POLITICAL CONNECTION AND RISK-TAKING: THE INTERACTION ROLE OF CORPORATE GOVERNANCE MECHANISMS

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POLITICAL CONNECTION AND RISK-TAKING: THE INTERACTION ROLE OF CORPORATE GOVERNANCE MECHANISMS

by

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LIST OF ABBREVIATIONS

AFC	Asian Financial Crisis
BOD	Board of Directors
CFTC	Commodity Futures Trading Commission
CG	Corporate Governance
EMIS	Euromoney Institutional Investor Company
ESO	Executive Stock Options
GLC	Government-Linked Companies
GLIC	Government-Linked Investment Companies
KNB	Khazanah Nasional Berhad
KWPS	Kumpulan Wang Simpanan Pekerja
LTAT	Lembaga Tabung Angkatan Tentera
LTH	Lembaga Tabung Haji
MCCG	Malaysian Code on Corporate Governance
MKD	Menteri Kewangan Diperbadankan
MNC	Multinational Corporations
NEP	New Economic Policy
NPF	Newly Privatized Firms
PCF	Politically Connected Firms
PCF_BOD	Firms politically connected through board of directors
PCF_BUS	Firms politically connected through businessmen
PCF_FAM	Firms politically connected through family members
PCF_GLC	Firms politically connected through government-linked companies
PNB	Permodalan Nasional Berhad
R&D	Research And Development
RDT	Resource Dependence Theory
RST	Rent-Seeking Theory
RT	Risk-Taking

SME	Small and Medium Enterprises
SOE	State-owned Enterprises
SOX	Sarbanes-Oxley Act
U.K.	United Kingdom
U.S.	United States of America

HUBUNGAN POLITIK DAN PENGAMBILAN RISIKO:
PERANAN TATA URUS SYARIKAT

ABSTRAK

Tujuan kajian ini adalah untuk mengkaji sama ada hubungan politik mempengaruhi pengambilan risiko firma. Ini adalah kerana terdapat banyak kajian lepas yang sering menyatakan bahawa firma yang mempunyai hubungan politik mempunyai prestasi yang lebih bagus berbanding dengan firma yang tidak mempunyai hubungan politik. Tetapi terdapat banyak kemungkinan bagaimana ini boleh berlaku. Salah satunya ialah firma dengan hubungan politik boleh dikatakan mempunyai lebih banyak sumber dan keupayaan yang lebih tinggi untuk mengambil lebih banyak risiko, justeru itu dapat memberikan prestasi yang lebih baik berbanding dengan firma yang tidak mempunyai hubungan politik. Oleh itu, kajian ini berharap dapat meneliti bagaimana hubungan politik boleh mempengaruhi pengambilan risiko firma. Untuk penelitian yang lebih mendalam dalam isu ini, kajian ini memisahkan hubungan politik kepada empat jenis hubungan politik yang berbeza untuk melihat sama ada hubungan politik yang berbeza mempunyai pengambilan risiko yang berbeza. Empat jenis hubungan politik tersebut adalah hubungan politik melalui lembaga pengarah, hubungan politik melalui ahli perniagaan, hubungan politik melalui ahli keluarga pemimpin kerajaan, dan hubungan politik melalui syarikat berkaitan kerajaan. Ini adalah kerana sesetengah firma dengan hubungan politik mungkin mempunyai peranan dan kewajipan sosial kepada masyarakat yang menyebabkan ia mengambil tahap risiko yang berbeza jika dibandingkan dengan firma yang lain. Di samping itu, kami juga menyiasat bagaimana tadbir urus korporat, khususnya mekanisme pemantauan, mengubah pengaruh hubungan politik terhadap pengambilan risiko. Data

untuk kajian ini adalah diambil dari tahun 2002 - 2017 yang merangkumi 493 firma yang disenaraikan di Bursa Malaysia. Berikutan masalah '*endogeneity'* yang dinyatakan oleh kajian-kajian lepas, kami menggunakan metodologi '*Generalized Method of Moments*' kerana metodologi ini mampu menyelesaikan masalah '*endogeneity'*. Daripada hasil kajian ini, kita mendapati bahawa hubungan politik (secara kolektifnnya) tidak mempunyai kesan ke atas pengambilan risiko firma. Walau bagaimanapun, apabila dipisahkan kepada empat jenis hubungan politik, kami mendapati bahawa firma yang mempunyai hubungan politik dengan ahli keluarga pemimpin kerajaan dan syarikat berkaitan kerajaan mempunyai kesan negatif terhadap pengambilan risiko firma. Untuk tadbir urus korporat, kami mendapati bahawa ia mempunyai peranan interaksi hanya di dalam firma yang mana hubungan politik tidak mempengaruhi pengambilan risikonya; iaitu firma yang mempunyai hubungan politik melalui lembaga pengarah dan firma yang mempunyai hubungan politik melalui ahli perniagaan. Daripada hasil kajian ini, kita mendapati bahawa apabila kuasa politik tidak campur tangan dalam pengambilan risiko firma, maka mekanisme tadbir urus korporat boleh berfungsi untuk mempengaruhi kecenderungan pengambilan risiko firma. Oleh itu, mungkin ini dapat menunjukkan bahawa pengaruh politik adalah lebih kuat berbanding dengan mekanisme tadbir urus korporat.

