

**UNIVERSITI TEKNOLOGI MARA**

**CORPORATE GOVERNANCE  
MECHANISMS, INSTITUTIONAL  
OWNERSHIP AND YIELD SPREADS  
OF CONVENTIONAL BONDS AND  
SUKUK**

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## ABSTRACT

Sukuk yields mimic those of conventional bonds due to having similar features. This motivated the study. Sukuk are shariah-compliant securities that offer different structures to those of conventional bonds. Therefore, it is believed that the spreading of yields should also be different. Agency theory explains the relationship between principal and agent and the possible misalignment of interest of both parties is reflected through what is termed agency cost. Reducing this agency cost requires monitoring and controlling in public listed firms which are represented by institutional investors which delegate this responsibility to the appointed board of directors (BOD). The presence of key institutional investors/owners and certain BOD characteristics as highlighted by the Malaysian Code on Corporate Governance (MCCG) may influence the yield to maturity (YTM) of conventional bonds and sukuk. It is argued that higher institutional ownerships will produce enhanced active monitoring on the cost of debt and presumably more control on the likelihood of default risk as measured by the yield spreads for conventional bonds and sukuk. Thus, the main objective of this study is twofold. First, to investigate the significant mean difference between conventional bonds and sukuk' yield spreads. Second, to investigate the relationship between these two yield spreads instruments with corporate governance mechanisms. The data is obtained from firm issuers' annual reports, the Bondinfo Hub of the Malaysian Central Bank, the Rating Agency Malaysia (RAM), the Malaysian Department of Statistics and Bloomberg databases for the period beginning 2000 to 2014 for 256 and 405 tranches of long-term and medium-term issuances of conventional bonds and sukuk respectively. Thus, unbalanced panel data are applied for the tests which cover the pooled ordinary least square (OLS), fixed effects (FE) and random effects (RE) models. The Bruesch Pagan Lagrangian Multiplier (BP-LM) and Hausman diagnostic tests are applied to determine which among the three models i.e. pooled OLS, RE or FE, is the best-fit and most appropriate model in explaining the relationship between yield spreads and corporate governance mechanisms deals with heterokedasticity problem. The most significant findings show that the presence of top-six and other institutional ownerships as corporate governance mechanism proxy significantly reduce yield spreads within the firm revealed by robust fixed effects and random effects models in long-term conventional bonds and sukuk. Otherwise, they are unable to reduce default risk in medium-term issuances for both financing instruments. With respect to BOD characteristics, only BOD role duality and BOD size have a significant relationship with yield spreads in long-term and medium-term issuances respectively. The study, therefore, proposed that the impact of the fixed effects approach applied in this study is important in future sukuk issuances since it provides the robust coefficient of estimation sign in the regression model. In addition, from the perspective of the random effects, it may facilitate the issuer in predicting the tranches of issuances which are nearing default and invariant correlated to the individual tranches effects. The institutional investors should have more shareholdings in the issuer firms which issue long-term conventional bonds and medium-term sukuk since the default risk is low. The BOD is also highly recommended to comply with MCCG for best practices in the firm.

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# **CHAPTER ONE**

## **INTRODUCTION**

### **1.1 BACKGROUND OF THE STUDY**

Firms and even governments are sometimes faced with the problem of scarcity of funds to finance profitable investments and promote economic development. The massive amount of funding required for these purposes is unlikely to be serviced by commercial banks. One way to raise funding is from financial institutions and public through the issuance of debt instruments. The instruments used are the sale of bonds, shares, and other forms of debt and equity, both in conventional and Islamic systems. The source of funding for such projects is from the public via the capital market which is a platform for trading of these financial instruments.

In Malaysia, the growth of the bond market can be traced back to the 1970s, when the government started issuing bonds to meet the massive funding needs for the country's development agenda at that time. By the mid-1980s, the private sector assumed a more important role in the strategic development of the Malaysian economy, with the aim of making it the main driver of growth as well as finance. During that period, the corporate sector was heavily reliant on finance from banks, which led the government to pursue the development of the corporate bond market as a key strategic priority.

The 1997 to 1998 Asian financial crisis highlighted the folly of over-reliance on bank loans. Lessons learnt from the crisis led the government to step up its efforts to develop the corporate bond market, to offer the public sector alternative sources of finance and reduce funding mismatches. Consequently, development of the corporate debt market gained greater importance and was accelerated to allow greater diversification of credit risk among economic agents, as well as to provide funding to the appropriate maturity structures. Today, the corporate debt market is aimed not only to provide an alternative to bank borrowings but to complement the more mature and established market in bonds and equities for both, conventional and Islamic financial instruments.