THE IMPACT OF CORPORATE GOVERNANCE ON *SUKUK* RATINGS: EMPIRICAL EVIDENCE FROM LISTED COMPANIES ON BURSA MALAYSIA 2008-2011

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ABSTRACT

Corporate governance is the system through which the companies are directed and managed. The essential role of corporate governance has been raised and discussed more recently due to the global financial crisis in 2007. In addition, Islamic finance industry has garnered attention in recent times because of its high growth, which among its central instruments is *sukuk*. Therefore, this study is conducted in order to investigate the impacts of corporate governance on *sukuk* ratings. This vital objective is achieved through the collecting of data from the corporations that are listed in the Bursa Malaysia from 2008 to 2011, and have issued *sukuk* during this period. Panel data analysis has been adopted for this study. The finding demonstrates that, separate board leadership structure, independent non-executive directors, smaller board size (at 10% significance) as corporate governance mechanisms contribute to better and higher *sukuk* ratings. Meanwhile, in regard to ownership variables, lower proportion of director ownership and higher proportion of institutional ownership (at 5% significance) leads to higher *sukuk* ratings. Whereas in control variables, it is shown that the bigger the size of issued *sukuk* (at 1% significance), the less years it takes to achieve maturity, with bigger firm size (at 10% significance), lower proportion of leverage, and less of net income amount, all of which contribute to better *sukuk* ratings. Lastly, all of these variables are found to be in line with the theoretical frameworks except for net income variable, which could be due to the nature of *sukuk* as a partnership and debt-based element, and it is contrary to the nature of bonds as a debt instrument. Finally, this finding is expected to contribute significantly in fields that concern regulators, issuers, investors, academicians as well as to the public.

ملخص البحث

تعرف الحوكمة بالإجمال بأنها النظام الذي يحدد علاقة ملاك الشركات بمديريها. لذا فتتابع حدوث الأزمات المالية والإقتصادية في العالم حديثا- كما وقع في نهاية عام 2007- دعى الكثير إلى إعادة النظر في دور الحوكمة لتقليل حدوث مثل تلك الأزمات وتخفيف ضررها. وبما أن التمويل الإسلامي جزء من المنظومة المالية العالمية - والتي تشكل فيه الصكوك نسبة ليست بالقليلة، تسعى هذه الدراسة لقياس ومعرفة أثر الحوكمة على تقييم الصكوك من خلال الشركات المدرجة في سوق الأسهم الماليزي من خلال الفترة مابين 2008 وحتى 2011. بالإجمال فقد أظهرت الدراسة أن عوامل عدد أعضاء مجلس الإدارة، وملكية المؤسسات، وحجم الصكوك المصدرة، وحجم أصول الشركة المصدرة لها دور فعال في التأثير على تقييم الصكوك. فقلة أعضاء مجلس الإدارة للشركات يساهم بارتفاع تقييم الصكوك. وبالمقابل فكلما زادت نسبة ملكية المؤسسات وحجم الصكوك المصدرة وأصول الشركة، كلما زاد تقييم الصكوك إيجابيا. وبناء على ذلك، فمن المؤمل والمتوقع أن تسهم هذه الدراسة اسهاما فعالا وبناءا لكل من له صلة بالتمويل الإسلامي وخاصة في مجال الصكوك كالأكاديمين والمساهمين والمستثمرين والمنظمين بالإضافة إلى العامة.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion; it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Science in Islamic Banking and Finance.

Sheila Nu Nu Htay
Supervisor

This research was submitted to the IIUM Institute of Islamic Banking and Finance and is accepted as a fulfilment of the requirement for the degree of Master of Science in Islamic Banking and Finance.

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DECLARATION

I hereby declare that this research paper is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for my other degrees at IIUM or other institutions.

Altwijry, Othman Ibrahim A

Signature .... Date ..28/2/2012

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Affirmed by Altwijry, Othman Ibrahim A.

.... Signature

28/2/2013 Date

To my father. mother. wife. sister. brothers and friends,

And to my son and daughter, Ammar and Shima, who light my world and home,

throughout the finalizing process of this paper.

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Say: "Truly, my prayer and my service of sacrifice, my life and my death, are (all) for Allah, the Cherisher of the Worlds

(Al-Anaam, Chapter 6, Verse, 162)

In the beginning, I would like to thank Allah (S.W.T), for all of the blessings and graces that He has generously given me. My thanks and prayers go to my supervisor, Dr. Sheila Nu Nu Htay for her guidance and help.

