level of readiness to incorporate the revised RWCR framework in their management of risk exposures. This will also pave the way for BNM in preparing banking institutions to consider adopting the standardised approach in credit risk management and eventually migrating to the internal rating based approach recommended by the Third Pillar of the new Basel Accord.

Supervision of Financial Conglomerates

In December 2003, BNM issued a concept





paper on the 'Consolidated Supervision of Financial Conglomerates' to address complex corporate group structures involving financial conglomerates. This attempt to address the issues arising from complex group structures is laudable. The framework proposed in this concept paper outlines the underlying regulatory principles of consolidation supervision and includes specific recommendations in five areas: financial conglomerate group structures, corporate governance, risk management, intra-group exposures and reporting requirements.

The concept paper recognises that a financial group organises itself according to management and market strategies but it requires that adequate safeguards be put in place to ensure that the group structure does not pose a systemic risk to the banking system. The concept paper, however, requires minimal transmission of financial distress, which may result in destabilisation of the banking system, from unregulated entities to regulated entities within the group. The government provisions of safety for depositors are not to be extended to non-depository institutions within the group.

The concept paper also recognises that the basic principles of good corporate governance are extended to the financial holding company (FHC). The FHC will be required to adhere to the group's capital adequacy requirements (CAR). The central bank will assess the financial institution's CAR on an individual and a consolidated basis (with its subsidiaries) as well, at the group and holding company level. On risk management, the FHC will be required to establish a group risk management committee to provide oversight of the overall management of the group's risk, review senior management's control and procedures and also to manage this risk and introduce remedial measures when necessary. To ensure that all potential sources of contagion risks (cross selling excluded) are identified and addressed promptly, clear written policies must be in place on intra group exposures. FHCs are required to submit periodic reports to the central bank to facilitate financial conglomerate assessment.

Financial Sector Masterplan

Finally, for an overall perspective of the central bank's efforts in enhancing corporate governance in the banking sector, it is important to consider the broad strategies for financial sector development as outlined in the Financial Sector Masterplan (FSMP)

launched in March 2001. The FSMP's end objective is to encourage the financial system to evolve into one that is competitive, resilient and dynamic. Since its inception, the FSMP's implementation has predominantly focused on strengthening the regulatory and supervisory framework to promote a safe and efficient payments system for domestic financial institutions to function effectively and competitively in the post crisis period.

The FSMP also sets the tone for market discipline to play its role in the banking system's corporate governance mechanism since it encourages developing the payments system through competitive marketplace forces. At the same time, a deposit insurance system will be introduced as an additional financial safety net to complement the central bank's role as lender of last resort. To ensure that the adverse effects of moral hazard, usually associated with deposit insurance, do not pose an impediment to the role of market discipline on banking institutions, a measured level of incentives is embodied in the deposit insurance system structure. These incentives include differential premium contributions from banking institutions that provide an appropriate level of protection coverage to the large majority of depositors. These incentives also give sufficient incentives for large and institutional depositors, with access to financial expertise, to monitor and instil effective market discipline on the banking institutions' risk taking behaviours.

ROLES OF SAFETY NETS AND PRUDENTIAL REGULATIONS

Bank Negara Malaysia has always considered the stability of the banking system as the most important policy objective in its conduct of monetary policy. The basis of this policy thinking is that the safety and stability of the payments system in general and the banking system in particular is a public good in Malaysia. It is the central bank's primary responsibility to ensure that the whole financial system, especially the banking system, is safe, strong and sound. The regulatory and supervisory process is a primary means of ensuring the banking system's safety and soundness.

Over the past 40 years, BNM has played a pivotal role in the systematic development of the financial infrastructure. As the financial regulatory structure evolved, an umbrella of financial safety nets and prudential regulations was put in place to ensure that the inherent safety and soundness of the banking institutions

would promote stability within the financial system. Operationally, this implies that any disruption in the banking system should not have a significant impact on the payments system as well as on aggregate real economic activities. An overriding requirement in developing a viable financial safety net and prudential regulations framework for enhancing effective market discipline is carefully balancing the need for effective regulatory oversight without, at the same time, increasing regulatory burden.

There are four pillars that support the financial safety net for the Malaysian financial system. The first pillar of support is based on prudential regulation and supervision by the central bank. The major sources of statutory regulations that form the fundamental regulatory framework of financial safety nets and prudential regulations for the banking sector are the Central Bank of Malaysia Act 1958, the Banking Ordinance 1958, the Essential (Protection of Depositors) Regulations 1986 and the Banking Act 1973 and the Banking and Financial Institutions Act 1989 (BAFIA). Three goals appear to emerge from the enactment of these banking regulations: to ensure the banking system's safety and soundness, to foster competitive efficiency within the banking system and to protect the consumers and depositors.

The second pillar of support is the central bank's lender of last resort facility to assist banks facing temporary liquidity problems. In the past, this line of support has been used to rescue banks and deposit-taking cooperatives that were facing serious liquidity problems. Priority payments to depositors in the event of bank insolvency represents the third pillar of support is the priority payments to depositors in the event of bank insolvency with the proposed deposit insurance system being the fourth pillar.

Depositor Protection Before and After the Crisis

Much of the prudential re-regulations aimed at protecting depositors in Malaysia were promulgated during the 1985-86 recessionary period when the central bank enhanced its powers to deal with the distressed deposit-taking institutions. This historical backdrop can provide some insight and understanding into the rationale of the government's concern and need for improving and tightening the financial safety net and prudential re-regulations during the period. These legislative instruments have provided the central bank the fundamental regulatory

framework with which to effectively resolve the problems of the recent 1997 banking crisis.

As early as 1966 the central bank stepped into Malayan Banking when its audited accounts gave rise to differences of opinion between the bank's directors about material advances that were not sufficiently backed by securities. The government is empowered to declare a bank, 'a protected bank' on grounds of public interest. When such a declaration is made, the shareholders' and the board of directors' powers cease. The government may also remove any director and acquire the shares of such a declared institution.

BNM, using the Essential (Protection of Depositors) Regulations (1986), took over the control and conduct of one commercial bank and four financial companies during the deposit-taking institutions debacle of the mid-1980s. The assets of 24 deposit-taking co-operatives, which had over 500,000 depositors, were frozen. This led to a contagion effect on the finance companies as certain of the co-operatives described themselves as finance companies.

In 1985 and 1986, three domestic commercial banks incurred losses of about \$1,267 million. Most of these losses emanated from inadequate internal controls, ineffective management and also fraudulent conduct. BNM's corrective actions included revamping the board of directors and senior management, setting up internal control mechanisms and injecting capital into these distressed banks.

The banking problems of the 1980s convinced BNM that there was a need to enhance its powers to deal with distressed deposit-taking institutions. During this period several legislative measures were introduced to prevent systemic failure and to maintain confidence in the banking and financial system in light of the problems the banking industry faced. One of the key legislative measures, introduced to protect depositors during this period, was the enhancement of the central bank's powers to deal with a banking crisis.

The central bank can use its power to implement measures to protect depositors during a crisis. With the concurrence of the Minister of Finance or by itself, BNM is empowered under the BAFIA to take remedial measures to ensure that the





distressed banking institutions' problems do not precipitate and amplify to unmanageable proportions. Some of these remedial actions to protect depositors and shore up confidence in the banking system include providing relief to alleviate against panic and bank runs, measures to rectify any mismanagement in the banking institutions and termination, if necessary, of the financial institution.

Although not explicitly stated, the Malaysian government's policy towards depositors' protection has always been demonstrated by its willingness to provide an implicit blanket guarantee to compensate depositors' losses when it has to bail out a troubled bank. For example, in the 1980s, depositors of the failed co-operative banks were compensated by the government's blanket guarantee. Similarly, when Bank Bumiputra Malaysia Bhd, the government-owned bank, was bailed out twice through funding from Petronas in 1984 and 1989, depositors' losses were protected by the government's implicit blanket guarantee. During the 1997 crisis when Bank Bumiputra Malaysia Bhd and Sime Bank Bhd failed, the government once again compensated their depositors by its implicit blanket guarantee.

Lender of Last Resort

In Malaysia, there have been situations when BNM has acted as the lender of last resort in a crisis. As a lender of last resort, the central bank makes a public commitment to a distressed institution so as to enable it to meet its depositors' demands for cash withdrawals. The BNM's public declaration that it would come to the aid of the distressed banking institution often suffices to allay the anxieties of the Malaysian public. Some of the ways in which BNM can perform this role as a lender of last resort are provided under Section 31A of the Central Bank Act 1958 and Section 78 of the BAFIA. BNM can grant loans to a locally-incorporated banking institution against the pledge of shares or it can take up the banking institutions' other collaterals.

BNM has used the lender of last resort facility several times in the last 30 years, when there were runs on some domestic banks such as the cooperative bank and Bank Bumiputra Malaysia Bhd and on Supreme Finance Bhd in the 1980s; and the run on Sime Bank Bhd during the crisis period. The central bank's experiences in these past situations demonstrated that the use of its lender of last resort facility could provide a stabilising function in a banking crisis. For example, in 1986, it was used to stabilise Supreme

Finance Bhd when there was a run triggered by the arrest of a businessman-cum-politician associated with the institution. However, the government seemed to have modified its strategy of providing the lender of last facility to banks that have been in trouble a number of times. In 1998, when Bank Bumiputra Malaysia Bhd was in trouble again, the government did not provide the usual financial support as in the past; it decided, instead, to merge the bank with the Bank of Commerce (M) Bhd.

