

CORPORATE GOVERNANCE IN MALAYSIA: THE EFFECT OF CORPORATE REFORMS AND STATE BUSINESS RELATION IN MALAYSIA

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ABSTRACT

The Asian Financial Crisis in 1997 not only introduced the term of corporate governance but also drew attention of the public about the weaknesses of Malaysian corporate governance practice. After 1998, Malaysian government decided to adopt corporate reform that could enhance the quality of good corporate management practice. This reform is clearly stated in the code and rules of corporate governance. The purpose of this research is to study the significance of implementing the code and rules of corporate governance since the public already realize the close relationship between business and politics. Three companies were chosen as indicators for this study. As a result, it was found that companies which are involved in corporate malpractice but have good relationship with states will always be excluded from the legal corporate action.

Keywords: corporate governance, corporate reforms, political economy, state business relation

INTRODUCTION

Asian Financial Crisis in 1997 not only introduced the term of corporate governance but also drew attention of the public about the weaknesses of Malaysian corporate governance practice. After 1998, Malaysian government decided to adopt corporate reforms that could enhance the quality of good corporate management practice. This included the introduction of the new Malaysian code and rules for corporate governance. The debate of corporate governance in Malaysia are often limited to agencies involved directly in law enforcement such as the Ministry of Finance, Kuala Lumpur Stock Exchange (KLSE),¹ Securities Commission (SC) and Registrar of Company.

On contrary, the aim of this paper is to study the significance of implementing the code and rules of corporate governance from the political economy

¹ Recently known as Bursa Malaysia.

perspective.² In Malaysia, the close relationship between the business and politics is no longer a secret (Gomez, 1990, 1994). This is further evidenced by firms which are wholly-owned and controlled by the ruling parties. This phenomenon leads to a question on whether these companies will face any corporate legal action should they fail to comply with any of the code and rules pertaining to corporate governance.

RESEARCH METHODOLOGY

This is an exploratory study which uses qualitative research methodology. This research extensively uses secondary data from various past researches, economic reports, company annual reports as well as articles from journals, working papers and books. Case study method has also been applied in this research in order to answer the assumption made by the researcher. The focus of this research is solely on links between state and capital. Hence, a case study was carried out on three politically linked business companies, namely Perwaja Steel Sdn. Bhd., Renong Bhd. and Malaysia Airlines System Bhd. (MAS). This is the first study of its kind in Malaysia which compares three infamous corporate malpractice cases.

Further analyses were carried out using the Basic "Black Box" Model of Corporation by Blair (1995), which explains how the elements of the corporate governance function. According to Blair, a corporation is unique because there is a substantial part of economic activity. Corporations are legal structures and their existence is not limited in time or space. As separate legal entities, corporations are distinct from any individuals who participate in them. They can own property and business asset in terms of land, building, equipment and intangible assets such as patents or brand names. Corporations can hire or contract work of millions of individual and thousands of corporation to create more wealth. Thus, corporations have to perform efficiently. Otherwise, their cost will be too high and they might be out of business. If corporations default on their debt, they will be unable to secure fresh loan or ended up paying high interest rate to compensate credit risk. Such phenomenon will lead to a big impact on the economic and government performance. On this note, corporate governance is definitely needed to control various participants in corporate enterprise. But, Blair did argue that the success of corporate governance enforcement is restricted on how much government intervenes in the economy.

² The concept of political economy here refers to political business which analyses the evolving links between politicians and large scale enterprises with emphasis given to the changing pattern of ownership and control ties among politically well-connected companies.

Based on Blair (1995), this research attempts to answer the following assumption: "Companies, which have good relationship with states will always be excluded from penalty under the rules and code of corporate governance."

The basis for this assumption also refers to Malaysia's long history of close political-business links in various forms (Gomez, 1990, 1994, 2002). In this regard, we refer to first, ruling parties owned companies. Second, corporate figures who have strong political networking and owned firms that once belonged to government which eventually re-nationalized and lastly, the government owned firms through state investment arms.

