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**A Review of Corporate  
Governance: Ownership  
Structure of Domestic-Owned  
Banks in Term of Government  
Connected Ownership, and  
Foreign Ownership of  
Commercial Banks in Malaysia**

# **Authors**

**Peong Kwee Kim,  
Devinaga Rasiah and  
Rahayu Binti Tasnim**

Faculty of Business and  
Law, Multimedia University  
(Malacca Campus),  
Malaysia

## **Asbtract**

The Asian financial crisis of 1997 resulted in Malaysian commercial banks seeking to strengthen their

corporate governance,  
transparency and  
disclosure levels. The aim  
of this research is to review  
corporate governance in  
relation to ownership

structure of domestic  
owned banks in terms of  
government connected  
ownership and foreign  
ownership of commercial  
banks in Malaysia. This

research has given a  
brighter insight into  
corporate governance and  
bank performance in  
selected Malaysian  
commercial banking

institutions. The findings have also provided useful information to investors, bankers and regulators pertaining to the importance of the role of

corporate governance practices in the Malaysian banking system and its performance. Different types of bank ownership have had different concerns

about implementing  
corporate governance  
practices among  
commercial banks in  
Malaysia.

**Keywords:** Bank  
Ownership, Corporate  
Governance, Banks and  
Performance.

# **Introduction**

The Malaysian banking system consists mainly of three types of institutions. There are commercial

banks (domestically-owned banks and foreign-owned banks), financial banks and merchant banks. Domestic commercial banks have the largest

share of the market. Among these three types of institutions, the government control the largest bank and second largest bank; namely

Maybank and Bank  
Bumiputra through a  
majority share  
(Detragiache and Gupta  
2004).

According to Bank Negara Malaysia (BNM) (2009), there are presently a total of 55 financial Institutions in Malaysia, comprising 23 commercial banks, 15

investment banks and 17  
Islamic banks. The 23  
commercial banks include 9  
domestic banks and 14  
locally- incorporated  
foreign banks. Foreign

commercial banks held over 90 percent of the share of the banking market in 1957 when Malaysia became independent. However, by

1997, they controlled only 16.7 percent of banking assets. The progressive decline of foreign banks was the result of a deliberate government

policy of developing the domestic financial sector, under which foreign banks had been prohibited to open new branches since 1971, and the last licence to

a foreign institution was granted in 1973. The market share of foreign banks was relatively stable in the 1990s until the crisis

(Detragiache and Gupta 2004).

Domestic and foreign commercial banks had engaged in retail banking

and corporate banking. They were the only institutions authorized to take demand deposits. On the other hand, the numerous small finance

banks provided instalment credit to consumers and small businesses. Merchant banks were a minor presence at that time. The merchant banks provided

short-term money market  
and capital raising activities  
including underwriting,  
loans syndication,  
corporate finance and  
management advisory

services, arranging for the issue and listing of shares as well as investment portfolio management.

# **Background Study**

Bank Negara Malaysia's banking sector restructuring efforts was substantially completed.

Danamodal was the capital injection vehicle for the central bank. Therefore, the operations of the central bank had been recovered following the closure of the

Corporate Debt  
Restructuring Committee  
(CDRC). Danaharta also  
completed its task of  
acquiring NPLs from the  
financial sector and was

making significant progress in its recovery operations. Danaharta had been very successful in containing the rise of the NPLs in order for the banking system to

function efficiently during  
the intermediation process  
(Koh 2004).

# ***Ownership Structure of Banks in Malaysia***

Consolidation of the  
banking industry usually  
changes the merged

banking groups'  
composition of ownership  
structure and the banking  
industry's market  
structure. In the Malaysian  
government's strategy to

consolidate the banking industry resulted in the reduction of the number of domestic commercial banks from 20 in 1999 to 10 in 2001 when the bank

merger programme was completed (Koh 2004). While the consolidation programme resulted in larger and better capitalised domestic

banking institutions, it does not seem to have had any significant effect on the composition of ownership structure in the banking industry. The government's

sudden decision to initiate a bank merger programme in 1999 to consolidate the banking industry may have had been prompted by the worsening situation in

some of the banking institutions in early 1998. As some banking institutions difficulties became apparent because of their substantial losses

and high non-performing loan ratios, the central bank acknowledged that domestic banks were in need of recapitalisation.

The banking regulations on ownership structure are quite effective given that legal ownership was clearly seen in terms of share ownership in the banks.