POLITICAL CONNECTION AND RISK-TAKING: THE INTERACTION ROLE OF CORPORATE GOVERNANCE MECHANISMS

ABSTRACT

The purpose of this study is to examine whether political connection affects corporate risk-taking. Anecdotal literature often finds political connection positively impact firm performance, but are many possibilities on how it can happen. One of them is that connected firms have more resources and higher capacity to undertake higher risk-taking which may eventually result in higher performance, compared to non-connected firms. Therefore, this study hopes to investigate whether firms that are politically connected may have a different risk-taking propensity as compared to firms that are not politically connected. To have a deeper understanding of this issue, this study further separates political connection into four different types to see whether different types of connection affect risk-taking differently. The four types of political connections are: firms connected through board of directors, firms connected through businessmen, firms connected through family members of government leader, and firms connected through government-linked companies. This is because some politically connected firms may have different roles and social obligations which in turn may affect risk-taking differently. Additionally, we also investigate the interaction effect of corporate governance mechanisms, more specifically the monitoring mechanisms, on how they may regulate the adverse effect of political connection on firm's risk-taking. In this study, we use the percentage of independent directors, board size, and financial leverage as the proxies for corporate governance mechanisms. The sample frame for this study is from year 2002 – 2017 covering 493 Malaysian public listed firms. To solve the endogeneity issue specified in the literature, this study uses

the Generalized Method of Moments methodology for running the analysis. From the results, we see that when political connection is collectively tested as a single dummy variable, it does not have any effect on risk-taking. However, when separated out into four types of political connection, we see that firms connected through family members of government leader and government-linked companies have a negative effect on risk-taking. On the interaction role of corporate governance mechanisms, we found that these mechanisms only work in firms where political connection does not influence risk-taking; i.e. firms connected through board of directors and firms connected through businessmen. Purely by looking at the result of this study, we see that only when political forces do not meddle in the risk-taking of firms, then corporate governance mechanisms can work to influence the risk-taking propensity of firms. Thus, perhaps this could indicate that political forces are more influential compared to corporate governance mechanisms.

CHAPTER 1

INTRODUCTION

1.1 Introduction

The fabric of corporate political connection is at the heart of research on political economy. Several investigations into this issue showed that political connection have a positive relationship with firm value (Fisman, 2001; Faccio, 2006). This inevitably lead to firms actively establishing political connections by hiring politically connected directors and or sometimes by financing election campaigns (Goldman, Rocholl, & So, 2009; Cooper, Gulen, & Ovtchinnikov, 2010). While the connection between political connections and firm value is practically well-known, there is little understanding about the mechanisms through which such connections create firm value and affect real economic outcomes. This study investigates one such mechanism: the risk-taking propensity of politically connected firms.

In emerging economies, it is common for the government to control an extensive range of financial and regulatory resources usually through its control over state-owned enterprises (Nee, 1992; McMillan, 1997). The economy in emerging economies also lacks sound legal systems for contract enforcement and property rights protection (Johnson, McMillan, & Woodruff, 2002; McMillan &Woodruff, 1999) as compared to developed economies. Therefore, it is customary that firms in developing economies maximizes the usage of political resources in order to avoid government extortions such as arbitrary fees and charges, and also obtain important resources offered by politicians.

According to majority of the findings of past literature[1], political connection positively affects firm value and performance, and this result is supported by a variety of reasons such as politically connected firms (PCF) getting preferences in government projects, loans, and information.

But how does political connection affect firm's risk-taking? Among the many investigations that focused on the topic of political connection, only Boubakri, Mansi and Saffar (2013) have investigated on this issue. However, their data encompass 77 countries and there are concerns about research with data from many countries. Such concerns include how to deal with country heterogeneity, the different political scenarios in every country and even the different stages in economic development among the sample data. In this study, we only focus on the sample from Malaysia, a country characterized by relationship-capitalism. According to Miller (2004), focusing only on the data of one particular country will be more advantageous as the study will be more concentrated and the authors would not need to acquire variables spanning a wide range of countries, which will then allow the researches to design the variables to capture the constructs that is being measured more cleanly.