The Proposed Deposit Insurance System in Malaysia

The government has, in the past, always provided the banking system with some form of implicit deposit guarantee. In 2003, BNM announced that substantial progress had been made towards finalising the features of a proposed deposit insurance system that would pave the way for its establishment. According to BNM, the proposed deposit insurance system would be an integral part of the financial safety net to enhance public confidence in the financial system by providing explicit protection on deposits. The key objective of the deposit insurance system is to provide a reasonable level of protection to commercial bank, Islamic bank and finance company depositors.

Institutional Structure

The deposit insurance system will be administered by a new statutory body or provided with a legislative mandate to carry out its functions and responsibilities. The agency's main function is to both administer the deposit insurance system and provide depositors protection from the loss of their deposits up to the insured limit in the event of a bank failure. The agency is also responsible to strengthen incentives for sound risk management in the banking industry and to promote and contribute to the financial system's stability.

In addition, the agency will have a role to undertake banking institution resolution under certain circumstances as may be required, based on the central bank's assessment. In this role, the agency will facilitate minimising the cost of bank resolutions to the financial system.

Membership and Coverage

Membership will be compulsory for commercial banks (including subsidiaries of foreign banks operating in Malaysia), finance companies and Islamic banks. According to the central bank, the extension of coverage of the deposit insurance system to all the

banking institutions that accept deposits will ensure that adverse selection in risk taking among smaller or perceived weaker banks will be avoided.

In November 2004, the central bank issued a concept paper to the banking industry; in the paper it sets out the system's scope of coverage. According to the central bank, deposit insurance protection will be provided up to a prescribed limit for all eligible depositors of member institutions. Deposits not payable in Malaysia, foreign currency deposits, negotiable instruments of deposits or other bearer deposits, repurchase agreements and money market placements would not be insured. However, there will be provisions made for the agency to approve new types of deposit products for deposit insurance in order to accommodate future developments in the banking industry.

There will be an adequate basic level of protection provided for every depositor in each member institution. Different deposit accounts (including joint and trust deposit accounts) in different institutions will be insured separately in order to provide additional coverage within the system for deposits involving such accounts. According to the central bank, the deposit insurance limit will be set at a level that will be sufficient to protect the vast majority of depositors, while retaining sufficient incentives for market discipline to prevail for larger and institutional depositors to monitor banking institutions.

Deposits in Islamic banks will be insured separately up to the deposit insurance limit. Deposit insurance for the Islamic banks is equivalent to that for conventional deposits in other banking and deposit-taking institutions to avoid any competitive price distortions between the two banking systems.

Premium Assessment

In early 2005, BNM and the banking industry were still in the process of considering an appropriate amount for premium assessment. In principle, the annual premiums paid to the deposit insurance fund will be based on the institution's total insured deposits. The fund will be used to reimburse depositors' losses in the event that the member institution is unable to meet its obligations or to provide financial assistance for the implementation of resolution schemes. Any losses arising from the resolution of the distressed institution

can be covered by additional premiums imposed on the member institutions. In this way, the redistribution of the resolution costs to the banking system can promote peer discipline within the banking system.

According to the banking industry, it is envisaged that a flat rate will be imposed for the first two years of the system's implementation; after that a risk adjusted differential premium will be applied. Under the differential premium system, any member institutions whose activities increase the risk of losses to the deposit insurance system will pay a high premium rate. The purpose of the risk-adjusted differential rates is to serve as an effective incentive for high risk banking institutions to improve on their risk profiles and therefore reduce their premium contribution cost.

Following a consultation process with the banking industry, the central bank envisages that the final outcome will be the establishment of the deposit insurance system that will be administered by a separate statutory body established under an Act of Parliament.

The BAFIA and Strength of Prudential Regulations

The BAFIA, which came into force on 1 October 1989, was a clear and robust regulatory response to the crisis of the mid-1980s. According to BNM, the BAFIA represents one of the main avenues that the central bank can use to introduce prudential reforms and regulations, including measures to liberalise commercial banks from structural restraints, to promote competition and enhance efficiency in the industry without compromising prudential standards.

In general, the strength of prudential regulations is in their impact on the following three areas of banking institutions: on entry and exit, on management and organisational structures and on ownership and control. By their nature, prudential regulations have inherent preventive elements that are their implicit strength.

Under the BAFIA, the central bank has the authority to decide on a host of prudential objectives of entry control. BNM has imposed the following entry controls:

- Written approval to be secured before any arrangements to acquire and dispose of a 5% holding in a licensed institution.





- Maximum permissible holdings of 10% for individuals and 20% for institutions: Consent and permission are required for such holdings and are based on the Minister being satisfied that they are in the public's interest and will promote a sound financial structure.
- Control through licensing with powers to revoke and /or circumscribe the scope of licensee business.

BNM has also instituted prudential regulations that have an impact on management including the appointment of senior management and directors of banking institutions. The central bank requires that only 'fit and proper' persons be directors, controllers or managers of the institution. This quality is related to probity competency, soundness of judgement and fulfilment of responsibilities of the position held; this regulation also ensures that the depositors' interests are not in any way threatened by those holding these important positions in banking institutions.

Further to the above, are prudential regulations that affect organisational structures which require institutions to maintain net assets and other financial resources to be able to conduct the business of banking in a prudent manner. These net assets should provide for the nature and scale of the institution's operations. They must be sufficient to safeguard the interests of depositors and potential depositors and prudently handle the risks inherent in the operations of the institution's other related corporations, so far as they are capable of affecting the institution.

The BAFIA's implicit strength is also in its provision of several preventive elements in the prudential regulations for banking institutions. These preventive elements pertain to the maintenance of reserve funds, capital funds, liquid assets and assets in Malaysia. The BAFIA requires that every licensed institution shall maintain a reserve fund that is both sufficient for the purpose of its business and also adequate in relation to its liabilities. These licensed institutions must also maintain, at all times, capital funds in all its offices in and outside Malaysia. In addition, these institutions must hold a minimum average amount of liquid assets in Malaysia at all times or over such period of time as may be set out in the specification. The central bank may prohibit any licensed institution from giving credit facilities to any person in the period during which the institution failed to comply

with any requirements under the BAFIA provisions.

Overall Evaluation: Balance between the Government's Safeguard Role and Market Discipline

Bank Negara Malaysia is considered as one of the best financial regulators in the ASEAN emerging market economies, renowned for its strict interpretation and transparency of its regulatory guidelines. In the course of the past 20 years since the banking problems of the 1980s, BNM's effort in constructing a comprehensive regulatory framework of a financial safety net and prudential regulations is laudable. The financial safety net and the prudential regulations now in place have served as a cornerstone for public confidence in the banking system's soundness.

In retrospect, it now appears that the prudential regulations introduced to solve the banking problems of the 1980s were largely aimed at need, on grounds of public interest, to correct inadequate internal controls, ineffective management and fraudulent conduct in the banking industry. Given the needs of the time, these strictly enforced compliance measures were necessary. Since Malaysia had adopted the Basle Capital Accord of 1988, long before the 1997 financial crisis, the lack of emphasis on corporate governance reforms in the banking system seems strange, particularly after the series of banking debacles in the mid-1980s. Discomforting as it maybe, regulatory reforms pertaining to corporate governance issues in the banking industry usually follow only in the wake of a banking crisis.

One of the recurring concerns about the Malaysian domestic banking system since the 1980s was government regulatory forbearance. Such concerns have led to public perception that moral hazard is a given in government-connected banks despite the arsenal of prudential regulations available to BNM to enforce strict compliance of its rules and regulatory guidelines by the domestic banking system. The constraint that BNM faces in the implementing its regulatory guidelines may be political in nature. BNM, like all government agencies, was required to implement the New Economic Policy's (NEP) restructuring objectives, then, and that of the New Development Policy (NDP) now. Whilst the NEP and NDP objectives have equity redistributive effects, these policy intents are sometimes easily subject to abuse by a few who benefit at the expense

of the common good. This concern is at the heart of the governance issue in the domestic banking system, especially when public attention is focused on the government connected banks, most of which are, in fact, very well managed and performance-driven.

As we have seen, the prudential re-regulations aimed at solving the banking problems of the 1980s were, in a major part, prescriptive in nature. When rule based regulatory guidelines are too prescriptive, it is possible that these guidelines could actually undermine the natural development of good corporate governance in the banking system, especially when there is enforced compliance to regulatory guidelines rather than pragmatically allowing for discretions and exceptions. It is not clear if the banking sector's failure in the 1997 financial crisis was a consequence of such over regulatory compliance that hindered the natural development of a good corporate governance culture within the banking industry.

Since the 1997 financial crisis, BNM has been more flexible and less prescriptive in its approach to re-regulating the banking industry. It is practising genuine visionary and progressive thinking in pursuit of a balance between regulatory compliance and developing and enhancing effective market discipline in the banking system. We are optimistic that this represents real change. In the final analysis, it should seem obvious even to the normally astute central bank that the prevalence of common sense and good judgement, rather than strict prescription will be the way for prudential re-regulation and to inculcate a good corporate governance culture in the domestic banking system.

INTERNAL CORPORATE GOVERNANCE MECHANISMS

The post-crisis period saw rapid enhancement of regulatory norms which resulted in structural changes in internal corporate governance in the domestic banking system. In particular, all board members are now cognizant of the elements considered significant in engendering a more effective board. The board of directors' overall role has become more complex. The board's responsibilities include such diverse functions as setting long-term strategies, establishing and monitoring internal control systems and ensuring that all decisions are made in a most responsible and transparent manner.