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CHAPTER ONE

1.1 INTRODUCTION

Islamic financial system has been introduced recently. It was an aim for Muslims to have *Shari'ah* based financial system. This system would carry the great principles and rules of *Shari'ah*, such as fairness, co-operation and honesty – which were conveyed by the Prophet Muhammad (p.b.u.h) whom the Almighty describes in the al-Qur'an:

> And We have sent you (O Muhammad صلى الله عليه وسلم): not but as a mercy for the *'Âlamîn* (mankind, jinn and all that exists). Al-Qura'n, 21: 107.

Islamic financial system was a dream because Muslims would be able to avoid getting involved in non-*Shari'ah* compliant activities like *Riba*, *Mayser* and *Gharar* that exist in conventional financial system. However, nowadays, this aim becomes a reality and achieved when the first Islamic financial system was introduced in the middle of the twentieth century (International Shari'ah Research Acadeimy for Islamic Finance ISRA, 2011). Therefore, the new area has many aspects that demand for new research in improving the state of the Islamic economy in order to serve the *Ummah* and give better alternative to others. One of these aspects is what this paper will look for, which, in particular is about corporate governance and *sukuk*.

1.1.1 Corporate governance

Corporate governance is one of the most important and significant pillar of the economic structure for any business organization. It is a fact that when the corporations are governed very well, it will affect positively on the entirety of the market. Moreover, investors are always looking for a good corporate governance to extend their investment and have sustainable growth (Allen, 2005). The important role of the corporate governance illustrates from the fundamental definition of it. According to the Cadbury Committee (Cadbury, 1992), the definition of corporate governance is "the system by which companies are directed and controlled". Another definition, which is considered more specific is what the International Finance Corporation (IFC, 2005), states that "corporate governance refers to the structures and processes for the direction and control of companies". In particular, Malaysian Code on Corporate Governance (MCCG, 2012) defined corporate governance as "the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long-term shareholder value, whilst taking into account the interest of other stakeholders". Lastly, Organization for Economic Co-operation and Development (OECD) Principles of Corporate Governance (2004), explains it as:

> Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

It is worth mentioning that transparency, justice, and accountability are represented by these definitions which are the main aim of corporate governance from the Islamic perspective. Thus, Islamic Financial Service Board (IFSB) contains all of the elements of corporate governance framework in the definition of it, with additional feature of the *Shari'ah* requirements such as applying of *fatawa* and monitoring the compliance of *Shari'ah* in all aspects of products, activates and operations (IFSB, 2006).

1.1.2 *Sukuk*

Capital market plays an essential role for developing and improving the position of financial institutions. Indeed, capital market has verity types such as stock and bond. Bond or security has the biggest share in the capital market. However, since bond is not allowed from the Islamic perspective due to the interest that it has (Security Commission Malaysia SCM, 2009), Islamic scholars and economists innovated and structured an Islamic alternative to bond, which is called Islamic bond, or as the Arabic term defined it as *Sukuk*.

Literally, *sukuk* (plural of *sak*) means certificates. According to the Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI), in its *Shari'ah* standard 17(2), '*sukuk*' is defined as "certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services, assets of particular project or special investment activity" (2010). While broadly, Security Commission Malaysia (SCM), in its Guideline on Islamic Securities (2004), defined *sukuk* as "document or certificate which represents the value of an asset".

After acknowledging the definition of *sukuk*, it is important to look into the market of *sukuk* globally and particularly in Malaysia. According to Islamic Finance Information Service (IFIS), the cumulative *sukuk* issued since the beginning of the market up to the mid of 2010, has amounted to approximately US$161 billion. In 2007, the *sukuk* market reached to the highest point which was almost US$47 billion. On the other hand, Malaysia, as a country, is still having the largest share of *sukuk* issued, which is around 60% of the total value of issued *sukuk* (ISRA, 2011).

1.2 PROBLEM STATEMENT

As a matter of fact, corporate governance is considered the heart of the companies, in which it determines the position of these corporations. The current global financial crisis might be the best feature that demonstrates the significant role of corporate governance in the structure of companies. Thus, this subject becomes interesting and essential for academicians, regulators, owners of corporations and others to be investigated and discussed in order to enhance and improve this essential aspect of company managing. Apart from the importance of corporate governance in modern corporations, Islamic financial institutions, which include banks and other financial institutions, are also subjected to the significant role of corporate governance since they are aimed at becoming better alternatives to the conventional corporations that are involved in invalid products and services such as loan with interest. As a result, corporate governance factor is highly considered by the Islamic financial institutions in order to get better position in the market. Indeed, IFSB, AAOIFI, SCM and other institutions have issued guidelines for corporate governance for institutions that offer Islamic financial services and update them from time to time (AAOIFI, 2010; IFSB, 2006; SCM, 2004).