What motivates this study is the lack of understanding, theoretically and empirically, on the impact of political connection on firm's risk-taking. Is it possible that risk-taking may serve as an important link that resulted in PCF having better performance compared to non-PCF? This is because the compensation for taking on greater risk is the expectation of higher performance. Therefore, if politically connected firms (PCF) have a higher risk-taking propensity than non-politically connected firms (non-PCF), then one should not be surprised when most of the

[1] See Peng and Luo (2000), Li and Zhang (2007), Wang et al. (2011), Li et al. (2008a), Li et al. (2008b), You and Du, (2012), and Su and Fung (2013)

literature indicated that PCF has better performance compared to non-PCF, as it should be expected.

1.2 Background of the study

The issue of political connection is widespread and prevalent in many countries. For example, Faccio (2006) found that they exist in 35 of the 47 countries in her sample and that these firms represent 7.76% of the world's market capitalization. In Malaysia, the government-linked companies have a combined market capitalization of about 42% of the total market capitalization of Bursa Malaysia[2] (Gomez, 2018). In Indonesia, when its long-serving President Suharto stepped down in May 1998, his family's wealth was approximately USD15 billion. Similarly, Liem Sioe Liong, one of President Suharto's closest ally in the business circle, used to be one of the richest person in Southeast Asia (Colmey & Liebhold 1999; King 2000).

Although the issue of political connection is quite prevalent, more so in emerging countries, the investigations in this area are still limited to several popular ones such as performance (Wu et al., 2012), debt level (Bliss & Gul, 2012), audit fees (Gul, 2006), and access to credit (Chiu & Joh, 2004; Dinç, 2005; Johnson & Mitton, 2003; Khwaja & Mian, 2005) just to name a few.

Firm's risk-taking has huge implications not only on the respective firms but also on the economy as a whole. Literature have documented that risk-taking is a crucial aspect of managerial long-term strategy as it is fundamental to firm performance and ultimately its survival. Risk-taking, if properly managed, is a source

[2] Malaysia's stock market exchange.

of growth, innovation, and prosperity. Firms with a high level of risk-taking indicates that they are more innovative and will be more inclined to take up risky investments that have a positive net present value. Previous studies have shown that entrepreneurs' inclination to take risks in order to achieve highly profitable opportunities is the central component of a country's long-term economic progress (John, Litov, & Yeung 2008). Moreover, in this increasingly competitive and complex global economy, firms are required to take bigger risks to innovate and generate economic value and an unsophisticated attempt to restrict risk-taking could unintentionally destroy that value.

On the other hand, excessive risk-taking may threaten a firm's bottom line, cause corporate failure, and therefore incur considerable costs for employees, customers, shareholders, and the broader communities, as demonstrated by several recent scandals and financial crises around the world.

The last two decades of the 20th century are mainly characterized by crises (Kibritcioglu, 2002). Such examples include the 1994-98 Mexican crisis, the 1997-98 Asian Financial Crisis (AFC) and the 1998 Russian financial crises. In all the three crises mentioned above, one of the common characteristics that all the three have is that they (either the government or the firms in the country) took on too much debt and ended up defaulting on those debts. However, the impact of those three crises mentioned above is mainly contained in their respective country or region. One crisis which has a global effect is the subprime mortgage crisis, which was also caused by excessive risk-taking. When Lehman Brothers, a large investment bank in the United States (U.S.) were unable to service their USD619 billion debt, it led to the largest bankruptcy in U.S.'s history which subsequently helped precipitate a global recession (Siepel & Nightingale, 2014).

Closer to home, during the Asian Financial Crisis (AFC) in 1997, there was also evidence that Malaysian firms (particularly PCF) took on too much risk in terms of borrowing from banks. When the value of Ringgit (in comparison to U.S. dollar) dropped due to the massive capital flight from Malaysia, we see that many Malaysians firms either went bankrupt or have to be bailed out by the government. These events demonstrate the drastic consequences that excessive risk-taking can have for firms and the global economy.

As indicated by Baird and Thomas (1985), "risk is embedded in most long-range decisions," (pg. 3) and thus "studying the risk-taking propensities of the decision-makers as they interact with particular decision situations" (pg. 16) will help us understand firms' strategies around the world better. There are many aspects that can influence risk-taking and they include environmental factors, which are sometimes beyond the control of the manager. In emerging countries like Malaysia which is often plagued by relationship-based capitalism, one of the most important environmental factors is the political institutions. The political environment of a country may play a big role in influencing a firm's managerial incentives to take risk and thus indirectly affect a firm's growth opportunities.