In this section, we report on the results of survey questionnaires designed by the Asian

Development Bank Institute (ADBI) to discern the unique features of board characteristics and board effectiveness through eliciting board members' subjective opinions. We conducted this survey by requesting a sample of the 10 domestic banks' executive and non-executive independent board directors to complete the survey forms in the period July to December 2004. It was encouraging to find that, on average, over 80% of the survey respondents believe that the boards in the domestic banking system are effective. This reads very well for the developing sound corporate governance practices in Malaysia, given the widely articulated concerns that the boards were ineffective and did not play their rightful roles before the crisis period.

Unique Features of Corporate Governance for Banks

Domestic banking institutions have particular importance in Malaysia's financial system and economy if for no other reason than their dominant role in the payments system. Banks are different from other commercial enterprises due to the unique role they must play to ensure stability in the financial and payments system. Since banking system stability is a public good, domestic private banking institutions have a public purpose. As such, domestic banking institutions are subject to BNM's policies and regulatory and also to its supervisory review of their own corporate governance policies and practices.

An important element inherent in banking business is that there are more stakeholders in the bank governance than in that of other commercial enterprises due to the banking institutions' unique function in supplying liquidity and their concomitant role to promote financial stability in the economy. Accordingly, a loss of public confidence in the banking system's safety and soundness caused by bank malfeasance or the appearance of it, has the adverse consequence of creating a severe dysfunction in the economy's monetary and real sectors that can impact a vast majority of the Malaysian society.

The focus of corporate governance for banks is also different because of the banking system's financial intermediary role. The domestic banking institutions' liability funding sources are typically in the form of deposits from both the sophisticated and unsophisticated depositors of the non-financial corporate sectors and the general population. It is important that the banking institutions' smooth financial intermediation



functions in the economy be uninterrupted and that small depositors, who are usually uninformed of banks' risk profiles and behaviours, be protected.

Malaysia's domestic banking system is also different because of its role as a financial intermediary to support and facilitate implementing the government's NEP restructuring objectives. The government has often used the domestic banking institutions as a main intermediary and channel, to supply funds and loans to various government directed economic sectors.

For all these reasons, the practice of good corporate governance in Malaysia's domestic banking system is an important public policy issue. Also, the domestic banking institutions are subject to the central bank's regulatory oversight. The domestic banking institutions' board of directors are responsible not only to the banking institutions' shareholders, but are also responsible to the depositors for the safety of their deposits. As such, the board of directors is held to the highest fiduciary standards especially when domestic banking institutions often have a direct and yet pervasive influence in almost all sectors of the economy.

The Questionnaire Surveys

An important contribution of this study is the presentation of the results derived from four sets of questionnaire surveys pertaining to corporate governance in the domestic banking system in Malaysia. The survey questionnaires cover all 10 domestic banking institutions in Malaysia in the time frame 2000-2003. The following surveys were conducted:

- Survey of Board of Directors and Basic Corporate Information
- Opinion Survey of Board Members
- Survey of Executive Compensation
- Survey of Risk Management Practices

In both the Opinion Survey of Board Members and the Survey of Risk Management Practices, the respondents completed questionnaire survey forms distributed to them. Besides conducting these questionnaire surveys, we extracted much of the required information for the Survey of Basic Corporate Information and the Survey of Executive Compensation from the domestic banking institutions' annual reports.

Survey of Board of Directors: Board Characteristics

In this section, we will present the main results of the questionnaire surveys. These are the most unique sets of surveys on corporate governance conducted for the domestic banking sector in Malaysia and therefore the results should be of interest to the local banking community. Our analysis will consider some of the salient characteristics of the board of directors in the Malaysian domestic banking institutions and focus on the board members' behavioural and perceived observations of their responsibilities and role in enhancing board effectiveness.

Table 11 provides a summary of the descriptive statistics of the ten domestic banking institutions' board characteristics. A few interesting features about board characteristics stand out in this table. The domestic banks' mean board size is nine members with about half of them being independent directors. Board members are generally very highly qualified, with one bank having nine directors who have either a professional law or accountancy designation. The mean number of directors with university degrees is five, which is half of the average board size. The number of women directors on the board is still small: only one bank has a maximum of two women directors.

In general, there are more independent directors in the various committees performing governance functions and responsibilities. The audit and risk management committees' mean size is four with a mean of three independent directors. In all the banks, the chairpersons of the audit and risk management committees are independent directors.

The mean number of members in the nomination committee is five, with a mean of three independent directors. In two of the banks, the nomination committee chairperson is not an independent director. This applies also to the compensation committee in three of the banks where the committee's chairperson is not an independent director.

Survey Results: Opinion Survey of Board Members

The basic format of the opinion survey is to ask the board member whether he/she agrees to a statement given in the questionnaires. Agreement with a statement

Table 11: Descriptive Statistics of Board Characteristics in 2003

Board Characteristics	Mean	Max	Min
Board size	9	11	7
Number of independent directors	4	6	3
Number of non independent directors	5	8	3
Number of directors formerly from government agencies	3	4	1
Number of directors who were politicians	*	1	0
Number of directors from financial institutions	2	4	0
Number of directors formerly from law/accountancy firms	1	3	0
Number of directors with professional law/accountancy designations	3	9	1
Number of directors with university degrees	5	7	2
Number of women directors	1	2	0
Audit Committees			
Total number of members	4	6	3
Number of independent directors	3	6	2
Chairman is an independent director	*	Yes = 10	No = 0
Nomination Committees			
Total number of members	5	6	3
Number of independent directors	3	4	1
Chairman is an independent director	*	Yes = 8	No = 2
Compensation Committees			
Total number of members	3	4	1
Number of independent directors	3	6	2
Chairman is an independent director	*	Yes = 7	No = 3
Risk Management Committees			
Total number of members	4	6	3
Number of independent directors	3	6	1
Chairman is an independent director	*	Yes = 10	No = 0

Note: The asterisk (*) in the table implies 'not relevant for the mean'.

Source: Survey of Board of Directors and Basic Corporate Information

is expressed as Y+ = strongly agree, Y = Agree, O = No opinion, N = Disagree and N+ = Strongly disagree.

The survey questionnaire eliciting the board members' opinions provided, for the first time, the behaviour they observed and their perception of the board's role and effectiveness, including important issues ranging from board members' independence to separation of the CEO's and the

chairperson's positions. Specifically, the structure of the survey questionnaires attempts to elicit the board members' opinions and views on the following:

- Responsibilities of the board,
- Role of board of directors,
- Effectiveness of the board,
- Independence of board members,



Table 12: Opinion Survey of Board Members: Accountability, Selection of CEOs and Independent Directors (in percentage)

	Responses (%)
Responsibilities of the board - most accountable to:	
Controlling shareholders	57.1
Minority shareholders	14.3
Financial supervisory agencies or taxpayers	28.6
Strongest voice in selection/dismissal of CEO:	
Board nomination committee	57.1
Controlling owner (non-CEO)	28.6
Government (financial supervisory agency)	14.3
Strongest voice in selection/dismissal of independent directors:	
Board nomination committee	42.8
Controlling owner (non-CEO)	28.6
Government (financial supervisory agency)	28.6

Source: Opinion Survey of Board Members

Table 13: Opinion Survey of Board Members' Agreement and Disagreement Responses (in percentage)

	Y+	Y	O	N	N+
Importance of role of bank directors	34.3	28.6	5.7	22.9	8.6
Importance of role of the board	19	19	4.8	9.5	47.6
Effectiveness of the board	48.6	32.9	15.7	2.9	-
Board independence	28.6	42.9	28.6	-	-
Agreement that independent directors are not truly independent	-	24.3	18.9	27.0	29.7
Importance of directors compensation	26.5	32.7	20.4	18.4	2.0
Whether board members can enhance board effectiveness	45.7	38.6	10.0	4.3	1.4

Source: Opinion Survey of Board Members

- Selection of the CEO and independent directors,
- Access to information by independent directors,
- Compensation of directors and their liabilities,
- Enhancing the effectiveness of the board, and
- The most important entities in improving corporate governance in banks.

The following three tables, Tables 12, 13 and 14, provide a summary of all the results in terms of percentages to the respondents' total aggregate views. An analysis of each of the tables follows.

Responsibilities of the Board

In Table 12, we find that 57.1% of the board members surveyed feel that the board is most accountable to the controlling shareholders, with a surprising 28.6% who feel that their responsibilities are more toward the financial supervisory agencies or taxpayers than to the minority shareholders (14.3%).

Strongest Voice in the Selection/Dismissal of CEO and Independent Directors

The board nomination committee is considered to have the strongest voice (57.1%) in selecting and dismissing both the CEO and independent directors. About 28.6% of those surveyed think that the controlling owner holds the trump card is held by the controlling owner while 14.3% believe that the financial supervisory agency plays an important role in this decision making process. With respect to selecting and dismissing independent directors, almost half of the respondents (42.8%) think it is the nomination committee which has the strongest voice. About 28.6% believe that the controlling owner makes this selection and dismissal decision; while another 28.6% believe the financial supervisory agency makes this decision.