As one of the most vital products for financial institutions, bond or debt financing is among the means to capitalize new projects and companies. Thus, this channel is influenced by how well the companies are run, which affects the confidence of the market and performance of the companies. Based on that, corporate governance is essential for companies that need access to capital and governments in order to stimulate private sector investment (Faulkner, 2000). Alternatively, Islamic corporations and governments that are willing to capitalize their projects are unable to use bonds since interest is involved and, consequently, are not allowed based on *shariah* perspective. Therefore, *sukuk* or Islamic bond would be a better alternative to those institutions or governments that want access capital, which is based on the *shariah* principles, such as *ijarah*, *murabahah* and *mudharabah*. Hence, investigating and discussing the relationship between corporate governance and *sukuk* would be beneficial and crucial to the study.

Indeed, many studies have been conducted to examine the impacts of corporate governance on bond ratings (Hollis Ashbaugh, 2004; Mark S. Klock, 2004; Sameh Ouni, 2010). So far, to the researcher's knowledge, no study has tried to examine the impacts of corporate governance on *sukuk* rating. Therefore, the central objective of this study is to examine whether corporate governance variables have any effect on *sukuk* rating. Given the above discussion, the research question will be formed as:

- To what extent will corporate governance be able to contribute towards higher *sukuk* rating?

1.3 SIGNIFICANCE AND CONTRIBUTION OF THE STUDY

Since the significant role of corporate governance on the performance of corporations and on the whole economic sectors holistically, this field actually needs to have more research and studies. To illustrate that, many researchers mentioned that corporate governance contributes vitally to the economic health. Global financial crisis is the best example of this aspect, whereby researchers believe that one of the causes of the 2007 and 2008 economic crises is the weakness of corporate governance (Rosen, 2010).

As such, researching in this area would contribute essentially to improve the corporate governance regulations and rules, which mainly would help the regulators and governors (such as SCM, BNM and AAOIFI). The reason is based on the result of this study which would provide valuable analysis to the regulators and policy makers in order to the development of new regulations in enhancing the operation of corporations that aim to issue or invest in *sukuk*. Thus, corporations would be governed better and would simultaneously reflect positively on the economic sector, especially, in the Islamic economic segment.

Moreover, writing this topic would provide to the academicians and researchers a better understanding of this important area that may relate to their fields of research. This study is intended to add more analyses and information to the previous literature that contributed to this field, since it is considered as the first paper that examines the relation between corporate governance and *sukuk* ratings.

Furthermore, this study would draw a clear conception and recent analysis for the investors about the corporate governance and its impacts on *sukuk* ratings area which operate using the *sukuk* instrument for their investment. This is due to the fact that they would be updated by the corporate governance factors that affect the *sukuk* ratings either negatively or positively. Hence, operators in the industry of *sukuk* would enhance the roles of corporate governance in their management, since it has a strong relation with the performance of the corporations which, as a result, would affect the profitability and also minimize risk.

This study would also contribute to the field regulators, academicians, and industry to the public in terms of *sukuk*, since it will examine the impacts of corporate governance on *sukuk* rating. It is a study that would illustrate the essential position of *sukuk* generally in the market and specifically in the Islamic capital market industry. Furthermore, *sukuk* is considered as one of most important growth aspects of Islamic capital market, which has been growing rapidly during the last ten years. According to IFIS the figure of cumulative *sukuk* issued in 2002 was almost at US$ billion, and it reached to US$47 billion in 2006 (ISRA, 2011). This huge growth should be paid attention to by the regulators, industry players, researchers as well as public in general who would examine the causes and impacts of this interesting area, and this paper attempts to be one of the contributions needed in this field.

1.4 ORGANIZATION OF THE RESEARCH

The research paper is organized as follows – the research paper is structured into five chapters, which are:

Chapter One is the introductory chapter, which mainly contains the background of the study that includes the definitions of corporate governance and *sukuk*, and their important roles. Problem statement, objective of the study, and research question are discussed. The significant and expected contributions of the study are also highlighted in this chapter. Lastly, it is concluded by the organization of the research.