According to Boubakri, Mansi and Saffar (2013), a country's political institutions can influence corporate risk-taking through direct and indirect mechanisms. The influence through the direct mechanism of political institutions is towards firms' operations, which in turn affects corporate risk-taking. Earlier literatures which supports this conjecture includes Stulz (2005), in which his "twin agency" model states that in countries with authoritarian regimes (i.e., those with weak political institutions that have fewer checks and balances) governments are likely to affect firm operations through over-regulation, solicitation of bribes, confiscatory taxation, and outright expropriation of firm assets. More specifically, government rent-seeking in such unconstrained political environments, and the resulting outright expropriation of firm assets (Caprio, Faccio, & McConnell, 2011), discourage corporate risk-taking. In addition, government policies are sometimes driven by the political objectives of policymakers, who typically seek to maximize social stability and employment (Fogel, Morck, & Yeung, 2008), also constrain the firms' ability to undertake risky investments. Qi, Roth, and Wald (2010) present related evidence that firms have a higher cost of debt financing in countries with relatively weak political rights. This will eventually lead firms to borrow less and to engage in less corporate risk-taking. Authoritarian governments are also likely to reduce risk-taking, as high policy risk, or the likelihood of policy reversals will lead career-concerned managers to overweight the uncertainty in the political environment by choosing sub-optimal investments.

On the other hand, the influence through the indirect effects of political institutions on risk-taking may stem from their effect on firm monitoring. John, Litov and Yeung (2008) show that political institution affects the firm's information environment which shapes the balance of power between the firm's insiders and outsiders, all of which will ultimately impinge on the extent and effectiveness of monitoring of corporate insiders. Additionally, Roe (2003) shows that political institutions affect the degree of ownership concentration, and hence the extent of monitoring they exert on managerial actions and decisions.

Partly in response to what has been mentioned about the indirect mechanism of political connection on risk-taking, this study further investigates whether corporate governance mechanisms (or more specifically the monitoring mechanisms) could have an interaction effect on the relationship between political connection and risk-taking.

If the monitoring mechanisms are really sufficient in mitigating the influence of political connection, then we should see that the interaction effect of monitoring mechanisms have significant results and that the power of corporate governance mechanisms (monitoring mechanisms) suffices to counter any counterproductive effect that political connection has on risk-taking.

In addition, the types of political connection may also matter when investigating its relationship with risk-taking, as the different connection may have a different effect. In order to make a clear understanding of this issue, we further segregate political connection into four types according to their respective characteristics and independently test their relationship with risk-taking.

Therefore, in this study, there are three things that we examine; (i) how political connection influence firm's risk-taking; (ii) how different types of political connection may affect risk-taking differently and; (iii) the role of corporate governance (monitoring mechanism) as an interaction effect on the relationship between political connection and risk-taking.

In formulating the arguments for the relationship between political connection and risk-taking, this study employs the resource dependence theory (RDT) and rent-seeking theory (RST). The RDT suggests that politically connected firms should increase risk-taking due to factors like government guarantee and the ability to get more information compared to non-connected firms. RST on the other hand advocates that politician will seek to extract rents from firms which will benefit them and thus reduce the firm's capacity to employ higher risk-taking.

In formulating the arguments for the interaction role of corporate governance (monitoring mechanisms) on the relationship between political connection and risk-taking, this study uses agency theory. Generally, the purpose of corporate governance mechanism is to mitigate any wrongdoing in firms for their overall benefit.

1.3 Problem statement

Does political connection influence a firm's risk-taking? Despite the pervasiveness of politically connected firms in emerging markets, little is known on its influence on firm's risk-taking. Political connection can be an important determinant of risk-taking due to several reasons. First, some politically connected firms, especially government-linked companies (GLCs) can control the decision-making of firms (Perkins, 1996). The decision-making of firms includes a wide array of facets and one of them is their risk-taking decisions (Singh, 1986). Second, being politically connected minimizes external risk such as political risk - which may include the decision of the government to increase or decrease taxes, subsidies, and tariffs. This study postulates that the reduction in external risk will then free up firms' capacity to undertake more profitable investment. Third, political connection may provide an implicit guarantee to firms (Jin, Wang & Zhang, 2018) especially in times of trouble and crisis where they are usually being bailed out by the government (Perkins & Woo, 2000) if faced with the risk of bankruptcy. Similarly, this will also free up firms' capacity to undertake more profitable investment. Even with the obvious influences of political connection on risk-taking specified out, many people do not have a clear understanding on how political connection can affect firm's risk-taking, despite the fact political power have large influences on the corporate sector, especially in emerging countries. The lack of understanding on this issue thus serves as a motivation of this study.