Role of Bank Directors

In Table 13, the results show that 62.9% of those surveyed agreed they have an important role in the board. That role could be representing or maximising the benefits of all shareholders and stakeholders, including affecting employees' job security. Bank directors also believed that one of their important roles is to ensure the bank is safe and sound, even at the sacrifice of shareholder interests. However, about 31.5% of the respondents do not share the same view, while a tiny 5.7% do not have an opinion about whether employee job security is more important than paying shareholder dividends.

Role of the Board

Board members' had quite mixed views regarding the board's role. About 38% are more positive about its role and believed the boardroom is a forum for serious discussion of all the bank's significant matters. However, a fairly sizable 57.1% disagree that there is any effective involvement on the part of the board in this area. This suggests that, though a substantial group of banks take steps to ensure the board is involved with decision-making, there are those who consider such decisions to be *fiat accompli* (i.e. to rubber stamp decisions made outside the board) to strategies formulated by the controlling owners with management independently of the board. This group thinks that the board's role is merely perfunctory. It is quite disturbing to see that 4.8% of the directors do not have an opinion about the board's role.

Effectiveness of the Board

A majority (81.5%) of the respondents in the survey agree that the board is effective in the conduct of corporate governance in domestic banking institutions. This is an encouraging sign for corporate governance policy and practice in Malaysia. Almost all directors believe that the board is effective in conducting the following tasks: actively involved in formulating long term strategies, establishing and monitoring the bank's risk management and internal control systems and discerning poor operating performance of the bank's business operations. This strong agreement is reflective that in the area of risk management, the setting up of internal control systems appears to have been very successful.

The board is also considered effective in overseeing potential conflicts of interest including related party transactions and self dealings and in ensuring the integrity of the bank's financial reporting; this is especially the case in the conduct of corporate governance in a transparent manner with adequate public disclosure of relevant information to the investing public.

Most members also believe that the board plays an important role in selecting, monitoring and replacing the CEO and in reviewing both executive and non-executive director compensation. It is interesting to note that a few respondents disagreed that they play an effective role in this area: this group could have come from banks whose dominant controlling shareholders' decision to select or replace a CEO would hold sway over that of the independent views or process. In addition the application of a strict 'fit and proper' test and also requiring the central bank's prior consent on appointment of the CEO operate as effective sieves for appointment of only acceptable professionals to the position.

Board Independence

About 71.5% of those surveyed agree that independent directors are truly independent of the CEO or the controlling shareholders while 28.6% of the respondents do not want to provide an opinion on this question.

The survey results on board independence are very mixed when factoring in the elements that the CEO has a role in selecting board members and making decisions about the extension or termination of their term on



the board. While 56.7% of the respondents think there is sufficient board independence, there is a relatively large 24.3% who believe that independent directors are not truly independent. Their views may include such concerns as personal relationships with other directors, fear of blame when their views turn out to be wrong and the perception that the CEO and the management team may be better informed than them. More disturbing is the observation that 18.9% of the survey respondents do not even express an opinion on this important issue of board independence. As board member independence is an important issue, domestic banking institutions may need to look into why there is such a concern among board members if there is disagreement on this issue.

Access to Information by Independent Directors

Almost all independent directors believe that they have access to adequate information to perform their function. Of the respondents, about half (53.6%) believe that they can access information often enough from managers and employees in the bank and they have adequate information in time to be digested before every board meeting. However, 39.3% of those surveyed say that only sometimes did they have a prior briefing of the board meeting agendas. Most board directors agree that they are permitted to obtain the services of outside legal, financial and other professional advisors at the bank's expense.

Compensation of Directors and Directors' Liabilities

Over 78% of those surveyed believed that the board's effectiveness can be enhanced

if director compensation is linked to the bank's performance. In fact, in all the banks, director compensation varies with individual efforts; and there is a formal mechanism for evaluating the performance of individual outside directors. However, Malaysian domestic banks have still not accepted the idea that the CEO and outside directors should be offered stock-based compensation to enhance their performance.

Slightly over half of those surveyed have serious concerns about a potential director's liability or of being sued. Overall, about 66.7% of the respondents believe that the fear of personal liability often or sometimes could discourage qualified person from serving as bank directors or to act in the bank's best interests. About 33.4% believe that this is rarely or never their concern.

Enhancing the Effectiveness of the Board

Regarding ways to enhance board effectiveness, our survey respondents' views are certainly more optimistic. Over 84% of those who responded to our survey believe that they can see many ways to enhance board effectiveness. A resounding 45.7% of those surveyed strongly agree and 38.6% agree on this point. This is very encouraging as it implies that Malaysian directors of domestic banking institutions do care about their boards' effectiveness.

All respondents agree that there are some common ingredients that can enhance board effectiveness. These include selecting qualified independent directors, promoting constructive criticisms and alternative views in boardroom discussions, and providing timely and adequate information to directors prior to board meetings. All respondents

Table 14: Mean Values of the Executive Compensations (RM'000): 10 Domestic Banks, 2001-2003

	2001	2002	2003
CEO Total Compensation	1,000	921	1,431
Executive Directors	1,667	1,677	2,263
Fixed Pay	1,068	1,075	1,320
Annual Bonus	406	439	533
Other Compensation	203	153	410
Non Executive Directors	513	967	1,084
Fixed Pay	264	374	437
Other Compensation	249	592	647

Source: Survey of Executive Compensation

believe that the chairperson's and CEO's roles should be separated. This view is now accepted as desirable for all boards of the domestic banking institutions in Malaysia.

Ten percent of the respondents abstain from giving an opinion when considering the contentious issues of formal annual evaluation of directors and the CEO or of linking directors' compensations more to performance and of having fewer or no members from among the controlling shareholders. About 5.7% disagree that there should be fewer or no members from among the controlling shareholders. Such dissenting views are obviously that of various interest groups in the boards of the domestic banking institutions.

Most Important Entity in Improving Corporate Governance in Banks

This is the second last question in this set of survey questionnaires; and the response is perhaps most telling about who is perceived to be most important in improving corporate governance in the banks. Slightly over half (57.1%) of the respondents consider the independent directors their choice of gatekeepers and 28.6% believe that the large shareholders are better in improving the country's banks' corporate governance. Only 14.3% think that the financial supervisory agency is a better choice, which could imply that the regulators may not be doing a good job in practice in this field.

Survey Results: Executive Compensation of the Board

This section summarises the survey results on executive compensation of board members. Table 14 presents the mean values of the 10 domestic banks' executive compensations in the period 2001-2003. In almost all the domestic banks, the data for the CEO's compensation is given as a lump sum figure without any breakdown. In cases where there was some breakdown of figures, it was noticed that the 1997 financial crisis has taken its toll on the CEO's total compensation in a few domestic banks: some CEOs lost their bonuses as a result of their banks' weak performance. Fixed pay made up the largest component of the executive directors' total compensation. The annual bonus and other compensations constitute about half the executive directors' fixed pay. In contrast, fixed pay made up about half of the non-executive directors' total compensation. In all domestic banks, directors are not offered stock-based compensation to enhance their performance.

Survey Results: Risk Management Practices in Banks

This section summarises the key results of the survey of risk management practices. Although, only 50% of the domestic banks responded to this survey, those who responded assured us that the results reflected the banking industry's procedural norms. Overall, the results of the survey reveal that risk management practices in Malaysian domestic banks have complied with international standards and requirements. In the domestic banking institutions, top management is usually responsible for the organisation's overall risk management; suggesting that there is sufficient management interest and accountability in ensuring that their banks comply with the high standards required for risk management in the banking industry.

In the area of credit management, the survey results suggest that all banks have written policies on their target markets, exception processing or reporting, approval authorities and the price and non-price items the bank is involved with. With one exception, all banks have written policies on the structure of limits and their portfolio mix. Of those surveyed, all banks regularly monitor the borrower's financial condition, collateral coverage and contractual payment delinquencies. All banks also monitor borrowers' compliance with existing covenants and potential problem credits that could arise.

With regards to market risk management, the survey results indicate that, except for hedging strategies and position-taking opportunities (where only one bank did not comply), all banks follow clearly defined and identified policies and procedures for limiting and controlling market risks. For example, all banks have very clearly defined lines of responsibility and accountability over market risk management decisions. All banks have well defined procedures for acquiring instruments, managing portfolios and for controlling aggregate market risk exposure.

In the area of operational risk management, all the banks, with the exception of one, have been using the standard tools to identify and assess their operational risks. Most banks use self or risk assessment techniques and all use risk mapping, key risk indicators and scorecards tools to identify and assess their operational risk exposure. All these banks also identify and make use of thresholds or limits to measure the degree of their risk exposure.



All banks have maintained very strict policies and procedures to manage their operational risks. All have checks on compliance with management controls and policies and procedures concerning review, treatment and resolution of non-compliance issues. In all the banks surveyed, there is a system of documented approvals and authorisations for monitoring adherence to assigned risk limits and for maintaining safeguards for access and use of bank assets and records. In addition, all of them indicated they have policies in place governing the segregation of duties to address potential conflicts of interest, procedures for disaster recovery and a business continuity plan.

The banks were asked whether they had completed or expect to complete their preparations for measuring credit, market and operational risk according to the New Basel Accord before the starting date of its implementation in early 2007. Two banks confirmed that they are ready now while three banks will be ready between 2005 and 2006. In addition, the respondents appear to be enthusiastic adherents of the more risk sensitive approaches: three banks say that they would likely adopt the standardised approach to manage their market and credit risks. Two banks would likely use the internal rating based (foundation) method to manage their market risks while two banks will manage their credit risks with the internal rating based (advanced) approach.

