CHAPTER I

INTRODUCTION

The Importance of the Financial System

The development of a sound and stable financial system is a pre-condition for sustainable economic growth in Malaysia. The intermediation function of the financial system has strong linkages to savings and investment decisions that can influence the pace of the economic growth. Meanwhile, a well-functioning and efficient financial system is needed to ensure the effective conduct of monetary policy. In this regard, Bank Negara Malaysia (BNM) plays a critical role to develop a modern and sophisticated financial system systematically, which is in line with the rapid structural change in the Malaysian economy to achieve the status of the industrialized nation by the year 2020.

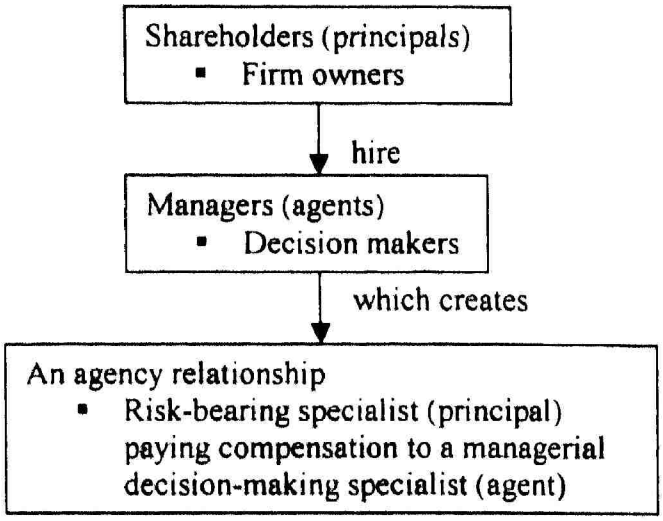
Financial stability that exists only if there is stability in both financial institutions and markets should be maintained for the steady and balanced economic development. Over the last decade, the financial markets, in particular, the capital market has witnessed significant development resulted from the high national savings and large domestic investor base under a favorable economic environment with price stability. The capital markets comprise of two main markets, namely equity market and bond market. The equity market dealing in corporate stock and shares, whereas the bond markets dealing in public and private debt securities with maturities exceeding one year to raise fund. The Kuala Lumpur Stock Exchange (KLSE) that in charge of the secondary market trading of stock and shares and listed private debt securities experienced substantial expansion in market capitalization from RM551 billion in 1995 to a peak of RM891 billion on 25 February 1997. It dipped to a low of

RM181 billion on 1 September 1998 as a consequence of the regional financial turmoil and rebounded to RM500.5 billion at the end of October 1999. On the other hand, the number of companies listed on the KLSE increased from 529 companies at the end of 1991 to 812 companies at the end of 2001. Over the same period, the number of the listed companies under the finance sector increased from 49 companies to 64 companies. It reflects the increasingly important role of the financial institutional in capital market.

The Separation of Ownership and Control

In today's modern corporations of Malaysian economy, ownership is vested in the hands of the shareholders, whereas control is vested in the hands of the professional managers. This separation between ownership and managerial control creates the agency relationship between the shareholders and the hired managers who run the daily operations of the firms (Figure 1). According to the neoclassical theory of corporate investment, the management is assumed seeking to maximize the present net value of the company i.e. the market value of the outstanding common shares. This proposition, however, is challenged by Jensen and Meckling (1976) who argued that the agency problems could arise due to the conflict of interest between the owners (shareholders) and agents (managers). According to Jensen and Meckling (1976), *agency relationship is a contract in which one or more persons [the principal(s)] employ another person (the agent) to perform some service on their behalf, which involves delegating some decision-making authority.* The dispersed shareholders are granted the right to elect board of directors as their representatives to safeguard the assets of the firm and assure that the company is run in line with their long-term interest.

FIGURE 1: AN AGENCY RELATIONSHIP



Source: Strategic management-competitiveness and globalization. By Hitt. Ireland and Hoskisson 1996.

However, since the operation of the business is vested in the hands of the Chief Executive Officer (CEO) or the management team rather than the elected directors, managers may tend to pursue self-interest at the expense of shareholders. The conflict of interests between managers and shareholders is called agency problem. Berle and Means (1932) pointed out that managers with little equity in the firm might indulge in utilizing corporate assets for their own benefits that diverge from the interest of shareholders. Marris (1964) and Murphy (1985) further provided evidence that the managers seek for personal goals in terms of security, prestige, power, advancement and personal income rather than maximize the wealth of shareholders.

