Faculty of Economics and Business

EFFECT OF CORPORATE GOVERNANCE ON BOND YIELDS AND BOND RATINGS: A STUDY IN MALAYSIA LISTED COMPANIES

Nieh Vun Ru

Bachelor of Finance (Honours)
2011

EFFECT OF CORPORATE GOVERNANCE ON BOND YIELDS AND BOND RATINGS: A STUDY IN MALAYSIA LISTED COMPANIES

NIEH VUN RU

THIS PROJECT IS SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE DEGREE OF BACHELOR OF FINANCE WITH HONOURS (FINANCE)

Faculty of Economics and Business

UNIVERSITI MALAYSIA SARAWAK

2011

Statement of Originality

The work described in this Final Year Project, entitled

Effect of Corporate Governance on Bond Yields and Bond Ratings: A Study in Malaysia Listed Companies

is to the best of the author's information that of the author except where due reference is made

______________________ ______________________

(Date submitted) (Student's signature)

NIEH VUN RU

21707

ACKNOWLEDGEMENT

This study would not have been possible without the guidance and the help of several individuals who in one way or another contributed and extended their valuable assistance in the preparation and completion of this study.

First and foremost, I would like to thank my supervisor, Professor Madya Doctor Venus Liew Khim Shen for helpful suggestion and guidance in preparing and completing this study. I am kindly appreciated the ideas and comment that have been given.

I owe my deepest gratitude to other lecturer and all staff in Faculty of Economic and Business, Universiti Malaysia Sarawak, who direct or indirectly give me valuable assistance and advice on this research topic.

I am indebted to many of my colleagues and lovely family members that give me moral support as well as financial support. Thanks for their understanding on my duty from the start of this study until the end by not disturb me.

Last but not least, I would like to show my gratitude to Universiti Malaysia Sarawak for giving me an opportunity to having this type of research and give me a chances to improve myself not just in writing but also to get more knowledge. I appreciate any comments, suggestions, or corrections that have been given to me for the improvement of this study as well as my writing skills.

TABLE OF CONTENTS

CHAPTER TWO: LITERATURE REVIEW

CHAPTER THREE: METHODOLOGY

LIST OF TABLES

ABSTRACT

EFFECT OF CORPORATE GOVERNANCE ON BOND YIELDS AND BOND RATINGS: A STUDY IN MALAYSIA LISTED COMPANIES

By

Nieh Vun Ru

This study examines the relationship between the corporate governance, bond yields and bond ratings in Malaysia's listed companies for nine time period starting year 2001 until 2009. Data are collected from annual report for each of the firms. Correlation, descriptive statistics, Ordinary Least Square, and Ordered Probit Model are the technique used to determine the relationship and significant linear relationship between the variables. The variables used includes dividend yield, institutional ownership, top five institutional ownership, outside directorship, debt-to-equity ratio, maturity, margin, above five percent institutional ownership, ratings, bond issues size and total asset. There are 142 firms together for this study and 162 firms which include the firms that issues bond for several years are reported in the appendix. Bond ratings are gathering from Rating Agency Malaysia (RAM) and Malaysia Rating Corporation (MARC). Empirical results shows that ratings are significant with bond yields and are inversely correlated which followed Bhojraj and Sengupta (2003).

Keywords: corporate governance, bond yield, bond rating

ABSTRAK

KESAN TATA URUS SYARIKAT KE ATAS HASIL SAHAM DAN PENILAIAN SAHAM: KAJIAN TERHADAP SYARIKAT BERDAFTAR DI MALAYSIA

Oleh

Nieh Vun Ru

Kajian ini meneliti hubungan di anatara tata urus syarikat, hasil saham dan penilaian saham terhadap syarikat berdaftar di Malaysia untuk tempoh Sembilan tahun, bermula tahun 2001 sehingga 2009. Data yang digunakan dalam kajian ini dikumpul melalui laporan tahunan syarikat berdaftar. Analisis Korelasi, ‘ordered probit model’, statistik deskriptif, dan kuadrat terkecil biasa adalah antara teknik yang digunakan untuk mengkaji perhubungan di antara pembolehubah-pembolehubah. Pembolehubah-pembolehubah yang digunakan dalam kajian ini termasuklah ‘dividend yield’, pemilik saham syarikat yang terbesar, lima pemilik saham syarikat yang terbesar, pengarah luar, nisbah hutang terhadap equity, tempoh matang, pemilik saham yang memiliki lebih daripada lima peratus, jumlah asset syarikat, margin, jumlah bond yang diisu, dan ‘rating’. Terdapat 142 syarikat yang digunakan untuk tujuan kajian ini di mana syarikat yang isu ‘bond’ lebih daripada sekali, hanya purata diambil, manakala 162 syarikat iaitu syarikat yang isu ‘bond’ pada tahun yang berlainan dikaji dan hasil kajian dilaporkan dalam lampiran. Data yang digunakan untuk ‘bond rating’ dikumpul daripada Rating Agency Malaysia (RAM) dan Malaysia Rating Corporation (MARC). Keputusan kajian menunjukkan bahawa ‘bond rating’ adalah signifikan dengan ‘bond yield’ tetapi berlawanan dengan teori yang menyatakan bahawa ‘bond yield’ dan ‘bond rating’ mempunya hubungan yang selari.