However, discriminating the beneficial ownership structure is more difficult since nominee directors and nominee shareholdings are normal vehicles to

cover up 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 merge reflects very much the influence of the government's New Economic Policy (NEP) established in 1970 (Koh

2004). As a result of the New Economic Policy (NEP), restructuring policy, the share of the government ownership in a few of the larger domestic

banking groups became substantial with major controlling rights. There are five main government agencies with large shareholdings in the

domestic banking institutions. These five government agencies are Permodalan Nasional Berhad (PNB), the Employees Provident Fund

Board (EPF), Khazanah Nasional Berhad, Pertubuhan Keselamatan Sosial (PKS) and Kumpulan Wang Amanah Pencen (KWAP). PNB is the

government's national  
capital corporation and  
Khazanah the Ministry of  
Finance's investment arm.  
EPF, PKS and KWAP are the  
government agencies social

security and pension funds  
(Koh 2004).

There are many studies  
conducted by other  
researchers. The past

researches have highlighted that the corporate governance and ownership structure impacts bank performance in various perspectives.

## ***Motivation of the Prior Studies***

The recent corporate failures all over the world have reinforced the

importance of corporate governance. It is important for investors to differentiate corporate on the basis of governance principles in order to find

out the good from the bad.  
Certainly, corporate  
governance was the need of  
the hour. Corporate  
governance is a control  
mechanism through which

suppliers of finance to corporations assure themselves of getting a return on their investment (Shleifer and Vishney 1997). Corporate

governance is concerned with managing the relationship among various corporate stakeholders (Lashgari 2004).

In Malaysia, Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz, the Governor of Bank Negara Malaysia, (2003) said that the corporate governance in banks involves the range

of practices covering proper conduct of business, values, ethics and the whole culture of organisational and staff behaviour. It not only involves process and

financial targets to serve the interest of the shareholders but also the best practices of conduct with depositors, customers and other stakeholders.

The major contribution of corporate governance was enhancing operating performance of firms and preventing the fraud (Yeh et al. 2002). Black et al.

(2002) found that companies with better corporate governance had better financial performance than companies with poor

corporate governance. This was well supported by Jensen and Meckling (1976) and Fama and Jensen (1983). They found that corporate governance

really helps owners to exert control over corporate affairs. Corporate governance mechanisms have given powerful position to the owners to

manage corporate insiders  
and managers.

## **Objective**

This study examines the motivation of the prior studies for corporate governance and bank

performance. It also presents the structure, evolution and restructuring of the Malaysian banking system. Here, the objectives

revolve around three  
areas:-

1. To look at the literature  
in relationship between

corporate governance  
and bank performance.

2. Examine literature in  
relation to the sensitivity  
of corporate governance

on bank performance  
especially with different  
types of bank  
ownerships.

3. Look at the theories relating to the conceptual framework in Corporate Governance.

# **Literature Review**

## ***Bank Governance and Bank Performance***

In a study conducted by  
Goodstein et al had

indicated that larger boards may act as an increased pool of expertise and a better ability to form reasonable judgment (Goodstein et al. 1994). It is

hard to gain an optimum number of directors of the board. Chiang (2005) found insignificant relationship between board structure and firm performance.

Ingrid Bonn (2004) also found that board size never leads to firm performance. He argues that it is not board size, per se, that is important for firm

performance but rather the composition of the boards in terms of the ratios of outside directors. Lang et al. (1999) found that inside directors generally had a

greater understanding of the company's operations. Alonso and Gonzalez (2006) found an inverted U shaped relation between bank performance and

board size that justifies a large board and imposes an efficient limit to the board's size. Other than that, Spong and Sullivan (2007) found that boards of directors are

likely to have had a more positive effect on community bank performance when directors had a significant

financial interest in the bank.

However, outside directors are more professional and in a better position to exert

control over management.  
Fama (1980) stated that  
independent directors are  
better in managing and  
monitoring management of  
self interest and

opportunism. Past researches have shown mixed results on performance influence of outside versus inside directors on firm

performance. Most of the researches support outside board members' influence on firm performance.

Alonso and Gonzalez (2006) found a positive

relation between the proportion of non-executive directors' performance and a proactive role in board meetings. They argue that

the bank board's composition and functioning are related to director's incentives to monitor and advise management. All these

relations hold after they control the bank business, institutional differences, and size and market power in the banking industry,

bank ownership and  
investors' legal protection.

