

Firms' Issuing Choice between Islamic and Conventional debt: Does Corporate Governance Structure Matter?

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ABSTRACT

The paper offers evidence concerning key governance factors that influence Malaysian public listed companies to issue either Islamic debt and conventional debt. Using 110 Islamic debt¹ issuers and 38 conventional debt issuers for the period between 2000 to 2009, the study uses logistic regression analysis to identify factors that would influence choice of related financial debt instruments. The current study is carried out to fill the gap in existing literatures as Malaysian corporations market are distinguished from some important governance structures: ownership is rather concentrated, influenced by ethnicity or controlled by government. Results from this study suggests that and only adjusted stock price run up can explain the difference in the securities choice of firms while governance variables namely Bumiputera ownership, board size have less influence on the related issuance choice prediction.

Key Words: *sukuk*, conventional debt, corporate governance, securities choice

INTRODUCTION

Financing decision is one of the crucial financial decisions made by businesses. It mainly involves decisions on the composition between debt and equity and the decision on type of financial securities to be issued. The financial behaviour of corporations can be influenced partly by financial environment in which they operate. Malaysian financial market is amongst the most conducive and innovative environment in the region. The government provides a wide range of facilitative framework in order to stimulate the capital raising activities among corporations. One of them is Malaysian Code of Corporate Governance (MCCG)². Good corporate governance practices will possibly have substantial impact on company's strategic decisions such as external financing, made by board of directors. Corporate governance has been identified in previous studies to influence firms' financing or capital structure decisions which also affect performance (see Berger *et al.*, 1997; Friend & Lang, 1988). The results of these empirical studies which mainly emphasize on developed economies often give inconclusive results. However, with the exception of Heng and Azrbajani (2012) and Saad (2010), there is scarce research on corporate governance especially with respect to firms' financing decisions in Malaysia.

There have been widely researched on factors that influence of different financial instruments particularly in the developed market. Most of the empirical studies are carried out in the UK (Marsh, 1982); the US (Hovakimian, Opler, & Titman, 2001; Jung, Kim, & Stulz, 1996) and Europe (Arrondo & Gomez-Anson, 2003; Gaud, Hoesli, & Bender, 2007; Panno, 2003). These studies investigate debt-

¹ Islamic debt or *sukuk* is used interchangeably in this paper.

² MCCG which was first issued in 2000 sets out principles and best practices of good governance. Three forms of recommendations are set out which are: Part 1: Principles of corporate governance. Part 2: Best practices in Corporate Governance and Part 3: Principles and best practices for other corporate participants.

equity choice and associated shareholders' wealth effect. Other empirical research which focus on specific types of debt namely convertible debt has also been extensively examined (Bancel & Mittoo, 2004; Dutordoir & Gucht, 2009; Lewis, Rogalski, & Seward, 1999). To date, there have been scarce empirical researches that look at the choice of another debt security known as Islamic debt (or *sukuk*) particularly from the perspective of corporate finance. Besides, *sukuk* possesses distinguished characteristics and therefore it is a unique financial instrument to be compared with its conventional counterparts due to their coexistence in the Malaysian capital market.

In addition to that, with the great effort that the government has put to establish Malaysia as an Islamic capital hub in the region, the issuance of Islamic debt securities as one of the capital raising instruments is claimed to fuel the rapid growth. Table 1 depicts the distribution of corporate conventional debt and Islamic debt. Although the Islamic debt is relatively new compared to conventional debt since the emergence of Islamic debt in Malaysian capital market only occurs in the mid 1990s, the number of Islamic debt picks up its momentum in 2005 and 2006. Only in recent years, studies have been conducted in examining the announcement effect of Islamic debt on shareholders' wealth (see for example Ashhari, Chun & Nassir, 2009; Godlewski, Turk-Ariss, & Weill, 2011; Ibrahim & Minai, 2009). In addition, a more recent study on determinants of Islamic debt issuance by Shahimi and Sapiyi (2013) has also ignored corporate governance factor in their study.

LITERATURE REVIEW

There are relatively a very limited number of literatures which focus on the comparison between Islamic and conventional financing. Among the earliest study that examines and compares behaviour of Islamic banking activity to the non Islamic counterparts is Aggarwal & Yousef (2000). Their findings suggest that using only profit-and-loss sharing principle in which Islamic banks should be based on may not be possible in economic environments they are operating in. Furthermore, as investors and banks monitor the performance of fund raisers, the finding intuitively points that the choice for Islamic finance depends on information costs between corporate insiders and outsiders. Therefore, the use of mark-up contracts could be used to overcome for example the need for some sort of debt-like instrument is a rational response to the informational problems.

