

CORPORATE GOVERNANCE OF BANKS IN MALAYSIA

COUNTRY PAPER

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1. Introduction: An Overview

The financial and banking system in Malaysia has always been considered as safe and sound and Bank Negara Malaysia (the Central Bank of Malaysia) 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 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 Asian financial crisis of 1997 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 in the processes to improve corporate governance in Malaysia.

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

In the post crisis period, Bank Negara Malaysia has relentlessly encouraged both the banking and the corporate sectors to minimize this gap in the practice of the governance framework. All banks have adopted strict measures in enhancing of Board structures and composition; i.e. by appointment of independent directors, audit, nomination, remuneration and risk management committees. Bank examination by the Central Bank's inspectors includes the review and scrutiny of minutes and loans portfolio and financials. There is greater disclosure in the notes to their financial statements. Board members and top management of banking institutions are incrementally enhancing their effectiveness and cognizant of their accountability in their decision making process. Implanting new forms of corporate governance behavior will require time for them 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 Bank Negara Malaysia 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.

1.2 Asian Crisis and Banking Sector Problems

In this section, we will highlight some of the key concerns of the Malaysian government and the Central Bank and the structural weaknesses in the banking system during the crisis. In the midst of the banking crisis in 1998, the Malaysian government made three important policy decisions that contained the crisis and paved the way for the successful implementation of the restructuring and recapitalization processes in the banking sector. These three policy decisions provided the turning point in resolving the financial crisis:

(a) First, the Malaysian government closed the off-shore ringgit markets to sever the link between the domestic inter-bank market rates and the off-shore market rates; and then pegged the ringgit to the USD at RM3.80 to USD\$1.00.

(b) Second, the Malaysian government reduced the domestic interest rates and the reserve requirements of the banks to reduce the liquidity pressures that were adversely affecting the ability of the banking sector to mobilize and intermediate funds necessary for recovery of the economy.

(c) And third, the Malaysian government redefined the classification of non performing loans from three months to six months; which gave the banking institutions and corporate sector the needed time and breathing space to work out feasible debt rescheduling and restructuring schemes.

The rationale of the first policy action of the government was to stop the currency speculations and re-establish stability and equilibrium in the ringgit exchange rate. The impact of the second policy action was to inject liquidity into the banking system to alleviate the problems of illiquidity both in the financial and corporate sectors during the crisis period. The rationale of the third policy action was to minimize any potential insolvency problem by allowing both the banking and the corporate sectors to rework their debt restructuring schemes. As a package, the three policy actions of the government were considered a success in halting the precipitation of the crisis.

In retrospect, it must be recognized that the government was swift and decisive in its policy actions to contain and halt the crisis. However, there was still the structural problem that had to be reckoned with. 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 took too much risk and had too many losses. Such banks and firms were the main nexus of the illiquidity and foreign exchange risks that provided the setting of the preconditions for them to become the victims of the crisis when it hit. This focuses on the parties making the decisions and asks why they would put themselves into this vulnerable position.

To answer this question, we take advantage of the availability of a sample of annual report data of mainly domestic banks in Malaysia to explain some of the key problems in the banking sector related to the Asian financial crisis of 1997. The sample of the data is derived from the annual reports and financial statements data of the ten lead anchor banks and six other smaller

domestic banks. In addition, the financial data for four foreign owned banks are available for our analysis of the post crisis period.

The annual data series include the years from 1997 to 2003. As a collection, this small sample can still provide some useful financial indicators for a cross section analysis of the individual domestic banks in the banking industry. Our focus here is mainly on the large amounts of non-performing loans that were the result of excessive lending and the risk exposures of some of the banks during the crisis period.

In the total banking system during the period 1994-1997, loan growth in the broad property sector averaged about 44 percent per annum compared to about 22 percent in the manufacturing sector. Loan growth for the purchase of shares and for consumption credits in the total banking system averaged about 11.5 percent and 13 percent, respectively, during the same period.

There was a large variance in the loan growth in the broad property sector among the ten domestic banks. The range of their loan growth was between 10.5 percent and 70.7 percent. In contrast, loans disbursed to the manufacturing sector generally grew slower than those for the broad property sector. Among the ten domestic banks, the mean of the loan growth rate was about 30 percent for the broad property sector compared to about 14 percent in the manufacturing sector. The reason for these differences was simply the fact that the lending to the broad property sector was a more lucrative business than lending to the manufacturing sector for the bankers.

The average loan growth for purchase of shares among the individual banks was about 35 percent and there was a corresponding large standard deviation of 65.3. Two banks had exceptional high loan growth for purchase of shares of over 125 percent while four banks saw their loan growth for purchase of shares decline during the crisis year. The uniqueness of the cyclical nature of excess lending in the broad property sector in Malaysia has always been related to the 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 results in the deterioration in the quality of the loans. During the crisis period, it was evident that high non-performing loans (NPLs) were related to lower than average loan loss provisions even among the larger banks. The smaller banks, too, had relatively higher average non-performing loans ratio of 19.7 compared to an average of 11.1 for the larger banks. The smaller banks also had a relatively lower average loan loss provisions ratio of 53.9 compared to an average of 63.9 for the larger banks during the crisis period.

Table 1.1: 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

Table 1.1 provides an aggregate view of the total non performing loans (NPLs) and the core capital adequacy ratios (CAR) in the commercial banks during the period 1998-2003. The NPL figures suggest that the after effects of the excessive loan growth problems are still been felt

even after the successful completion of the government's recapitalization program in 2002. Despite the fact that the commercial banking sector appears well capitalized, the NPLs based on a six month classification have not improved significantly even after 2002; and one possible source of the high level of NPLs in the commercial banking sector is the sizable amount of unresolved old NPLs, especially the property related bad loans that are still in the books of the banks.

The annual report data provides evidence that some banks were indeed exposed to liquidity risks and market risks in the inter-bank markets. Liquidity risks are represented by the loan to deposit ratio and liquid assets to short term funding ratio. Market risks are measured by the net inter-bank asset (or liabilities) to total asset ratio. If the loan-deposit ratio is considered to represent the gearing ratio of a bank, the five banks with high gearing ratios (Arab-Malaysia Bank, Bank of Commerce, EON Bank, MayBank and Southern Bank) also had relatively low liquid asset ratios. As shown in Table 1.2, in contrast, Public Bank had an above average liquid asset ratio (61.7 percent) and a relatively lower gearing ratio (53.8 percent), implying relatively low vulnerabilities to liquidity risks. Except for Public Bank, the liquid asset ratios of most banks were between 27 to 42 percent during the crisis period.

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

Table 1.2: Liquidity Risks and Market Risks Ratios (%) of Ten Domestic Banks in 1997/98

	Liquidity risk: Total loans to deposits	Liquid assets to short term funding	Market risk: Inter-bank asset to total asset	Net inter- bank asset to total asset
Affin Bank	86.9	34.4	17.4	10.3
Alliance Bank	82.2	27.4	13.2	11.9
Arab-Malaysia Bank	145.4	28.1	20.2	-21.4
Bank of Commerce	100.8	28.6	20.9	8.6
EON Bank	127.7	42.0	26.4	-8.9
Hong Leong Bank	90.4	28.1	13.1	9.7
MayBank	108.4	32.6	18.2	-2.5
Public Bank	53.8	61.7	34.3	19.1
RHB Bank	98.4	38.4	17.5	-0.1
Southern Bank	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.

Table 1.3 summarizes the correlations between the key financial ratios of the sample of 16 domestic banks during the crisis year. The evidence suggests that the prudent behaviors of the banks are related to their risk exposures and profitability performance. A few key features stand

out in the correlation matrix about the behaviors and performance of the domestic banks during the crisis period:

(a) Banks with large amount of non performing loans usually had low loan loss provisions, suggesting that risk management in these banks was less than satisfactory.

(b) The more prudent banks held large amount of liquid assets and placed aside larger amount of loan loss provisions.

(c) Banks that held large amounts of liquid assets also held large amounts of inter-bank assets, implying that 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 ratio and the overhead cost ratio, but profitability of the banks is negatively correlated with their gearing ratios.

Table 1.3: Correlation Matrix of Banks' Financial Ratios in 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	Overhead cost to total 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	1

Sources: Annual Reports of the respective banks

The evidence from the annual report data suggests that the problems of excessive loans growth with rising non-performing loans and the problems of risk exposure with illiquidity in the banking institutions are related. The high level of non-performing loans represents default obligations of highly geared firms: associated with the troubled banks, there were also troubled and overleveraged firms in the corporate sector. We believe 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. The lessons from this crisis is that there is now a challenge for both the Central Bank and the leaders in the banking and corporate sectors to ensure that the internal corporate governance mechanism works and the regulatory guidelines to strengthen market discipline and fiscal discipline are implemented in practice to prevent any repeat of another financial crisis in the future.

1.3 Significance and Objectives of the Study

One of our primary concerns in this report is to explain why the corporate governance mechanism in the Malaysian banking system was frayed to extremis during the Asian financial crisis of 1997. 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 analyzing the changes and developments in the corporate governance regulatory norms as applied in the banking sector since 1997.

The scope of our study will be confined to the domestic banking industry where our analysis will be focused on the ten 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 approaches in the domestic banking industry. The results in the opinion survey of the Board members have provided us with some useful insights for our understanding of how Board members consider such important issues as the effectiveness of a Board, the independence of Board members and the key elements for enhancing the effectiveness of Boards in the domestic banking system especially in the changing banking industry landscape during this period.

The significance of this study is that some evidence have emerged from the results of the survey questionnaires that the rapid enhancement of the regulatory norms such as the Central Bank's regulatory guidelines GP1 (Guidelines on Directorship in the Banking Institutions) and GP8 (Guidelines on the Specimen Financial Statements for the Banking Industry) have resulted in structural changes being made into the internal governance mechanism of the 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.

