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# POLITICAL INFLUENCES AND INVESTORS' PERCEIVED RISK: A PRELIMINARY STUDY

(Pengaruh Politik dan Tanggapan Risiko Pelabur: Suatu Kajian Awal)

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*ABSTRACT*

The objective of the study is to discuss the effects of political influence on investors' perceived risk under the political connected firms. Under the Malaysian political environment, relationship based of economic system which commonly practiced by most of the listed firms would enhance the needs of politician to participate as directors of the firm in order to ensure the firm's survival in competitive industry. The effects of systematic exchange of favours between politician and firms has led to the arguments of political hypotheses in governance literature. As supported under the helping hand effects, empirical evidences have shown a favourable impact on firms accounting value and market based-performance due to the government favours and bailed-out to connected firms. However, the government obligations towards the people in social and political agenda have exacerbated the rent-seeking activities of political directors in realising the objectives. Moreover, due to the increasing number of cases reported involving high political figures in allegations of misallocation of firm's resources and abuse of power in the 1MDB (1Malaysia Development Berhad), manipulation of stock figures and forgery of signatures of board members for a numbers of transactions in FGV (Felda Global Ventures Holdings Berhad), the credibility of politicians to perform his duties as firms' director to maximising the shareholders' wealth is questioned. As a consequence, a negative perception on the government may lead to inefficient capital market thus impair the investors' confidence in future investment.

*Keywords:* political connections; perceived risk; political hypotheses

*ABSTRAK*

Objektif kajian ini adalah untuk membincangkan kesan pengaruh politik terhadap tanggapan risiko pelabur dengan persekitaran politik dalam kalangan firma berkaitan. Dalam persekitaran politik di Malaysia, perkaitan hubungan ahli politik dalam sistem ekonomi oleh kebanyakan firma yang disenaraikan akan meningkatkan keperluan ahli politik untuk mengambil bahagian sebagai pengarah firma bagi memastikan kelangsungan firma dalam industri yang kompetitif. Kesan pertukaran pertimbangan yang sistematik antara ahli politik dan firma telah membawa kepada hujah-hujah hipotesis politik dalam literatur tadbir urus. Seperti yang disokong di bawah bantuan 'kabel besar', bukti empirikal telah menunjukkan kesan yang menggalakkan ke atas kedudukan firma dan prestasi berasaskan pasaran disebabkan oleh talian hayat kerajaan menyelamatkan firma yang berkaitan. Walau bagaimanapun, kewajipan asas kerajaan terhadap agenda sosial dan politik rakyat telah mencemarkan lagi untuk menempatkan ahli politik sebagai pengarah dalam merealisasikan objektif. Lebih-lebih lagi berikutan peningkatan bilangan kes yang dilaporkan melibatkan tokoh politik dalam dakwaan penyalahgunaan sumber dan dana firma dalam 1MDB (1Malaysia Development Berhad), manipulasi angka saham dan pemalsuan tandatangan ahli lembaga untuk beberapa transaksi dalam FGV (Felda Global Ventures Holdings Berhad), kredibiliti ahli politik dalam melaksanakan tugasnya sebagai pengarah firma untuk memaksimumkan kekayaan pemegang saham dipersoalkan. Akibatnya, persepsi negatif terhadap kerajaan mungkin menyebabkan pasaran modal yang tidak cekap itu menjejaskan keyakinan pelabur dalam pelaburan masa hadapan.

*Kata kunci*: pertalian politik; tanggapan risiko; hipotesis politik

## 1. Introduction

Most of East Asian countries, including Malaysia, are characterised by a relationship-based system where the informal relations between firms and fund provider is more important than a formal contract enforcement (Rajan & Zingales 1998). In Malaysia, the informal relationships between firms and fund provider is commonly found in family owned firms as the relatives' supports are easy to obtain because it builds on trust between families. Another form of relationship-based argued by Rajan and Zingales (1998) is a good relationship between firm and banks that resulting to favourable term on financing facilities offer by the banks and such opportunity may be beneficial to firms with poor operating cash flows.