THE CONCEPT OF CORPORATE GOVERNANCE

The phrase "corporate governance" is often used but yet lacks a precise definition (Low, 2000: 46). Most of the definitions focused on the structure and the function of the board of directors or the rights and prerogatives of any shareholders in boardroom decision making. The High Level Finance Committee Report³ on Corporate Governance in Malaysia also defined corporate governance from the same perspective. They defined corporate governance as "the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long-term shareholder value whilst taking into account the interest of other stakeholders" (Lee, 2003: 41).

From the definition, corporate governance mainly focuses on the process used to direct and manage the business and affairs of the company with the objectives of striking a balance on:

- The attainment of the company's objectives.
- The alignment of corporate behavior to meet the expectations of shareholders.
- Accountability and good stewardship, taking into consideration the interests of shareholders, stakeholders, corporate participants and society at large.

³ The committee comprises the Ministry of Finance, the SC, the Companies Commission of Malaysia, the Financial Reporting Foundation, The Malaysian Accounting Standards Boards, Bank Negara Malaysia, Association of Bank Malaysia, The Association of Merchant Banks Malaysia, KLSE, The Association of Stock Broking Companies Malaysia, The Malaysian Association of the Institute of Chartered Secretaries and Administration and the Federation of Public Listed Companies.

Thus, corporate governance can be described as the proper procedure on how the "government" of a company (the managers and board of directors), should be responsible to their "voters" (the shareholders, creditors and investors). Corporate governance emphasized on the transparency of decision making process, fairness and trustworthiness in managing a company. However, Blair (1995) viewed the definition and concept of corporate governance from a wider perspective but at the same time still emphasized on the ownership and control element as suggested by Cadbury (1992), Monks and Minow (1995)⁴ and The High Level Finance Committee Report for Blair, the degree of good enforcement of corporate governance very much depended on the roles of the state.

THEORETICAL MODEL

Figure 1 illustrates the basic model of corporation. Corporations are organized and run by entrepreneurs or a management team that raise funds to acquire physical capital and to finance initial operation by borrowing from banks and other lenders (debts) or by issuing and selling "equity" shares. The decision made in the boardroom will directly affect the shareholders and financial institution while indirectly affect the employees, suppliers and customers. The board of directors has the responsibility of making the right decision that should directly or indirectly benefit all parties involved. Meanwhile, the concepts of ownership and control are important to ensure the company practices check and balance system between the owner and the company's management. The owner of the company or the shareholders has the rights to obtain accurate information which will enable them to be comfortable with the company's operation and be sure on return of their investment. They also have the rights to offer their opinion and suggestion to the company's management in improving certain actions that need to be taken by the company's management, or object upon any decision, which they believe as inappropriate or unprofitable to the company. The directors of the companies have to prove their abilities in making the right decisions especially decision related to investment and loan in order to preserve the interest of shareholders and other stakeholders.

Eventhough the corporate governance recognized the rights and power of the shareholders and director as the shareholder's proxy, the rights and power are still subjected to the law regulated by the government (Blair, 1995). This means that the actual rights and power of the principal and its agent in the company's

⁴ The concept of ownership and control is to establish an internal management system in a company to avoid misuse of resources and fraud. The boards of directors and shareholders of company play an important role in determining the company's direction. At the same time, the balance of interest of all individual, company and society were done to encourage and develop investment opportunities, which benefit all parties involved. See Nor Azizah (2004: 32–37).

management is very much dependent on how much the state intervenes in the economy. In this case, Blair concluded that the state is the actual company controller compared to policy or law regulated under the rules and code of corporate governance. Financial institutions also play an important role in the enforcement of the corporate governance. The stability of the financial institution will also lead to company's stability. However, the problem arises when the financial institution is also owned by the state. As the owner, the state is enabled to control the company through the financial policy besides the rules and corporate laws.