Because of the richness and quality in the basic corporate information content of the banks' annual reports, we have attempted to construct a monitoring and disclosure index of the ten domestic banks for the period 1998-2003. In developing this monitoring and disclosure index,

our objective is to relate the implementation of Bank Negara Malaysia's regulatory guidelines GP1, GP3 (Guidelines 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 guidelines GP8 on disclosures requirements among the 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 Central Bank's 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 that were introduced over thirty years ago. The restructuring objectives of the NEP have very far reaching policy effects on the redistribution of wealth and income in the Malaysian society during the past thirty years; and invariably these restructuring objectives of the NEP set the tone of 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 categorized into government owned banks, family owned banks and a couple of banks with corporate and widely held ownership structure.

We believe that the issue of ownership structures in the banking industry is an important one, especially from the Malaysian government policy perspective. Our purpose here is to establish a statistical relationship between the performances of the domestic banks and 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.

1.4 Summary of the Findings on Corporate Governance of Banks

The main theme of this report is to discern whether the internal corporate governance mechanism in the banking system has improved in Malaysia during the post crisis period. Post 1998 saw a rapid enhancement of regulatory norms, such as the Central Bank guidelines GP1 and GP8, which resulted in structural changes being effected into the internal governance mechanism in the banking system. In a survey conducted by questionnaires of the opinions of the Board of Directors, some very interesting results were revealed about the emerging dynamics of corporate governance in the domestic banking institutions. The key elements of the survey and how it was conducted are described in Section 4.2.

A major concern of the survey is to discern the roles and effectiveness of the Board of Directors in the domestic banking system. On average, over 80 percent of our respondents in the survey believe that the Boards in the domestic banking system are effective. In particular, we have found that Board members are cognizant about the elements that are 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 not effective 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, discerning poor operating performance of the bank's business operations and playing an important role in selecting, monitoring and ensuring that the CEO is performing his/her role in the interests of the shareholders, the depositors and other stakeholders.

It is encouraging to see that all members of the Board of Directors surveyed agreed that they are effective in the establishment of risk management and internal control systems in the domestic banking institutions. This strong agreement is in the main reflective of the conclusion 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 BAFIA (The Banking and Financial Institutions Act 1989) have 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 effectiveness of the Board to ensure 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' perspective on the issue of conflict of interests and related party transactions. Of those surveyed, a large majority agree that their Board is effective in overseeing this crucial area of governance abuse. It is noteworthy that there is a small percentage that holds the view that the Board is not effective in this area. It is difficult to surmise the reason for this disagreement.

In the spirit of guidelines GP1, the power of the controlling owners and CEO/Executive Chairman 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 the governance operations in their organizations.

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 Board room. In all the banks, the Chairman of the Audit Committee and the Risk Management Committee is an independent director. We think that this trend augurs well for the conduct of governance in the banking sector.

In two of the banks, however, the Chairman of the Nomination Committee is not an independent director. Similarly, in three banks, the Chairman of the Compensation Committee is not an independent director. Perhaps, to allay the fears that the presence of a non-independent Chairman could affect the dynamics in these committees, the non-independent Chairman of these committees could mitigate the concern by allowing an independent member of the Board to take over the Chair of these committees.

Over 84 percent of those surveyed believe that they can see many ways to enhance Board effectiveness. Such spirits of Malaysian directors are very encouraging for the development of effective Boards in the domestic banking institutions. All those surveyed seem to agree that there are some common ingredients to enhance Board effectiveness.

Most of the respondents believe that selecting better qualified and truly independent directors can enhance the effectiveness of the Board. The requirements of independence is not confined to independent directors, it should be an integral characteristics of all Board discussions. Again almost all respondents surveyed agree strongly that promoting constructive criticism and alternative views in Boardroom discussions will enhance the effectiveness of the Board.

The survey results reveal that the variety of recent Central Bank's regulatory reforms that mirror and encourage the value and role of independent directors has been significant. In general, about 71.5 percent of those surveyed agree that independent directors are truly independent from the CEO or the controlling shareholders. The survey results implied that regulatory norms that have both regulatory and legislative bite can have a desired advantage because they are not optional or subject to the discretion of the controlling owners to institute these structural changes.

The issue of whether independent directors are truly independent is important when reservations exist about whether they are truly independent. For example, about 24 percent agree that independent directors are not fully independent. Their main concern may have arisen because either the CEO/controlling owners selected them or could decide on the extension or termination of their directorship. More disturbing is that 18.9 percent of those surveyed do not even have an opinion on this important issue of Board independence. This signals that more is needed to be done to ensure that Board independence is the prerequisite for Board members to play their role effectively.

All respondents believe that the roles of Chairman and CEO should be separated but there is no mandatory requirement that this should be so. All Board members believe that better disclosure of Board activities can enhance the effectiveness of the Board. This is important in the light of the Central Bank'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.

While there are agreements on some common ingredients to enhance Board effectiveness, some respondents also feel that they cannot agree on certain contentious issues: these include introduction of formal annual evaluation of directors and the linkage of directors' compensation to performance. About 10 percent of those surveyed abstain from providing an opinion. It is difficult to discern whether a no opinion vote in such issues actually means disagreement: about 5.7 percent of those surveyed disagree that having fewer or no Board members from the controlling shareholder's family could actually enhance the effectiveness of the Board. The results obviously reflect the various interest groups in the Boards of the domestic banking institutions.

2. Evolution and Restructuring of the Banking Sector

In 1998, the Malaysian government established three institutions to resolve the growing non-performing loans (NPLs) problems in the banking sector. These institutions were Danaharta, Danamodal and the Corporate Debt Restructuring Committee (CDRC). The responsibility of Danaharta, the asset management company, was to purchase NPLs from banking institutions and manage these NPLs in order to maximize their recovery value. The complementary role of Danamodal was to recapitalize the ailing domestic banking institutions to a healthy level. And the role of the CDRC was to facilitate the restructuring of the corporate debts among creditors and debtors by mediation without resorting to legal proceedings.

The banking sector restructuring effort of Bank Negara Malaysia is substantially completed. Five years after its establishment in 1998, Danamodal (the capital injection vehicle for the Central Bank) wound down its operation on the last day of December 2003, following the closure of the CDRC in August 2002. Danaharta has also completed its task of acquiring NPLs from the

financial sector in 2001 and is making significant progress in its recovery operations. Danaharta had been very successful during the crisis period in containing the rise of the NPLs in order for the banking system to function efficiently during the intermediation process.

2.1. Overview of Banking Sector Restructuring After the Crisis

The accomplishment of Danamodal is quite impressive. Danamodal's success in recapitalizing the ailing banking institutions has enabled these banking institutions to 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 banking crisis of 1997. This capital injection is significantly below the initial budget of RM16 billion allocated for this purpose. The success of Danamodal 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, which is also supported by due diligence reviews of the viability of the banking institutions 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 recapitalization. In the final analysis, Danamodal was able to keep the total cost of recapitalization at a low level of about 0.2 percent of GDP.

The task of Danamodal did not stop after its recapitalization of the weak but viable banking institutions. As a strategic shareholder in these recapitalized banking institutions, Danamodal also was responsible to initiate and carry out micro reforms such as proper risk management practices, good corporate governance and higher operational efficiencies. With the improved capital position, coupled with the operational and efficient restructuring, these banking institutions could resume their business of bank lending activities without unnecessary lagged time. Danamodal in its role as a strategic shareholder or bondholder had the opportunity to facilitate the bank merger and consolidation exercise of Bank Negara Malaysia during the post crisis period.

The accomplishment of Danaharta is equally impressive. Of the RM52 billion adjusted loan rights acquired in its portfolio, Danaharta expected to recover about 58 percent or RM30.6 billion over the duration of its operation. At the end of 2003, about 73 percent 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 2.1 shows the distribution of the RM52 billion loan rights acquired by Danaharta at the end of 2003.

Table 2.1: Danaharta Loan Recovery as at 31st December 2003

	Adjusted Loan Rights acquired (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

At the end of its term in August 2002, the CDRC completed the debt restructuring efforts undertaken since 1998. During the four years of its operation, the CDRC had resolved successfully 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 2.2, a total of 87 cases were referred to the CDRC and out of this total, 11 cases were transferred to Danaharta and 28 cases were rejected or withdrawn.

Table 2.2: Status of CDRC Cases as at 31st December 2002

	Total Debt Outstanding (RM million)	Number of Accounts
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

2.2. Ownership Structure of Banks Before and After the Crisis

Consolidation of the banking industry usually changes the composition of the ownership structure in the merged banking groups and the market structure of the banking industry. 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 program was completed. While the consolidation program resulted in larger and better capitalized domestic banking institutions, it does not seem to have any significant effect on the composition of the ownership structure in the banking industry.

The government's sudden decision to initiate a bank merger program 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 the difficulties of some banking institutions became apparent as a result of their substantial losses and high NPLs ratios, the Central Bank acknowledged that two banks and three finance companies were in need of recapitalization. Two of the larger domestic banks, Sime Bank and Bank Bumiputra which had losses of about USD420 million and USD200 million, respectively, were eventually taken over by RHB Bank and Bank of Commerce.

In July 1999, the government initiated a robust bank merger program 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, resulting in criticisms that the plan was predominantly politically motivated rather than targeted to resuscitate the ailing banking industry from the crisis or to promote efficiency in the banking system. Moreover, the merger plan did not seem to improve the asset quality of the merging groups, 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 a minimum shareholder funds of RM2 billion and an asset base of at least RM25 billion. This new merger program, which allowed all domestic banking groups to choose their own lead anchor bank, was finally completed in 2001.

Table 2.4 reflects the legal shareholdings and ownership control structure in the ten lead anchor bank groupings 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 percent Bumiputra participation in commerce and industry.