The relationship-based system can also be explained in political context. Firms creating connections with political person or government officials might be a beneficial strategy for firms to stay sustainable in competitive industry nowadays. Since most of fundamental capital resources are controlled by the government, firms may need someone with political power to get an access on those resources thus increasing its value (Agrawal & Knoeber 2001). For instance, during the Asian financial crisis in 1997/98, financially distressed firms have seeking for government bailed-out and later becoming one of the government-linked companies (GLCs) through an equity ownership of such firms by the government (Johnson & Mitton 2003a; 2003b). Since then, empirical studies have found that the connected firms performed more aggressively than non-connected firms since the bailed-out (Wu *et al*. 2012). Consistently supported under the helping hand theory, the intervention of government in business decisions may provide benefits to the firms thus enhance their performance.

However, due to political hypothesis as proposed in most of governance studies, the existence of political director in firms as directors may perceived risky by investors if the grabbing hand effects are more dominant than the helping hand. Additionally, the inclining number of cases of corporate scandals involving politician in business decisions deflect the incompetence and unethical behaviours of political directors. The allegations of misallocation of resources and abuse of power by ex-Prime Minister in the 1Malaysia Development Berhad (1MDB) scandals in year 2015 has called attention of investors to highlight the needs of politician on the board since their existence in these cases may jeopardised the value of the firm thus perceived risky by investors. Therefore, in our preliminary study, we are going to give knowledge and literature on the effects of political hypothesis on connected firms which may affect the investors' perceived risk.

Furthermore, under the Malaysian environment, a relationship based economic system is a common practices done by most Malaysian firms. Since the grabbing hand effects may provide to unfavourable outcomes, the connected firms may be perceived risky than non-connected firms due to several reasons. First, the expropriation activities by political directors may harm the value of shareholders. Second, government bailed-out on politically connected firms (PCONS) particularly during the financial distress may not teach them to improve their governance system to be good as others. More factors provided from empirical studies will be discussed in section Review of Past Literatures.

## 2. The Overview of Corporate Governance in Malaysia

Previous scholars posit that the Asian financial crisis in 1997/98 was occurred due to the unstable macroeconomic policies and vulnerable banking procedures that lead to fraudulent manoeuvres (Annuar 2014). However, the ineffectiveness of the corporate governance systems was partly blamed in causing the crisis to be widespread (Mitton 2002). The ineffectiveness in firm governance system was a consequence of several factors pertaining to market discipline such as high concentrated ownership, lack of participation of shareholders and weak enforcement mechanisms (Haniffa & Hudaib 2006). Despite some early warnings by virtue of corporate scandals, it was not taken seriously enough by all market participants (Clarke 2000). As a response to the crisis, the Malaysian Code of Corporate Governance (MCCG) was introduced and incorporated into the listing requirements in 2001. The focus of the code is on monitoring and control of the board of directors particularly by the independent non-executive directors, shareholders and institutional investors. Later, the code was subsequently revised in 2007 to further elucidate the importance of the board's monitoring function and include suggestions of more active participation of directors in firm's strategic plannings (Annuar 2014).

### *2.1. Independent directors of the board*

The needs for independent directors on the board arise due to the diversion of interest between managers and shareholders which resulting to unfavourable outcomes through high agency problems. Since empirical evidence has found the effectiveness of independent directors to mitigate the agency conflicts, regulators has clearly established the roles and responsibility of directors to discharge its fiduciary and leadership functions. Hence, a revision of MCCG in 2012 from 2007, has enforced to strengthen the functions of independent directors by introducing the independent procedures and policies that must be fulfilled by all directors of the firms.

Under the political perspective, the intervention of government in business decisions channelled via an appointment of politician as independent director of the firm. The independency level of such directors deflect check-and-balance mechanism to enhance board effectiveness through monitoring activities (Fama & Jensen 1983). Therefore, an increased level of board independence signals an increase in good governance practices of a firm. In addition to the definition, Darmadi (2011) referring Ararat *et al*. (2010) defined independent directors as a person who are free from any specific relationships with firm. They further stated that independent directors should neither have any privileges nor be the owner of more than 1% of shares in company. Likewise, such recommendations are consistently applied in Malaysia whereby the composition of independent directors in all listed firms should consist at least 33% or one third from the board size.