In terms of operational risk management, there appears to be a wide diversity in the approaches to be adopted. Of those surveyed, one bank plans to continue to use the basic indicator while two banks are likely to adopt the standardised approach to manage their operational risks. One bank was likely to adopt the advanced measurement to manage its operational risks while another had not as yet to decide on the approach it would adopt.

Summary Analysis: Effectiveness of Internal Corporate Governance Mechanisms

The survey results have provided very encouraging evidence that there have been improvements in the practice of corporate governance and risk management processes in the domestic banking system in Malaysia since the crisis period. Most board members agree that the board is effective and that they have an important role in enhancing the board's effectiveness in conducting corporate governance policy and practice. Specifically, almost all directors believe the board is an effective means in establishing

and monitoring the risk management and internal control systems of the bank's business operations. This is reflective of the success of the central bank's regulatory guidelines in the post crisis period. This trend augurs well for the conduct and practice of corporate governance in the domestic banking system.

Most board members now believe that there is greater public disclosure of banking activities and that the board is effective in ensuring the integrity of the bank's financial reporting of relevant information to the investing public. This is important in the light of the central bank's efforts to encourage greater and better disclosure of banks' activities (which is at the heart of the governance issue in the domestic banking industry) and the efforts to facilitate the role of market discipline in monitoring banks' risk choices. However, a small percentage of board members still think there is room for improvement in the bank's financial reporting procedures.

The issue of conflict of interests is always a major concern in bank governance. Most board members view the board as effective in overseeing potential conflicts of interest including related party transactions and self-dealings. The BNM/GP7 Guidelines on the Code of Conduct for Directors, Officers and Employees in the Banking Industry may have been instrumental in effecting such awareness among board members about their responsibilities in this important area of governance.

As the main boards delegate functions to board committees in the spirit of the GP1 Guidelines, there are also more independent directors in the various committees performing governance functions and responsibilities. In all the banks, the chairpersons of the audit and the risk management committees are independent directors. An area of concern is that the chairpersons of the nomination and the compensation committees in some banks are not independent directors. When the controlling owner still exercises his/her power in nominating independent directors or in determining their compensations, there is bound to be concern about whether independent directors are truly independent.

Most board members agree there are some common ingredients that may be used to enhance board effectiveness. For example, selecting better qualified and truly independent directors, better disclosure of

board activities and promoting constructive criticism and alternative views in boardroom discussions are important ingredients to improve boardroom culture that can enhance board effectiveness.

The results of the survey of executive compensation pointed to one salient feature of the compensation of executive directors. In contrast to the annual bonus, fixed pay is the largest component of the executive directors' total compensation. However, fixed pay made up only about half the non-executive directors' total compensation. In all domestic banks, directors are not offered stock-based compensation to enhance their performance.

The overall results of the risk management practices survey have been very positive for the domestic banks. In all three key areas of risk management: credit, market and operational risk management, the survey results revealed that all the banks surveyed have complied with all the written policies and rules of risk management. The overall results suggest that risk management practices in Malaysian domestic banks have complied with international standards and requirements. And most of the banks surveyed are also ready for the New Basel Accord.

The key results of the opinion survey of the board of directors and the survey of risk management imply that the practice of good corporate governance has become a norm in the domestic banking institutions in Malaysia. However, there is still the concern that this norm has to be practised at every level of the banking system, especially in the post merger banking landscape where the ownership structures and management of the financial conglomerates have become more complex and opaque.

ROLES OF MARKETS IN DISCIPLINING BANKS

Overview of Competition in the Banking Industry

According to BNM, the banking industry in Malaysia operates in an open competitive environment despite the recent consolidation of domestic banking institutions. Both the domestic and foreign owned banking institutions are governed by the same set of banking regulations and legislation, though foreign banks have an additional restriction on the opening of branch offices. Some foreign-owned banks such as OCBC Bank (Malaysia) Bhd, HSBC Bank Malaysia

Table 15: Market Shares of Top Three Banks, 1998-2003

	1998	2003
% of Total Assets	58.9	59.0
% of Total Loans	60.1	60.9
% of Total Deposits	62.8	59.0
Herfindal Index	1047	1177

Conceptually, the Herfindal index equals 10,000 for a monopoly market and takes on a lower value when the market becomes more competitive with entry of new banks.

Sources: Annual reports of respective banks

Bhd, Standard Chartered Bank Malaysia Bhd and United Overseas Bank (Malaysia) Bhd, which have a long historical presence in the Malaysian banking industry have always been regarded as domestic financial institutions by most consumers in Malaysia. As a result, foreign owned banks still have a very strong presence in the market, accounting for 26% of commercial banking assets, 27% of the loans market and 25% of the deposit market.

Table 15 compares the top three banks' market shares in terms of total assets, total loans and total deposits for the years 1998 and 2003. Judging from the measure of the concentration ratios, the merger exercise has not materially affected the banking industry's market structure. The main explanation for this *status quo* position is that the bank mergers merely represented a market extension and concentration of deposits for the existing lead anchor banks. Mergers changed the acquired banks' ownership without reducing the number of branches competing in the post merger period relative to the pre-merger period.

Despite fears that the bank mergers would result in greater concentration of market power with the already dominant government owned banks, the Herfindal index and the market shares data do not seem to support this view. The Herfindal index, using each individual bank's total deposits as a basis for their market shares in a sample of 16 domestic banks (including the merged banks in 1998) and four foreign-owned banks (HSBC Bank, Standard Chartered Bank, OCBC Bank and UOB Bank), was computed at 1047 for the pre-merger market compared to 1177 for the post merger market

Although the market share data appears to imply that competitive forces in the oligopolistic domestic banking industry were



weak, this is far from the truth. All domestic banks began to diversify their portfolios to non-interest incomes businesses as competition in the banking industry reduced some of their net interest margins and spreads of some banks in the post crisis period. Between 1998 and 2003, four banks (AmBank, Bumiputra-Commerce Bank, Hong Leong Bank and Southern Bank) experienced increases in their share of fee incomes. Non-interest incomes are quite significant for Bumiputra-Commerce Bank and AmBank, each with a strong investment bank arm and strong proprietary and bond trading desks. Certain types of non-interest income businesses, especially the unit trust and credit card businesses are proving to be quite healthy and profitable for some banks.

In 1998 (the currency crisis year), three banks (Maybank, Bumiputra-Commerce Bank and Affin Bank) had over 40% of their non-interest income coming from foreign exchange transactions. In 2003, the share of foreign exchange (forex) profits in total non-interest incomes of all the banks had declined considerably from the 1998 level, suggesting that off balance sheets activities were now less pronounced than in 1998.

While the three largest banks continue to dominate the banking industry in terms of their size as measured by total assets, there is a significant variance in the different banking groups' profitability and risk management abilities and risk exposures. This should continue to be a public policy concern. If BNM's regulatory guidelines do not seem to completely minimise the variance of the domestic banking groups' risk management abilities, the question remains whether market discipline will perform this important function. This leads us to consider the next important issue in this report, the banking sector's market discipline.

Market Discipline and Stakeholders

The challenge the central bank faces in the post-merger environment is how to make market discipline more effective within its own regulatory structure and framework. The prudential regulations and supervisions and financial safety nets designed can no longer be considered mere substitutes to market discipline. Both regulatory designs and market discipline should now be considered as complementary inputs in the production function of financial stability and soundness. One of the beneficial externalities of BNM's GP8 Guidelines

(Specimen Financial Statements for the Banking Industry) is to encourage and enhance disclosure of banking information that improves the market's ability to assess a bank's value, a *sine quo non* of effective market discipline. It now appears that GP8 is serving more than a perfunctory role of compliance regarding disclosure of financial statement information to the public and to market investors. In fact, GP8 provides the bridge to enhance the effectiveness of market discipline.

Monitoring and Disclosure Index

In this section, we attempt to construct a monitoring and disclosure index (MDI) using a set of panel data for the ten domestic banks for each of the years from 1998 to 2003 to measure the extent of banking information disclosure during this period as required by the central bank's regulatory guidelines. The revisions of the GP1, GP3, GP7 and GP8 Guidelines on disclosure requirements have resulted in greater disclosure of information in all the domestic banks' annual reports. There is, therefore, a difference in the information content as well as the extent of disclosure between the years 1998 and 2003. We have taken advantage of this difference to demonstrate that there is indeed an improvement in the disclosure as well as the value of the information content in banks' annual reports in the recent years. Thus, the data set required to construct our MDI can be found in the domestic banks' annual reports.

The MDI is composed of 28 key elements relating to the GP1, GP3, GP7 and GP8 Guidelines. Table 16 presents a summary of the elements used in constructing the MDI. In general, we use the binary 1 and 0 to denote disclosure or non-disclosure and whether a bank specific ratio is rising or declining, respectively. We will use the MDI to discern the central bank's ability to use its regulatory guidelines to improve the domestic banking industry's state of disclosure.

The BNM/GP1 (Guidelines on Directorship in the Banking Institutions) requires banks to set up board committees. In the past, domestic banks have had only an audit committee. However, since 2001, most banks have established nomination, remuneration and risk management committees. There is, however, a considerable variance among the domestic banks in the number of independent directors that make up these committees. For example in the period 2001-2003, Public Bank had six independent

directors in its audit committee while the average number of independent directors in the other banks' audit committees was between two and three members. In the case of the nomination and remuneration committees, we use the binary entry of 1 to denote that the controlling owner is not the chairperson of these committees.