Furthermore, past literature which investigates on the issues of political connection tend to focus on issues like firm value and performance (Fisman 2001; Muttakin et al. 2015; Sun et al. 2015; Ding et al. 2015), taxation (Kim et al. 2011; Kim and Zhang 2016), corporate governance or transparency (Chen et al. 2011; Shen et al. 2015; Leuz and Oberholzer-Gee, 2006), audit quality (Wahab et al., 2009; Wahab et al., 2011) and corporate social responsibility (Lin et al. 2015; Li et al. 2016), putting little emphasis issue of risk-taking.

By looking at the intention of forging political connection, we conclude that one of the main reason firms want to be connected is due to the resources that political connection brings. The resources that political connection can bring to firms are the social capital resources which may include networking, background, knowledge, and know-how of the government process. This can be explained by the Resource Dependence Theory (RDT), where the RDT recognizes the influence of external factors (such as political influence) on firms' behaviour (such as risk-taking behaviour). To harness the benefits of external resources like political influence, firms may undertake several ways such as appointing former government servants into their board of directors and establishing friendship with the government leader.

Although being politically connected seems to bring many advantages to firms[3], at times it can also be detrimental to firms. This happens when there are rent-seeking activities in connected firms. Rent-seeking in politically connected firms happens when connected directors expropriate the firms they are in for their own benefits. Government-linked companies (GLCs) are the most susceptible to the rent-seeking activities of politicians as GLCs are directly under their control. For example, politicians may use GLCs to serve their interest which will guarantee their success in future elections and hence long tenure in power (Boubakri, Cosset & Saffar, 2013). If this occurs, GLCs are less likely to seek performance improvements through cost-

[3] Hillman, Zardkoohi, and Bierman (1999) find that abnormal shareholder returns accrue to firms whose top managers are elected or appointed to federal positions in the U.S. government. Peng and Luo (2000) find that ties between Chinese managers and government officials (social ties) help improve market share and that this relationship is even stronger for firms with greater dependence on the government. Hillman (2005) finds a relationship between financial performance and ex-politicians on the board, particularly in more heavily regulated firms.

cutting or to undertake risky investments as these may lead to opposition from employees or voters. As indicated by Fogel, Morck and Yeung (2008), this phenomenon is prominent in countries with powerful government.

In the case of Malaysia where relationship-based capitalism is practiced, how does political connection affect firm's risk-taking behaviour? The limited anecdotal evidence (refer to Table 2.2) does not provide us with many clues on how these two variables interact with each other. The relationship between the two variables is important to be investigated because it will provide us with a deeper understanding on the extent of the influence of political connection, as it does not only influence firms in terms of performance and leverage but also its risk-taking[4].

However, political connection can be a complicated matter to investigate because there is no one definite way on how businesses can choose to be connected. In order to make a clear understanding of this issue, we further segregate political connection into four types according to their respective characteristics and independently test their relationship with risk-taking. There four types of politically connected firms (PCF) in Malaysia due to the combination of several events that unfolded during the pre-independence and post-independence years. The four types are – (i) government-linked companies (PCF_GLCs); (ii) firms with politically connected board of directors (PCF_BOD); (iii) firms with business owners who have close ties with top government official (PCF_BUS) and; (iv) firms with family

[4] As mentioned by Ding, Jia, Qu & Wu (2015), risk-taking, if properly managed, is a source of growth, innovation, and prosperity. Prior studies have shown that entrepreneurs' willingness to take risks in the pursuit of profitable opportunities is a fundamental underpinning of long-term economic growth (Acemoglu and Zilibotti, 1997; Baumol, Robert, and Schramm 2007; DeLong and Summers 1991; John, Litov, and Yeung 2008). Sustained growth, in turn, results in higher levels of economic development.

members of top government official as its owners or sitting in their board of directors (PCF_FAM).

The reason for different PCF classification is due to reasons like the different roles the connected directors play, the identity of the connected person, and the firm's ownership. For example, although PCF_GLCs are usually categorized as politically connected firms, their role and responsibility differ from those that are held by private owners. PCF_GLCs may have the obligation to improve the lives of common people such as providing employment and taking up unprofitable but socially beneficial projects- something that is not undertaken by other types of politically connected firms. It would be interesting to see if different types of political connection have a different impact on firm's risk-taking. Thus, this becomes the second research interest of this study.