## 3. Political Connection in Malaysia

Faccio (2006) has documented a prevailing factor of political connections in business both in emerging and developed countries. However, such connections are more prominent in countries who practices relationship based economic system that creates a self-governing network of close connections among banks, politicians, government, and other stakeholders (Effiezal *et al*. 2016). Under the Malaysian perspective, the political influence in most listed firms in Malaysia has exist since the formation of National Economic Policy (NEP) in 1970 and more significant later in year 1991 after the establishment of National Development Policy. The objective of these policies is to improve the issues on socio-economic imbalance between the ethnic groups in Malaysia immediately after independence in 1957. The increasing participation of Bumiputra in Malaysian corporate ownership and capital markets has signal preliminary efforts of government to politically interfere firm business decisions after a series of privatization and corporatization of some government departments leading to the formation of many public-listed companies (PLCs). The formation of new statutory bodies and GLCs to further assist the policies have established the widespread growth of political connections in Malaysian setting. As a result, the increasing number of PCONS firms has positively improve the capital market efficiency. Though the number of GLCs is relatively small, representing less than 10 percent of the companies listed on Bursa Malaysia, these companies account for approximately MYR 260 billion in market capitalization, or approximately 36 percent of the Bursa Malaysia market capitalization. Hence, the significant percentage of shares hold by GLCs are shown to influence the efficiency of capital market.

However, Gomez and Jomo (1997) argue that the approach brought by the NEP was found to create a positive discrimination as the advantages only enjoyed by Bumiputras instead of the people as a whole. In addition, previous scholars also believe that the effects of NEP have promote cronyism (Gomez & Jomo 1997; Gul 2006; Johnson & Mitton 2003a), weak professional development (Effiezal *et al*. 2016), and poor management control in terms of executing government contracts (Hamid 2011). Until today, the high participation of politician in business decisions has evidenced PCONS as highly leveraged, poor enforcement to protect investors, and has a concentrated ownership and family firms (Effiezal *et al*. 2016).

## 4. Review of Past Literatures

Most of the literature that examined the effects of politics in business decisions lies on governance perspectives. Empirical evidence has examined the impact on firm performance and value (Fisman 2001; Goldman *et al*. 2009; Wu *et al*. 2012) the effects on financing decisions (Boubakri *et al*. 2012) and firm policy like dividend (Benjamin *et al*. 2016). However, there are still limited studies found to determine its impact under the Malaysian environment. Nevertheless, the arguments of political influence on business decisions are commonly being discussed under the political hypotheses, that is the effects of helping hand versus the grabbing hand.

### *4.1. Helping hand effects on PCONS firms*

The effective roles of politician or government officials on the board as defined under the resource dependency theory, their contributions are similarly important for the networking and status capacity instead of skills, experience and expertise (Hamid 2011). Many prior scholars posit that politician or government officials on the board might be useful to have considerable access to government subsidies and lucrative government contracts (Gomez & Jomo 1997; Agrawal & Knoeber 2001; Goldman *et al*. 2009). The continuous efforts of government to supply subsidies and offer projects to PCONS may ensure the stability of returns being paid to shareholders thus eliminate the volatility of stock prices. In China, the government intervention in business activities shows a negative impact on firm value for state-owned enterprises (SOEs) but conditional for non-SOEs. According to Chen *et al*. (2017), the firm value increases initially at a lower level of connections and then begins to decrease at a higher level suggesting that higher level of connections has led to rent seeking activities that might outweigh the benefits.

In other studies, PCONS firms are capable to utilise their political capacity to impose tariffs on competitors and enjoy reduced regulatory requirements at the same time (Agrawal & Knoeber 2001; Faccio 2006). As such, these may increase the economic barriers of non-PCONS firms to stay competitive in the market. In worst situation, the pressure received by non-connected firms may push them to exit from the industry and leaving the connected firms under controlled. Such situations were found in Indonesia when import licenses are systematically awarded to firms connected with the Suharto regime at the expense of other firms in the same industry that are not politically connected (Mobarak & Purbasari 2006).