Table 2.4: Ownership Structure of the Domestic Banking Groups

Domestic Banking Groups	Ownership Control Structure
Affin Bank	Government connected ownership
Alliance Bank	Corporate ownership and widely held
Arab-Malaysian Bank	Family and corporate ownership
Bumiputra Commerce Bank	Government connected ownership
EON Bank	Government connected ownership
Hong Leong Bank	Family and corporate ownership
MayBank	Government connected ownership
Public Bank	Family and corporate ownership
RHB Bank	Family and corporate ownership
Southern Bank	Corporate ownership and widely held

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

The banking institutions involved in the merger program are shown in Table 2.5. The bank merger program has resulted in a banking landscape that involves financial conglomerates with increasingly complex group structures. While the basic ownership structure of the ten 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 given in the annual reports now.

Table 2.5: Bank Mergers of Domestic Banking Institutions

Lead Anchor Bank	Original Merging Commercial Banks	Other Merging Financial Institutions
Affin Bank Group	Perwira Affin Bank BSN Commercial Bank	Asia Commercial Finance Bhd Perwira Affin Merchant Bank BSN Finance Bhd BSN Merchant Bankers Bhd
Alliance Bank Group	Multi-Purpose Bank International Bank Malaysia Sabah Bank	Sabah Finance Bhd Bolton Finance Bhd Amanah Merchant Bank Bhd Bumiputra Merchant Bankers
Arab-Malaysian Bank Group	Arab-Malaysian Bank Bank Utama	Arab-Malaysian Finance Bhd Arab-Malaysian Merchant Bank Mbf Finance Bhd Utama Merchant Bankers Bhd
Bumiputra Commerce Bank Group	Bank of Commerce Bank Bumiputra	Bumiputra Commerce Finance Bhd Commerce International Merchant Bankers
EON Bank Group	EON Bank Oriental Bank	EON Finance Bhd City Finance Bhd Perkasa Finance Bhd Malaysian International Merchant Bankers

Hong Leong Bank Group	Hong Leong Bank Wah Tat Bank	Hong Leong Finance Bhd Credit Corporation Bhd
Malayan Banking Group	MayBank Pacific Bank PhileoAllied Bank	Malayan Finance Bhd AseamBankers Malaysia Bhd Sime Finance Bhd Kewangan Bersatu Bhd
Public Bank Group	Public Bank Hock Hua Bank	Public Finance Bhd Public Merchant Bank Bhd Advance Finance Bhd Sime Merchant Bankers Bhd
RHB Bank Group	RHB Bank	RHB Sakura Merchant Bankers Bhd Delta Finance Bhd Interfinance Bhd
Southern Bank Group	Southern Bank Ban Hin Lee Bank	United Merchant Finance Bhd Perdana Finance Bhd Cempaka Finance Bhd Perdana Merchant Bankers Bhd

Source: Bank Negara Malaysia Annual Report 2001

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. For example, the three substantial shareholders of MayBank in 2003 are Skim Amanah Saham Bumiputra (33.95 percent), Permodalan Nasional Berhad (13.81 percent) and the Employees Provident Fund Board (9.81 percent). And the three largest shareholders of Bumiputra Commerce Bank in 2003 are the Employees Provident Fund Board (26.61 percent), Khazanah Nasional Berhad (11.26 percent) and Kumpulan Wang Amanah Pencen (7.62 percent).

The government ownership structure in the domestic banking system in 2003 is shown in Table 2.6. There are five main government agencies that have 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 is the investment arm of the Ministry of Finance. EPF, PKS and KWAP are the social securities and pension funds of the government agencies.

Reading down the column of Table 2.6 shows the percentage of shareholdings that each government agency holds in each of the domestic banking institutions. For example in 2003, PNB held about 50.9 percent of the total shareholdings of MayBank; and this included the shareholdings of its unit trusts which PNB used as its vehicles 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). In total, PNB had about 60.2% shareholdings ownership in the ten domestic banks combined.

Table 2.6: 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	1.18	8.53		0.52		39.46		49.69
Alliance Bank	0.39	0.88		0.41				1.68
Arab Malaysia Bank	0.91	10.78		1.22	0.37			13.28
Bumiputra Commerce Bank	6.09	26.61	11.26		8.77			52.73
EON Bank		0.93		0.22			50.1	51.25
Hong Leong Bank		0.19						0.19
MayBank	50.93	9.81	1.35	0.62	1.89			64.60
Public Bank		4.91						4.91
RHB Bank	0.10	31.77		0.56	11.01			43.44
Southern Bank	0.60	2.67						3.27
Column Total	60.20	97.08	12.61	3.55	22.04	39.46	50.1	

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

Historically, the EPF has been an important source of funds for the government to tap to promote its economic development objectives. Now it is also a major vehicle in which the government can have shareholding ownership control in the domestic banking institutions. In 2003, EPF owned 26.6 percent of the total shareholdings of Bumiputra Commerce Bank and 31.8 percent of the total shareholdings of RHB Bank. In the aggregate (the column total), EPF had 97 percent shareholdings in all the ten domestic banking institutions combined.

Reading across the row of Table 2.6 shows the total shareholdings of all the government agencies in an individual domestic bank in 2003. For example in the row total, 64.6 percent of the shareholdings of MayBank were owned by the various government agencies or investment vehicles. And 52.7 percent of the total shareholdings of Bumiputra Commerce Bank were owned by the various government agencies with EPF and Khazanah being the largest government controlling shareholders.

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

Table 2.7: Family Ownership Structure in the Domestic Banking Institutions Shareholdings (%) by Family Groups in 2003

	Family Ownership Structure Shareholding Percentage to Total
Arab Malaysia Bank	35.2
Hong Leong Bank	60.9
Public Bank	32.6
RHB Bank	32.0

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

The family ownership structure in the domestic banking system is more straightforward. Table 2.7 provides the direct shareholdings of the four main family groups: Tan Sri Azman Hashim (Arab Malaysia Corporation Berhad, AMCB), 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 is now the largest controlling shareholder in the RHB Banking Group.

The ownership structures in both Table 2.6 and Table 2.7 imply that there is a high concentration of shareholding by ownership types. Interesting enough, Section 46 of the Banking and Financial Institutions Act (BAFIA) of 1989 requires that all banks should institutionalize their shareholding structure by restricting ownership in a bank to no more than 20 percent for each institution and no more than 10 percent for individuals. Although the restriction of ownership under Section 46 has been in place for a long time, it appears that this regulation has not been strictly enforced by the Central Bank. The reason is that the regulation does not apply retrospectively to the ownership structure of the banks that has already been in place before 1989.

2.3. Recent Policy Efforts to Enhance Corporate Governance of Banks

Banking crises have significant externalities in the economy. Much of the externalities are negative in nature and are related to the effects of the direct and indirect costs of crisis resolution. Ironically, one of the beneficial externalities that resulted from the 1997 banking crisis is the acceleration of the government's program to institute measures to enhance corporate governance in the banking system.

A brief review of the policy efforts of Bank Negara Malaysia to enhance corporate governance in the banking industry is considered in this section. 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:

- (a) Statutory provisions that govern entry, ownership and appointment of key officers;
- (b) Regulatory guidelines that govern the control of composition of Board of Directors, setting up of subcommittees in audit, nomination, remuneration and risk management;
- (c) Regulatory directives to set up internal control systems within the banking institutions.

Since the crisis period, Bank Negara Malaysia has revised and issued a number of regulatory guidelines; and in terms of classification of these Central Bank guidelines, there is now a set of eleven GPs (Garis Paduan is the Malay term for guidelines). Table 2.8 provides a list of these Central Bank regulatory guidelines.

Table 2.8: 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/GP	Guidelines on Minimum Audit Standards for Internal Auditors of Financial Institutions

Source: Bank Negara Malaysia Guidelines

In the post crisis period, the Central Bank’s policy focus to enhance corporate governance in the banking system has been mainly on categories (b) and (c). We consider the two most important regulatory guidelines of the Central Bank that will have far reaching policy implications in the banking industry are GP1 (Guidelines on Directorship in the Banking Institutions) and GP8 (Guidelines on the Specimen Financial Statements for the Banking Industry).

2.3.1 GP1: Guidelines on Directorship in the Banking Institutions

Guidelines GP1 which was 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 Bank Negara Malaysia, the intent of these guidelines is to enhance effectiveness of the Board 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: nominating committee, remuneration committee and risk management committee.

We believe that this Guidelines GP1 provides the implied countervailing force to balance the concentration of power of the controlling owners and CEO/Executive Chairman in some domestic banking institutions. By way of structuring the various committees with the most competent individuals appointed and elected 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 Guidelines GP1 was also in response to one of the major concerns that the Boards in the banking industry were not effective 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 the Central Bank for the appointment of the CEO and other directors and this test operates as an effective sieve for appointment of only acceptable and competent individuals to the Boards.

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

The Guidelines GP1 allows 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 Guidelines GP1 also define the role of independent directors: the primary responsibility of each independent director is to protect the interest 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:

- (a) The Guidelines impose a 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 the lapse of five years.
- (b) The Guidelines also require that the banking institution’s Audit Committee must give prior approval to any provision of non-audit services by the same audit firm before the latter could provide such services to the banking institution.
- (c) The Guidelines require that the approval of the re-appointment of external auditors on an annual basis must be decided by Bank Negara Malaysia. The re-appointment decision should not compromise on the auditor’s independence in the interim period before the five years rotation requirement takes effect.

2.3.2 GP8: Specimen Financial Statements for the Banking Industry

This Guideline (GP8) was first introduced in 1988 primarily to ensure that financial institutions comply with the provisions of the Companies Act 1965 and the required accounting standards. GP8 places the primary responsibility for the preparation of financial statement on the Board that is expected to develop a sound financial reporting structure to ensure the integrity and reliability of its accounts. Although GP8 recognises a self regulatory stance, it is also less prescriptive, thus enabling the banking institution to have some flexibility in disclosing their policies and reporting their financial performance and business operations according to the specific circumstances pertaining to the institution.

