

Corporate Governance And Bank Performance In Indonesia

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ABSTRACT

This study examines the corporate governance mechanism and their impact on performance of commercial banks in Indonesia. Focusing on differences between conventional banks (CBs) and Islamic banks (IBs), this study assessed the effect of board structure (board size and board independence) and ownership concentration on the performance of the banks as measured by ROA. The study used structured review of documents, and commercial banks financial data were collected covering a period 2015 to 2016. By employing random-effect GLS technique to test the hypotheses, this paper found that board size and bank size had statistically significant positive effect on bank performance; whereas ownership concentration had statistically significant negative effect on bank performance.

Keywords: Bank performance; Corporate governance; Indonesia

1. Introduction

Bank performance is a key measure in assessing the resilience of the national banking system. When of the global financial crisis happened in 2008, the world economic turmoil also affected the performance of Indonesian banks. Although not fatal, but then the commercial banks in Indonesia, both conventional banks (CBs) and islamic banks (IBs), suffered from liquidity difficulties (Ningtyas, et.al, 2013). Lloyd (in Ermina & Maria, 2010) stated that the financial crisis is the impact of corporate governance failures within the company, one of which is because the board of directors is unable to properly anticipate crisis risks.

Many studies have heightened the relationship between bank performance and corporate governance mechanism. They suggest that better governance would have at least mitigated some of the effects of the financial crisis (Mollah & Zaman, 2015). In contrast, the bankruptcies of big firms like Enron, WorldCom, Barings Bank, Polly Peck and Lehman Brothers are the result of poor corporate governance practices. Moreover, banks, as financial institutions with depositors other than shareholders, are the type of firms that are more vulnerable to agency conflicts that undermine the performance of banks, and therefore are strictly bound by regulations (Boussaada & Karmani, 2015; Dewayanto, 2008; Fanta, 2013; Hajer & Anis, 2016; Jahdi, 2014; Mollah & Zaman, 2015).

This study focuses on examining the effect of corporate governance mechanism on bank performance in Indonesia. Furthermore, because Indonesia is a country that embraces dual banking system, i.e conventional and sharia, then the testing of both groups is done separately.

This is because there are different characteristics of corporate governance and its resistance to the financial crisis (Mollah & Zaman, 2015).

2. Framework and Empirical Studies

Agency Theory

Agency theory is the foundation of corporate governance (Jahdi, 2014). The main point of this theory is on how to mitigate agency conflict (Ahmad & Septriani, 2000; Jensen & Meckling, 1976; Reverte, 2009). Agency conflicts arise when managers take unprofessional business moves, such as creating information asymmetries or moral hazard in banking operations such as transfer pricing, asset stripping, employing family members, and undue credit allocations (Dewayanto, 2008).

The agency conflicts within the company will incur costs for the company, called agency costs. One effort that can be made to reduce these costs is by optimizing the implementation of corporate governance mechanism that fit the needs of the company (Htay et.al., 2012; Jensen & Meckling, 1976).

Corporate Governance Mechanism

Corporate governance is a system that affects the way companies communicate with stakeholders (Elsakit & Worthington, 2014; Jamali & Rabbath, 2007; Moon et al., 2013; Taha & Haziwan, 2009). The embodiment of corporate governance is called the corporate governance mechanism, which consists of two dimensions: (1) governance bodies and (2) ownership structure. The governance bodies consist of two elements: board structure and audit committee. In this research, governance bodies dimension is represented by board size and board independence variables.

Board Size

Indonesia adheres to a two-tier system in its board structure, which the board of commissioners is a separate part of the board of directors (Kamal, 2011; Moor, 2014). Therefore, in this study the board size variables refer specifically to the board of commissioners. This variable is measured by the total number of members of the board of commissioners recorded at a certain reporting date.