Having connections with the government also may provide advantages to PCONS firms to obtain financial facilities from financial provider. For example, in Pakistan, the appointment of ex-politician as firms' directors had given opportunity to connected firms to obtain loan with special interest rates (Johnson & Mitton 2003b; Khwaja & Mian 2005). The findings are consistently found by Fu *et al*. (2017), that the connected firms in Indonesia raises the probability to receive the full amount of loan from banks and the results are more significant for SMEs firm.

In access to equity financing, firms with a politically connected audit committee have better access to equity financing (Cho & Song 2017) thus providing them with lower cost of equity than non-connected peers (Ben-Nasr *et al*. 2012).

Following tax perspective, PCONS also documented for paying less taxes than non-PCONS firms through its special tax deductions and tax-free government bailouts which resulting to lower effective taxes rates (Adhikari *et al*. 2006; Embong *et al*. 2012). The lower operating costs borne by the firms has provide them an excess of profit to be distributable to shareholders.

Empirical evidence posit that the government bailed out for connected firms is more visible during the financial distress or economic downturn. Consistently proposed by Johnson and Mitton (2003a) which suggest that PCONs in Malaysia are more likely to be bailed-out by the government when they are suffering losses or during the economic recession. Equally, Boubakri *et al*. (2012) argues that when government does back up for such firms particularly to release them from monetary constraint, they are less sensitive to market competitions and pressure than comparable non-connected firms. As a result, they are financially better than firms who without connections (Wu *et al*. 2012). These arguments truly supported the evidence found in Singapore. Feng *et al*. (2004) posit that the PCONS firms is outperformed the non-PCONS firms in the areas of profitability, efficiency and financial returns thus these firms relatively claimed to be more transparent in corporate governance practices and play effective role as directors and managers. In the study, PCONs are measured based on the percentage of government ownership in the companies.

The conclusion of helping hand effects to connected firms leads to a low market-wide risk in overall exposure during the economic downturns, thus enhance the stability of the share price. Hence, the effects of helping hand as abovementioned may eliminate the investors' perceived risk.

### *4.2. Grabbing hand effects in PCONS firms*

Prior studies have found that having close ties with the governments may not always benefit the firms as the governments may have obligations towards the people which are depart of value-maximizing objectives and shareholders' wealth maximization. Academic researchers argue that governments use firms' resources to benefit their cronies and supporters, who in turn provide votes, political contributions, and bribes (Bushman *et al*. 2004; Gul 2006; Al-Dhamari & Ku Ismail 2015). They further argue that politicians seeking to establish relationships with firms because they wanted to control and use the firms to achieve their political goals. The power gained by the politicians to extract political benefits at the expense of other stakeholders in the firm may impact on firm's reputation and performance. A rent-seeking activities by the politician or government officials on the board through their autocratic power in decision making may lead to value-decreasing of PCONs. Such reciprocal relationship due to the systematic exchange of favour between firms and politician may jeopardise firms' value thus increasing the agency conflicts.

The grabbing hand effects of connected firms are commonly discussed in governance literature and still debating. Most of empirical evidence documented a poor governance practices among PCONS firms increases the agency conflicts through expropriation activities at the expense of stakeholders' benefits. For instance, In China, the expropriation activities of controlling owners through self-dealing and tunnelling are more pronounced in PCONs compared to non-connected firms. They further argue that the ineffective roles of government to support business is more prominent in countries with weak legal and regulatory protections of minority shareholders (Qian *et al*. 2011). This arguments supported the earlier studies done by (Gomez & Jomo 1997) that the connected firms will tend to misallocate some of firms' resources which consequently impair the investors' confidence to further in future investment. Even if they do, investors will require higher return from the firms for holding an excess risk from the investment portfolio, hence, detrimental the firm's earnings quality.

The arguments of adverse impact on firm's performance by poor governance practices of PCONS is supported by Chen *et al*. (2009). The misalignment of interest between the politically connected directors on the board and their shareholders exacerbate the rent seeking behaviour through misallocation of firm's resources to realise their political and social agenda. Consequently, the expropriation activities have resulting to lower share price compared to other non-connected firms.