The Guideline (GP8) is a very important set of regulatory guidelines pertaining to disclosure requirements. The Guideline GP8 requires financial institutions to disclose material and exceptional facts to facilitate users in their assessments of the financial position and performance of the financial institution. 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 the improvements in accounting standards of the Malaysian Accounting Standards Board (MASB) 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 role of the Board of Directors in the preparation of financial statements, assessment of the banking institution's operations in the past and the coming year; and also on 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 operations of the Interest Free Islamic Banking Scheme, the updating of accounting standards by the MASB and the increasing requirements for greater public disclosure to foster market discipline.

2.3.3 Guidelines on Risk Exposures and Capital Adequacy

After the crisis period, Bank Negara Malaysia 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, the Central Bank 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 risk exposures to these sectors 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 the 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.

In line with the objective of Basel II on capital adequacy and the need to attain greater risk sensitivity in the measurement of capital requirements, the Guidelines also require the banking institutions to increase their capital requirements to support the institution's exposure to these sectors should the risk exposure exceeds a predetermined threshold. The intent of these revised Guidelines 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 that was perpetuated during the crisis period.

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

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

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

2.3.4 Supervision of Financial Conglomerates

On December 2003, the Central Bank issued a concept paper on the “Consolidated Supervision of Financial Conglomerates” to address complex corporate group structures which involve 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: group structures, corporate governance, risk management, intra-group exposures and reporting requirements of the financial conglomerates.

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

The concept paper also recognizes that the basic principles of good corporate governance are extended to the financial holding company (FHC). The FHC will be required to adhere to capital adequacy requirements (CAR) for the group. The Central Bank will assess the CAR of the financial institution on an individual and consolidated basis (with its subsidiaries) as well as 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 all potential sources of contagion risks (cross selling excluded) should be identified and addresses promptly, clear written policies must be in place on intra group exposures. FHC are required to submit periodic reports to the Central Bank to facilitate assessment of the financial conglomerate.

2.3.5 Financial Sector Master Plan

Finally, to derive an overall perspective of the Central Bank’s efforts to enhance corporate governance in the banking sector, it is important to consider the broad strategies for the development of the financial sector in the Financial Sector Master Plan (FSMP) that was launched in March 2001. According to the Central Bank, the end objective of the FSMP is to

encourage the financial system to evolve into one that is competitive, resilient and dynamic. The implementation of the FSMP since its inception have been predominantly focused on the strengthening of the regulatory and supervisory framework to promote a safe and efficient payments system for the domestic financial institutions to function effectively and competitively with their enhanced capacity and capability since the post crisis period.

The FSMP also sets the tone for market discipline to play its role in the corporate governance mechanism of the banking system since it encourages the development of the payments system through the competitive forces of the market place. And at the same time, a deposit insurance system will be introduced as an additional financial safety net to complement the role of the Central Bank as a 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 structure of the deposit insurance system. These incentives include differential premium contributions from banking institutions that provide an appropriate level of protection coverage to the large majority of depositors and at the same time giving sufficient incentives for large and institutional depositors with access to financial expertise to monitor and instil effective market discipline on the risk taking behaviours of the banking institutions.

3. 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 the conduct of its 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 primary responsibility of the Central Bank to ensure that the whole financial system especially the banking system is safe, strong and sound. A primary means of ensuring the safety and soundness of the banking system is through the regulatory and supervisory process.

Over the past forty years, the Central Bank 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 will 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 the development of a viable financial safety net and prudential regulations framework is the careful balancing of the need for effective regulatory oversight without, at the same time, increasing regulatory burden with the enhancement of effective market discipline.

There are four pillars that support the financial safety net for the Malaysian financial system. The first pillar of support is based on the prudential regulation and supervision by the Central Bank. The major sources of statutory regulations that form the fundamental regulatory framework of financial safety net 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, 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 safety and soundness of the banking system, to foster competitive efficiency within the banking system and to protect the consumers and depositors.

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

3.1 Depositor Protection Before and After the Crisis

Much of the prudential re-regulations that were aimed to protect 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. And this historical backdrop can provide some insight and understanding of the rationale of the government's concern and need for improving and tightening the regulatory financial safety net and prudential re-regulations during the period. These legislative instruments have now provided the fundamental regulatory framework for the Central Bank to resolve effectively the problems of the recent 1997 banking crisis.

As early as 1966 the Central Bank stepped into Malayan Banking Berhad 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. Under the Emergency (Essential Powers) Ordinance No 12, 1969, the government is empowered to declare a bank, "a protected bank" on grounds of public interest. When such a declaration is made, the powers of the shareholders and the Board of Directors cease. The government may also remove any director and acquire the shares of such a declared institution.

The Central Bank, 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 twenty four deposit-taking co-operatives which had over 500,000 depositors were frozen. This led to a contagion effect on 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 were emanated from inadequate internal controls, ineffective management and also fraudulent conduct. The corrective actions taken by the Central Bank included revamping of the Board of Directors and the senior management, setting up internal control mechanisms and the injection of capital into these distressed banks.

The banking problems of the 1980s convinced the Central Bank that there was a need to enhance its powers to deal with the 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 faced by the banking industry. One of the key legislative measures introduced, during this period, to protect depositors was the enhancement of the powers of the Central Bank to deal with a banking crisis.

The Central Bank can use its power to implement measures to protect the depositors during a crisis. With the concurrence of the Minister of Finance or by itself, the Central Bank is empowered under BAFIA to take remedial measures to ensure that the problems of the distressed banking institutions do not precipitate and amplify into 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 a bank run, measures to rectify any

mismanagement in the banking institutions and termination, if necessary of the financial institution.

3.2 Lender of Last Resort

In Malaysia there have been situations when the Central Bank 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 the demands for cash withdrawal of its depositors. The Central Bank'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 the Central Bank 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 BAFIA, where the Central Bank can grant loans to a locally incorporated banking institution against the pledge of shares or it can take up other collaterals of the banking institutions.

Past experiences demonstrated that the Central Bank has a stabilizing function in a banking crisis. For example, in 1986, it was used to stabilise Supreme Finance Berhad when there was a run triggered by the arrest of a business man cum politician associated with the institution. However, when the government uses this facility several times to bail out the same problem bank, then the public would construe this as regulatory forbearance. For example, the Bank Bumiputra Berhad was bailed out three times by the government, twice through the funding from Petronas in 1984 and 1989. In 1998, when the bank was in trouble again, the government decided to merge the bank with the Bank of Commerce.

3.3 The Proposed Deposit Insurance System in Malaysia

The government in the past has always provided the banking system with some form of implicit deposit insurance. In 2003, the Central Bank announced that substantial progress has been made towards finalizing the features of a proposed deposit insurance system that will pave the way for its establishment. According to the Central Bank, the proposed deposit insurance system will 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 the depositors in the commercial banks, Islamic banks and the finance companies.

3.3.1 Institutional Structure

The deposit insurance system will be administered by a new statutory body or agency that will be provided with a legislative mandate to carry out its functions and responsibilities. The main function of the agency is both to administer the deposit insurance system and to 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 stability of the financial system.

In addition, the agency will have a role to undertake the resolution of banking institutions under certain circumstances as may be required, based on the assessment of the Central Bank. In this role, the agency will facilitate in the cost minimization of bank resolutions to the financial system.

3.3.2 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.

The Central Bank issued a concept paper on November 2004 to the banking industry; in the paper it sets out the scope of coverage of the system. According to the Central Bank, deposit insurance protection will be provided up to a prescribed limit for all eligible depositors of member institutions. Deposits that are 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 the banking institutions.

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

3.3.3 Premium Assessment

In early 2005, the Central Bank 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 implementation of the system; after that a risk adjusted differential premium will be applied. Under the differential premium system, a high premium rate will be paid by any member institutions whose activities increase the risk of losses to the deposit insurance system. 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 cost of premium contribution.

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.

3.4 BAFIA and Strength of Prudential Regulations

The BAFIA which came into force on October 1, 1989 was a clear and robust regulatory response to the crisis of the mid-1980s. According to Bank Negara Malaysia, BAFIA represents one of the main objectives that the Central Bank can use to introduce prudential reforms and regulations, including measures to liberalise the 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 the banking institutions: on entry and exit, on management and organizational structures and on ownership and control. By their nature, prudential regulations have preventive elements inherent in them; and these preventive elements are the implicit strength of prudential regulations.

Under BAFIA, the Central Bank has the authority to decide on a host of prudential objectives of entry control. The Central Bank has imposed the following entry controls:

- (a) Written approval to be secured before any arrangements to acquire and dispose of 5% holding in a licensed institution.
- (b) Maximum permissible holdings of 10% for individuals and 20% for institutions. The required consent and permission is based on the Minister being satisfied that it is in the public interest and will promote sound financial structure.
- (c) Control through licensing with powers to revoke and /or circumscribe the scope of licensee business.

Prudential regulations that have an impact on management include the appointment of the senior management and of the directors of the banking institutions. The Central Bank requires that only "fit and proper" persons can be directors, controllers or managers of the institution. This quality is related to probity competency, soundness of judgment and fulfilment of responsibilities of the position held; this regulation also ensures that the interests of the depositors are not in any way threatened by those holding these important positions in the banking institutions.

Prudential regulations that affect the organizational structures require that the business of banking shall be conducted as the institution maintains net assets and other financial resources in a prudent manner. These net assets should provide for the nature and scale of the institution's operations and should be sufficient to safeguard the interests of depositors and potential depositors and prudently handle the risks inherent in the operations of any other related corporations of the institution, so far as capable of affecting the institution.

The implicit strength of BAFIA is also in its provisions of several preventive elements of prudential regulations for the banking institutions. These preventive elements pertain to the maintenance of reserve funds, capital funds, liquid assets and assets in Malaysia. 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 any credit facilities to any person during the period in which the institution has failed to comply with any requirements under the provision of BAFIA.