Pearce and Zahra (1984)  
argued that there was a  
high degree of association

between executive ratio and firm performance. This was well supported by Mahajan and Sharma (1985). They found that a board with high proportion

of independent directors works effectively. It was common practice that the CEO of the bank may act as chairman of the board of directors. There was

contrasting opinion among researchers regarding the CEO of the firm concurrently acting as chairman of the board. One set of researchers argued

against it, just because board effectiveness may come down drastically due to lack of independence. On the other hand, CEO can give ultimate direction to

the boards regarding company's future strategy and bale to run in a proper way. Past researches in the direction provide support for both arguments. Chiang

(2005) found it had a negative effect on performance if CEO assumes the role of chairman of the board. The same results were provided

by Fama and Jensen (1996).  
On the other hand,  
Anderson and Anthony  
(1986) argue that it may  
reduce conflict between  
CEO and the board of

directors, and that leads to effective functioning of board. Board meeting is an important element in the board governance.

Apart from that, the literature on the impact of managerial and board ownership structure either inside or outside on performance are also

discussed in this research.  
The effects of the presence  
of outside directors,  
especially directors from  
foreign countries in the  
corporate board structure

have impacts on bank performance. The extent of the foreign ownership level, not the mere existence of foreign ownership, has a significant positive

association with the bank return (Choi and Hasan 2005). Choi and Hasan had also indicated that the number of outside board of directors have no

significant effect on performance, but the presence of a foreign director on that board is significantly associated with bank return and risk.

This was well supported by Dahlquist and Robertsson (2001), who investigated foreign ownership among Swedish firms, and found that foreign investors are

typically mutual funds or other institutional investors and reported a positive association with performance.

Bonin et al. (2003) argue that over the second half of the 1990s, foreign ownership in the banking sectors of transition countries increased

dramatically. The performance of foreign-owned banks was significantly higher than domestically owned banks, and the extent of such

foreign ownership  
impacted bank efficiency  
significantly in eleven  
transition countries.  
Yudaeva et al. (2003)  
investigated the effects of

foreign ownership on productivity of Russian firms and found that foreign firms are more productive than domestic firms. They also found

positive spill over from foreign-owned firms to domestic firms in the same industry but reported negative effects on domestic firms that are

vertically related to foreign-owned firms. Meanwhile, Havrylchyk (2003) reveals that foreign-owned banks are found to be more efficient than their

domestically owned bank counterparts. Goldberg et al. (2000) found that foreign-owned banks outperform domestically

owned banks in developing countries.

It is understood that private domestically owned banks have a long term

orientation which encourages a strategic approach. Government-connected ownership that controlled private domestic banks seldom give up

management control to managers, and they are experts at retaining ownership. Past literature show that government-connected ownership was

positively significant to profitability. However, it was less significant to market returns. According to Narendar et al. (2005), foreign banks in Indian put

up better performance than other domestic banks. The bank controlling rights and cash flow rights have positive correlations in the government-connected

ownership of private domestic banks (La Porta et al. 1998). The reason for the wide spread government intervention in private domestic banks in

emerging countries is that the government's credibility is more or less dependent on stable financial sectors in the

country (Arun and Turner 2002).

The research on the role of the board of directors in Modern Corporation

primarily focused on the board's effectiveness in monitoring management (Fama and Jensen 1983). It was argued that by monitoring management,

outside directors can limit the exercise of managerial discretion, thus lowering contracting costs between shareholders and management (Fama 1980;

Fama and Jensen 1983).  
Bhagat and Black (2000)  
found that the proportion  
of outside directors on the  
boards is negatively related  
to firm performance. The

quantitative Meta analysis  
by Rhoades et al. (2000)  
reports that one third of the  
variation across board  
composition studies was  
the result of sampling error

and does not reflect the true differences in the relationship between board composition measure and financial performance.

The research on effect of  
low ownership  
concentration on the bank  
performance, controlling  
for shareholders protection  
laws and bank regulations

is also discussed here.

There exists an interaction  
with ownership  
concentration influences on  
the bank performance in  
shareholders protection

laws. Magalhaes et al. (2008) show the evidence that the increasing ownership concentration is more important to increase bank performance when

the protection of shareholders is low. They also argue that ownership concentration is more important to increase the bank performance with

concentrated ownership structures when the supervisory authority is less independent from the government and the banking system. This is

supported by Pinteris (2002) who provides empirical finding that indicates there was a negative relationship between bank ownership

concentration and bank performance.

The following subsection discusses the relationship between corporate

governance and bank performance, and the sensitivity of corporate governance and bank performance on the type of bank ownership in detail.

# ***Relationship between Corporate Governance and Bank Performance***

Theoretically, corporate governance is divided into

two perspectives which are external governance and internal governance. Both governances have greater impacts on the performance of bank firms.

However, the following subsection focuses on the prudential regulations in banking system. Regulations are important for banks because they

could discipline all kinds of banking activities of either domestic or foreign commercial banks.