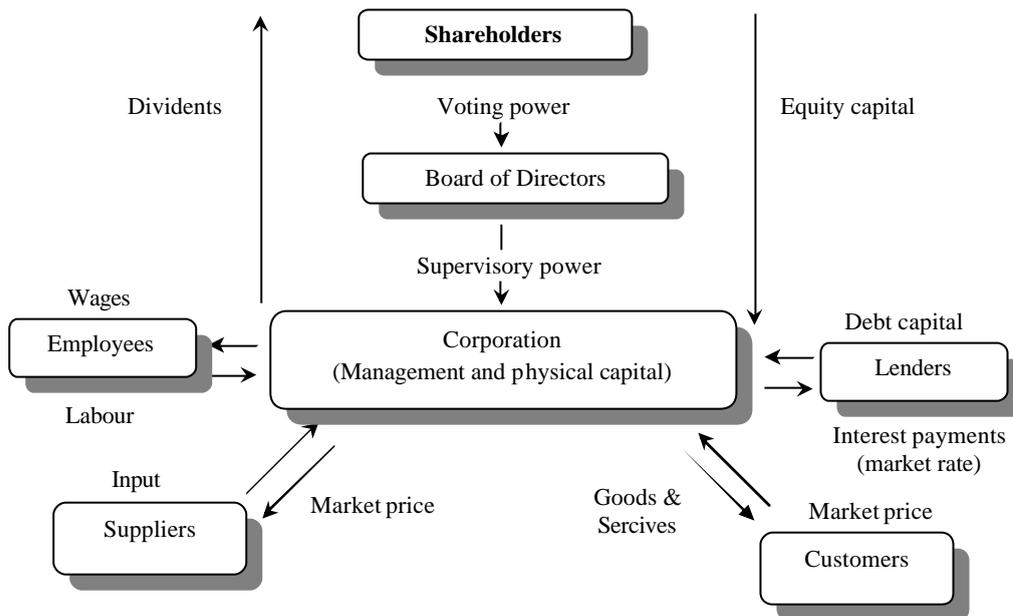


Figure 1. Basic "Black Box" Model of Corporation

Source: Blair (1995: 21)

RESEARCH ANALYSIS

Corporate Reforms and Achievements

The Asian Financial Crisis led government to adopt corporate reforms. Since 1998, government and private sector had chosen to enhance the corporate law in order to improve the level of corporate governance in the country. In 1999, under the Ministry of Finance, a High Level Financial Committee on Corporate

Governance was formed. The committee was given the responsibility to review the corporate framework and make recommendations to improve the level of corporate governance in the country. The committee felt that there were serious corporate governance weaknesses particularly in the following areas – transparency and disclosure requirement, corporate monitoring responsibilities and accountability of company directors including the rights of minority shareholders (Das, 2000: 19). Therefore, the code of corporate governance, which included the principles and best practices in the corporate governance, were established for the corporate participants. This code essentially aimed to encourage transparency management of a company besides providing relevant information to the investors to enable them to guide the company's direction. This code can also serve as guidelines to the board of directors on how to manage the company based on their roles and responsibilities (Low, 2000: 438).

The Bursa Malaysia and SC had gazetted new rules for the public listed companies. They were required to disclose their financial status, shareholders structure and loan position on a quarterly basis. A company's manager is subjected to penalty or jail sentence if they fail to comply with the rules. The government had granted a warrant amounting to US\$100,000 to Malaysia Institute of Corporate Governance (MICG) to conduct research and training program in order to improve the corporate governance standard and quality (Das, 2000: 19).

In August 2000, Minority Shareholder Watchdog Group was established to encourage the company to comply with the principles of corporate governance and to improve the awareness among the minority shareholder about their rights and the appropriate methods to enforce their rights. Members of this committee were from the government fund institutions such as Employees Provident Funds (EPF), Armed Forces Fund Authority (LTAT), Pilgrims Fund Board (LUTH), Social Security Organization (SOCSSO) and Permodalan Nasional Berhad (PNB) (Yusof Abu Othman, 2000).