A binary entry of 1 is given if the separation of the controlling owner/chairperson's and CEO's role and a statement of the directors'

responsibilities is disclosed in the bank's financial statements. All banks now provide a statement of their internal control policy and the external auditors' responsibilities in their annual reports. All banks have been assigned an entry of 1 for disclosure of this information for each of the years in the period 1998-2003.

Information on loans quality disclosed has become more important since the 1997 crisis, and BNM has revised its GP3 Guidelines



Table 16: Key Elements of the Monitoring and Disclosure Index

Categories	Elements	Binary Entries or #
GP1 disclosure requirements	Audit committee	# of independent directors
	Nomination committee	independent Chair = 1
	Compensation committee	independent Chair = 1
	Risk management committee	# of independent directors
	Chairman is not CEO	separation = 1
	Internal control/external audit	Disclosed = 1
GP3 disclosure requirements	Problem loans by type	Disclosed = 1
	NPL/total loans	Greater than 20% = 0
	Loan loss provisions/total loans	Greater than 10% = 1
	Loans by type	Disclosed = 1
	Loans by counterparty	Disclosed = 1
GP7 disclosure requirements	Director's responsibilities	Disclosed = 1
	Director's interests	Disclosed = 1
GP8 disclosure requirements	Market risk policy	Disclosed = 1
	Credit risk policy	Disclosed = 1
	Net inter-bank market transactions	Positive = 1
	Dealing securities	Disclosed = 1
	Contingent liabilities	Disclosed = 1
	Off balance sheet items	Disclosed = 1
	Related party transactions	Disclosed = 1
	Material disclosures	Bad news = 0
	Loan loss reserves	Disclosed = 1
	Segmental analysis	Disclosed = 1
	Net interest margins	Rising = 1
	Share of non interest incomes	Rising = 1
	Subordinated bonds	Positive = 0
	Unsecured subordinated bonds	Positive = 0
BNM capital adequacy requirements	Capital adequacy ratios	Greater than 8% = 1

Sources: Annual reports of the respective domestic banks

(Classification of Loans as Non-performing) to ensure that banks comply with the disclosure requirements for their NPLs and loan portfolios. We assign the binary entry of 1 for disclosure of information on loans by type and counterparty. All banks provide information on loans by type, but not on loans to counterparties.

We also considered the ratio of NPLs to total loans and the ratio of loan loss provisions to total loans as indicators of loans quality in the bank's loan portfolio. Here, we assign a binary entry of 0 if the NPL ratio is greater than 20% and an entry of 1 if it is lower than 20%. Similarly, we assigned a binary entry of 1 if the bank has a loan-loss provision ratio greater than 10% and 0 for lower than 10% ratio. We have been cautious in analysing these results. For example, Public Bank, one of the strongest domestic banks in Malaysia, has a lower than 10% loan loss provision ratio since it has a significantly low NPL ratio. In this case, we made an exception by assigning a binary 1 to Public Bank when it has a very low loan loss provision ratio.

The BNM/GP8 Guidelines on Specimen Financial Statements for the Banking Industry is the most important guideline on banks' disclosure of information. For example, in the 2003 annual reports, all banks include details on their interest rate sensitive assets and liabilities by maturity segments. This is an improvement over the perfunctory write-up on their market and credit risks policies in the annual reports before 2003. The disclosure or detailed write-up of the bank's market risk and credit risk policies in the annual reports are given a binary entry of 1 and 0 otherwise.

We consider the memo items in the annual reports as an important source of disclosure information: the memo items represent the compliance requirements of the regulatory GP8 Guidelines. These memo items include contingent liabilities, related party transactions, material disclosures, loan loss reserves and capital adequacy ratios. Commitments and contingencies, especially the unsecured off balance sheet items such as foreign exchange related and interest rate related contracts constitute important information relating to the degree of the bank's risk exposures. All banks now comply with this requirement and provide sufficient information on their contingent liabilities for the fiscal year's banking business. An entry of 1 is given to the disclosure of such information and 0 otherwise.

Compared to the past, the director's report in the annual report now provides quite detailed information on both the executive and non-executive independent directors' direct and indirect interests. This is the result of the regulatory GP7 Guidelines on Code of Conduct for Directors, Officers and Employees in the Banking Industry. The purpose of this guideline is to avoid bank directors' conflicts of interests. A binary entry of 1 is given if such information is disclosed, and 0 otherwise.

Both related party transactions and material disclosures are important disclosure items for investors. Related party transactions include dealings involving associated companies and subsidiary companies as well as banking institution directors, officers and employees. We provide a binary entry of 1 for disclosure and 0 otherwise. Material disclosures are related to any pending litigation against the

Table 17: Monitoring and Disclosure Index of the Banking Groups: 1998-2003

Banking Groups	1998	1999	2000	2001	2002	2003
Affin Bank Bhd	61.4	71.4	67.8	75.0	75.0	75.0
Alliance Bank	64.2	57.1	53.5	64.2	64.2	103.5
AmBank (M) Bhd	53.5	53.5	57.1	50.0	60.7	64.2
Bumiputra-Commerce Bank Bhd	60.7	64.2	64.2	82.1	89.2	89.2
EON Bank Bhd	75.0	78.5	82.1	92.8	75.0	85.7
Hong Leong Bank Bhd	71.4	67.8	71.4	71.4	75.0	92.8
Maybank Bhd	75.0	71.4	71.4	78.5	82.1	89.2
Public Bank Bhd	89.2	85.7	89.2	103.5	110.7	112.1
RHB Bank Bhd	60.7	57.1	53.5	75.0	71.4	75.0
Southern Bank Bhd	75.0	67.8	71.4	75.0	75.0	85.7

Sources: Computed from data in the annual reports of the respective banks

banking institution. We have found only one bank with such negative material disclosure involving litigation against it. If it is a bad news item, we assign a binary entry of 0 and if the disclosure is immaterial, then the entry is given a binary 1 entry.

In 2003, almost all banks provide a segmental analysis of their revenue sources. This is an important source of information on the bank's ability to diversify its portfolio; it may also demonstrate its comparative advantage in certain niche markets. We have assigned the entry with a binary 1 when such information is disclosed and 0 otherwise.

The bank's investment portfolio is also an important set of information to market investors. All banks are required to provide information about their interbank market transactions. If a bank has net interbank liabilities, it is an indication of its inability to bridge its short-term liquidity fluctuations. We assign an entry of 0 in this situation. We also assign an entry of 0 in the case where banks issue subordinated bonds to refund its capital requirements.

The composite MDI is derived as the mean of the entries. The higher the index, the greater the amount of information that the banks have disclosed. Over the period 1998-2003, the central bank has made a number of revisions to its regulatory guidelines with the intention of enhancing the extent of disclosure in the banking industry. However, in some cases, there is a lag effect, on the banks' part, to fully comply with the regulatory requirements. As such, in retrospect, we observe some variance in the information content of the different banks' annual reports. Table 17 provides

the composite MDI index for the individual banks over the period 1998-2003.

Empirical Analysis of Market Discipline

In this section, we consider whether depositors monitor banks' risk behaviour. Our hypothesis here is that depositors will require a higher interest rate if they cannot discern the banks' risk behaviours. We believe that BNM's revisions of the regulatory GP1, GP3, GP7 and GP8 Guidelines on disclosure requirements have resulted in greater disclosure of information in the domestic banks' annual reports between the years 1998 and 2003. We posit that if there is value in the information content disclosed, then the strength of market discipline will be enhanced. Our hypothesis is that there is an inverse relationship between the cost of interest expense to the banks and the MDI disclosure index: the cost of interest expense for the bank will be lower if depositors are able to assess the banks' risk behaviours through greater information disclosure.

In addition, we use the ratio of overhead expenses to total assets and the logarithm of total assets as two bank specific variables that could affect the cost of interest expense to the bank. If depositors consider high overhead expenses as an indication of bank management inefficiency and a signal of bank risk, then they would require a higher interest rate on their deposits, and vice versa. The log of total assets is a surrogate measure of bank size. If depositors regard large banks as safe due to their ability to diversify their portfolios or due to their perception of the government's too-big-to-fail policy, then they will not require a higher interest rate on their deposits. We have used the following equation, specifically, as our empirical model:

Table 18: Estimated Results with Interest Expense Using the GLS Regression: 1998-2003

	Equation 1		Equation 2	
	Coefficients	t-values	Coefficients	t-values
MDI	-0.0958	-2.29	-0.0825	-1.80
Overhead Expenses	-3.8486	-2.23	-4.0758	-2.29
Log of Total Assets			-0.6875	-0.75
Constant	17.5767	4.87	23.8529	2.59
R-square	0.179		0.183	
Wald (joint)	Chi-square (2)= 12.44 **		Chi-square (3) = 12.56 **	
Wald (dummy)	Chi-square (1)= 23.73 **		Chi-square (1)= 6.72 **	
Number of Observations = 60				



$$Y_{it} = \alpha + \beta X_{it} + \delta MDI_{it} + \varepsilon_{it}$$

where Y_{it} is the cost of interest expense of the i^{th} individual bank during the t^{th} period, MDI_{it} is the vector of the disclosure indexes that characterise the extent of the individual bank's disclosure of risk elements, X_{it} represents the vector bank-specific variables that affect the individual bank's interest expense and ε_{it} the random error term. The intercept is given by α . We estimate the column vectors of coefficients β , and δ . The δ coefficient characterises the disclosure effects and the β coefficient the bank-specific effects. The standard assumptions about the error structure in this type of model are applied.