Kata kunci: tata urus syarikat, ‘bond yield’, ‘bond ratings’

CHAPTER ONE

INTRODUCTION

1.1 Introduction

This study examines the empirical relationship and effect between governance structure of public corporation in Malaysia and the ratings and bond yields issues. Corporate governance was introduced in year 1997 after the Asian Financial Crisis and strengthen by reformed due to implementation of Malaysian Code of Corporate Governance in the year 2000. It has been amended as listing requirement in year 2001 by Bursa Malaysia Berhad. After the crisis, Bond was issued in 2000. The sample in this study started in 2001, where companies that issue bond in 2000 were private corporations and financial institutions. Rating variable used in this study was obtained from Malaysia Rating Corporation Berhad (MARC) and Rating Agency Malaysia (RAM).

This study is important in determining the relationship between corporate governance with bond yields and bond ratings since many previous researchers agreed that better governance may help to improve company's performance and help to protect investors and stakeholders' interests. Based on their researches, they stated that the higher the rate, the lower the yield. This is because when companies have a better rate, it means that the bond is a safety bond while lower rate gives a higher yield because issuers used this technique to attract investors' attention.

The main purpose of this study is to determine and investigate the contribution of corporate governance for listed firms in Malaysia. This study's aim is to determine the relationship between bond yields and bond ratings with corporate governance, where prior study states that good corporate governance has a higher yield compared to poor corporate governance. Besides, a higher bond rating shows that the lower the yield of the bonds. The main objective to do this study is to find out the relationship among corporate governance, bond ratings and bond yields in Malaysia's Listed Companies which as discuss in this chapter.

Skaife et. al. (2006), stated that strong governance benefit from higher ratings; Ouni and Omri (2010) come across that governance mechanism and financial attributes can be used to achieve target ratings; Dey (2008) finds that firms with greater agency conflicts have better governance mechanism in place, particularly those related to the board, audit committee and auditor; Sulong and Nor (2010) said that the benefits of better governance through enhanced board governance are not the same across all firms since their incentives vary with respect to dividend and different types of ownership structure mechanism; Koehn and Ueng (2005) acknowledge that company with weaker boards performed more poorly were significantly less profitable and reported earning with a higher volatility than firms characterized as having stronger corporate governance;

Loh and Ragayah (2007) held that a good corporate governance practice offers more conductive business environment for the investors; and Bhojraj and Sengupta (2003) discover that effective corporate governance mechanism can affect bond yields and ratings through its impact on default risk of the firm.

Corporate governance is a set of policies, laws, processes and customs which lead the way of the corporation performance. Corporate governance takes into consideration the relationship between the stakeholders and help to govern the goals of the corporation. The stakeholders include shareholders, customers, debtors, creditors, suppliers, employees, board members, and the large communities. There are few principles that are commonly accepted which include (1) rights and equitable treatment of shareholders; (2) interests of other stakeholders; (3) roles and responsibilities of the board; (4) integrity and ethical behavior; and (5) disclosure and transparency. Corporation which adopts corporate governance in their management will also adopt corporate social responsibility in their corporation. Corporation that adopts this in their management will give a better trustworthiness to the investors or creditors. In the year 2000, corporate governance was reformed due to implementation of Malaysian Code of Corporate Governance and it became an amendment in Bursa Malaysia as a listing requirement in year 2001.

The separation of roles between CEO and board Chairman is recommended by the MCCG 2000. In contrast to the majority of prior studies that mostly focused on developed markets such as US and UK, Sulong and Nor (2010) are utilized in the non-financial Malaysian listed firms' panel dataset for a large firms sample during the post-reform period taken by Malaysian capital market regulators. Furthermore, the firms listed on Bursa Malaysia are relatively smaller and more growth-oriented compared to those in the developed market.