## ***Prudential Regulations***

As the financial regulatory structure evolved, an umbrella of financial safety nets and prudential

regulations was put in place to ensure that the inherent safety and soundness of the banking institutions would promote stability within the financial system.

Operationally, this implies that any disruption in the banking system should not have a significant impact on the payments system as well as on aggregate real

economic activities. An overriding requirement in developing a viable financial safety net and prudential regulations framework for enhancing

effective market discipline  
is carefully balancing the  
need for effective  
regulatory oversight  
without, at the same time,

increasing regulatory  
burden (Koh 2004).

In banks, depositors rely on  
the government's role to  
protect their bank deposits

from expropriating  
management. It might  
encourage economic agents  
(bank managers) to deposit  
their funds into banks  
because a significant part of

the moral hazard cost is guaranteed by the government. In other words, if the government explicitly provides deposit insurance, bank managers

probably still have an incentive to increase their risk taking because it is at the government's expense. This moral hazard problem can be restored through the

use of economic regulations  
such as asset restrictions,  
interest rate ceilings,  
reserve requirements and  
separation of commercial  
banking from insurance

and investment banking  
(Arun and Turner 2003).  
The effects of these  
regulations limit the ability  
of bank managers to over  
issue liabilities or turn

away assets into high risk ventures.

## ***Manager and Director Ownership***

Managers and directors whose personal wealth is significantly linked to the

value of the firm have the incentive to act in the interests of outside shareholders. According to Jensen and Meckling (1976), outside

shareholders can economically assess the extent to which an owner and manager impose agency costs on other shareholders, the market

value of the firm's stock will be reduced, and the owner's wealth will be decreased. Many studies on corporate governance literature cite that

increasing stock ownership  
by managers and directors  
can be an effective control  
mechanism designed to  
reduce the moral hazard  
behaviour of firm

managers. If this was an effective control mechanism, then an increase in the extent of its use would induce a reduction in the level of

other monitoring mechanisms such as the presence of block holders and outside directors.

## ***Block Holder Ownership***

The presence of shareholders holding a high proportion of the firm's capital comprises another

way to mitigate the effects of the separation of ownership and control on firm value. For example, the manager of a firm in which each shareholder holds

only a small fraction of the firm's capital can engage in value reducing activities (Berle and Means 1932). However, in reality, a shareholder with a little

stake in the firm have weak incentives to engage in the monitoring of managers since he or she supports all the costs of monitoring, while getting only a small

fraction of the benefits or  
the typical free rider  
problem (Tam and Tan  
2007).

In contrast, an ownership structure in which one or more shareholders own a large block of stock have the potential for disproving managers from engaging in

moral hazard behaviour.  
The presence of block holders may represent a threat to the company's management because of the power to launch a proxy

fight, or a takeover bid. A block holder may also propose a person to represent him or her in the board of directors in order to ensure that the

management is acting in the interests of shareholders.

Consequently, firms with block holder ownership are

expected to have less  
agency problems.

## ***The Proportion of Outside Directors***

A number of academicians and professionals argue that the presence of

directors who are not employees of the firm may enhance the effectiveness of the board of directors in monitoring managers and improving firm value. The

rationality behind this statement is that outside directors are more likely to defend the interests of outside shareholders. It can be proven in Fama and

Jensen (1983) study that outside directors have the incentive to act as monitors of management because they want to protect their reputations as effective,

independent decision makers. On top of that, Weisbach (1988) found that outside dominated boards are more likely than inside-dominated boards to

replace the chief executive officer (CEO) in response to poor performance.

## ***Chief Executives Officer (CEO) – Chairman Duality***

Apart from that, many researchers who studied corporate governance

consider that separating the titles of chairman and CEO will reduce agency costs and improve firm performance. The reason is that when the CEO is the

chairman of the board, the power within the firm becomes concentrated in one person's hands. This allows the CEO to control

information available to other board members.

The board becomes under the control of managers, which prevents it from

effectively accomplishing  
its tasks of hiring,  
ultimately firing, rewarding  
top executive officers and  
confirming and monitoring  
important decisions. Given

the decrease in the effectiveness of the board, the potential agency costs resulting from the separation of ownership

and decision making are worsening.

Jensen (1993) recommends that companies should separate the titles of CEO

and board chairman. Pi and Timme (1993) study a sample of banks over the 1987 to 1990 period. The results of their study suggest that after

controlling the bank size and other variables, costs are lower and returns on assets are higher in banks with two different persons holding the CEO and

chairman titles. Control mechanisms are designed to mitigate the agency problem and expected to be used to a larger extent in

companies operating with a dual leadership structure.