The undertaken reformation illustrated that the government and the private sector had put much effort in order to enhance the standard of Malaysian corporate governance. An investment bank, CLSA Emerging Market in collaboration with Asian Corporate Governance Association (ACGA) through their research regarding the Asian Corporate Governance, reported that Malaysia has achieved the highest score of 9.0 compared to other Asian countries in reforming their corporate rules and regulation (Halim, 2003). However, the same research also showed that the score for the enforcement of corporate rules and regulation was among the lowest (refer to Table 1). With a score of only 3.5, Malaysia was ranked 4th lowest position ahead of Indonesia, Philippines and Thailand. This scenario tells us that the law reforms and implementation are inconsistent.

Table 1
Rank of Countries Based on Corporate Reforms and Enforcement

Countries	Laws and rules reforms	Enforcement
Singapore	8.5	7.5
Hong Kong	8.0	6.5
India	8.0	6.0
Taiwan	7.0	5.0
Korea	7.0	3.5
Malaysia	9.0	3.5
Thailand	7.5	3.0
China	5.0	4.0
Philippines	6.5	2.0
Indonesia	4.5	1.5

Source: Amended from CLSA Emerging Market in Halim Wahab (2003)

In Malaysia, it can be seen that the state intervention in the economy began in 1970 when the government initiated the positive discrimination policy, i.e. the New Economic Policy (NEP).⁵ Under the NEP, government tried to groom *Bumiputera* entrepreneur groups in modern economic sector.⁶ Therefore, the trustee system⁷ was created to achieve NEP's overall mission. Public enterprise was among the first method introduced by the government to increase *Bumiputera* participation in the commercial trading sector. However, this method had actually initiated the relationship between business and politics. Initially, the state involvement was merely to act as the shareholder for the *Bumiputera*, but eventually become owners of companies or shareholders or investment proxy through companies owned by the ruling parties.

⁵ NEP was introduced with an objective to obtain national integration through poverty elimination and society restructuring to eliminate economic trademark by race.

⁶ Government tried to achieve 30% *Bumiputera* ownership of the corporate sector.

⁷ The trusteeship system refers to trusted individual or organization in implementing certain policy. According to Jomo et al. (1986: 5), there are two basic criteria in trustee strategy in Malaysia. Firstly, decision on budget allocation and resources and preferred investment were done according to rules and method determine by the trustee. Secondly, the power on economic resources is with the trustee and separated from the parties who owned it. There are two level of trusteeship. The first level is that small group of individuals who makes political decision. The second level is those superior officers and government servants who serve as the middlemen in implementing and controlling multiples projects and programs under the trustee system. Under the system, the level of poverty or wealth is very much dependent on decision made by the trustee and how the decision is derived. If the decision making process were done with efficiency and fairness, proper production and distribution can be obtained effectively compared to capitalism system and socialism system. See Gomez (1990) and Nor Azizah (2004).

Three companies were selected as indicators in this research. They are Perwaja, Renong and MAS. The context of discussion focuses on ownership and control as well as discordance rules and regulation governing these companies. Hence, this paper tries to demonstrate how the government and business work hand in hand to conceal the evidence of wrongdoing and malpractice.

Perwaja was established in 1982 by HICOM Bhd., a company owned by the government in collaboration with a Japanese company, Nippon Steel Corporation to fulfill the government's mission in implementing the heavy industrial policy. This is an example where the government had direct interest, as shareholders in a company. On the other hand, Renong⁸ was known as United Malays National Organization (UMNO)'s investment company in the corporate sector. Renong became a successful conglomerate after Halim Saat,⁹ Daim's protégé took over its management. Halim has spurred UMNO's move in business (Yong, Wong, Chong, Lim, & Chan, 1991). Renong was awarded with many infrastructure development contracts by the state.¹⁰ Another similar case involved MAS, whose establishment and ownership are also related to the state. MAS which started off as an airline company wholly owned by the government, was later sold to Bank Negara as a private entity. However, despite the transfer of ownership, the government still owned the "golden share",¹¹ which bundles together with the veto power to influence MAS's decision making process. In 1993, Bank Negara sold MAS to Naluri Bhd. As the case of Renong, Naluri's owner, Tajudin Ramli was also Daim's protégé. The veto power of the government remained unchanged.