Chapter Two is aimed to enrich this study and give a comprehensive and better understanding of the area of the research. It is entitled the literature review, which presents the theories of corporate governance. The theory that is discussed is the agency theory - due to its close relation to this topic compared to other of corporate governance theories. Subsequently, this chapter highlights and discusses the empirical prior researches that have been done in areas that related to this research field. Consequently,

Chapter Three is intended to highlight the research methodology of the research and it contains two parts. The first part explains the development of hypothesis, whereas the second part mentions the research design.

Chapter Four presents the findings of the research.

Chapter Five concludes this research by mentioning briefly the result that would be found from this research. Furthermore, it will also state the limitation and suggested areas that need further study and research.

CHAPTER TWO

2.1 INTRODUCTION

It is essential to illustrate the theoretical assumption of this research in order to have better understanding of the issue. This chapter is organized into three sections. The first section will be discussing about the theoretical framework of this research, i.e. agency theory. The empirical studies and contributions by prior researchers will be conducted in the second section. Finally, this chapter will be concluded in the last section along with the main findings and results.

2.2 THEORY AND FRAMEWORK

2.2.1 Agency Theory and Corporate Governance

Particularly in the modern times, not only the structure of business is complicated, but the financial crisis that has frequently occurred in some parts of the world raised the importance and significance of corporate governance. Thus, since corporate governance plays this crucial role for the management and performance of a corporation, it has many fundamental theories that discuss the structure and framework of governing the corporations. Some of these theories are agency theory, stewardship theory, stakeholder theory, resource dependency theory, transaction cost theory and political theory. However, in regard to this research, the main theoretical assumption depends on the agency theory, since the central theoretical assumption of this research depends on this theory. Therefore, corporate governance and ownership structure will be discussed further in the following parts from the agency framework perspective.

Before looking into corporate governance and ownership structure, it is necessary to define agency theory and shed light on its development. 'Agency theory' refers to the relationship between the owner of the corporation who is called the 'principal' and the agent, 'manager' who are authorized to control and direct the use of the collective capital for future gains (Alexander N. Kostyuk, 2007). In this theory, the shareholders or owners of the corporation would hire the agent to manage and perform on their behalf (Clark, 2004). According to that, (Daily, 2003) asserted that there are two factors can affect on the importance of agency theory. Firstly, the theory is conceptually used to focus to the two participants, which are the managers and the principals. Secondly, it recommends that managers or employees in corporation could also perform their duties based on self interest.

On the other hand, this agency theory raises some issues that may negatively affect the performance of the corporations. One of these problems is the issue of moral hazard. To illustrate that, the agents of the company are appointed mainly by the owners to maximize the returns to the shareholders' "owners", since they are skilled and qualified to improve the efficiency of the company. Otherwise, the owners would run the corporation by themselves. Jenson and Meckling (1976) assume that the agents will not always decide according to the interest of the shareholders, but they may enhance their own personal wealth at the cost of the shareholders. The impact of that will be on the agency cost. However, to solve such an issue, (Jensen, 1983) suggested there are two steps to minimize the potential problems for such a case. The first one is that the risk borne by the principles and agents must be designed efficiently, whereby each one of them should be aware of the risk and responsibility that is borne by each agent and the gains out of it as well. The second one is based on the first step, which is achieved by having contractual monitoring that is signed between the principles and agents. Another solution suggested by (Jensen, 1976), is called the 'interest model'. This model recognized the fact that the main cause of this problem is self-interest; hence, it recommended that the manager should be included among the owners by having some shares 'incentive'. As a result, the managers will be motivated to enhance the returns of the corporation's shareholders in order to have more return for them as well.

In regards to the development of the agency theory, Adam Smith in his book 'Wealth of Nations' (1776) predicts that if a corporation is not managed by the owner, the objectives of the owner will most likely not be fulfilled. This concern by Adam Smith (1776), has been noted by the economists to develop the organizational theory such as (McCraw, 1990) and (Berle and Means, 1932). However, according to Haslina Abdullah (2009), the roots of agency theory in economic theory was set forth by Alchian and Demesetz (1972) and was further developed by Jensen and Meckling (1976). Later on, the development of this theory has been contributed by many of the contemporary researchers and writers.