Previous studies have shown contradicted findings. Some revealed that small size boards are expected to be more effective in mitigating communication problem and increase the board's ability to control management than larger board size (Fanta, 2013; Htay et al., 2012; Said et al., 2009; Taha & Haziwan, 2009). Beside, larger board size raises the coordination costs due to the low incentive of the board of commissioners to seek information and supervise the manager. In contrast with this finding, some other research revealed that board size positively affects the performance of a bank (Adams & Mehran, 2012; Dewayanto, 2008; Hajer & Anis, 2016). This result suggests that fewer board members might increase the pool of expertise, resources, and workload of individual members which limit monitoring ability of the board. Accordingly, in this paper the first hypothesis will be tested:

H₁ : Board size is positively related to bank performance.

Board Independence

Board independency refers to a number of independent commissioners on board. The independency of the member of a board is considered to be a major corporate governance

mechanism (Khan, et al., 2013). Theoretically, board independence is positively related to a company's performance. Independent commissioners, whose status has no direct financial and familial relationship with managers, are considered to be more effective in monitoring the performance of managers and are able to give advises from different perspectives on issues faced by managers (Adams & Mehran, 2012). In addition, independent commissioners are expected to perform monitoring in the role of safeguarding stakeholders interests, reduce the benefits of withholding information and improve the quality of monitoring the financial disclosure (Esa, Anum, & Ghazali, 2012; Jizi, Salama, Dixon, & Stratling, 2014; Jo & Harjoto, 2012; Khan et al., 2013; Moor, 2014; Said et al., 2009; Taha & Haziwan, 2009).

Nevertheless, Adams & Mehran, (2012) and Mollah & Zaman (2015) stated that independent commissioners also have potential disadvantages, such as the cost due to they may lack relevant of firm-specific information, which is larger in the case of banks, which limits the pool of directors from which banks can choose. Based on these two contradictory opinions, it is interesting to clarify the effect of board independency on bank performance empirically. Therefore our second will hypothesis:

H₂ : Board independency is positively related to bank performance.

Ownership Concentration

The results of Riewsthirathorn et al., (2011) showed that the concentration of ownership is not only statistically significant but also economically meaningful. A more concentrated ownership is associated with poorer bank performance, higher operating costs and less risk-taking. The higher the concentration of share ownership, the greater majority shareholder's control over minority shareholders, that leads to agency conflicts and decrease in bank performance. In relation to risk, banks with concentrated holdings will tend to avoid risky projects because shareholders will conduct intensive and tight monitoring that tends to prevent managers from taking actions that can harm them.

Contrary to the results of the study, Boussaada & Karmani (2015) found that concentrated shareholdings actually improved the Bank's performance. This is due to the potential cause for agency conflicts in the banking sector are more complex and unique than other types of companies. Agency conflicts associated with scattered ownership will increase agency costs. Conversely, concentrated ownership reduces these costs because shareholders have the power to gather information and influence management decisions. Unite & Sullivan (in Boussaada & Karmani, 2015) also mentioned that in the banking sector, majority shareholders are able to reduce discretionary management behavior and increase firm value through tight oversight of lending practices, operational efficiency and risk management. Based on this argument, this third hypothesis will be tested:

H₃ : Ownership concentration is positively related to bank performance.

3. Methodology and Data

The study used secondary data collected from the financial statements of Indonesian CBs and IBs, and the data covered the period of 2015-2016. The study also emphasize the analysis on both banking sectors, as they have different governance characteristics and performance. The purposive sampling method was used in this study to determine the sample size. The total numbers of the two groups of banks is equal. The sample consists of banks that hold the two banking systems, or those that have a parent-subsidiary relationship. In addition, the selected banks are those that has published the financial statements in 2015 and 2016 via www.idx.co.id;

www.bi.go.id; www.ojk.go.id; or company website respectively. From these provisions, there are 11 banks obtained from each group with 2 periods of time so as to generate 44 observations as final sample. The sample distribution is presented in the following table.