Nagano (2009) looks at the order of Islamic finance in Malaysia and Islamic banking borrowers in Gulf Corporation Council (GCC) countries. Using two stage least squares and Tobit estimation model in examining the choice of bond issuance (i.e. *sukuk* and non *sukuk*), results shows support for pecking order theory. This is because the information cost measured by the ratio of accumulated *sukuk* issued in prior years to the book value of liability is between normal debt finance and equity. *Sukuk* is also chosen prior to the above external financial order when financing choice provides managerial benefits to the issuers. Shahimi and Sapiyi (2013) attempt to extend the study by Nagano (2009) by identifying determinants of issuing *sukuk* as opposed to conventional debt. In their model, the effect of relevant variables such as leverage and taxes are added besides other variables such as firm size, return on asset, firm past *sukuk* issuances, firm past bond issuance, and capital investment. Results show that firm size, past *sukuk* issuance and tax incentives are the variables that significantly influence the choice of a firm to issue Islamic debt over conventional debt.

Other empirical studies on *sukuk* alone or in comparison with conventional debt are mainly on post announcement stock market reaction on issuers (Godlewski, Turk-Ariss, & Weill, 2010, 2011; Ibrahim & Minai, 2009). Others include studies on exploring differences between Islamic debt and conventional debt (Ravindran, Shanmugam, & Mohd Hanif, 2011; Safari, 2011). For instance, Ravindran *et al.*, (2011) compare durations and convexities of conventional and Islamic bonds. The results show that *sukuk* stands better in these sensitivity measures compared to conventional bonds. When empirically analyzed for *sukuk*'s riskiness, the results reveal that they are moderately riskier than conventional debt. The other study by Safari (2011) found that yield to maturity of *sukuk* is significantly different from its conventional counterparts, holding same issuer and issue's tenure. Besides, the study finds that issuers' risk as measured by absolute changes in beta is significantly different before and after issuance of security.

RESEARCH FRAMEWORK

To the best knowledge of the author, there is no specific theory explaining the economic benefit of Islamic debts relative to conventional debts. Nevertheless, the Islamic finance theory defines Islamic

financial product as *Shariah*³-compliant. Islamic financial products are specially designed to cater for Islamic marketplace although non-muslims are not constrained to subscribe the products or services. They are distinguished from their conventional counterparts by their compliance with *Shariah* in terms of the contractual and structural underpinning although they appear to be similar from the economic perspective such as in terms of cash flow, risk, and agency cost mechanism. The scarce literature that is available on Islamic bond wealth effect is utilized to propose some hypotheses that could be examined in this study. The following corporate governance variables are hence hypothesized to have some influence over the choice of *sukuk* issuance over conventional bond issuances while variables such as firm size, growth opportunity, stock price run up, profitability, deviation of total debt from industrial average and asset tangibility serve as firms characteristics variables.

Managerial ownership Issuance costs for Islamic debt is expected to be lower than conventional debt due to tax incentives offered by the Malaysian government. A wide range of tax incentives across Islamic finance spectrum are offered including tax exemption on expenses incurred on the issuance cost of Malaysian ringgit Islamic securities that use the *Shariah* principle of *Mudharabah*, *Musyarakah*, *Ijarah*, *Istisna* or other Islamic securities approved by SC or Labuan FSA up to year assessment 2015. Thus, for managers who have large shareholdings, the decreased of after tax cost of issuance in Islamic debt financing could increase their earnings. This would lead to preference of Islamic debt as opposed to conventional debt. Thus, for managers who have large shareholdings, the decreased of after tax cost of issuance in Islamic debt financing could increase their earnings. This would lead to preference of Islamic debt as opposed to conventional debt.