There were debates on how the high prevalence of PCF in Malaysia during the 1990s has contributed to building up the bubble for the crash during the Asian Financial Crisis (AFC). In post AFC, the Securities Commission Malaysia introduced the Malaysian Code on Corporate Governance (MCCG) as part of the effort to combat the misconducts in the corporate sector. The MCCG spelled out many mechanisms that are designed to help firms self-regulate but so far only few studies (John et al., 2008; Su & Lee, 2013; Boubakri, Cosset & Saffar, 2013; Cohen et al., 2013; Kusnadi, 2015) have investigated on the interaction role that CG play in relation to risk-taking, with none investigating on the issue of political connection. The overall consequences of regulating firms' governance structures are not yet well understood. For instance, one of the questions still under assessment is to what extent corporate governance regulation interacts with firms' and managers' incentives and ultimately affects corporate operating and investment strategies. Therefore, in this study, we also look at the interaction effect of corporate governance mechanisms on the above-mentioned relationship. In the empirical literature, it is mentioned that corporate governance mechanisms play a significant role in resolving agency problems (Shleifer, 1985; Shleifer & Vishny, 1997), due to its effective monitoring system. In the context of firm risk-taking, firms with a good set of corporate governance mechanisms will be able to mitigate the bad risk-taking behaviour of firms. For example, a politically connected firm could be undertaking too much risk - perhaps due to the implicit guarantee provided by the government. Agency theory presumes that a firm with a good CG mechanism will be able to reduce this risk-taking. Vice versa, if politically connected firms (such as GLCs) engage its government-appointed directors to pressure the firms to not engage in risky but profitable investments in order to safeguard their chances of re-election, then from the perspective of agency theory, firms with good CG mechanism will be able to increase this risk-taking. Whether or not corporate governance mechanisms will be able to mitigate the relationship between political connection and risk-taking will be the third research interest of this study.

This study hopes to provide a better insight into the aforementioned issues. The next section will outline all the research questions and research objectives identified in order to answer the research interests mentioned in this section.

1.4 Research questions

1) What effect does political connection have on the risk-taking of firms?
2) What effect do different types of political connection have on the risk-taking of firms?
3) How can corporate governance mechanisms mitigate the effect of political connection on the risk-taking of firms?

1.5 Research objectives

1) To examine the effect that political connection has on the risk-taking of firms.
2) To examine the effect of different types of political connection on the risk-taking of firms.
3) To examine whether corporate governance mechanisms could mitigate the effect of political connection on the risk-taking of firms.

1.6 Significance of the study

This study provides three significances to the study in the area of political connection. First, we add to the corporate finance literature by examining another impact of political connection, which is risk-taking. Going beyond John et al. (2008), who established that shareholder rights protection and rule of law affect the extent of risk-taking by corporations around the world, we show that political connection also matters beyond these institutional constraints. In addition, this study also adds to the literature from the perspective of resource dependence theory, rent-seeking theory, and agency theory in explaining the factors which could affect corporate risk-taking. The integration of these three theories offers the opportunity a unique and nuanced understanding of how power arising from various political and governance mechanisms could influence risk-taking behaviour, which could possibly add on or destroy shareholder value (Lewellyn & Muller-Kahle, 2012).

Second, by showing the effect of political connection on corporate decision-making process such as risk-taking, this study may help corporate managers and policy-makers in making a more informed decision when dealing with issues like setting up corporate governance mechanisms to monitor the effectiveness of firm's risk-taking behaviour. Furthermore, governments may need to undertake the necessary reforms to decrease government predation and extraction in order to encourage investment at the firm level, and hence innovation and overall growth. By presenting evidence of the role that political connection had in promoting excessive risky lending practices, corporate directors and policymakers will be empowered and more capable of designing and enacting governance and regulatory frameworks that result in not only profitable but prudent risk-taking (Lewellyn & Muller-Kahle, 2012).

Third, we add to the literature by examining the corporate governance and risk-taking link in a non-U.S. setting, which is Malaysia. Our work is motivated on the premise that current findings, with the exception of a few recent studies on Japan and China, are mainly based on U.S. firms, which may not be relevant in countries with diverse institutional and market environments and agency conflict characteristics. There are significant institutional differences between Malaysia and the U.S., with regard to political institutions which we assume will have considerable bearing on managerial risk-taking incentives. A better understanding of the impact of political constraints on firms' strategic choices is of particular interest to foreign investors or even multinational companies (MNCs) who are seeking opportunities in Malaysia.

1.7 Definition of key terms

A number of important key terms are repeatedly used throughout the study. Consequently, a mutual understanding on the concepts or meanings of these key terms is needed. The key terms are namely: politically connected firms, firms politically connected through board of directors, firms politically connected through businessmen, firms politically connected through family members, firms politically connected through government-linked companies, non-politically connected firms, risk-taking, corporate governance, independent director, board size, and financial leverage.