Bond ratings simply help investors to evaluate which bonds are more risky and to balance the risk of default with the interest rate payments that are paid for those bonds. Therefore, bond ratings are used to help investors to understand the relative risks that are involved in the purchases of various bonds. All bonds face certain potential risk of default, expect for federal issued bonds. The changes in the information of ratings are reflected by the change in the financial stabilities or the earning outlook of the corporation. Therefore, bond ratings can represent the financial stability of a corporation. Companies with poor ratings present a credit risk to the bond market or their investors. To determine the ratings of the bond, we can get further information from Malaysia Rating Corporation Berhad (MARC) or Rating Agency Malaysia (RAM). When the ratings of the company is low, it is hard and expensive for the company to obtain credit or to get a loan from outside creditor due to higher interest expended payable on the bonds.

Bursa Malaysia which is also known as Kuala Lumpur Stock Exchange (KLSE) sets corporate governance as the listing requirements amendments which are released in January 2001. These requirements necessitate at least one third of the board of directors to be independent directors. Independent directors means self-determining from management and free from the significant shareholders. In October 2010, Bursa Malaysia consists of 858 companies. In this study, only companies that issue bonds and adopt corporate governance in their companies are selected.

Generally, this study is important because although researchers have explored widely the role of the institutional owners and outside board members in corporate governance, however, the role of each in reducing agency risk is still under debate (Bhojraj and Sengupta, 2003). Besides, although bond market in Malaysia is developing rapidly, yet, not much is understood in term of causes of bond yield spreads changes, where bond yield spreads is referred to the interest rate differences between two bonds (Norliza, Joriah and Tajul, 2009). Based on prior studies by researchers, most of their studies focused mainly on the internal and external of the corporation; whereas this study will take into consideration the performance of the corporation.

Moreover, it is also important because we will be able to understand better whether corporate governance can give an influence towards bond yields and bond rating or otherwise. Therefore, the years 2001 until 2009 have been selected as the sample periods of this study. The reason behind the selection of the years is due to only financial institutions and private companies issued bond in year 2000 which is excluded in this study, therefore, the data collection for this study is taken from the year 2001. The nine years period from 2001 until 2009 is chosen mainly due to limitation of available resources where many of the firms have not published their latest annual report yet for year 2010. The variables and data selection are discussed further in chapter three.

Therefore, the main findings of this study as explained in chapter four are slightly different from the results with Bhojraj and Sengupta (2003) in which the models are observed. Since few important variables have been excluded due to limitation in obtaining the data, Governance variables only seem to be important in determining rating with statistically significant at 5% and 10% level while in determining yield, it's seems to be insignificant. Loan characteristics, such as total asset seem to be statistically significant at 5% level in determining rating while significant at 10% level in model 4 in determining bond yield. Bhojraj and Sengupta (2003) showed that bond yields are negatively correlated and statistically significant with bond rating, which is also verified in this study.

1.2 Background of Study

The Corporate Governance continues to be important from time to time in Malaysia, so do as other countries around the world. In Malaysia, corporate governance becomes a requirement for listing. Any companies wanted to be listed in Bursa Malaysia need to practice corporate governance in their companies. This corporate governance is not only applied for shareholders but also for stakeholders such as creditors, debtors, investors, employees and the entire community.

There are many internal and external factors that can influence the Corporate Governance, same goes to yields and bond ratings for the corporations. Corporate governance variables used in prior study usually involves the power of the Boards, CEO, independent director and non-independent director and so on. Inflation and other economic condition and companies' financial status will influence the bond ratings of that companies bond and in return the yields given to investors in return will be higher. The reason behind high yields and low bond rating is depending on the risk that is involved. When ratings are low, it means that the return is uncertain and power to payback is low as well. Therefore, the companies choose to give out higher yields to attract investors.

The prior study empirical result shows that the higher the yields of the company, the lower the bond ratings. In the next sections, corporate governance, bond yields, bond ratings, ratings agency in Malaysia and Bursa Malaysia background will be discussed further. From all the prior researches, few problems which have not been solved have been discovered. For that reason, they become the motivation and problem statements of this study. Next, the objective of this study will be stated out. The significant and organization of study will be discussed further in the last section of this chapter.

As shown in Bhojraj and Sengupta (2003) study, and as explained in Chapters three and four of this study, independent variables used such as INST, OUTDIR and LSIZE are expected to have negative relationship with bond yield and positive relationship with bond rating, while INST5, BLOCK, MATUR and DE are expected to have positive relationship with bond yield and negative relationship with bond ratings.