Bumiputera ownership Since from the economics perspectives, Islamic bond and conventional bonds are similar, the main reason *sukuk* is preferred over conventional bonds is the *Shariah* -compliant features. As majority of Bumiputera are Muslims, it is their religious duty to refrain themselves from being involve in non *Shariah*- compliant securities. Thus, with regard to securities choice, firms with Bumiputera ownership is expected to prefer Islamic debt than conventional debt. Furthermore, another important unique aspect about ownership structure of Malaysian firms is associated with historical and political background of corporate system. A company is regarded as “Bumiputera-controlled company⁴” when either one of the following two criteria⁵ is satisfied: More than 50% of its equity is owned by Bumiputera shareholder; or at least 35% of its equity is owned by an identified Bumiputera shareholder (Securities Commission, 2000). As the government owned companies, which are mainly owned and managed by Bumiputera directors, the role of government is very crucial in promoting the Islamic financial market. Thus, it is expected that the decision to issue Islamic bonds is partly driven by the desire to support the government aspiration.

Institutional ownership Debt has played an important role in reducing agency problems caused by managers who consume corporate resources for their own benefit at the expense of outside shareholders. High institutional ownership also signifies the ability for large shareholder to influence corporate governance process. The disciplinary role of debt as highlighted by Friend and Lang (1988) may be substituted by the prevalent role of institutional ownership. With a greater ownership concentration by institutions, information is expected to be more symmetric between outsiders and insiders. This enables the shareholders to engage in low cost monitoring activities. Thus, a lower level of asymmetric information would in turn reduce the management’s need to use debt as a signalling device to inform market participants regarding expectation of firm performance. However, the effect of domestic fund ownership, (as another proxy for institutional ownership) on the choice of Islamic debt and conventional debt is not clear. As for foreign fund ownership, it is expected that firms with high foreign fund ownership would prefer conventional debt due to the fact that they are more familiar with conventional debt relative to Islamic debt.

³*Shariah* refers To Islamic Ruling Based On Al- Quran And Al-Hadith

⁴ The five largest public institutional investors which are widely known as government link institutional companies (GLICs) or government link companies (GLCs) companies consists of two pensions funds such as Employees Provident fund (EPF), Armed Forced fund / Lembaga Tabung Angkatan Tentera (LTAT), Pilgrim Fund Board/ Lembaga Tabung Haji (LTH); an investment fund: Permodalan Nasional Berhad (PNB) and an insurance company: Social Security Organization (SOCSO)

⁵ Other criteria include the identifiable non-Bumiputera groups should not own more than 24 percent of the voting power of the company (Marimuthu, 2010). Besides, the shareholding of the Bumiputera group is not associated directly or indirectly with any non-Bumiputera group.

Board size Past studies have recognized board size as one of the imperative factors in corporate governance (Jensen, 1993; Lipton & Lorsch, 1992). These studies indicate that size of board is an important determinant as it affects the extent of monitoring, decision making and controlling. Nonetheless, empirical evidence found mixed result with regard to association of board size and corporate governance. For instance, Jensen (1993) suggests that free riding problem amongst directors are more likely to occur with larger board size. Moreover, he adds that an increase in board size makes the board less effective in monitoring management and increase decision making time. Similarly, larger board size prevent board from reaching consensus on decision which indicate weak corporate governance system (Wen, Rwegasira, & Bilderbeek, 2002).

Percentage of Bumiputera directors on board As pointed in Chuah (1995), Malaysian managers are said to be associated by race, education and type of organization they work for. Race is selected as it signifies class relations and provides a principle according to which “conflicts over wealth and state power takes place”(Fossen, 1998,p.89). Furthermore, the effect of race may be of significance in multicultural societies where ethnic groups prefer to maintain its ethnic identity (Sendut, 1991). Alhabshi (1994) suggests that in general, managers perform the same functions but the way they do it could be different as it may be associated by one’s own tradition, values, beliefs and culture. Malays are normally associated with high uncertainty avoidance, which may be attributed to their strong belief in religion (Haniffa & Cooke, 2002). Furthermore, since Bumiputera directors are usually Muslims, it is religious obligation for Muslims to stay away from securities that are not comply *Shariah* standard.