Table 1. Sample Distribution

No	Conventional Banks (CBs) (Holding Company)	Islamic Banks (IBs) (Subsidiary Company)
1	PT Bank Central Asia Tbk.	PT Bank BCA Syariah
2	PT BPD Jawa Barat dan Banten Tbk.	PT Bank Jawa dan Barat Banten Syariah
3	PT Bank Negara Indonesia (Persero) Tbk	PT Bank Negara Indonesia Syariah
4	PT Bank Rakyat Indonesia (Persero) Tbk	PT Bank Rakyat Indonesia Syariah
5	PT Bank Tabungan Pensiunan Nasional Tbk	PT Bank Tabungan Pensiunan Nasional Syariah
6	PT Bank Bukopin Tbk.	PT Bank Syariah Bukopin
7	PT Bank Mandiri (Persero) Tbk.	PT Bank Syariah Mandiri
8	PT Bank Maybank Indonesia Tbk.	PT Bank Maybank Syariah Indonesia
9	PT Bank Mega Tbk.	PT Bank Mega Syariah
10	PT Bank Pan Indonesia Tbk.	PT Bank Panin Syariah Tbk
11	PT Bank Victoria International Tbk.	PT Bank Victoria Syariah

This study identified three variables as determinants of bank performance. Board size (BS) is measured by the numbers of commissioners who sit on the board of commissioner. Board independency (BINDP) is measured by the proportion of independent commissioner from the total members of the board. Meanwhile, ownership concentration (CONC) is measured by the ratio of shares held by the largest shareholder from the annual reports of the companies in 2015 and 2016.

Consistent with prior literature, this study include accounting-based return on assets (ROA) as a measure of bank performance. This ratio is considered to be a powerful ratio in comparing the efficiency and performance of a company's operations as it measures the outcome of asset use. This study also considered bank size as control variable. Bank size (SIZE) is measured as the natural logarithm of total assets.

This study applied a random-effect GLS technique to test the hypotheses. Mollah & Zaman (2015) states several reasons that make this technique more appropriate for this type of research than OLS. First, OLS ignores the panel structure of the data. Second, the variable board size, board independence and ownership concentration are the types of variables that do not vary much over time, so that the use of fixed-effect estimations would lead to a massive loss of degree of freedom.

Based on the framework and hypotheses that had been developed in previous chapter, the model for this study is:

$$BP_{it} = \beta_0 + \beta_1 BS_{it} + \beta_2 BINDP_{it} + \beta_3 CONC_{it} + \beta_4 SIZE_{it} + \varepsilon_{it} \quad (1)$$

where for company i :

- BP : Return On Assets ratio in year t
- BS : Board size
- $BINDP$: Board independence

CONC : Ownership concentration
SIZE : Bank size
 \mathcal{E} : error term.

4. Discussion on Empirical Results

Descriptive statistics

The average number of members sit on board of commissioners on CBs is generally two times more than the IBs (Figure 1). The number of boards of commissioners in IBs is still relatively small because the age of these sub-sample companies is relatively new and the amount is limited only to meet the minimum requirements set by the regulator.

While the independence level of the board of commissioners in the two sub-samples did not differ significantly, but the independence on CBs was higher (Figure 2). In the concentration of ownership variable data, the disparity between both groups is quite sharp. In CBs, ownership structure tends to be scattered and varied, indicated by a concentration level below 50%. Whereas in the IBs where ownership is highly concentrated and almost owned by one control shareholder. This is because the ownership of IBs in Indonesia on average almost completely owned by related CBs as the holding company.