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

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

In retrospect, it now appears that the focus of the prudential regulations that were introduced to solve the 1980's banking problems was largely aimed at the need, on grounds of public interest in the banking industry, to correct inadequate internal control, ineffective management and fraudulent conduct. Given the needs of the time, these strict enforced compliance measures were necessary; and not the result of the government and regulators overreactions to the fraudulent behaviour of a few in the banking problems of the 1980s. Nevertheless, regulatory reforms pertaining to corporate governance issues in the banking industry often follow in the wake of banking crisis. Since Malaysia had adopted the Basle Capital Accord of 1988, long before the 1997 financial crisis, it seems strange that there was a lack of emphasis upon the need to inculcate a culture of good corporate governance in the banking system after the series of banking debacle in the mid-1980s.

One of the recurring concerns about the Malaysian domestic banking system since the 1980s was the government regulatory forbearance. Such concerns have led to public perception that moral hazard is a given in the government connected banks despite the arsenal of prudential regulations that are available for the Central Bank to enforce strict compliance of its rules and regulatory guidelines in the domestic banking system. The constraint that the Central Bank faces in the implementation of its regulatory guidelines may be political in nature. The Central Bank, like all government agencies, was required to implement the restructuring objectives of the government's New Economic Policy (NEP) then and the New Development Policy (NDP) now. Whilst the objectives of the NEP and the NDP 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. And 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, much of the prudential re-regulations that were aimed to solve the banking problems of the 1980s were very much 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 an enforced compliance to the regulatory guidelines rather than pragmatically allowing for discretions and exceptions. It is not clear if the failure of the banking sector during 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, the Central Bank has been more flexible and less prescriptive in its approach to re-regulating the banking industry. There is a genuine visionary and progressive thinking in the minds of the Central Bank to pursue a balance between regulatory compliance and the development and enhancement of 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 inculcation of a good corporate governance culture in the domestic banking system.

4. 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 about the elements that are considered significant in engendering a more effective Board. The overall role of the Board of Directors has become more complex. The responsibilities of the Board 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 that were designed by the Asian Development Bank Institute (ADBI) to discern the unique features of Board characteristics and the effectiveness of the Board through eliciting the subjective opinions of the Board members. We conducted this survey by requesting a sample of both the executive and non executive independent directors of the Board of ten domestic banks to complete the survey forms during the period July to December 2004. It was encouraging to find that, on average, over 80 percent of our survey respondents believe that the Boards in the domestic banking system are effective. This is reads very well for the development of corporate governance practices in Malaysia, given the concerns that the Boards were not effective and did not play their rightful roles before the crisis period.

4.1 Unique Features of Corporate Governance for Banks

The domestic banking institutions have particular importance in the financial system and the economy in Malaysia 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 have to play in order to ensure stability in the financial and payments system. Since the stability of the banking system is a public good, the domestic private banking institutions have a public purpose. As such, the domestic banking institutions are subject to the policies and regulatory guidelines issued by the Central Bank and also to the supervisory review of their own corporate governance policies and practices.

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

The focus of corporate governance for banks is also different in the banking system because of the financial intermediary role. The liability funding sources of domestic banking institutions are typically in the form of deposits from both the sophisticated and the unsophisticated depositors of the non-financial corporate sectors and the general population. In the past, the government's regulatory forbearance for government connected banks has been perceived as triggering the removal of the incentives for depositors, or debt holders of the banks to monitor the financial conditions and performance of the domestic banking institutions.

The domestic banking system in Malaysia is also different as a result of its role as a financial intermediary to support and facilitate the implementation of the restructuring objectives of the government's New Development Policy (NDP). The government has often used the domestic banking institutions as a main intermediary and channel to supply funds and loans to the various government directed economic sectors.

For all these reasons, the practice of good corporate governance in the domestic banking system in Malaysia is an important public policy issue and the domestic banking institutions are subject to the regulatory oversight of the Central Bank. The Board of Directors in the domestic banking institutions are responsible not only to the shareholders of these banking institutions, 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 the domestic banking institutions often have a direct and yet pervasive influence in almost all the sectors of the economy.

4.2 The Questionnaire Surveys

An important contribution of this study was the conduct of four sets of survey questionnaires pertaining to corporate governance in the domestic banking system in Malaysia. The survey questionnaires include all the ten domestic banking institutions in Malaysia and the time frame is for the period 2000-2003. The following surveys were conducted:

1. Survey of Board of Directors and Basic Corporate Information
2. Opinion Survey of Board Members
3. Survey of Executive Compensation
4. Survey of Risk Management Practices

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

4.3 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 survey results about corporate governance that have been conducted for the domestic banking sector in Malaysia and therefore these results should be of interest to the domestic banking community in Malaysia. Our analysis will consider the mean values about the Board characteristics and the results of the opinion survey of the Board of Directors in the sample of domestic banks that we received from the respondents. Table 4.1 provides a

summary of the descriptive statistics of the Board characteristics of the ten domestic banking institutions.

A few interesting salient features about the Board characteristics stand out in Table 4.1. The mean Board size in the domestic banks is 9 members with about half of them being independent directors. The Board members are generally very highly qualified, with one bank having 9 directors who either have a professional law or accountancy designation. The mean number of directors with university degrees is 5, which is half of the average Board size. The number of women directors in 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 mean size of the Audit Committee and the Risk Management Committee is 4 with a mean of 3 independent directors. In all the banks, the Chairman in the Audit Committee and the Risk Management Committee is an independent director.

The mean number of members in the Nomination Committee is 5, with a mean of 3 independent directors. In two of the banks, the Chairman of the Nomination Committee is not an independent director. This again applies in the Compensation Committee in three of the banks where the Chairman is also not an independent director.

Table 4.1: 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

The asterisk (*) in the Table implies “not relevant for the mean”

Source: Survey of Board of Directors and Basic Corporate Information

4.4 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 is expressed as Y+ = strongly agree, Y = agree, O = no opinion, N = disagree and N+ = strongly disagree.

The structure of the questionnaires in the survey attempts to elicit the opinions of the Board members regarding their views on the following:

- (1) Responsibilities of the Board
- (2) Role of Board of Directors
- (3) Effectiveness of the Board
- (4) Independence of Board members
- (5) Selection of the CEO and independent directors
- (6) Access to information by independent directors
- (7) Compensation of directors and their liabilities
- (8) Enhancing the effectiveness of the Board
- (9) Most important entities in improving corporate governance in banks.

The survey by questionnaire of the opinions of Board members has produced some very interesting results. The following three tables Table 4.2, Table 4.3 and Table 4.4 provide a summary of all the results in terms of percentages to the total aggregate views of the respondents. An analysis of each of the tables follows.

Responsibilities of the Board

In Table 4.2, we find that 57.1 percent of the Board members surveyed feel that the Board is most accountable to the controlling shareholders, with a surprising 28.6 percent who feel that their responsibilities are more toward the financial supervisory agencies or taxpayers than to the minority shareholders (14.3 percent).

Role of Bank Directors

In Table 4.3, the results show that 62.9 percent of those surveyed agreed that they have an important role in the Board. That role could be representing or maximizing the benefits of all shareholders, the controlling shareholders or all stakeholders, including affecting employees' job security. Bank directors also believed that one of their important roles is to ensure that the bank is safe and sound, even at the sacrifice of the shareholders' interests. However, about 31.5 percent of the respondents do not share the same view, while a tiny 5.7 percent do not have an

opinion about whether employee's job security is more important than paying dividends to shareholders.

Table 4.2: Results of the Opinion Survey of Directors Responses (in percentage to total)

	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
Director's view of corporate governance in the bank compared with other banks:	
Much better	57.1
Slightly better	14.3
About the same	28.6

Source: Opinion Survey of Board Members

Table 4.3: Results of the Opinion Survey of Directors Agreement and Disagreement Responses (percentage to total)

	Y+	Y	0	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

Role of the Board

The views of Board members regarding the role of the Board are quite mixed. About 38 percent are more positive about its role and they believed that the Boardroom is a forum of serious discussion for all the significant matters of the bank. However, a fairly sizable 57.1 percent 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 that 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 that have been formulated by the controlling owners with management independently of the Board. This group thinks that the role of the Board is merely perfunctory. It is quite disturbing to see that 4.8 percent of the directors do not have an opinion about the role of the Board.

Effectiveness of the Board

A majority (81.5 percent) of the respondents in the survey agree that the Board is effective in the conduct of corporate governance in the 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 system 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 the compensations of both the executive and non executive directors. 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 will hold sway over that of the independent views or process. In addition the application of a strict "fit and proper" test and also the prior consent of the Central Bank on appointment of the CEO operate as an effective sieve for appointment of only acceptable professionals to the position.

Board Independence

About 71.5 percent of those surveyed agree that independent directors are truly independent from the CEO or the controlling shareholders while 28.6 percent of the respondents do not want to provide an opinion on this question. When factoring in the elements that the CEO has a role in selecting the Board members and making decisions about the extension or termination of their term on the Board, the survey results on Board independence are very mixed. While 56.7 percent of the respondents think that there is sufficient Board independence, there is a relatively large 24.3 percent 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 percent of the survey respondents don't even express an opinion on this important issue of Board

independence. The independence of Board members is an important issue and if there is disagreement on this issue, the domestic banking institutions may need to look into why there is such a concern among Board members.

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

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

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 percent) 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 percent of those surveyed say that only sometimes that they have prior briefing of the agendas before a Board meeting. Most Board directors agree that they are permitted to obtain the services of outside legal, financial and other professional advisors at the expense of the bank.

Director’s Liabilities

Slightly over half of those surveyed have serious concerns about a potential director’s liability or of being sued. Overall, about 66.7 percent 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 best interest of the bank. About 33.4 percent believe that this is rarely or never their concern.

Table 4.4: Results of the Opinion Survey of Directors Responses (in percentage to total)

	Often	Sometimes	Rarely	Never
Access to information by independent directors	53.6	39.3	3.6	3.6
Director’s fear of personal liability	14.3	52.4	28.6	4.8

Source: Opinion Survey of Board Members

Enhancing the Effectiveness of the Board

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

All respondents agree that there are some common ingredients that can enhance the effectiveness of the Board. 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 believe that the roles of Chairman and CEO should be separated and this view is now accepted as desirable in all the Boards in the domestic banking institutions in Malaysia.