In order to avoid the possibility of managerial opportunism, the shareholders establish governance and control mechanism by electing and empowering the board of directors with the power to appoint or dismiss the managers. In Malaysia, the Companies Act 1965 imposes on the board a strict and absolute fiduciary duty to ensure that the company is run in the long run interest and well being of the shareholders. In the context of financial institutions, the enactment of the Banking and Financial Institutions Act (BAFIA) in 1989 extended BNM's power for

supervision and regulation of all licensed institutions i.e. commercial banks, finance companies, merchant banks, discount houses and money brokers. In addition, BNM is also responsible for the supervision and regulation and development of the insurance industry effective on 1 May 1988. In this regard, BNM had issued two sets of guidelines governing the roles, responsibilities and code of conduct of directors, chief executive officers (CEO) and bank officers, namely the Guidelines on directorship in the Banking Institutions (GP1) and the Guidelines on the Code of Conduct for Directors, Officers and employees in the Banking Industry (GP7).

In fact, the board of directors is sometimes portrayed as passive supporters of top management. It is because of the internal directors seldom challenge their CEO. As a result, the CEO can simply gain a majority vote on decisions by persuading a few of the external directors. The inability of the board to control management may lead to opportunistic behavior of managers, which in turn has adverse effect on the returns on common stock and hence the value of the firm. The implications of the separation of ownership from management control on firm performance have been subject of debates since the landmark study of Berle and Mean (1932). With this respect, a lot of studies have been carried out to investigate the relationship between equity ownership structure and firm value. In this study, the validity of this relationship will be further explored. The study will be focused on the financial firms listed on the KLSE under finance sector due to the importance of financial system to the economy as a whole as noted before. In addition, it is an attempt to further explore the study of Sew (1995) that found some significant relationship between the degree of ownership concentration i.e. institutional shareholding and sample financial firms' value, which is not shown by other industry.

The foreign shareholding owned by corporation is taken into account in the context of this study. In Malaysia, the insurance, stockbroking and investment banking sector are very open and liberalized compared with other developing countries, as indicated by a relatively high foreign participation rate. Under the New Economy Policy (NEP) that contained in the First Outline Perspective Plan 1971-1990 (OPP1), foreign equity in the corporate sector was limited not to exceed 30 per cent by the year 1990 as opposed to its high stakes of more than 70 per cent in 1969. In the 1990s, foreign direct investment (FDI) and portfolio investment are the main contributor to the capital inflows in Malaysia. FDI as an impetus for economic growth involves transfer of a package of services including financial capital, managerial know-how, technical know-how and higher standard of disclosure and performance to the domestic markets. The government, however, downplayed the NEP by relaxing the limitation on foreign equity ownership to revitalize the economy after the financial crisis.

This study investigates the pattern of the ownership in Malaysian financial sector for the past seven years as well as to test whether there exists correlation between ownership structure, namely the fraction of shares owned by insiders, outside shareholders and foreign corporation, and firm value.

Purpose and Significance of the Study

This study is conducted with the objectives to examine:

1) The relationship between the ownership structure and the firm value.
2) The relationship between ownership structure and the firm value after controlling the size effect.
3) The sensitivity of the firm value to a set of control variables.

4) The relationship between ownership structure and return on assets (ROA).

Scope of Study

A pooled cross-sectional study is carried out for a sample of 64 financial institutions listed on the KLSE over the period 1995 to 2001. The sample firms in this study are taken from those remained listed at least four consecutive years throughout the study period. The equity ownership among insiders and outsiders refers to the percentage of ordinary shares held by directors and corporate bodies respectively. The secondary data is collected from the KLSE annual companies handbook, annual reports of individual firms, daily diaries and KLSE website.

Limitation of the Study

This study made no attempts to measure the equity ownership registered under nominee companies' name that has not been disclosed. It is unable to capture the interest of the holding companies in their subsidiaries. Both of these may influence the true distribution of stock ownership and in turn affect the pattern of the ownership in general.

Organization of the Report

This report consists of five chapters. Chapter one starts off with a brief background introduction of the research in discussion. It outlines the main objectives and significance of this study paper. The scope of the study and its limitation are also being identified.

Chapter two gives a review of the literature on the areas of the study that were conducted by overseas and local researchers. The literature review indicates the

contribution of prior studies from both of the theoretical and empirical front as well as the limitations that are important and beneficial to the present study.

Chapter three elaborates in detail the research methodology employed in this study. It also discusses the theoretical framework that supports the hypotheses of ownership structure and firm value. It further explains how the dependent and independent variables as well as a set of control variables are measured. The methods used to analyze the results are presented in the later part of this chapter.

Chapter four reports the results of descriptive statistic and the hypotheses testing. The inferences drawn from various observations are presented as well.

Chapter five concludes with the major findings in this study. It relates the findings with the relevant theories. This chapter, finally, offers some recommendation for further studies.