Estimated Results with Interest Expense

We estimated two panel data regression equations. Equation 1 relates interest expense as the dependent variable while the MDI and the ratio of overhead expenses are the independent variables. Equation 2 adds the log of total assets as another independent variable. Both equations are estimated using generalised least squares (GLS) and Table 18 shows the estimated results. These results were estimated using PcGive, an econometric software package.

The R-square of the estimated Equation 1 is 0.179, which is somewhat low for panel data estimates. Both the Wald test (joint) and the Wald test (dummy) are significant. The coefficient for the MDI variable has the expected negative sign and is significant according to the t-values. If depositors believe that there is a higher level of disclosure information, there is no necessity

to demand a higher interest rate on their deposits to compensate for uncertainty. As expected, the results also show an inverse relationship between interest expense and overhead expenses. However, when the natural logarithm of total asset is included to capture the scale effects of the different banks' sizes in Equation 2, the MDI variable becomes insignificant. The log of total assets variable is not significant in the second equation. Nevertheless, the evidence in Equation 1 appears to support the contention that some degree of market discipline is being exercised in the Malaysian banking industry.

Potential of Subordinated Debts

An item in the financial statement that has the potential to be a good proxy measure of market discipline is the banking institutions' subordinated debts. These include the subordinated bonds, unsecured subordinated loans and subordinated certificates of deposits held by the banking groups in Malaysia. The concept of issuing subordinated debt to enhance market discipline is intuitively appealing. Since holders of such bonds have the lowest priority in terms of recovering their investments in case of bank failures, they have a greater incentive, than other asset holders, to monitor the banks' risk behaviour. If banks demonstrate risky behaviours, then they would have to pay a higher yield on the subordinated bonds.

Rising yield spreads on subordinated debts above a certain threshold could be a useful market signal to investors that there may be potential problems with a particular bank.

Table 19: Subordinated Debts of Malaysian Banks

Banks	Type of Subordinated Debts	Amount	Year of Issue	Yields
Alliance Bank Group	10 year non callable 5 year subordinated bonds	RM535 million	2001	7.75 %
AmBank Group	Redeemable unsecured bonds	RM435 million	1997	5.0 %
	Unsecured subordinated term loan	RM75 million	2000	8.5 %
Bumiputra-Commerce Bank Group	Subordinated Notes	USD300 million	2003	US Treasury rate + 3.55%
EON Bank Group	Secured fixed rate bonds	RM300 million	2002	5.25 %
Maybank Group	Subordinated bonds	RM610 million	2001	5.65 %
	Subordinated Notes	USD380 million	2002	6.125 %
Southern Bank Group	Subordinated CD	RM400 million	2000	7.3 %
	Subordinated bonds	RM300 million	2002	8.0 %
OCBC Bank (Malaysia) Bhd	Subordinated term loan	USD100 million	2003	5.55 %

Sources: Annual reports of the respective banks

Yield spreads on subordinated debts may also provide additional useful information in assisting banking regulators monitor the changing conditions of the institution under their supervision. Regulators can take prompt corrective actions to correct any potential problems, if the sources of the adverse conditions are serious enough to warrant further in-depth examination of the problem institution in order to avoid unwise regulatory forbearance decisions.

Despite the positive arguments for using yield spreads of subordinated debts as a market signal for market discipline, there is no regulation for the mandatory issue of subordinated debts in Malaysia. The issue of subordinated debts by Malaysian banking institutions has been mainly to increase the Tier-2 capital adequacy requirements and for the computing the risk weighted capital adequacy ratio.

In Malaysia, the potential of using subordinated debt as a proxy measure of market discipline is promising, as some banking institutions have begun to restructure their debt-equity ratio by sourcing their capital through the debt markets. Table 19 presents a sample of the issue of subordinated debts by the individual banking institutions in the 1997-2003 period. Concomitantly, there will be an increased use of the banking institution risk rating for this purpose.

Bank Ownership/Governance and Bank Performance

This section considers the effects of ownership structure on the ten domestic banks' performance in the 1998-2003 period. Much of the empirical literature that considers the relationship between bank performance and ownership structure suggests that banks do not perform well in cases where either the government or families own the majority shareholdings. The rationale for this hypothesis is the

entrenchment effects of government and family ownership structures.

Based on our knowledge of the Malaysian banking system, we do not completely accept this hypothesis. For example, we believed that the family owned banks, especially Public Bank and Hong Leong Bank, are very well-managed by professional bankers. Our hypothesis contends there is a positive relationship between bank performance and family owned banks in Malaysia.

Empirical Analysis of Ownership Structure on Bank Performance

We have used returns on assets (ROA) as the measure of performance. The ROA is defined as the bank's net income divided by its total assets. There are two dummy variables to represent the government ownership and family ownership structures. We have not included a widely held ownership structure dummy variable to avoid the dummy variables trap. These two ownership structures are prevalent in the Malaysian domestic banks, given that four out of the ten domestic banks have government connected ownership structures (Maybank, Bumiputra-Commerce Bank, EON Bank, and Affin Bank) and another four banks are very much family controlled (Public Bank, Hong Leong Bank, AmBank and RHB Bank). The remaining two banks (Alliance Bank and Southern Bank) have ownership structures that are apparently more widely held.

Our hypothesis contends that in the Malaysian domestic banking institutions, there is a negative relationship between bank performance and the government ownership structure and a positive relationship between bank performance and the family ownership structure. To test our hypothesis, we have used the following random effects model as our empirical model:

$$Y_{it} = \alpha + \beta X_{it} + \delta D + \varepsilon_{it}$$

Table 20: Correlation Matrix of Ownership Structures and Bank Specific Variables: 1998-2003

	Government-Owned Banks	Family-Owned Banks	NPLs to Total Loans	Net Interbank Assets to Total Assets
Government-Owned Banks	1			
Family-Owned Banks	-0.8165	1		
NPLs to Total Loans	0.0597	-0.2033	1	
Net Interbank Assets	-0.0041	-0.0724	-0.0240	1
Annual Growth Rate of Real GDP	0.0000	2.740E-02	0.0393	0.0112

Sources: Annual Reports of the respective banks



where Y_{it} is the performance measure of the i^{th} individual banks during the t^{th} period, D is a vector of dummy variables that characterize ownership structure, X_{it} is a vector of control variables to represent bank-specific characteristics that might affect the individual bank's performance and ε_{it} is a random error term. The intercept is given by α . The column vector of coefficients δ and β are estimated. The elements of the δ coefficients characterise the ownership structure effects and the β coefficients represent the bank-specific effects. The standard theoretical assumptions about the error structure in this type of model are applied.

We have used two bank specific variables – the ratio of non-performing loans to total loans and the ratio of net interbank assets to total assets – and the annual GDP growth rate as control variables. The ratio of non-performing loans to total assets reflects the banks' asset quality. We expect an inverse relationship between NPLs and the ROA. The value of its net interbank assets shows the profitability of the bank's Treasury activities. We can expect a positive relationship between this variable and ROA. We included the annual real GDP growth rate as a control variable to capture the cyclical effects of the economy. It can be expected that both the ROA and the real GDP growth rate variables will be positively correlated.

Table 20 presents the correlation matrix for the two dummy variables for ownership structures and the bank specific control variables. Except for the high correlation between the two ownership structure variables, the correlation matrix suggests

that there is very little multi-collinearity among the other bank specific control variables.

Estimated Results with Ownership Structures

The panel data regression equations of ownership structure and bank profitability have been estimated using generalised least squares (GLS). We estimated one equation for the effects of the government ownership and family ownership structures on the ROA, the results of which are shown in Table 21. We have used a 5% significant level for the t-tests. The t-values for the coefficients are shown in the table.

Both the government-connected ownership and the family ownership dummy variables' coefficients are not significant according to the t-values. The negative signs for both the coefficients conform to the literature on the relationship between government and family ownership structures and bank performance. Thus, it does not validate our expectations of a positive relationship between the family owned banks and their performance in Malaysia.

The other bank specific control variables have the expected signs. The non-performing loans variable is inversely related to the ROA and both the net interbank assets and real GDP growth variables are positively related to the ROA as expected.

Summary of Findings

Despite fears that the government initiated merger programme would increase the already dominant government controlled

Table 21: Estimated Results of Effects of Ownership Structure on Profitability (ROA) Using GLS: 1998-2003

	Panel Data Analysis Equation	
	Coefficients	t-value
Govt Banks	-0.4343	-0.94
Family Banks	-0.2285	-0.48
NPL to Total Loans	-0.0527	-3.58
Net Interbank Assets to Total Assets	0.0236	2.25
Annual Growth Rate of Real GDP	0.0345	1.98
Constant	1.4208	2.77
R-square	0.294	
Wald (joint)	Chi-square (5) = 22.53 **	
Wald (dummy)	Chi-square (1) = 7.68 **	

Note: Results estimated using PcGive.

banking groups' monopolistic market power, this did not happen. At least, there is no evidence of any significant change in the individual banking groups' market shares and cost structures from their pre-merger positions. Although the three largest banks continue to dominate the market in the deposits and loans markets, there is evidence that competition in the fee income and other non-interest income businesses is quite intense in the domestic banking industry. The central bank has also provided evidence that its bank merger programme has resulted in substantial improvements in the banking industry's overall efficiency arising from the rationalisation and streamlining of the banking groups' operations after the merger.