When considering the contentious issues of formal annual evaluation of directors and the CEO or of linking directors' compensations more to performance or having fewer or no members from the controlling shareholders, 10 percent of the respondents abstain from giving an opinion. About 5.7 percent disagree that there should be fewer or no members from the controlling shareholders. Such dissenting views obviously reflect the views 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 percent) of the respondents consider the independent directors as their choice of gatekeepers and 28.6 percent believe that the large shareholders are better in improving corporate governance of banks in the country. Only 14.3 percent 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.

Comparing Corporate Governance with Other Banks

Over half (57.1 percent) of the respondents believe that corporate governance in their bank is much better than other banks; while 14.3 percent believe that they are only slightly better. About 28.6 percent believe that the state of corporate governance in their banks is the same as any other banks in the country.

4.5 Survey Results: Executive Compensation of the Board

The survey results on Executive Compensation of Board members are summarized in this section. Table 4.5 presents the mean values of the annual total compensation, fixed pay, annual bonus and other compensation of the CEO, the executive directors and the non executive directors of the ten domestic banks for the years 2001 to 2003. One salient feature stands out in these results. The average total compensation of the executive directors of the Board is the highest for the groups. Over the three year period, the average total compensation of the executive directors was about 50 percent to 80 percent higher than the average total

compensation of the CEO of a domestic bank. One of the unintended consequences of the 1997 financial crisis has been its effect on the CEO's bonuses: some CEOs lost their bonuses as a result of the weak performances of their banks. The average total compensation of non-executive directors, including independent directors is about 30 percent to 50 percent of the average total compensation of the executive directors.

Table 4.5: Mean Values of the Executive Compensations (RM'000) in the Ten Domestic Banks during the period 2001-2003

	2001	2002	2003
CEO total compensation	1000	921	1431
Executive Directors	1677	1667	2263
Fixed pay	1068	1075	1320
Annual bonus	406	439	533
Other compensation	203	153	410
Non Executive Directors	513	967	1084
Fixed pay	264	374	437
Other compensation	249	592	647

Source: Survey of Executive Compensation

4.6 Survey Results: Risk Management Policies and Procedures in Banks

Only 50 percent of the domestic banks responded to the survey of risk management policies and procedures. Nonetheless, the results reflect the procedural norms in the banking industry. In Table 4.6, the survey results show that top management is usually responsible for the overall risk management of the banks; suggesting that the domestic banks have complied with the high standards required for risk management in the banking industry.

Table 4.6: Survey Results: Overall Risk Management

Who is ultimately responsible for approving the strategy and major policies of the bank for managing the following risks?	All but one bank	One bank
Market risk	Board of Directors	Management committee
Credit risk	Board committee or management committee	Board of Directors
Operational risk	Board committee or management committee	Board of Directors

Source: Survey of risk management

Table 4.7: Survey Results: Credit Risk Management

Are the following items covered by written policies?	All but one bank	One bank
Target markets	yes	
Structure of limits		no
Exception processing/reporting	yes	
Portfolio mix		no
Approval authorities	yes	
Price and non price items	yes	
Does the bank regularly monitor the following items?		
Current financial condition of borrower or counterparty	yes	
Compliance with existing covenants	yes	
Potential problem credits	yes	
Collateral coverage relative to obligor's current condition	yes	
Contractual payment delinquencies	yes	

Source: Survey of risk management

Table 4.7 provides some key results pertaining to credit management policies and the monitoring procedures in the domestic banks. These 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 that the bank is involved with. Except for one exception, all banks have written policies on the structure of limits and their portfolio mix. Of those surveyed, all banks regularly monitor the financial condition of the borrower, the collateral coverage and contractual payment delinquencies. All banks also monitor borrowers' compliance with existing covenants and the potential problem credits that could arise.

With regards to market risk management, the survey results in Table 4.8 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.

Table 4.8: Survey Results: Market Risk Management

Are the following clearly defined and identified in the bank's policies and procedures for limiting and controlling market risk?	All but one bank	One bank
Lines of responsibility & accountability over market risk management decisions	yes	
Authorized instruments	yes	
Hedging strategies		no
Position taking opportunities		no
Quantitative parameters defining the acceptable level of market risk	yes	

Purpose or objectives for which instruments may be used	yes	
Procedures for acquiring instruments	yes	
Procedures for managing portfolios	yes	
Procedures for controlling aggregate market risk exposure	yes	

Source: Survey of risk management

Table 4.9 shows the results pertaining to the management of the operational risk in the banks. Except for one bank, all other banks have been using the standard tools to identify and assess their operational risks. Most banks make use of the techniques of self or risk assessment and they all use the tools of risk mapping, key risk indicators and scorecards 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 the operational risks in the banks. All banks have checks on compliance with management controls and they have policies and procedures concerning review, treatment and resolution of non-compliance issues. All banks have a system of documented approvals and authorizations for monitoring adherence to assigned risk limits and for maintaining safeguards for access and use of bank assets and records. Of the banks surveyed, all of them indicated that they have policies in place governing the segregation of duties to address potential conflict of interest and procedures for disaster recovery and a business continuity plan.

Table 4.9: Survey Results: Operational Risk Management

Does the bank use the following tools to identify and assess operational risk?	All but one bank	One bank
Self or risk assessment	yes	developing
Risk mapping	yes	developing
Key risk indicators	yes	developing
Scorecards	yes	developing
Thresholds or limits	yes	developing
Measurement exposure	yes	developing
Are the following maintained by the bank?	All banks	One bank
Checks on compliance with management controls	yes	
Policies and procedures concerning review, treatment and resolution of non compliance issues	yes	
System of documented approvals and authorizations	yes	
Policies governing segregation of duties to address potential conflict of interest	yes	
System for monitoring adherence to assigned risk limits	yes	
System for maintaining safeguards for access and use of bank assets and records	yes	
System to ensure appropriate expertise and training for staff	yes	
System and policies to identify business lines or products	yes	

where returns are out of line with reasonable expectations		
System for regular verification and reconciliation of transactions and accounts	yes	
Disaster recovery and/or business continuity plan	yes	

Source: Survey of risk management

When the banks were asked whether they have 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, and 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 standardized approach to manage their market risks and credit risks. As indicated in Table 4.10, two banks would likely use the internal rating based (foundation) method to manage their market risks and 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 would likely adopt the standardized approach to manage their operational risks. One bank would likely adopt the advanced measurement to manage their operational risks while one bank has not yet decided on the approach yet.

Table 4.10: Survey Results: Response to the New Basel Accord

Which approach is the bank likely to adopt?	Market risk	Credit risk	Operational risk
Standardized	3 banks	3 banks	
Internal rating based (foundation)	2 banks		
Internal rating based (advanced)		2 banks	
Don't know yet			
Basic indicator			1 bank
Standardized			2 banks
Advanced measurement			1 bank
Don't know yet			1 bank

Source: Survey of risk management

4.7 Summary Analysis on the Effectiveness of Internal Corporate Governance Mechanism

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 effectiveness of the Board in the conduct of corporate governance policy and practice. Specifically, almost all directors believe that the Board is an effective means in establishing and monitoring the bank's 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 during 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, there are still a small percentage of Board members who think that there is still 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 Central Bank's guidelines 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. However, a small percentage of Board members hold the view that the Board is not effective in this area. It is difficult to surmise the reason for this disagreement: we are unsure whether the respondents are more keenly aware of complex transactions which are difficult to detect or be monitored or the unthinkable reason that the respondents are quite aware that related party transactions may have been entered into without proper authorizations. This is just a conjecture on our part in trying to understand the counterintuitive aspect of this result.

Almost all of those surveyed also believe that the Board plays an important role in selecting, monitoring and ensuring that the CEO is performing his/her role in the interests of the shareholders, the depositors and other stakeholders. But there is no doubt in the minds of all respondents that the roles of Chairman and CEO should be separated.

As the main Boards delegate functions to Board committees in the spirit of Guidelines GP1, there are also more independent directors in the various committees performing governance functions and responsibilities. In all the banks, the Chairman in the Audit Committee and the Risk Management Committee is an independent director. An area of concern is that the Chairman of the Nomination Committee and the Compensation Committee in some banks is not an independent director. 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 believe that they can see many ways to enhance Board effectiveness. Such spirits of Malaysian directors are very encouraging for the development of effective Boards in the domestic banking institutions. All those surveyed seem to agree that there are some common ingredients that may be used to enhance Board effectiveness. For example, most of the respondents believe that selecting better qualified and truly independent directors can enhance the effectiveness of the Board. Most Board members surveyed agree strongly that promoting constructive criticism and alternative views in Boardroom discussions are important ingredients to improve boardroom culture and all Board members believe that better disclosure of Board activities can enhance the effectiveness of the Board.

The key results of the opinion survey of the Board of Directors imply that the practice of good corporate governance has become a norm in the domestic banking institutions in Malaysia. But 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. While the Central Bank has already initiated a concept paper to deal with the internal governance mechanism of financial conglomerates, it is unfortunate that the survey questionnaires did not focus on this area of concern. The clue to improving corporate governance in the domestic banking system in the future will require a deeper understanding and the ability to disentangle the web of complexity of the internal corporate governance mechanism in these super financial holding companies where the government also plays a dominant role of control and ownership.

5. Roles of Markets in Disciplining Banks

5.1 Overview of Competition in the Banking Industry

According to the Central Bank, the banking industry in Malaysia operates in an open competitive environment despite the recent consolidation of the 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, HSBC, Standard Chartered Bank and UOB, which have a long historical presence in the Malaysian banking industry, have always been construed as a domestic financial institution by most consumers in Malaysia. As a result, the foreign owned banks still have a very strong presence in the market, accounting for 26 percent of commercial banking assets, 27 percent of the loans market and 25 percent of the deposit market.