1.7.1 Politically connected firms

There are a few ways on how a firm may be politically connected. In the context of Malaysia, they can be categorized into four types; political connection through the board of directors, political connection through businessmen, political connection through family members of government leader, and political connection through government-linked companies. If firms fall into any of the four categories stated above, they will be classified as politically connected firms (PCF). The definition for the four types of PCF are given in the following subsections.

1.7.2 Firms politically connected through board of directors

Firms politically connected through board of directors (PCF_BOD) are firms where there is at least one former government servant or politician serving on its board of directors. In Malaysia, the appointment of former government official (who previously held a high position in the government prior to retirement) to a firm's board of directors is quite common. The data for PCF_BOD is obtained from manual checking in the annual reports in Bursa Malaysia. See Appendix for the list of PCF_BOD firms.

1.7.3 Firms politically connected through businessmen

Firms politically connected through businessmen (PCF_BUS) are defined as firms where its owners have a close personal relationship with the government leader. The list of firms in this category is obtained from Gomez and Jomo (1997) and Johnson and Mitton (2003). They are then updated, where firms which are still connected are retained while those no longer connected are excluded. See Appendix for the list of PCF_BUS firms.

1.7.4 Firms politically connected through family members

Firms politically connected through family members (PCF_FAM) are defined as firms where the immediate family members of government leader serve in its board of directors, or has ownership in the firm. The list of firms in PCF_FAM is obtained partly from the date of Gomez and Jomo (1997), where further checks are conducted to exclude firms which are no longer connected through family members. Through online sites, additional names of the immediate family members of government leader is obtained. These names are cross-checked in the annual reports from Bursa Malaysia to find if they hold any directorship or ownership in any firm. See Appendix for the list of PCF_FAM firms.

1.7.5 Firms politically connected through government-linked companies

Firms politically connected through government-linked companies (PCF_GLC) are defined as firms where the government has a direct controlling stake in it via government-linked investment companies (GLICs). GLICs are the government's investment arms that distribute government funds to the government-linked companies. As of the year 2017, there are six GLICs in Malaysia – Khazanah Nasional Berhad (KNB), Kumpulan Wang Simpanan Pekerja (KWSP), Lembaga Tabung Angkatan Tentera (LTAT), Lembaga Tabung Haji (LTH), Permodalan Nasional Berhad (PNB), and the Ministry of Finance (MOF). See Appendix for the list of PCF_GLC firms.

1.7.6 Non-politically connected firms

Non-politically connected firms (non-PCF) are the public-listed firms in Malaysia which does not fall into any of the four specified types of PCF above.

1.7.7 Risk-taking

Risk-taking is defined as corporate risk-taking. It includes the management's proactive strategic choices in the allocation of resources, and the uncertainty about the firm's income (Bowman, 1984; Bromiley, 1991). In most cases, these decisions cause changes in organizations, which ultimately introduce uncertainty in the firm. According to John et al. (2008), riskier corporate operations have more volatile returns to capital, and thus, the proxy for the degree of risk-taking in firms' operations will be based on the volatility of corporate earnings. John et al. (2008) recommends two measures of the volatility of corporate earnings and they are the standard deviation of return on assets (ROA) and the standard deviation of return on equity (ROE).

1.7.8 Corporate governance

Corporate governance (CG) is defined as the mechanisms where firms are directed and controlled. Good governance can have a positive impact on the transparency and accountability of firms. Furthermore, a well-governed firms perform better in commercial terms. This study concentrates more into the aspect of the monitoring role of corporate governance mechanisms. The monitoring role is seen as an important CG mechanism to the shareholders against the management. The three CG proxies used in this are the percentage of independent directors in the board, the size of the board, and the financial leverage of the firm. They are being discussed further in the sections below.

1.7.9 Independent director

Independent director (ID) is defined as the percentage of independent directors in the board of directors. Independent directors are principally hired to protect the interests of minority shareholders (Young et al., 2008) and to maintain controls and checks on the effective functioning of a firm (Haider & Fang, 2016). The general consensus in the existing literature is that having independent directors suggests a high quality of corporate governance (Zhou & Li, 2016).

1.7.10 Board size

Board size (BS) is defined as the size of the board of directors in a firm. The prime role of the board of directors is to minimize the agency problems between shareholders and management by monitoring and advising the leading executives. Board of directors plays a key role in firms' strategic and investment decisions. An efficient board will improve the performance of a firm by scrutinizing its management's decisions. For the effective working of a board, its size is one of its vital characteristics (Haider & Fang, 2016).