The state ownership in all the three companies created close relationship between business and politics. According to Gomez (1990), this relationship can no longer split the business and politics as two different entities, but make them indispensable and dependable on each other.¹² In our point of view, this relationship can easily cause fraud and corruption in the trustee system and offer much freedom to the businessman to act above the corporate law.

⁸ It started when Renong (after being taken over by Halim Saat) bought all Fleet Group assets from Fleet Holding (UMNO's investment company – refer Yong, Wong, Chong, Lim, & Chan (1991) via reverse takeover with RM1.226 billion shares issuance. Halim Saat admitted that he is an UMNO proxy in the business. See Gomez (1994: 117).

⁹ Halim Saat was the director in several governments owned companies, i.e. Landmark Holdings and Paremba. He was also the director for several listed public companies where Daim's (the Minister of Finance at the time) family members were among the shareholders, i.e. Roxy, D&C Bank and Clod Storage (Gomez, 1990: 49–50).

¹⁰ See Gomez & Jomo (1999: 97–98).

¹¹ See Lennane (1997: 26–30).

¹² Businessman needs politician's support for ease of being awarded with resources owned by the government. While politicians need businessmen support to fund their political campaigns during the election season to enable them to be reelected as representative in the government.

Since incorporated, Perwaja had not only failed to gain any profit but was involved in endless scandals and corruption.¹³ Within six years, it was knocking on bankruptcy's door. Perwaja suffered losses of RM2.95 billion and at the same time owed banks another RM7 billion. Perwaja was also facing colligations of corruption and mismanagement in tender and contract awarding. For example, Mah Sun Company and its related companies were awarded with RM967 billion worth of contracts without any authorization from the board of directors. Another RM103 billion worth of contract were also awarded to the same company with no documents traced. Furthermore, doubtful trading transactions and payments were carried out to non-existing company, i.e. Frilsham Enterprise.¹⁴ Datuk Seri Anwar Ibrahim (Minister of Finance at that time) informed Parliament that Perwaja was insolvent. However, no legal actions were taken against Perwaja until Eric Chia was arrested in Mac 2004. Today, Perwaja is still in operation with fresh funds being injected by the government (Netto, 2004).

In another case, the problems happened in Renong has revealed the malpractice of corporate governance in Malaysia. The Asian Financial Crisis which led to Ringgit depreciation has further caused serious financial problem. Apart from this, it has also increased the amount of Renong accumulated debt between RM20–28 billion which constituted more than 5% of loans by Malaysian banking systems (Gomez, 2002: 102; Thomas, 2002: 154). Many economists were puzzled with this situation. The main issue was how did the company obtain such a large fund as their corporate loans? Did the board of directors and shareholders play a part in executing their rights to enable Renong to obtain such a big amount? Had the loan process and procedure been simplified? According to Gomez (2002), those figures indicated that a significant amount of bank loans had been channeled to a selected minority. During the crisis, Halim, who owned not more than 78% of the company's equity tried to save it via restructuring process. He used his subsidiaries to pay Renong's debt¹⁵ but the minority shareholders were not pleased with his act as it was against their rights and interest and was a felony pertaining to corporate governance rules.¹⁶ Majority of

¹³ In 1986, Perwaja reported a loss exceeding RM131 million, due to internal management problems and currencies movement as a result of economic crisis, where Japanese Yen appreciated against Ringgit Malaysia. See *Financial Times* (April 1, 2002).

¹⁴ See Nor Azizah (2004).

¹⁵ Halim bought Renong's shares via UEM, while PLUS issued RM17 billion of bonds at coupon rate of not less than 10% per annum, in order to settle Renong's debt amounting to RM8 billion in seven years. See Jayasankaran (2003).