DATA AND METHODOLOGY

There are three different sources of information for this study. Data on corporate debt issuing companies are obtained from the websites of Securities Commission Malaysia.⁶ The bond information was then matched with corporate governance variables from respective annual reports and financial information is sourced from Thomson Reuters DataStream. A total of 110 Islamic debt issuers and 38 conventional debt issuers are sampled for the period between 2000-2009. The choice between Islamic debt and conventional debt is examined using logistic model. The observed outcome, j is represented by random variable, y where $j=1$ if Islamic debt financing, $j=0$ if otherwise. Assume that the error term follows a logistic distribution, we have the logit model. More specifically, the following model is tested.

$$\text{Security choice} = f(\text{MOWN}, \text{BUMIOWN}, \text{DOMPFUND}, \text{FORFUND}, \text{BRDSIZE}, \text{BUMIBRD}, \text{FSIZE}, \text{GROWTH}, \text{ADJRUNUP}, \text{PROFIT}, \text{ADJTD2TA_AVG}, \text{TANG})$$

(Eq 1)

Where:

MOWN	=	Managerial ownership which measured by percentage of shares owned by executive directors.
BUMIOWN	=	Bumiputera ownership, measured by percentage of shares held by Bumiputera shareholders
DOMPFUND	=	Domestic private fund ownership, measured by total percentage of shares owned by insurance companies, pension funds, unit trust funds and professional managers who hold shares on behalf of individuals
FORFUND	=	Foreign fund ownership, measured by shares ownership by companies or foreign fund companies such as Capital International Emerging Investment Fund.
BRDSIZE	=	Number of directors (excluding alternate director) on board.
BUMIBRD	=	Bumiputera directors on board which is measured by the proportion of Bumiputera directors to board size
FSIZE	=	Firm size, measured by natural logarithm of the book value of total assets and market value of equity
GROWTH	=	Growth opportunity; measured by market value divided by book value of equity.
ADJRUNUP	=	Stock return minus market return over a period of 12 months preceding issue.
PROFIT	=	Earnings before interest taxes and depreciation to Book value of total asset.

⁶ www.sc.com.my

ADJTD2TAAVG	=	Deviation of total debt to total asset from industry; measured by difference between firms' long term debt ratio and average industry's long term debt ratio.
TANG	=	Asset tangibility; measured by ratio of Gross fixed asset divided by Total asset.

The corporate governance model is extended by including firms' characteristics variables, in the attempt to verify that these variables do not significantly classify Islamic bond issuers from conventional bond issuers. Before the final predictive model can be derived, a number of logit analyses are carried out using all variables presented. However, after each analysis, variables which are not significant are excluded from the final model. As a result, the final model consists of only significant variables obtained after conducting several regressions. The reduced models are presented in each respective models. To test between the two models, the likelihood ratio test (LR-test) between the full model and its reduced counterpart is performed.

RESULTS AND DISCUSSION

Results from Model 1a of Table 2 shows that BUMIOWN⁷ is significant at 10% (odds ratio of 7.535; standard error of 8.296). This suggests that firms with high Bumiputera ownership is more likely to issue *sukuk* than conventional debt. BRDSIZE has a significant negative relationship at 10% in the full model but limited evidence is found in the restricted model. The marginally significant of BRDSIZE variable suggests that the greater is the board size, the lower is the likelihood of issuing Islamic debt. One possible reason is that larger board size might be less effective in making timely strategic decision, such as financing. As a board gets too big, it becomes difficult to coordinate. This also means that smaller numbers of board members lead them to make timely decision compared to larger boards (Zahra & Pearce, 1989). Thus, as Islamic debt is relatively new compared to conventional debt, large board members are less likely to reach consensus of issuing financial instrument that they are not familiar with.

Model 2 is tested to examine how firm characteristics influence the choice between Islamic debt and conventional debt. Results from model 2a show that the adjusted stock price run-up (ADJRUNUP) is highly significant (odds ratio of 0.2201 and standard error of 0.139). The negative relationship between adjusted stock price run-up and issuance of Islamic debt infers that issuers with high prior stock return will choose to issue conventional debt while issuers with lower prior stock return will consider issuing Islamic debt. The finding appears to support previous empirical results by Godlewski, Turk-Ariss, and Weill (2010; 2011). They observe differences in the characteristics of the issuers in terms of profitability and debt level. Firms issuing *sukuk* are in worse financial and operating shape than those issuing conventional bonds. These weaker firms may have economic incentives to prefer issuing a security based on a profit-and-loss sharing principle rather than a fixed-income instrument that imposes more financial burden. They argue that *sukuk* issuance is likely to send a negative signal on the financial state of the issuing firm. Thus, low stock return prior to issuance of securities is associated with low profitability of issuers and vice versa. Furthermore, Suchard and Singh (2006) argue that during a period of rising stock market, interest rates are relatively high. In this scenario, issuers who expect high stock return will prefer interest based financing (conventional debt) to maximize their gain in the likely event of success. On the other hand, if issuers expect a lower stock price, they will prefer profit and loss sharing financing scheme (Islamic debt) to minimize their loss in the likely event of failure. Thus, firms with lower prior adjusted stock price is more likely to issue Islamic debt, while firms with higher stock price run up is more likely to choose conventional debt.