## ***Board of Directors***

The expenditure defeats the advantages achieved from having more people to depict on. Jensen (1993 p.

865) indicates that by “keeping boards small can help improve their performance. When the number of board of directors gets beyond seven

or eight people, they would be lesser probability that they function effectively and difficult for the CEO to control." Lipton and Lorsch (1992) also call for

adoption of smaller boards  
and recommend that board  
size be limited to seven or  
eight members.

Yeramck 1996 and Eisenberg et al. (1998) indicate that a number of studies have shown negative results in relation to board size on firm

performance.

Consequently, corporate mechanisms such as insider block holder ownership and the presence of high proportions of outside

directors have developed  
into an important issue in  
firms with large boards.

## ***Principal-Agent Problem***

Nonetheless, several markets and governance mechanisms could reduce bank's agency cost. There

are several strategies to help reduce agency cost of banking institutions.

Firstly, for instance, labour market provides some incentives for bank

managers to serve  
shareholder interests, since  
better performing  
managers will be regarded  
and rewarded more highly  
and have greater

marketability (Fama 1980 and Cannella et al. 1995). Secondly, capital markets can also encourage better performance on the part of bank managers since any

performance issues could put pressure on stock prices and increase the potential for takeover and new management. Through these market mechanisms,

it is a partial substitute for  
direct incentives for  
themselves.

## ***The Effect on Bank (Firm) Performance***

Although the classical argument about the relationship between

corporate governance  
variables and firm  
performance was for some  
variables, the greater the  
level of the variable, the  
better the firm

performance, but the opposite holds for other variables; for instance, stock ownership by insider and block holders. The largely shared good sense

about these two control mechanisms, the firms with more insider ownership and block holder ownership, is that they achieve a better

performance. The same argument holds for the presence of outside directors on the board; for example, the more outside directors the firm have on

its board, the better its performance. Regarding the size of the board, a number of researchers and professionals call for smaller boards of directors

based on intuition or empirical findings. The rationale behind this is because the effectiveness of larger boards is lower and firms will gain in terms of

performance, if they choose to operate with boards composed of a limited number of directors.

# ***Ownership Structure and Bank (Firm) Performance***

In theory, as ownership  
separates from  
management, firm

performance may decrease due to growing difference in interests between the two persons who are managers and shareholders (Jensen and Meckling

1976). When ownership is concentrated in a single shareholder, there will be closer alignment of interests, and this could affect firm performance.

Therefore, conflicts of interest between managers and shareholders are argued to be more important in firms with dispersed ownership

structures, as coordination problem hinders effective monitoring of managerial actions by small shareholders, who have to rely on external monitoring

through the market for corporate control (Fama and Jensen 1983 and Jensen 1988).

In contrast, conflicts between managers and shareholders are expected to be less important in firms with concentrated ownership structure, as

controlling shareholders have strong incentives to monitor managers and replace them in the case of poor performance (Franks et al. 2001).

In summary, monitoring of managerial actions is difficult in a firm with dispersed ownership structure. A concentrated ownership structure

providing effective monitoring in principle is expected to enhance firm performance. However, another potential conflict of interest arises in firms with

concentrated ownership, as the controlling shareholders may engage in activities that expropriate minority shareholders (Shleifer and Vishny 1986;

Faccio and Stolin 2006).

Therefore, concentration of ownership may have a negative impact on corporate performance due to expropriation of

minority shareholders by  
controlling shareholders.

In the role of large  
shareholders model,  
Burkart et al. (1997)

challenge the view that monitoring is simply beneficial by describing a trade off between the benefits of monitoring and the ones of managerial

discretion. In other words, too much monitoring reduces manager's initiative to seek firm specific investments which is harmful to firm performance. They propose

the ownership structure as a commitment device to delegate a certain degree of control to management. The mentioned theories suggest that a non-linear

relationship between ownership concentration and firm performance is possible. In fact, Miguel et al. (2004) predicted and found empirical evidence of

a quadratic relationship in which performance (firm value) increases at low levels of ownership concentration (due to the monitoring effect), and

decreases at high levels (as a result of the expropriation effect). Tam and Tan (2007) show that concentrated ownership is positively related to firm

performance in Thailand and Asia. Such a relationship was especially pronounced in countries where investor protection was low because ownership

concentration was found to mitigate conflicts between owners and managers.

On the other hand, relying on the theoretical argument

that expropriation in general is costly (Burkart et al. 1998), we should expect less severe expropriation in a highly concentrated ownership structure. This

makes it possible for a cubic relationship between ownership concentration and performance, but until now they are not supported by any empirical evidence

(Miguel et al. 2004).