Another expropriation activity normally practices by PCONs under an effective governance system is to squander the excess cash in projects that maximize the managers' wealth at the expense of outside investors (Jensen 1986; Stulz 1990). According to Al-Dhamari and Ku Ismail (2015), the characteristics of emerging market particularly in protecting minority shareholders is poor (La Porta *et al*. 1998), the government intervention is high and poor governance system (Bhattacharyay 2004), the controlling managers (in this case controlling shareholders in Malaysia) are tend to take advantage from retained cash reserves at the expense of minority by investing the free cash in destructive activities (Hamid 2011). Hence, it leads to a potential crash of firm price.

In a similar vein, a case in Indonesia reported by Leuz and Oberholzer-Gee (2006), suggest that PCONS choose not to be cross listed on U.S. markets because it will increase the difficulties for PCONS to extract private benefits due to high requirements of cross-listing. This further suggest that PCONs were suffer more agency conflicts due to expropriation activities at the expense of minority shareholders.

Furthermore, Bertrand *et al*. (2007) posit that PCONs in France exhibit lower profits than non-connected firms, especially in elections years and during politically contested areas. The authors explain this lower profitability by the higher rates of job creation and plant creation around elections aimed to secure more supporting votes. Another recent study that found to affect firms bottom line is done by Fan and Chen (2017) which they found higher effective tax rate among connected firms than non-connected peers. They argued that the PCONS directors in China are worked for the interests of the government and restrict the firms' tax planning activities. However, the findings are not consistently found by Adhikari *et al*. (2006). They argue that the relationship-based economic system practices by firms in Malaysia has provide the listed firms with special tax deductions and tax-free government bailouts which resulting to a lower effective rate.

In line with arguments advocated by grabbing hand theory that suggests government rent seeking activities may exacerbate the agency conflicts through misalignment of interest between the PCONS directors and managers. Due to the deviation of objectives between the political and business orientation may in turn placed firms in a risky position that the allocation of firms resources may be allocated to realise the PCONS directors obligation towards the people instead of maximising the wealth of shareholders through dividend. As a consequence, firms who having connection with the government may seems to be less attractive and risky resort to generate better return in the future.

Additionally, the multiple obligations of politician towards the party and community may strengthened the arguments of rent seeking behaviour of political directors that may jeopardised the investors value and were financially perceived risk (Chang & Wong 2004).

The issue of stock price crash of Felda Group Ventures (FGV), Malaysian Airlines (MAS), misuse of power by Tabung Haji and Employee Provident Fund (EPF), misallocation of fund and resources of 1MDB by high political individual in few years back has called attention to highlight the needs of politician on the board since their existence in these cases may jeopardised the value of the firm. Furthermore, the increasing number of corruption cases as discussed above has questioned the roles of politician to provide their helping hand to mitigate the impact of uncertainty thus perceived less risk than non-connected firms.

## 5. Conclusions

The increasing number of cases in corporate scandals involving politician as directors in firms has called attention to investors to highlight the needs of politician on the board since their existence in these cases may jeopardised the value of the firm thus perceived risky by investors. The appointment of politician as directors of the firm was made to ensure that the helping hand of the government is continuously provided to guarantee the survival of the firms. As such, the demand for participation of politician as directors of the firms may increase hence, it could be part of the corporate strategy for firms' long term benefits. However, government participation would demand company to serve political and social obligations as politician is bound with those obligations which could jeopardise the shareholders' value (Chang & Wong 2004). The impact would be more severe if such appointment was made due to their power to obtain capital resources from the government (Hamid 2011) instead of the academic qualification and experience in business. In conjunction to this matter, this scenario may highlight the needs of politician to participate in business as their existence as directors in firms may resulting to inconsistent impact on firms' value.

Therefore, this study may intend to investigate the effects of political influence on investors' perceived risk under the political hypotheses among connected firms. Under a unique environment of Malaysia, a multi-racial country that shape the political party and the efficiency of capital market (Abdul Wahab *et al*. 2016) may create a motivation for the researcher to further contributes to the body of knowledge and scarcity of empirical evidence in the field.

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