1.2.1 Corporate Governance in Malaysia

The definition given by Finance Committee on Corporate Governance in Malaysia in the Report on Corporate Governance (2001) stated that: “Corporate governance is the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long term shareholder value, whilst taking into account the interests of other stakeholders”. From this definition, we can perceive that corporate governance is not only applied to shareholders but also to stakeholders.

Turnbull (1997) states that “corporate governance describes all the influences that affecting the institutional processes which including those for appointing the controllers and regulators and involved in organizing the production and sale of goods and services”. Reforms of corporate governance in Malaysia are established through the implementation of Malaysian Code of Corporate Governance in 2000 and it becomes the amendments of Bursa Malaysia for Listing Requirements in year 2001.

Malaysia corporate governance practices have improved since 1998 following the Asian financial crisis. The reforms of the corporate governance include the formulation of a ten-year Capital Market Master Plan in 2001, the demutualization of the Bursa Malaysia Stock Exchange, the introduction of the Code on Corporate

Governance in 2000 and changes in the composition and role of the Board of Directors (eStandardForum, 2010). The reform of this corporate governance is due to several weaknesses which have been pointed out in the World Bank Report on the Observance of Standards and Codes (ROSC) such as government's high level of equity ownership, low free float, weak protection of minority shareholders, and inadequate director' accountability. Corporate governance department in Bursa Malaysia was implemented in 2008. The main job of this department is to implement and monitor corporate governance policies of listed companies.

Malaysia Code of Corporate Governance is brought in by weak corporate governance practice during the Asian Financial Crisis in 2000. Malaysian Code on Corporate Governance adopted a hybrid of a prescriptive and a non-prescriptive model where prescriptive model sets the standards of desirable practices for disclosure of compliance while non-prescriptive model requires actual disclosure of corporate governance practices (Beh, 2007). Meanwhile, good corporate governance is based on the idea that firms should pursue the interests of the stakeholders. The aim of the code is to encourage disclosure by providing adequate, timely and relevant information to the investing public, to facilitate informed investment decision being made and to evaluate the performance of the companies; and set out the principles and best practices on structures and processes that the companies may use in their operations towards achieving the optimal governance framework (Beh, 2007).

Code of corporate governance are divided into four parts which are principles of corporate governance; best practices in corporate governance; principles and best practices for other corporate participants; and the explanatory notes (Beh, 2007). These include six principles where the first principle touches on ensuring the basis for an effective corporate governance framework, the second principle is about the right of shareholders and key ownership function, followed by the third one which is related to the equitable treatment of shareholders, next is the role of stakeholders in corporate governance, and as for the fifth is about the disclosure and transparency and lastly is the responsibility of the board.

Corporate Governance Guide

According to Bursa Malaysia (2010), this practice is used to encourage boards, managers and shareholders to eschew a tick-the-box approach in favour of thoughtful governance and to raise the level of corporate governance through the structuring and implementation of sound practices and processes which engender an effective board.

Besides, this guide is also designed to act as resources for the board of directors and its core committees to a better understanding on their roles, authorities and discharge of their oversight duties (Bursa Malaysia, 2010).

1.2.2 Yields

Bond yield is a percentage that investor receives from their investment. Bond yields are used to measure the profit made from an investment. The greater the profit, the lesser an investor needs to pay for that bond. Therefore, bond yield is a good indicator to determine how strong the stock market is and how much the interest will be given out.

Bond yield is an important investment measurement since bonds will tie up investor's money for a long period of time. Besides, bond yields are also important for individuals or organizations who wish to issue bonds since it provides market indication of the cost of raising capital by issuing bond.

Bond yields and bond price have an inverse relationship where when bond price goes up, bond yields will be going down and vice versa. The reason why bond price will increase is due to demands. When demands increased, bond price will increase as well.

Corporate bonds will pay higher yields than a government bond to attract investor to invest in their corporation. The most important is the credit ratings which estimate the credit risk of a corporation represents for bond investors. Higher rate bonds will have lower yields compared to lower rate bonds.

There are two problems that always need to take into consideration which is the time value of money and interest rate changing. Time value of money means a dollar today is worth more than a dollar tomorrow. While interest rates changing have a significant impact on bond trading and eventually in yields where the interest rate changes in the market do not have impact on those bonds that are already issued but it will affect the annual return that needs to be quoted on the newly issued bond.