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Executive Summary

Governing State-Owned Enterprises: Lessons learned from 1MDB

The 1MDB crisis has been a longstanding public and political issue both in Malaysia and even abroad. What critics miss out however, are deeply rooted systemic and regulatory issues with regards to the governance of Government Linked Companies (GLCs) in Malaysia. In this study, author Rama Ramanathan focuses on how policymakers can avoid mismanagement of GLCs like the 1MDB from occurring again by strengthening the overall governance structure of GLCs.

1MDB came into the public eye for several reasons:

1. **1MDB's excessive borrowings** amounting to RM42 billion in 2014, and as at January 2016 RM50 billion with interest rates between 7.25-9.85% was a great cause of concern especially with the borrowings backed against assets worth RM 51 billion – this put 1MDB's debt at 2.5% of Malaysia's GDP according to Moody's estimates.
2. **1MDB risked defaulting on its loans.** 1MDB had asked for several extensions to repay its loans. Its financiers Maybank Investment Bhd and RHB Investment Bank were both concerned at 1MDB's ability to repay its loans and its 'particularly high' borrowing rates.
3. **Other issues include**
    a. Risk of 1MDB default negatively impacting Malaysia's sovereign credit ratings
    b. Revaluation of 1MDB assets to create a surplus in value of assets over liabilities. 1MDB posted revaluation gains of its assets worth RM2.7 billion in 2013 alone.
    c. Sales of 1MDB assets to other GLCs at a huge loss to Government revenue, e.g., the sale of land to Tabung Haji at 42 times the initial price bought by 1MDB 4 years ago.
    d. Allegations of abuse of 1MDB funds for electioneering and investigations on 1MDB by both local and international financial authorities for non-compliance, misappropriation and money-laundering.

Following this, the Government took swift action against 1MDB by accepting the resignation of 1MDB's Board of Directors, appointing the Royal Malaysian Police to investigate 1MDB as well as transferring 1MDB's subsidiaries to Minister of Finance Incorporated.

Although these actions are commendable, much more needs to be done to stop the 1MDB problem from occurring again with other GLCs. Parliamentary committees like the Public Accounts Committee and regulatory agencies must play a stronger role in overseeing GLCs that may be similarly mismanaged and must make systemic improvements to the overall governance of our GLCs.

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Learning from 1MDB the paper recommends the following:

Creating a Mechanism to Track the Performance of GLCs

1. Malaysia's economy has a high dependence on GLCs – the 15 GLCs included in the GLC Transformation Programme alone contributes to 5% of the national workforce and accounts for approximately 36% and 54% respectively of the market capitalisation of Bursa Malaysia and the benchmark Kuala Lumpur Composite Index.
2. Yet, we do not know how many GLCs that are currently in operation and how they are performing. This is why we need to create a registry of GLCs that ranks GLC performance according to established measures of business success. 1MDB for example was not noticed until it got into trouble.

Set and Enforce Expectations for Debt Gearing of GLCs

1. Borrowing domestically and from foreign markets are common practices of all governments and many private businesses. Borrowers must however know how much they have borrowed as well as their capacity to make repayments. A company's debt-to-equity ratio, calculated by dividing a firm's total debt by its total assets, is measured by a firm's **gearing**.
2. 1MDB unsustainable borrowings has taught us that GLCs must establish clear goals on its gearing and that there must be limits on how much a GLC can borrow. Furthermore, GLCs must receive Parliamentary approval prior to issuing letters of guarantee to support loans.
3. Finally, non-compliances to laws must be treated as a crime in order to deter the mismanagement of GLCs.

Stop Appointing Public Officials to GLC Boards

1. Although, international guidelines such as the OECD Guidelines on Corporate Governance of GLCs do not prohibit members of the state administration from being board members they have strict guidelines to prevent potential conflicts of interest.
2. Steps taken can include the creation of a registry of public officials serving as board members in GLCs with a specific timeline to replace them. The list should include both those who are elected to public office and those who are appointed.
3. There should also be legal prohibitions against GLCs funding political parties or individual politicians to avoid the potential abuse of GLCs by public officials.

Establish Rules to Curb Profiteering by Selling State-Owned Assets

1. The Government manages state property, e.g., land, equipment and businesses for the public. In the case of 1MDB, land was sold to Tabung Haji at 42 times its initial price resulting in a huge loss to the *rakyat*.
2. As such it is recommended that contracts for the sale of public assets by the Government must include the condition that any gains from subsequent sales (of the public asset) be shared with the Government.

Make Public The Quantum of Fines Imposed on Those Who Flout Regulations

1. Unlike the Swiss and Singaporean authorities, Bank Negara did not reveal the specifics of 1MDB's offence, or the quantum of the fine. We recommend that all charges brought and penalties imposed by regulators including Bank Negara be made public to establish Malaysia as a financial centre of international repute.

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Establish a Programme of In-Depth Reviews of GLCs

1. General audits cannot correctly asses how well a public company is managed which is how 1MDB Board members made decisions without exercising due diligence.
2. To avoid this grave error, we recommend that the Auditor General be provided with a mandate to conduct regular in-depth audits of GLCs. The audits should look into matters such as adherence to the stated aims of the business, due diligence prior to making investment decisions and missing financial reporting dates.

About the Author

Rama Ramanathan is a mechanical engineering graduate of the University of Edinburgh in Scotland. He worked in manufacturing and quality management in the rubber, consumer products and medical device industries for 33 years. In the second half of his career he worked as the Quality Leader in Asia Pacific for two multi-billion dollar US-based multinationals. Since 'retirement,' he focuses on studying and writing about socio-political issues, and occasionally takes on consulting work in ethics, quality and risk management. Rama is also a member of The Society for the Promotion of Human Rights (PROHAM).