Overall, corporate governance variables model yields lower Pseudo R² (5.77%) than firms-specific variables (7.67%). However, when both models are examined together, greater strength of association (R² of 11.74%) is found between the dependent variable and the independent variables. This suggests that corporate governance has a lesser extent of influence in firms' financing choice.

⁷ An analysis (results are not shown due to space constraints) is also done to separate ownership by Bumiputera individuals and Bumiputera as government-link companies.

CONCLUSION

Islamic debt or *sukuk* is a unique feature of debt in Malaysian capital market. As such, there are relatively limited studies that have been conducted on this topic. This paper tries to fill in this gap by comparing Malaysian firm' issuing choice between *sukuk* and conventional debt. The main finding of this study is that compared to corporate governance factors, firms characteristics namely stock price run up has a more prominent role in explaining choice between Islamic debt and conventional debt. This is consistent with explanations made by Alam, Hassan, & Haque (2013) who suggest that only borrowers who have low return expectations will have an enticement towards *sukuk* in order to minimize their loss in the event of failure since *sukuk* is mainly based on profit-and-loss sharing financing scheme. Meanwhile, issuers who have a high expected, interest-based financing (conventional debt) is preferred to maximize their gain in the event of success. With regards to corporate governance characteristics, only board size and Bumiputera ownership appears to be significant in certain model. This shows that the code of corporate governance has in certain extent influence firms' financing choice. Future research can look at the economic differences between these debts. Knowing the economic differences is imperative as many Malaysian companies are substantially owned by non Muslims who might make their financing decisions based on the costs and benefits of these two choices. These can be done through interviewing financial managers of debt-issuing companies and investment banks. Besides, greater awareness or knowledge about different *Shariah* principles and their applications associated with Islamic financing could be done through directors' training.

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TABLE 1 : Number of approved corporate private debt securities.

Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Avg
Conventional (CD)	77	137	87	75	50	52	60	52	23	33	40	40	61
Islamic debt (ID)	35	34	31	49	77	64	52	43	11	25	44	41	42
Combination of CD and ID	0	0	0	0	0	2	8	4	0	1	1	0	1

Source: Various issues of Securities Commission Malaysia Annual report

TABLE 2 : Logistic regression result of corporate choice between Islamic debt and conventional debt

	GOVERNANCE MODELS FIRM SPECIFIC MODEL				OVERALL MODEL	
	Model 1a	Model 1b	Model 2a	Model 2b	Model 3a	Model 3b
MOWN	3.132 (2.764)				2.553 (2.408)	
BUMIOWN	7.535 (8.296)*	3.824 (3.249)			6.878 (8.719)	
DOMPFUND	0.078 (0.237)				0.072 (0.232)	
FORFUND	0.186				0.478	

BRDSIZE	(0.380)				(1.077)	
	0.856	0.847			0.845	
	(0.076)*	(0.072)**			(0.090)	
BUMIBRD	0.544				0.635	
	(0.461)				0.600	
FSIZE			0.886		0.926	
			(0.112)		0.169	
GROWTH			0.730		0.891	
			(0.267)		0.356	
ADJRUNUP			0.220	0.183	0.263	0.183
			(0.140)**	(0.115)***	(0.175)**	(0.115)***
PROFIT			97.914		23.734	
			(337.814)		90.455)	
ADJTD2TAAVG			0.303		0.189	
			(0.378)		0.262)	
TANG			0.764		0.641	
			(0.372)		0.336)	
Pseudo R ²	5.77	3.16	7.67	5.10	11.74	5.10
LR Chi ²	9.73	5.32	12.93	8.61	19.79	8.61
Prob (Chi ²)	(0.1366)	(0.069)	(0.0441)	(0.0034)	(0.0712)	(0.0030)
Likelihood ratio test		4.44		4.33		11.18
full model and reduced model		(0.354)		(0.5033)		(0.428)

Std errors for the odds ratios are shown in brackets *,**,and ***c denotes significance of 10%, 5% and 1% level respectively