Table 5.1 compares the market shares of the top three banks 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 market structure in the banking industry has not been materially affected by the merger exercise. The main explanation for this *status quo* position is that the bank merger was merely a market extension and concentration of deposits for the existing lead anchor banks: it changed the ownership of the acquired banks 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 to the already dominant government owned banks, the Herfindal index and the market shares data do not seem to support this view. Using total deposits of each individual bank 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, Standard Chartered Bank, OCBC and UOB), the Herfindal index was computed at 1047 for the pre-merger market compared to 1177 for the post merger market. Conceptually, the index equals 10,000 for a monopoly market and takes on lower values when the market becomes more competitive with entry of new banks.

**Table 5.1: Market Shares of Top Three Banks, 1998-2003
(Total Assets, Total Loans and Total Deposits)**

Market shares of top 3 banks	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

Sources: Annual Reports of the respective banks.

Although the market shares data appears to imply that competitive forces in the oligopolistic domestic banking industry were weak, it is far from the truth. As competition in the banking industry reduced the net interest margins and the spreads of some banks during the post crisis period, all the domestic banks began to diversify their portfolios to non-interest incomes businesses. Between 1998 and 2003, four banks (Arab-Malaysia Bank, 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 Arab Malaysia Bank which are the two top merchant banks in the country, each with a strong investment bank arm and strong proprietary and bond trading desks. Certain types of non-interest income businesses, especially unit trust and credit cards businesses are proving to be quite healthy and profitable for some banks.

In 1998 (during 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 has declined considerably from the 1998 level, suggesting that off balance sheets activities are 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 profitability and the risk management abilities and risk exposures among the different banking groups and this should continue to be a public policy concern. If regulatory guidelines of the central bank do not seem to completely minimize the variance of the risk management abilities among the domestic banking groups, the question remains whether market discipline will perform this important function. This leads us to consider the next important issue in this report, the market discipline of the banking sector.

5.2 Market Discipline and Stakeholders

The challenge that 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 design of prudential regulations and supervisions and financial safety nets can no longer be considered as 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 the Central Bank's regulatory guideline GP8 (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 about disclosure of financial statement information to the public

and the market investors. In fact, GP8 provides the bridge to enhance the effectiveness of market discipline.

5.2.1 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 disclosure of banking information as required by the Central Bank's regulatory guidelines during this period. The revisions of the Central Bank's regulatory guidelines GP1, GP3, GP7 and GP8 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 the annual reports in the recent years. Thus, the data set that is required to construct our MDI can be found in the annual reports of the domestic banks.

The MDI is composed of 28 key elements relating to the Central Bank's guidelines GP1, GP3, GP7 and GP8. Table 5.3 provides a summary of the elements that are used in the construction of 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 ability of the Central Bank to use its regulatory guidelines to improve on the state of disclosure in the domestic banking industry.

The Central Bank's guidelines GP1 (Guidelines on Directorship in the Banking Institutions) requires banks to set up Board committees. In the past, the domestic banks have only an audit committee. But since 2001, most banks have established nomination committees, remuneration committees 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 during the period 2001-2003, Public Bank had six independent directors in its audit committee while the average number of independent directors in the audit committees of the other banks was between two and three members. In the case of the nomination committee and the remuneration committee, we use the binary entry of 1 to denote that the controlling owner is not the Chairman of these committees.

The separation of the role of the controlling owner/Chairman and CEO and a statement of the directors' responsibilities in the bank's financial statements are also given a binary entry of 1 if such information is disclosed. All banks now provide a statement of their internal control policy and the responsibilities of external auditors in their annual reports. All banks have been assigned an entry of 1 for the disclosure of this information for each of the year during the period 1998-2003.

The disclosure information about loans quality has become more important since the 1997 crisis and the Central Bank has revised its regulatory guideline GP3 (Classification of loans as non-performing) to ensure that banks comply with the disclosure requirements of its non-performing loans and its loan portfolio. We assign the binary entry of 1 for disclosure of information on loans by type and by counterparty. All banks provide information on loans by type, but not about loans to counterparty.

We also considered the ratio of NPL to total loans and the ratio of loan loss provisions to total loans as an indicator of the loans quality in the bank's loan portfolio. Here if the NPL ratio is greater than 20%, we assign a binary entry of 0, and lower than 20% an entry of 1. Similarly, we assigned a binary entry of 1 if the bank has a loan loss provision ratio of greater than 10% and 0

for lower than 10%. We have been cautious in analyzing these results. For example, Public Bank, which is one of the strongest domestic bank in Malaysia, has both 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 Central Bank's guideline GP8 (Guidelines on Specimen Financial Statements for the Banking Industry) is the most important guideline on disclosure of information by the banks. For example, in the 2003 annual reports, all banks now include details about their interest rate sensitive assets and liabilities by maturity segments. This is an improvement over the perfunctory write-up on their market risks 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 guidelines GP8. 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 are important information relating to the degree of risk exposures of the bank. All banks now comply with this requirement and provide sufficient information about their contingent liabilities in the course of doing their banking business during the fiscal year. 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 about the direct and indirect interests of directors, both executive and non-executive directors as well as non independent and independent directors. This is the result of the regulatory guideline GP7 (Code of Conduct for Directors, Officers and Employees in the Banking Industry). The purpose of this guideline is to avoid conflicts of interests of directors in the banks. A binary entry of 1 is given if such information is disclosed, and 0 otherwise.

Table 5.3: Key Elements of the Monitoring and Disclosure Index

Categories	Elements	Binary Entries or #
GP1 disclosure	Audit committee	# of independent directors
Requirements	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	Problem loans by type	Disclosed = 1
Requirements	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	Director's responsibilities	Disclosed = 1

Requirements	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.

Both the related party transactions and material disclosures are important items of disclosure for the investors. Related party transactions include dealings involving associated companies and subsidiary companies as well as directors, officers and employees of the banking institutions. We provide a binary entry of 1 for disclosure and 0 otherwise. Material disclosures are related to any litigation pending against the banking institution. We have found only one bank that has 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 about their revenue sources. This is an important source of information about 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 the market investors. All banks are required to provide information about their transactions in the inter-bank markets. If a bank has net inter-bank liabilities, it is an indication of its inability to bridge short term fluctuations in its liquidity. 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 has been disclosed by the banks. 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 in the banks to fully comply with the regulatory requirements. As such, in retrospect, we observe some variance in the information content in the annual reports of the different banks. The composite MDI index for the individual banks over the period 1998-2003 is provided in Table 5.4.

Table 5.4: Monitoring and Disclosure Index of the Banking Groups for the years 1998-2003

Banking Groups	1998	1999	2000	2001	2002	2003
Affin Bank	71.4	71.4	67.8	75.0	75.0	75.0
Alliance Bank	64.2	57.1	53.5	64.2	64.2	103.5
Arab-Malaysian Bank	53.5	53.5	57.1	50.0	60.7	64.2
Bumiputra Commerce Bank	60.7	64.2	64.2	82.1	89.2	89.2
EON Bank	75.0	78.5	82.1	92.8	75.0	85.7
Hong Leong Bank	71.4	67.8	71.4	71.4	75.0	92.8
MayBank	75.0	71.4	71.4	78.5	82.1	89.2
Public Bank	89.2	85.7	89.2	103.5	110.7	132.1
RHB Bank	60.7	57.1	53.5	75.0	71.4	75.0
Southern Bank	75.0	67.8	71.4	75.0	75.0	85.7

Sources: Computed from data in the Annual Reports of the respective banks.

5.2.2 Empirical Analysis of Market Discipline

In this section, we consider whether depositors monitor the risk behavior of banks. Our hypothesis here is that depositors will require a higher interest rate if they cannot discern the risk behaviors of the banks. We believe that the revisions of the Central Bank's regulatory guidelines GP1, GP3, GP7 and GP8 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 risk behaviors of banks through greater disclosure of information.

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 the inefficiency of the bank management and a signal of bank risk, then depositors 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 depositors will not require a higher interest rate on their deposits.

Specifically, we have used the following equation as our empirical model:

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

Where Y_{it} is the cost of interest expense of the i^{th} individual banks during the t^{th} period, MDI_{it} is a vector of the disclosure indexes that characterize the extent of disclosure of the risk elements of the individual banks, X_{it} are the vector bank-specific variables that affect the individual bank's interest expense and ϵ_{it} is a random error term. The intercept is given by α . The column vector of coefficients β , and δ are estimated. The δ coefficient characterizes the disclosure effects and

the β coefficients represent the bank-specific effects. The standard assumptions about the error structure in this type of model are applied.

5.2.3 The Estimated Results with Interest Expense

We estimated two panel data regression equations. Equation 1 relates interest expense as the dependent variable while 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 generalized least squares (GLS) and the estimated results are shown in Table 5.5. These results were estimated using PcGive.

The R-square of the estimated equation is 0.1791 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 sizes of the different banks, 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 there is some degree of market discipline being exercised in the Malaysian banking industry.

Table 5.5: Estimated Results with Interest Expense using GLS regression for the period 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	= 0.1791		R-square = 0.1831	
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	Number of parameters	6	
Number of individuals	10 from year	Time series	6 (1999-2003)	balanced panel

5.2.4 The 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 subordinated debts of the banking institutions. 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 to monitor the risk behavior of the banks than other asset holders. If banks demonstrate risky behaviors, 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 the investors that there may be potential problems with the particular bank. Yield spreads on subordinated debts may also provide additional and useful information to assist banking regulators to monitor the changing conditions of the institution in their supervision. Prompt corrective actions (PCA) can be taken by regulators 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 mandatory issue of subordinated debts in Malaysia. The issue of subordinated debts by Malaysian banking institutions has been mainly for the purpose of increasing the Tier-2 capital adequacy requirements and for the computation of 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 5.6 provides a sample of the issue of subordinated debts by the individual banking institutions in the past few years. Concomitantly, there will be an increasing use of risk rating of the banking institutions for this purpose.