Performance or firm value is also argued to increase in the presence of strong shareholder protection laws aimed to avoid

expropriation by  
controlling owners  
(Classens et al. 2000; La  
Porta et al. 2002).

The effectiveness of shareholder protection laws is very important in banks because it could affect the relationship between ownership

structure and performance. However, the unique characteristics of banks may interfere in such relationship (Caprio et al. 2007). First, due to the

higher opacity and  
complexity of banks  
(Morgan 2002), investor  
protection laws alone may  
not provide effective  
protection to small

shareholders. Second, heavy regulations imposed on banks may substitute for interference with investor protection laws or make these latter extra. As a

consequence, it is not clear that we should expect a positive impact of investor protection laws on banks performance and valuation as it is the case for non

financial firms. Third, the emergence of bank regulations aimed to reduce expropriation by insiders should enhance bank performance and

valuations. Fourth, the presence of deposit insurance aimed to protect depositors through the reduction of excessive risk taking by banks may cause

inefficiencies in terms of performance and valuation (Caprio and Levine 2002).

***Model Relationship  
among Ownership  
Structure, Corporate  
Governance and Firm  
Performance***

The subsequently subsection discusses the relationship between corporate governance and bank performance sensitive to types of bank ownership

in detail. In general, the type of bank ownership has a greater impact on the performance of banks.

***Corporate Governance  
and Bank Performance:  
On Types of Bank  
Ownership***

The type of bank ownership is divided into two categories which are private domestically-owned banks and foreign-owned banks. Nevertheless,

the structure of bank ownership control can be classified into two groups. They are government-connected ownership for private domestically owned

banks and foreign  
ownership for foreign  
banks. These structures of  
bank ownerships have  
greater significant impacts  
on corporate governance

practices and outcome of bank performance itself. The reason is that the ownership control structure represents the power of owners to control

the bank in maintaining  
their corporate governance.

## ***Government-Connected Ownership***

Government ownership of banks is a common feature in many developing

economies (La Porta et al. 2002). The reasons for such ownership may include solving the severe informational problems intrinsic in developing

financial systems and aiding the development process (Arun and Turner 2002). The government is more fitted to allocate capital to certain

investment (Boubakri et al. 2005).

There are two additional theories which have been advanced for government

participation in the financial market, namely the development view and political view. The development view suggests that in some countries

where the economic institutions are not well developed, government ownership of strategic economic sectors such as banks is needed to jump

start both financial and economic development and foster growth. In political view, governments acquire control of banks in order to provide employment and

benefit to supporters in return for votes, contributions and bribes. Such approach is greater in countries with underdeveloped financial

system and poorly developed property rights. Under development view, government finance projects are socially desirable. Therefore,

governments finance projects that would not be privately financed in both views (La Porta et al. 2002).

Greater government ownership of banks tends to be associated with lower bank efficiency, less saving and borrowing, lower productivity and slower

growth (Barth et al. 2000). Government residual ownership is likely to have an effect on performance (Boubakri et al. 2005). In Malaysia, the almost status

quo position in the ownership and control structure in the banking industry after the merge reflects very much the influence of the

government's New Economic Policy (NEP). As a result of the NEP restructuring policy, the share of government ownership in a few of the

larger domestic banking groups became substantial with major controlling rights (Koh 2004).

Therefore, most studies have shown that there exist direct relationships between bank performance and government ownership of banks. Government

ownership is generally positively related to the level of non-performing loans in an economy, but not strongly linked to the other performance

indicators (Barth et al. 2000).

## ***Foreign Ownership***

With regard to the theme of foreign ownership, prior research suggests that cultural connections might

also affect the ability of foreign banks to take full advantage of local opportunities (Clarke et al. 2001). Most sources agree that the more similar the

cultural backgrounds of those involved in the interaction process, the greater the likelihood of achieving market closeness (Ford 1989 p.825-826).

Cultural likeness is an important determinant of a firm's ability to estimate the needs and requirements of various stakeholders (Holden and

Burgess 1994). It may be the mechanism in the interaction process. While trust and experience are only gained or lost through interaction, cultural

likeness can be influential before interaction begins (Swift 1999). Head quartered in origin foreign countries versus those located outside the origin

countries, Berger et al. (2000) found that foreign-owned banks headquartered in the origin foreign countries are likely to lend to some classes of

their small businesses than foreign banks headquartered outside the origin countries. The assumption is that similar culture and language would

offer advantages to origin  
foreign countries rather  
than from other places.  
Lark et al. (2001) suggest  
that any specific  
advantages foreign banks

are likely to have over domestic banks are likely to be greater for foreign banks headquartered within the East Asia region. This is possible due to shorter

distances and similarity in language and culture. In fact, the impact of these factors also have been observed in other financial phenomena and used to

explain home bias effect of investors who tend to be averse to including foreign stocks in their portfolio (Grinblatt and Keloharju 2001).