In Malaysia market discipline is still very much in its infancy stage. Depositors and most market participants have a long learning curve ahead to understand market discipline's purpose and practical effectiveness. We have attempted to show how BNM has used its regulatory GP8 Guidelines on disclosure to enhance market discipline's effectiveness. We constructed a monitoring and disclosure index based on the central bank's regulatory disclosure requirements of GP1, GP3, GP7 and GP8 to test whether, to the market, disclosure matters in monitoring the Malaysian banking industry.

Using a set of panel data for the 10 domestic banks for the period 1998-2003, we have found some evidence that appears to support the contention there is some degree of market discipline being exercised in the Malaysian banking industry. Our panel data regression analysis demonstrated a significant statistical relationship between interest rate on deposits and the disclosure index, suggesting that depositors do monitor the banks, that they do have a preference for risk aversion and that better disclosures always lead to lower interest expense for the banks.

We have seen that the ownership structure in the Malaysian banking industry is quite neatly categorised into government owned banks, family owned banks and a couple of banks with corporate and widely held ownership structures. Although the government and family owned banks ownership structure coefficients have the expected negative signs as suggested in the literature, they are not statistically significant. It is generally expected in the literature that government-owned banks do not perform well because of

the entrenchment effects. However, we find exceptions in the Malaysian case, where government-controlled banks, such as Maybank and Bumiputra-Commerce Bank, are very well managed and profitable.

Similarly, the negative relationship results between profitability and the family ownership structure, in the equation, conforms to the literature's expectations. However, the result was not what we expected. Our observation is that, in the Malaysian domestic banking sector, family-owned banks were very well managed, efficient and competitive. For example, without any burden from the problems of non-performing loans, Public Bank, a very well managed family owned bank, has emerged from the 1997 crisis as one of the strongest banks in Malaysia's domestic banking industry.

CONCLUSION: OVERALL EVALUATION AND MAJOR POLICY ISSUES

In the post-merger banking environment, it appears that the task of striking a balance between the use of the various regulatory policy instruments and market discipline is now more challenging to Bank Negara Malaysia. While there is certainly an increasing role for market discipline in the design of regulatory policies, there is also a need for the central bank to rethink the appropriate policy weights given to regulatory supervisions and financial safety nets relative to market discipline, in its design of regulatory strategy in the new post-merger Malaysian banking environment.

In the 1998-2003 period, BNM has taken important steps to revise and improve its various regulatory guidelines with the aim of enhancing market discipline's effectiveness through greater disclosure and transparency of financial information in the banking industry. However, the experience of past government regulatory forbearance and the government's implicit deposit guarantee may still pose an impediment to the central bank's ability to use its regulatory guidelines effectively to mitigate moral hazard and excessive risk taking. The public and market investors may not have forgotten perceptions of past government regulatory forbearance. As such, market discipline is likely to be more effective, the greater the degree of disclosure among the banks, the larger the extent that bank's risk choices are observable and the lesser the degree of public perception that government regulatory forbearance will continue to exist.





BNM has made great strides in the post crisis period in revising its regulatory guidelines and developing a comprehensive Financial Sector Masterplan within its broad strategic regulatory framework to ensure that its regulatory policies are relevant to the financial and banking sector's changing complexity. Obviously BNM's task is not easy. Given the short period of time since the financial crisis distorted the economic and fundamental soundness of Malaysia's financial and banking system, BNM has worked very hard to regain the confidence of market participants, both in the domestic and the global economy, that the Malaysian financial and banking system is still very safe and sound.

Equally, the domestic banking institutions have come a long way in making the practice of corporate governance a priority as well as a norm in their decision-making and in their conduct of banking business. There is already a growing consensus in Malaysia that corporate governance practice in the financial and banking system has improved. In the post-crisis period, there is some persuasive evidence to suggest that both banking and corporate leaders have embraced the importance of corporate governance practice in Malaysia. We have seen that all banks have adopted strict measures to enhance board structures and composition. All domestic banking institutions are now cognizant of the value of enhancing the relevance and effectiveness of the internal governance mechanism within their organisational structures.

Even when much has been achieved in the post-crisis period, there is always much more to be done. If the momentum of progress and achievements is to be sustained, both BNM and the banking leaders will have to continue their efforts to work together to ensure that the financial and banking system in Malaysia always remains safe and sound. Working towards this objective means that BNM and the banking sector will have to address some of the issues of concern at both public policy and banking institutional level.

At the public policy level, there is always the need for BNM to continue its efforts to reform the financial and banking system. One important area of public concern is that of disclosures and transparency of the workings of the boards in the domestic banking institutions. Much work has already been done by the central bank in this aspect

as we have seen in the far reaching impact of GP1 and GP8 Guidelines. The change in the financial and banking system's regulatory framework towards more disclosure and transparency in order for market discipline to function effectively is important. However, this change at public policy level must be translated into practice at institutional level.

A major element of public concern during the crisis period was the close connectivity between banks and corporate borrowers. It is acknowledged that much has already been done in terms of regulatory guidelines (GP1, GP5, GP6 and GP7) to ensure the avoidance of conflicts of interest and the problem of large single corporate borrowers. With this, the associated dire consequences will not occur and have an adverse impact on the whole financial and banking system. However, it must be recognised that BNM cannot solve the root of the problem by using its regulatory guidelines alone. While regulatory bites can have its advantage, there must also be the banking industry's corporate leaders' will to ensure that the intents of the regulatory guidelines are implemented in practice.

A potential area of concern in the domestic banking system's post-merger period is that the ownership structures of the dominant domestic banking institutions' financial conglomerates have become more complex and more opaque. If not done properly, the restructuring of the internal governance mechanisms will be ineffective to deal with the possible divergence between the control and ownership in the financial conglomerates. BNM has already moved in this direction with its concept paper on the supervision of financial conglomerates. Perhaps the clue to improving corporate governance in the domestic banking system in the future is to understand and disentangle the web of ownership structure complexity in these super financial holding companies where the government also plays a dominant role in control and ownership.

Much still remains to be done to enhance board effectiveness and independence at the banking institutional level. The board must be more conscious and passionate of its role in establishing the ethical and cultural values of good corporate governance. Board diversity is always an important ingredient for those interactions to take place that are necessary to promote open and constructive engagements within board discussions and

decision-making processes. We have seen that the increasing role of independent directors in the boardroom is an important ingredient for this diversity.

Board independence is a prerequisite for enhancing board effectiveness. The results of the survey questionnaires show there is still room for improvement in this important basis of the internal governance mechanism. All board members, especially the independent directors, must truly feel independent without any reservations about, first, whether their term can be terminated if they don't toe the line, or second, if they have an obligation to the controlling owner or CEO who appointed them. This is a difficult area for most banking leaders to tread; and improvements must be made at the board level if the board is truly committed to the idea of enhancing board effectiveness .

In some instances, the ideals of GP1 to restructure the internal governance mechanism by strengthening and structuring various governance committees as a counterbalance to the powers of the controlling owners/chairperson and CEO has been, in the main, heartening and encouraging. The structuring of the various governance committees has also the advantage of enhancing the independent directors' roles. However, there are still desired elements of governance that the controlling owners/chairperson must respect. To avoid the concern of independent directors that they must feel truly independent, controlling owners/chairpersons should voluntarily abdicate from their role as chairpersons of such important governance committees like the nominating and the remuneration committees.

The appointment of board members is very much a contentious issue. A perusal of the board composition in the domestic banking institutions in Malaysia reveals the fact that very little change has taken place in terms of recruitment of new board members: there is still a reluctance to recruit unfamiliar independent non-executive directors to the board in domestic banking institutions. Appointment of non-executive directors should not be based on 'who you know' but should be based on 'who is best'. A simple criterion of choice should be on the candidate's merits and passion to engage in constructive boardroom discussions and create value for the shareholders as well as other stakeholders.

It is not an understatement to say that the board member's job should be an interesting one and not just as a status symbol. While a minor concern, improvements in the logistics of board meetings to enhance boardroom chemistry, can gain much mileage in making the boardroom an interesting place for members to serve. The periodical exposure of board members to both the institutional and minority shareholders' concerns can be useful and a refreshing change when shareholders' views are communicated directly first hand to the board as a whole.

We believe that our study has made a modest contribution to understanding the status and development of corporate governance in the domestic banking system in Malaysia in the post financial crisis period. We sincerely hope that in the future Malaysian researchers will do more work in this important area of public interest. We also like to thank all our survey questionnaire respondents for their willingness to share their knowledge and insider views of the workings of the boardroom. We appreciate their willingness to share their concerns on some of the limitations of current corporate governance practices. This truly reflects the board members' desire to improve and enhance the boards' effectiveness and to contribute to the ideals of a safe and sound domestic banking system in Malaysia **BJM**

Editor's Note: On 11 August 2005, the Malaysia Deposit Insurance Corporation Act 2005 was gazetted. Following this, Bank Negara Malaysia announced the introduction of a deposit insurance system and the establishment of an independent statutory body called Perbadanan Insurans Deposit Malaysia (Malaysia Deposit Insurance Corporation) to administer the system. Under the Act, all financial institutions licensed under the BAFIA1989 and Islamic banks licensed under the Islamic Banking Act 1983 will be members of the deposit insurance system.

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