1.7.11 Financial leverage

Financial leverage (LEV) is defined as the debt of the firm. It is calculated using the ratio of total debt to total asset. LEV is used as one of the CG mechanisms in this study because banks, and other large creditors can also provide a good monitoring capability. If a firm has high financial leverage, banks or other large creditors will be keen to monitor the management of the debtor's firm, which will subsequently reduce agency problem.

1.8 Organisation of the thesis

This thesis is divided into five chapters. Chapter 1 discusses the background of the study and the problem statement which motivated this study. It is then followed by the research questions and objectives. The significance and the expected contributions of the study are also outlined in this chapter. Chapter 2 provides the review of the existing literature regarding the topic of political connection, corporate risk-taking and corporate governance mechanisms. While reviewing the literature, concurrently the hypotheses of this study are also provided. Chapter 3 states the methodology used in this research, the data collection process, the research framework, the econometric tests, the control variables, and the models which will be used to test the research objectives of this study. Chapter 4 provides the result of the regression using the Generalized Method of Moments (GMM) methodology. At the end of Chapter 4, the overall discussion on all the results will be presented. Chapter 5 summarized the highlights of this study and concludes the results of this study.

CHAPTER 2

LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

2.1 Introduction

This chapter provides a review of the literature on political connection, risk-taking, and corporate governance and the rationales of their relationships. Section 2.2 provides the definition of political connection and the different types of political connection in Malaysia. It is followed by the empirical works in the area of political connection. Section 2.3 provides the definition of risk-taking and discusses its importance. It is followed by the development of risk-taking empirical works. Section 2.4 discusses the relationships between political connection and risk-taking and the two main theories used in this study. Then, the hypotheses development are presented in Section 2.4.3. Section 2.5 provides an explanation of how corporate governance mechanisms could influence the relationship between political connection and risk-taking. Then, the hypotheses are presented in Section 2.5.8. Section 2.6 presents the full research framework of this study. Finally, Section 2.7 summarizes the chapter.

2.2 Political connection

2.2.1 Definition of political connection

The definition of politically connected firms (PCF) varies slightly from studies to studies. This is because each study caters for their specific research needs and it also depends on the specific country they are investigating. For example, in Fisman (2001), PCF is termed as firms that are connected through family members and friends of the President of Indonesia, Johnson and Mitton (2003) defined them as firms that are connected through businessmen friends, Faccio (2006) defined them as firms that are connected through politically connected boards of directors, businessmen friends, and family of the top official, while Wu et al. (2012) defined them as state-owned enterprises and politically connected boards of directors. Generally, political connection can be described by establishing a social relationship with the intention to gain power or influence.

In this study, the definition of political connection depends largely on how political involvement became more and more intertwined in the businesses sector in Malaysia. The varieties of political connection that exist in Malaysia today are the result of the combination of several events that happened during the pre-independence and post-independence years[5]. They can be categorized into four types; political connection through the board of directors, political connection through businessmen, and political connection through family members of government leader, and government-linked companies.

[5] Malaysia gained her Independence in year 1957.

2.2.1(a) Political connection through the board of directors (PCF_BOD)

Companies that are defined as firms with politically connected board of directors (PCF_BOD) are firms that have former government servants or politicians serving on its board of directors. In Malaysia, there are two opinions regarding how this connection was established. First, this type of connection was brought about by the 1969 incident[6]. As a result of the incident, the New Economic Policy (NEP) was implemented, which resulted in many Chinese-owned businesses appointing "prominent Malays with a background in politics or the civil service as company directors, mainly to serve as avenues to secure access to the state or bypass bureaucratic red-tape in government" (Gomez, 2003, p.64). Second, the process of privatization also pushed politicians and bureaucrats into the business world (White, 2004), which, ultimately, led to an increase of PCF_BOD.

In Malaysia, the appointment of former government official (who previously held a high position in the government prior to retirement) to a firm's board of directors is quite common. For example, Yaacob bin Mat Zain, the ex-chief Army in Malaysian Armed Forces, was appointed to Mah Sing Group Berhad as its chairman after his retirement. Abdul Rahman bin Ismail, who used to serve in the Malaysian Police Force, was appointed to United U-Li Corporation Berhad.

PCF_BOD is not unique to Malaysia. In fact, it is quite a common phenomenon in other countries as well. For example, Goldman, Rocholl and So (2010) mentioned it in the context of U.S., Khwaja and Mian (2005) in Pakistan, and Faccio (2006) in a cross-country study.

[6] A riot which has happened in Malaysia in 1969 due to racial tension.