# **Conceptual Framework**

## **Independent Variables**

Board Ownership Structure  
(Internal Governance)

- Government-connected Ownership
- Foreign Ownership

# External Forces- Regulation (External Governance)

- Capital Ratio

- Fixed Asset and Inventories to Capital

# **Dependant Variable**

## **Bank Performance**

The conceptual framework model shows the

relationship between  
corporate governance and  
bank performance sensitive  
to the types of bank  
ownership in Malaysia.

Types of bank ownership

moderate the effect of corporate governance on the bank performance in Malaysia. The type of ownership in Malaysia is divided into two

perspectives which are foreign-owned banks and second, there are private domestically owned banks. Therefore, these types of bank ownership have a

significant effect on internal corporate governance in terms of board ownership structure in banks. This implication may lead to banks having poor or good

corporate governance and  
directly resulting in its  
profitability increasing or  
decreasing.

In Malaysia, the ownership structure for private domestically- owned banks consist of government connected ownership, corporate ownership and

widely held family and corporate ownership. Nevertheless, in this research, it selects government-connected ownership of private

domestically- owned banks  
in order to have a  
comparison of corporate  
governance significant to  
foreign ownership of

foreign-owned banks in  
Malaysia.

The reason for this is that  
the government provides a  
huge amount of funds to

bail out savings deposit and  
takes over temporarily  
illiquid banks. Banks have a  
dominant position in  
developing economic  
financial systems especially

Malaysia and are important engines of Malaysia's economic growth.

Upon review of past studies as discussed earlier, two

hypotheses were developed. They are:

- a) Better corporate governance will lead to

better bank  
performance.

b) The relationship  
between corporate  
governance and bank

performance is more sensitive for foreign-owned banks rather than for private domestically- owned banks in Malaysia.

# **Research Methodology**

The research methodology adopts two exogenous variables in order to align with the goal and objectives

in this research as used by KK Peong and D Rasiah (2010). The exogenous variables that are being used in this research constitute capital ratio

(CR), and fixed assets and inventories to capital (FAI). Therefore, the ratio of these two exogenous variables is presented as follows:

Firstly the capital ratio is equal to Loan loss provision plus Equity divided by Total loan. Further more the loan loss provisioning was equal to

allowance for losses  
divided by total loan.  
Secondly the fixed asset  
and inventories to capital  
(FAI) is equal to fixed asset  
and inventories divided

capital assets and  
inventories to capital (FAI).  
Thirdly fixed asset and  
inventory is equal to fixed  
asset and inventory divided  
by capital.

This study comprised of 4 private domestically-owned banks and 7 foreign-owned banks. The following variables were looked at in this study.

- Percentage of shares in shareholders
- Loans and advances
- Total equity

- Loan loss and provision
- Net profit for the year
- Fixed assets

- Share capital

## ***Proxy Variables for Bank Performance***

This research employs a single proxy for bank

performance relevant to return on shareholder's investment, called return on equity (ROE). ROE is a net income available to common stockholders

divided by common equity  
by Brigham and Ehrhardt  
(2005) and KK Peong and D  
Rasiah (2010). The ratio of  
ROE can be shown as  
Return on equity ( ROE) is

equal to Earnings divided  
by common equity.

## ***Regression Model***

This research uses simultaneous equation model. The purpose of using the simultaneous

equation model is to examine the causal relationship in higher level of analysis (Bodkin and Hsiao 1996). The coefficient parameters will

be estimated by using generalized method of moment (GMM). This technique is useful to eliminate the econometric assumption problem.