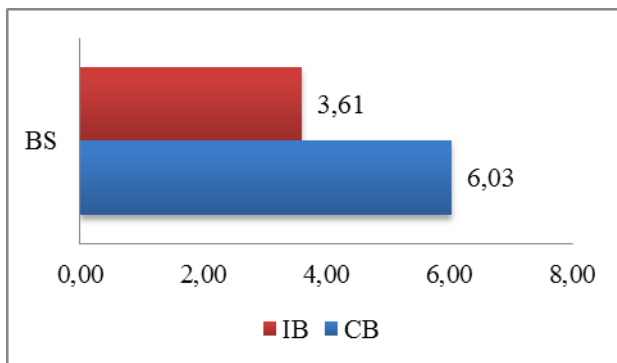


Figure 1. Mean Value of Board Size

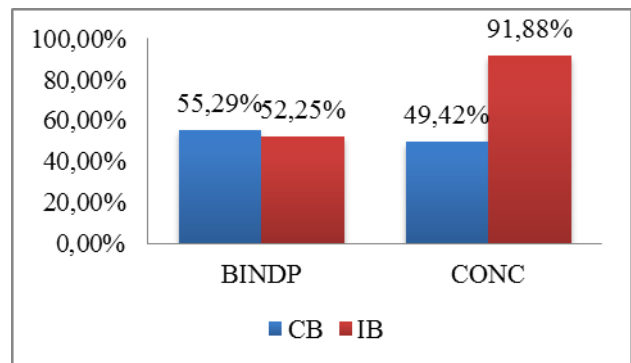


Figure 2. Mean Value of Board Independency and Ownership Concentration

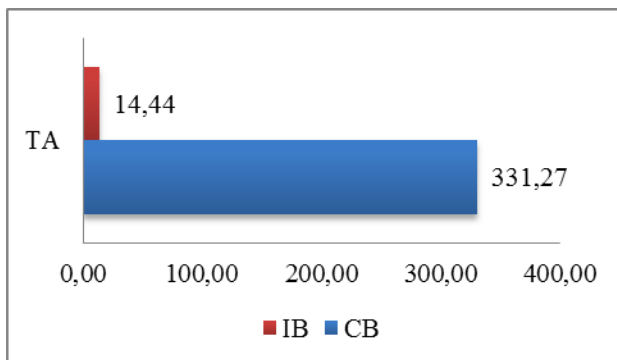


Figure 3. Mean Value of Total Assets

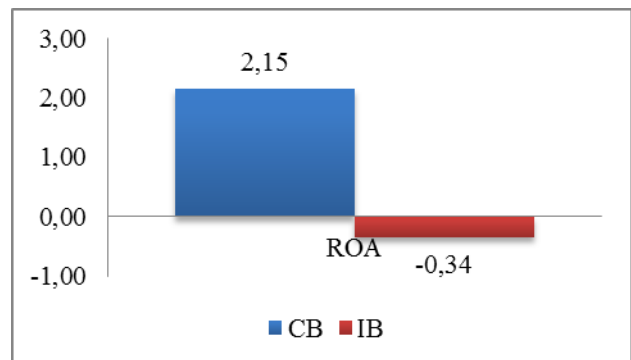


Figure 4. Mean Value of ROA

In figure 3, there is a noticeable difference between the CBs and IBs' firm size. CBs total assets reach average of 333 trillion rupiah. While the average total assets of IB only reached 14

trillion rupiah. Thus it can be concluded that CBs are large companies, while the IBs are small companies on average.

Meanwhile, the ROA variable as the proxy of bank performance also shows significant differences between the two sub-samples. The average CBs' ROA is positive and reaches 2.15. A number that indicates good performance. On the contrary, ROA in IBs group is negative. This result is in line with the monitoring by Otoritas Jasa Keuangan (OJK) during 2016 which shows a continuous decrease in ROA of IBs from Q2 through the end of Q4 (Otoritas Jasa Keuangan, 2016).

Table 2. Detail results of the regression analysis

Variables	Bank Performance		
	Full sample	CBs	IBs
Board size	-0.221251*	-0.208625**	-0.963473
Board Independence	0.015492	0.001669**	0.003549
Ownership concentration	-0.002839*	0.008556	-0.020055
Firm Size	0.714230**	0.755248**	1.166.575**
Constant	-20.75089	-21.99605	-29.27829
Observations	44	22	22
Adjusted R ²	0.527500	0.217867	0.559806

Notes : **, * statistically significant variable at the 1% and 5% levels, respectively

Test of Hypotheses

Table 2 reveals that the adjusted R² of full sample is 53%; Indicating that the regressors in the model can explain 53% of the variation in the dependent variable (ROA). The partial regression results in the CBs and IBs sub sample show different adjusted R² values. In CBs sub sample, the variations of bank performance can only be explained by independent variable as much as 22%, whereas in IBs sub sample, can be explained as much as 56% and the rest is explained by other factors outside model.