¹⁶ In November 1997, Halim sold 32.6% of Renong shares to UEM at RM3.24 per share, 35% higher than cost price of RM2.40 per share (Ranawana, 2000). According to Gomez (2001), this acquisition implemented partly through a RM800 million loan provided by government-owned and politically well-connected banks, upset UEM minority shareholder. Later, PLUS, a Renong subsidiary, was used by Halim to fund Renong's debts. See Nor Azizah (2004: 59–64).

analysts were of the view that this type of funding was ridiculous, as subsidiaries fund was not supposed to be utilized to bail out its parent's debt.

Last but not least, MAS was also faced with internal management problems. Prior to the Asian Financial Crisis, MAS had already suffered huge debts caused by the new management under Tajudin Ramli. This had put MAS at risk during the crisis as all their transactions were done in US dollars. At the same time, Tajudin also had huge personal debts.¹⁷ However, the veto power of the government in MAS's management had limited plan for MAS to expand and revise funding strategies for its debts, i.e. decision on airlines destinations were subjected to government's decision and endorsement. At the time, the destinations decided by the government were not popular destinations or less concentrated areas, but MAS had to oblige and extend its services to comply with Malaysian foreign policy. This type of veto decision contributed to lower return for MAS compared to other air lines. Consequently, the Asian Financial Crisis affected both MAS and Tajudin badly due to the significant increase in debts. MAS had sold nine of their aircrafts costing RM10 billion at a price of RM14 billion to pay Tajudin's personal debts (*MASSA*, April 17, 1999). By December 1999, Naluri's loans were RM888.25 billion causing the company to be deemed as unqualified to be in charge of MAS's operation anymore (Fauziah, 2000).

CONCLUSION

At this point, we can see that the states involvement in business had changed and therefore increased the roles of state in many different ways. First, the state at its capacity as the shareholders had the right to be informed about the business operation and plan of the company. They can accept or reject any proposals and plans as well as instruct the management of the company to pursue according to government's needs. Second, the state as the owner of the financial institutions¹⁸ controlled the financial institutions that provided funds and working capitals. Third, the state as a ruler, can instruct any agency and government offices to process applications for contracts, loan tender, etc. from its wholly owned companies. The state, in the ruler's capacity is also the enforcer of any rules and legislation gazetted by the government.

¹⁷ Tajudin obtained personal loans amounting to RM1.8 billion from four banks to enable him to buy Bank Negara's share in MAS (Jayasankaran, 1999).

¹⁸ Malayan Banking Berhad (MBB) and Bumiputra Commerce Berhad (BCB) are examples of financial institutions owned by the government. The government through Permodalan Nasional Berhad (PNB), chaired by the Prime Minister, controls MBB. Commerce-Asset Holdings, subsidiary of Renong Berhad, controls BCB.

These roles, which are conflicting with each other, had caused interruptions in the appropriate ownership and control practice. This situation led to an imbalance condition between the owner and controller of the company, perhaps causing the misuse of government and financial institutions in the event where "check and balance" system was neglected.¹⁹ This scenario also showed that the balance of power within the state had shifted in favor of increasingly centralized executives. Hence, this situation conforms to Blair's (1995) model, which strongly emphasized the rights and power of the principle and its agent in company's management are still subjected to the degree of government intervention.

Even though the Asian Financial Crisis is over and we had successfully overcome the situation, we can never let it happen again as such crisis will lead to a great loss of our resources in the long term. We learn from history that government's intervention in economy is essential as free market had failed to build up the conducive economic environment. However, the degree of government's intervention should be limited to certain extent, or else it could jeopardize the level of democratic practice by the key market players. The politics and business interest should be aligned in order to prevent any corporate misconduct, hence avoiding selected legal phenomena, which will eventually affect the government's credibility as the ruler.

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¹⁹ Basic principles of corporate governance such as transparency, fairness and trustworthiness were not implemented.

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