Apart from that, this research also adopts the regression model of KK Peong and D Rasiah (2010). As in the earlier discussions, the

simultaneous equation model was computed by two exogenous variables of external governance, ownership structure variables for private

domestically owned banks  
and foreign-owned banks  
(internal governance) and  
bank performance variable.  
The simultaneous equation

model can be performed in this research as follows:

$$1) CAR_G = \frac{1}{OWN_G + 1} + \beta_1 CR + \beta_2 FAI + \beta_3$$

$$ROE_G = \beta_1 + \beta_2 CAR_G + \beta_3$$

$$2) \text{CAR}_F = \frac{1}{1 + \beta_1 \text{CR} + \beta_2 \text{FAI} + \beta_3 \text{OWN}_F + \beta_4}$$

$$\text{ROE}_F = \beta_1 + \beta_2 \text{CAR}_F + \beta_3$$

Descriptions of simultaneous equation model are shown below:

CR = Capital ratio

FAI = Fixed asset and  
inventory

$CAR_G$  = Capital adequacy  
ratio for private  
domestically owned banks

$OWN_G$  = Ownership  
structure for private  
domestically owned banks

$ROE_G$  = Return on equity for  
private domestically owned  
banks

$CAR_F$  = Capital adequacy ratio for foreign-owned banks

$OWN_F$  = Ownership structure for foreign-owned banks

$ROE_F$  = Return on equity for  
foreign-owned banks  
= intercept

= coefficient of  
parameters

= residual error

## **Findings**

The type of bank ownership consists of foreign-owned

banks, private  
domestically- owned banks  
and state-owned banks  
(Berger et al. 2005). Even  
though Malaysia had state-  
owned banks in financial

institutions, its functions totally differ from commercial banks functions as retail banking. Furthermore, it is also categorised as development

financial institution and a non-financial institution. Thus, only two types of bank ownership are investigated in this research, which are

foreign-owned banks and private domestically-owned banks.

In internal governance mechanisms, ownership

structure has an important role as a key determinant of corporate governance. This variable represents controlling shareholders who govern the policy of

the firm in implementing good corporate governance (Supriyatna et al. 2007). Ownership structure is the relative amount of ownership claims held by

insiders (management) and outsiders (investors with no direct role in the management of the firm) (Jensen and Meckling 1976). The highest

proportion percentage of ownership structure (majority ownership) indicates the higher power of the owners to control the bank. In this research, the

measurement of ownership structure is based on the highest proportion percentage of government-connected ownership ( $OWN_G$ ) for private

domestically- owned banks.  
This research also  
measures the highest  
proportion percentage of  
foreign ownership ( $OWN_F$ )  
for foreign-owned banks in

Malaysia perspective. The  $OWN_G$  and  $OWN_F$  represent the power of owners to control the bank in maintaining their corporate governance.

# **Discussion and Conclusion**

In brief, there have been multiple bank closures and substantial overhaul of

banking regulation among Malaysian banks especially private domestically-owned banks and foreign-owned banks. Banks are to make changes in order to

be globally standard and to be able to compete for stability and profitability of the banking sector. There has been no study in the literatures examining the

effects of corporate  
governance in private  
domestically-owned banks  
and foreign-owned banks  
on bank performance  
respectively. This study

employs foreign and domestic commercial bank data from 1995 to 2005 to investigate the effect of corporate governance and bank performance, mainly

transparent ownership and  
governance on bank  
performance of private  
domestically- owned banks  
and foreign-owned banks in  
Malaysia. Particularly, this

research investigates  
foreign ownership as well  
as capital and fixed assets  
and inventory to capital on  
the return or bank

performance of sample  
foreign banks.

Empirical studies indicate  
that managers ought to be  
concerned about

possession, and that good governance effects on good bank performance and profitability. In Malaysia, the researchers have identified that there are

two types of bank ownership which are private owned banks and the domestically- owned banks or foreign-owned banks. These findings

confirm that foreign-owned banks were implementing good corporate governance and had higher advantage of increasing their performance, and private

domestically- owned banks were at implementing corporate governance. As a result, they have a better performance than that of foreign-owned banks.

Subsequently, shareholders with information also have an important role to play and they can force the bank management to implement better corporate

governance. In order to be positive, bank managers implement efficient corporate governance and establish positive control mechanism. This may have

different concerns on implementing good corporate governance. For example, foreign-owned banks may be concerned about implementing good

corporate governance practices across various management levels. As a result, their performance is much better than that of private domestically-

owned banks in the  
Malaysian banks.

Bank Negara Malaysia or  
the Central Bank of  
Malaysia has to encourage

commercial banks to  
implement corporate  
governance practices  
through enacting rules and  
regulations. Good  
Corporate governance

practices in commercial banks will be positive that banks maintain the level of risk they can handle and give depositors a sufficiently safe level of

their savings and investments. Several commercial bank regulations encourage good corporate governance practices and as such have

implemented lending limits, the quality of assets, knowledge of your customers and regulations against money laundering as indicated by Bank

Negara Malaysia Regulation  
Guidelines (From  
BNM/GP1 till BNM/GP11).  
As a result, privately-  
owned and domestically-  
owned banks in Malaysia

have a good performance  
because of implementing  
superior corporate  
governance.

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