2.2.1.1 Agency Theory and Board Leadership Structure

In most of the big corporations, the decision is not only made by one person; but it in fact, comes through many procedures and processes. In this sense of decision making, there would be two structures. Firstly, the chairman of the board of a corporation – who is usually one of the owners of the corporation – plays the role of being the chairman of the board, while the chief executive officer (CEO) will simultaneously manage the company's daily activities. Secondly, the day-to-day management is led by the CEO and his team, whereas the chairman is the director of the board, who observes and monitors the performance of the corporation that are being managed directly by the CEO (Htay, 2011).

According to this fact, there are two different views on this issue. In the UK's Combined Code on Corporate Governance, it is considered the best practice to separate the roles of the two positions – the chairman and CEO. In other words, the UK models prefers to select the chairman of a corporation solely and not as the CEO of the same corporation. On the contrary, the US model prefers the chairman to also be the CEO of the corporation (Brennan, 2008). Jensen and Meckling, 1976; Fame and Jensen, 1983; Jensen, 1993, argued that the agency theory in this context should have a separation of the responsibility between the chairman and CEO of the board. Therefore, the structure of leadership will be separated. The reasons of this are, firstly, to monitor the CEO. Since the CEO is the one who manages the corporation on a day-to-day basis, the leader of the board, who is the chairman, needs to verify the decisions that are made by the CEO because the decisions will affect the performance and efficiency of the corporation either positively or negatively.

The second reason is that when the leadership structure is based on the separation between the position of the chairman and CEO, the chairman would be able to watch over the process of hiring, retrenching, evaluating, and compensating of the CEO -- since the CEO is employed to run the company according to a contract that includes the monitoring and bonding process in order to reduce the cost of agency (Brickley, 1997). As a result, the board will have the efficiency to oversee the performance of the CEO. On the contrary, if there is no such separation of the leadership, the roles of the chairman will be missed and would consequently impact on the management of the company. Indeed, human are greedy by nature; therefore, lack of rules and regulations would succumb them to greediness, and they would try to gain and increase their wealth at the expense of the shareholders. Hence, Florackis and Ozkan (2008) believe that the combined leadership structure will cause CEO entrenchment by minimizing board monitoring effectiveness. As such, having separate leadership structure would govern the corporations better than combination the positions of the chairman and CEO, since the CEO will monitor and is overseen by the director of the board.

2.2.1.2 Agency Theory and Board Composition

It is a known fact that the board directors play significant roles in the efficiency of the management of the corporations, which involves the management body, and setting the strategic plan for the organization. These important roles should be managed and directed by those who have the ability to carry this responsibility. Therefore, the board directors should have this ability; otherwise, the functions of the board will not be implemented. For instance, if the board members do not have the ability to check and monitor the CEO due to reasons such as lack of knowledge or skills, the CEO will not be questioned about his decisions that will affect the performance of the corporation. As such, Rashid (2011) asserted that this raises an important question, which is "who will monitor the monitors?" Since the shareholders are the one who appoint and remove the managers as a part of their monitoring of the board due to their ownership, no one is monitoring their decisions and activities while they might not be interested about the inside activities of the corporation.

It is argued that the board should be structured and composed in such a way that the board is able to monitor its own activities, which indeed shows the importance of agency theory in regards to board composition. This fact is illustrated by many researchers and authors like Choe and Lee (2003), who mentioned that such a move is very important since it efficiently monitors the managers and reduces the agency cost. Hence, the board should have independent directors who will better monitor the top management due to their experience, fresh ideas, and independence, even though the managers have skills, knowledge, and expertise of the firm's operating roles and daily activities (Michael Firth, 2002). In this sense, from an agency theory perspective, the involvement of independent non-executive directors in the board will be more accurate to the corporation's performance because they can monitor any self-interested actions by managers and to reduce the agency cost (Nicholson, 2003 and Ozkan, 2008).

2.2.1.3 Agency Theory and Board Size

Regarding to the board size, agency theory argues that a small board might be better for the efficiency of the board. This perspective may not be preferred by some. However, certain researchers such as Jeff Huther (1997), Yermack (1996), Florackis and Ozkan (2008), and Kim and Nofsinger (2007) are of the opinion that the board of directors should consist of fewer members. Furthermore, some of them such as Florackis and Ozkan (2008) and Jensen (1983) specified that the number of a small board should not exceed seven or eight members. The rational reasons behind this belief are mentioned:

1. When the board directors are few, each may feel the need to put more effort as they realize that there are few to monitor and carry the responsibility of being members of board directors. Alternatively, in the case of large board members, they may rely on others to do the task of monitoring, which might lead to the increasing of the agency cost, which is not preferable.