Table 5.6: 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 %
Arab-Malaysian Bank 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 Malaysia Berhad	Subordinated term loan	USD100 million	2003	5.55 %

Sources: The annual reports of the respective banks.

5.3 Bank Ownership/Governance and Bank Performance

This section considers the effects of ownership structure on the performance of the ten domestic banks during the period 1998-2003. 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 the majority shareholdings of the banks are owned either by the government or by families. The rationale for this hypothesis is that of the entrenchment effects of government ownership 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 all the family owned banks, especially Public Bank and Hong Leong Bank are very well managed by professional bankers. Our hypothesis contends that there is a positive relationship between bank performance and family owned banks in Malaysia.

5.3.1 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 net income of the bank divided by its total assets. There are two dummy variables to represent government ownership structure and family ownership structure. 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 structure (MayBank, Bumiputra Commerce Bank, EON Bank, and Affin Bank) and another four banks are very much family controlled (Public Bank, Hong Leong Bank, Arab Malaysian Bank and RHB Bank). The remainder (Alliance Bank and Southern Bank) have ownership structures that are apparently more widely held.

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

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

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 characterize 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, the ratio of net inter-bank assets to total assets and the annual growth rate of GDP as the control variables. The ratio of non-performing loans to total assets reflects the asset quality of the banks. We expect an inverse relationship between non-performing loans and the ROA. Net inter-bank assets is the profitability of the bank's Treasury activities and we can expect a positive relationship between this variable and ROA. We included the annual growth rate of real GDP as a control variable to capture the cyclical effects of the economy; and it can be expected that both the ROA and the growth of real GDP are correlated positively.

Table 5.7 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.

Table 5.7: Correlation Matrix of Ownership Structures and Bank Specific Variables for the period 1998-2003

	Government t owned Banks	Family owned Banks	Non- performing loans to total loans	Net inter- bank assets to total assets	Annual growth rate of real GDP
Government owned Banks	1				
Family owned Banks	-0.8165	1			
Non performing loans to total loans	0.0597	-0.2033	1		
Net inter-bank assets	-0.0041	-0.0724	-0.0240	1	
Annual growth rate of real GDP	0.0000	2.740E-02	0.0393	0.0112	1

Sources: Annual Reports of the respective banks

5.3.2 Estimated Results with Ownership Structures

The panel data regression equations of ownership structure and bank profitability have been estimated using generalized least squares (GLS). We estimated two separate equations: Equation 1 for the effects of government ownership structure and Equation 2 for the effects of family ownership structure on ROA, respectively; and the results are shown in Table 5.8. We have used a 5 percent significant level for the t-tests and the t-values for the coefficients are shown in the table.

Both the coefficients of the government connected ownership dummy variable and the family ownership dummy variable are not significant according to the t-values. The negative sign for the coefficient of the government ownership structure variable conforms to the literature on the relationship between government ownership structure and bank performance. The positive

relationship between the coefficient of the family ownership structure variable and the ROA validates our hypothesis about this relationship in the case of the family banks in Malaysia.

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

Table 5.8: Estimated Results of Effects of Ownership Structure on Profitability (ROA) using GLS during the period 1998-2003

	Equation 1		Equation 2	
	Coefficients	t-value	Coefficients	t-value
Govt Banks	-0.2527	-1.01		
Family Banks		-0.79	0.1431	0.51
NPL to total Loan	-0.0514	-3.68	-0.0503	-3.43
Net inter-bank assets to total assets	0.0238	2.36	0.0246	2.34
Annual growth rate of real GDP	0.0344	1.98	0.0344	1.98
Constant	1.2194	4.60	1.0166	3.51
R-square	= 0.2993		R-square	= 0.2781
Wald (joint)	Chi-square (4)	23.50 **	Chi-square (4)	21.19 **
Wald (dummy)	Chi-square (1)	21.20 **	Chi-square (1)	12.34 **
Number of observations	60	Number of parameters	5	
Number of individuals	10 from year	Time series	6 (1998-2003)	balanced panel

Notes: These results were estimated using PcGive.

5.4 Summary of Findings

Despite fears that the government initiated merger program would increase the monopolistic market power of the already dominant position of the government controlled banking groups, this did not happen or at least there are no evidence of significant change in the market shares and cost structures of the individual banking groups from their pre-merger positions. Although the three largest banks continue to dominate the market shares in the deposits and loans markets, there is evidence that competition in the fee incomes and other non interest incomes businesses are quite intense in the domestic banking industry. The Central Bank has also provided evidence that its bank merger program has resulted in substantial improvements in the overall efficiency of the banking industry arising from the rationalization and streamlining of the operations of the banking groups after the merger.

In Malaysia market discipline is still very much in its infancy stage and depositors and most market participants have a long learning curve to understand the purpose and the practical effectiveness of market discipline. We have attempted to show how the Central Bank has used its regulatory guidelines GP8 on disclosure to enhance the effectiveness of market discipline.

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 disclosure matters to the market in monitoring the Malaysian banking industry.

Using a set of panel data for the ten domestic banks for the period 1998-2003, we have found some evidence that appears to support the contention that there is some degree of market discipline being exercised in the Malaysian banking industry. Our panel data regression analysis demonstrated that there is a significant statistical relationship between interest rate on deposits and the disclosure index, suggesting that depositors do monitor the banks and 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 categorized into government owned banks, family owned banks and a couple of banks with corporate and widely held ownership structure. Although the coefficients for the ownership structures of government owned banks and family owned banks have the expected signs, we still have some reservations about the results. While it is generally expected in the literature that government owned banks do not performed well, we find exceptions in the Malaysian cases, such as the MayBank and Bumiputra Commerce Banks which are very well managed and profitable.

Similarly, the positive relationship between profitability and family ownership structure in the result did not surprise us. In fact, the result was expected and this was based on our observation that the family-owned banks in Malaysia 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 bank in the domestic banking industry in Malaysia.

6. 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, it is now widely recognized that central banks cannot totally rely on market discipline because of moral hazard, safety net concerns, unwise regulatory forbearance and limited public tolerance for the propagation of banking crisis emanating from market failures. Therefore there is a need for the Central Bank to rethink the appropriate policy weights that are given to regulatory supervisions and financial safety nets relative to market discipline in the design of its regulatory strategy in the new post merger banking environment in Malaysia.

During the period 1998-2003, the Central Bank has taken important steps to revise and improve its various regulatory guidelines with the aim of enhancing the effectiveness of market discipline through greater disclosure and transparency of financial information in the banking industry. But the experience of past government regulatory forbearance and the government's implicit deposit insurance 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. And this perception of past regulatory forbearance has not been forgotten by the public and the market investors. 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.

The Central Bank has made great strides in the post crisis period in revising its regulatory guidelines and developing a comprehensive Financial Sector Master Plan within its broad strategic regulatory framework to ensure that its regulatory policies are relevant to the changing complexity in the financial and banking sector. Obviously the task of the Central Bank is not easy. Given the short period of time since the financial crisis distorted the economic and fundamental soundness of the financial and banking system in Malaysia, the Central Bank has worked very hard to regain the confidence of market participants, both in the domestic economy 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 to make the practice of corporate governance a priority as well as a norm in their decision making and in the conduct of the business of banking. There is already a growing consensus in Malaysia that the practice of corporate governance in both the financial and banking system has improved. Both the banking and corporate leaders have embraced the importance of the practice of corporate governance 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 organizational 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 are to be sustained, both the Central Bank and the banking leaders will have to continue their efforts to work together to ensure that the financial and banking system in Malaysia will always be safe and sound. Working towards this objective means that both the Central Bank and the banking sector will have to address some of the issues of concern at both the public policy level and at the banking institutional level.

At the public policy level, there is always the need for the Central Bank 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 Guidelines GP1 and GP8. The change in the regulatory framework for the financial and banking system toward more disclosure and more transparency in order for market discipline to function effectively is important. But this change at the public policy level must be translated into practice at the institutional level.

A major element of public concern during the crisis period was the close connectivity between the banks and corporate borrowers. Although much has already been done in terms of regulatory guidelines (GP1, GP5, GP6 and GP7) to ensure that conflict of interests and the problem of large single corporate borrowers will be avoided and the associated dire consequences will not occur to have an adverse impact on the whole financial and banking system, the root of the problem cannot simply be solved by the Central Bank alone using its regulatory guidelines. While regulatory bites can have its advantage, there must also be the will of the corporate leaders in the banking industry to ensure that the intents of the regulatory guidelines are implemented in practice.

A potential area of concern in the post merger period of the domestic banking system is that the ownership structures of the dominant domestic banking institutions have become more complex and more opaque in their financial conglomerates. If not done properly, the restructuring of the

internal governance mechanism will be ineffective to deal with the possible divergence between the control and ownership in the financial conglomerates. The Central Bank 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 to disentangle the web of complexity of the ownership structures in these super financial holding companies where the government also plays a dominant role of control and ownership.

At the banking institutional level, there still remains much to be done to enhance the effectiveness and independence of the Boards. 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 the enhancement of an effective Board. We have detected from the results of the survey questionnaires that 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 the effectiveness of the Board.

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

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 changes take 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 the 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 criteria of choice should be on merits and the passion of the candidate 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 job of Board members 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 the chemistry in the Boardroom, can gain much mileage in making the Boardroom an interesting place for members to serve. Periodical exposures of Board members to the concerns of both the institutional and small shareholders 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 the understanding of the status and development of corporate governance in the domestic banking system in Malaysia during the post financial crisis period. We sincerely hope that more work will be done in the future by Malaysian researchers in this important area of public interest. We also like to thank all those respondents to our survey questionnaires for their willing to share their knowledge and insider views of the workings of the Boardroom. We appreciate their willingness to share their concerns about some of the limitations of current practices of corporate governances. This truly reflects the desire of Board members to improve and enhance the effectiveness of their Boards and to contribute to the ideals of a safe and sound domestic banking system in Malaysia.

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