The regression results also show that at overall sample, board size and ownership concentration are statistically significant at 5% and firm size is significant at 1%. In the CBs sub sample, the board size variables, board independence and bank size are all statistically significant at 1%. While in IBs sub-sample, it's only bank size variable which has significant effect on bank performance.

Board size and bank performance

The statistic test on the effect of board size toward bank performance on samples and both sub-samples shows that board size has a negative effect on bank performance. This result is in line with the results of the Fanta (2013) which states that too many board members will cause communication problems between members and make them unproductive. This leads to director free riding problem i.e. directors consume more resources than they contribute to the bank, and thereby reducing bank performance. In the IBs sub-sample, the number of members of the board of commissioners has no effect on the bank performance, so the addition or reduction of the

commissioner is not the main issue in an effort to raise the bank's performance. The result, therefore, reject the hypothesis H₁.

Board independence and bank performance

Table 2 shows that board independence has a positive correlation with bank performance. In the CBs sub-sample, the effect of this variable is significant; each addition of one independent commissioner will increase the ROA by 0,002%. This result supports the argument of Adams & Mehran (2012) who stated that the composition of larger independent commissioners makes monitoring more effective and has a broader view of providing solutions or direction to managers. Thus the hypothesis H₂ is supported.

Ownership Concentration and bank performance

The overall regression result shows that the relationship between these two variables is negative. This means that concentrated ownership of share is not a good factor in improving bank performance. This justifies the argument of Riewasathirathorn et al., (2011) that over-concentrated ownership makes controlling shareholders more likely to limit management's decision-making, especially on high-risk project. Eventually, this condition will decrease bank performance. This condition happened to IBs sub-sample which almost all of its shares are controlled by conventional bank holding company, so that policy making process is very limited by control shareholder interest.

Different results were found in the CBs sub-sample. In this group, increasingly concentrated ownership actually improves bank performance. As mentioned in the descriptive statistic, ownership structure in CBs tends to spread, so according to Boussaada & Karmani (2015) this condition will lead to agency costs to collect information and supervise management performance. Therefore, in the current condition of CBs, the ownership structure needs to be more concentrated to some extent that is considered to make the shareholder performance most effective and optimal. If it exceeds the limit, then the effect of ownership concentration will change to negative, as happened in IBs sub-sample. Based on regression result in full sample, H₃ hypothesis is rejected.

Bank size and bank performance

Regarding the variables of control, our findings suggest that larger bank size is significantly related to greater bank performance. In this study, CBs which are big companies have average ROA that is much higher than the IBs group as small banks. According to Fanta (2013), this is because the economies of scale and the broader market share are owned by large banks.

5. Conclusion

The objective of this paper was to investigate the effect of corporate governance mechanism towards bank performance in Indonesia, by analyzing the financial statements in 2015 and 2016, reported by 11 CBs and IBs.

The findings in this paper are as follows. First, the performance of CBs and IBs in Indonesia has a value and a considerable development. CBs has a stable and high financial performance. While the IBs' performance in the sample period tends to decrease and in low value. Second, board size and board independence are positively related to bank performance, but only board size that is found to be significant in driving bank performance. In other words, banks

have larger board size and have more independent board, tend to have better monitoring efficiency that results in higher performance. This finding also contributes to the interest of all audiences, more than shareholders and creditors.

Third, the results show that ownership concentration is negatively related to bank performance. In the firms whose shares are highly concentrated, minority shareholders were practically powerless to prevent large shareholders from implementing their plans for the company. Therefore, the steps of managers to take any policies or actions tend to be limited by the supervision of shareholders.

Future research can be oriented in depth and more extended analysis about what causes the different levels of bank performance between CBs and IBs in Indonesia. To better assess the performance level, next researcher should also involve other relevant measurement of bank performance and corporate governance mechanism.

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