

CHAPTER I

INTRODUCTION

A. Background

Indonesia faced the second global financial crisis on 2008 after they successfully survived the biggest one on the last decade. The financial crisis has major influences on the economic activity in Indonesia. According to the data that is provided by *Bank Indonesia*, the economic growth of Indonesia has decreased from 6,3% to 6,1%. They also stated that the financial crisis has negative influence on balance of payments' performance, exchange rate of Rupiahs and the inflation. Regarding this situation, *Bank Indonesia* and *Otoritas Jasa Keuangan* issue some policies to minimize the effect of financial crisis. The policies-issued are governing the monetary sector, payment sector and banking sector. As the financial institutions, banking industry is full of regulations that govern their daily operation so that they receive the biggest impact by the new regulation-issued. However, there is also a debate that banking industry is the root of the crisis since they have a bad regulation on compensation structure (Gou et al, 2015).

According to *Infobank* on 2015, financial service industries such as bank are considered as a high risk industry. An industry is considered as a high risk based on two conditions, either they operate within a high-risk industry or risk of financial failure exists. As what has been stated above,

financial crisis is one of the examples of financial failures. Because of that, the banking industries are highly affected. On the other hand, banking industries also can become antecedents for the crisis itself. Gou et.al (2015) said that the compensation structure of the banking firms is the root of the financial crisis that happened in 2007. This is also in line with what has been published in the local newspaper in Indonesia named *Kontan* on February 23, 2015. They stated that the enormous remuneration that is done by the banking firms was triggering the financial crisis on 2008. Despite of the economic condition, the poor corporate governance of the financial institutions is often be blamed as the one of the factor that causes financial crisis. The existence of the governance is also being questioned, whether they already operated effectively or not.

By the existence of the compensation, bank executives often just focus on the short-term gains and forget the long-term gains. Logasvathi et al. (2013) stated that compensation particularly in financial institution often trigger the directors to neglect the entity's sustainability and just focus on the short term gain. Despite of this, the excessive risk-taking on the banking industries is not well understood (Murphy, 2009 cited on Gou et.al, 2015). Because of that, *Otoritas Jasa Keuangan* tries to prevent the behavior of excessive risk taking which is usually done by banking industries by issuing some regulations. *Otoritas Jasa Keuangan* issued regulation governing the remuneration for the banking industries on the end of the year 2015. The regulation issued was number 45 regarding the principle of remuneration that

must be fulfilled by banking industries (Peraturan Otoritas Jasa Keuangan Nomor 45/POJK.03/2015 tentang Penerapan Tata Kelola Dalam Pemberian Remunerasi Bagi Bank Umum). Previously, *Bank Indonesia* also issued regulation regarding the assessment on bank health (Peraturan Bank Indonesia Nomor 13/1/PBI/2011 tentang Penilaian Tingkat Kesehatan Bank Umum). It is type of self-assessment by using risk approach including the risk profile, good corporate governance, earnings and capital.

The two regulations regarding the issue of remuneration in banking industry hopefully can prevent or at least reduce the excessive risk taking. It will lead to the good governance of banking industry itself. Before *Otoritas Jasa Keuangan* and *Bank Indonesia* issued these regulations, there was no strict regulation that governed about this. As a result, banking industries still applied the same mechanism to assess the performance of its employee by giving a huge amount of remuneration in form of bonus. In 2013, there were some banks which didn't pay dividend to the investors but still gave a big number of bonuses to their employees and even increased from previous year (*Kontan* newspaper, 4th April 2013). For example, BTPN gave the remuneration with the total of Rp 82,1 billion. It increased 41% from the previous year. This also happened with BRI Agro and OCBC NISP. The banks argued that every performance of the employees must be appraised since they already gave their best effort to the company. This is the proof that the unhealthy bonuses practices still exist. They gave a high bonus rewarding but ignored the risks that would arise in the future. Therefore it might

endanger the financial condition of the bank if the bank was not able to absorb such losses. Even though the employee knew the effect, they kept doing it because they only wanted to benefit themselves. Therefore, *Otoritas Jasa Keuangan* takes the right step by issuing the regulation.

This research uses Lee and Isa (2015) and Purwoko and Sudiyatno (2013) as main references. Lee and Isa (2015) examine the association between directors' remuneration and performance and corporate governance in the Malaysian banking sector. The result show there is a positive association between directors' remuneration and performance. However, there are some negative results on the characteristic of the governance for example the board size. On the other hand, Purwoko and Sudiyatno (2013) explore the factors affecting bank performance in Indonesia. The factors including operating efficiency, credit risk, market risk, capital and liquidity. The result varies in each factor. Operating efficiency and credit risk have negative influence toward bank performance while market risk has positive influence toward bank performance. Moreover, the rest of the factors such as capital and liquidity have no influence on bank performance.

The prior research in the other countries regarding the new regulation also gives some insight how it will affect the bank performance. Nagar et.al (2016) also investigates the association between risk governance and bank performance. The results show that there is a significant relationship between risk governance and bank performance. Their study took a setting in

Bangladesh which includes in developing countries. In Indonesia itself, Pramana and Yunita (2015) study about the relationship between the effect of risk approach ratio toward bond rating. The result shows that there is no relationship between risk approach ratios toward bond rating. Moreover, Kale et.al (2015) investigates the effects of regulations, macroeconomic changes, and political events on the efficiency of the Turkish banks. The result shows that the tighter regulation, monitoring, restriction, strong supervision, more capital, and new reforms have a positive impact on efficiency.

In regard with the fact that exists in Indonesia and the inconsistent result, it is important to investigate how the risk-taking practice toward bank performance in Indonesia since the result varies in every country. Based on Infobank Research Bureau for the year book 2013, Bank Danamon experienced significant salary ratio increase. This was because in 2013 there was a change in the mechanism of the highest salaries at the bank. In 2012 the highest salary ratio in Bank Danamon is only 80.40 times, and in 2013 it jumped to 230.80 times. This very high surge is in contra with their business achievement in 2013. This was reflected in the achievement of profit that grew minus 8.74% or decreased to Rp2, 96 trillion. In contrast, labor costs versus total revenues declined from 19.27% in June 2013 to 14.36% in June 2014. Similarly, labor costs versus total cost decreased from 25.44% in June 2013 to 20,57 in June 2014. Other indicators, such as operating expenses compared to operating income, also decreased from 75.74% to 69.75%. Meanwhile, net interest margin (NIM) decreased from 8.45% to 7.11%. To

the extent of it, the relation of corporate governance and the remuneration also becomes crucial to be investigated. It is regarding how the banks manage their good governance and how much the remuneration that will be received by the executives.

From the explanation above, the purpose of this study is to examine the relationship between firm risk, remuneration and corporate governance on bank performance. Thus, the writer will conduct a study with the title “The Effect of Firm Risk, Remuneration and Corporate Governance on Bank Performance” (Empirical Study on Bank joined in the Corporate Governance Perception Index held by Indonesian Institute for Corporate Governance during 2012 – 2016).

B. Scope of the Problem

Based on the introduction, the writer identifies a problem regarding the effect of firm risk, remuneration and corporate governance on bank performance. The writer’s main focus is on the banks which are listed in Indonesia Stock Exchange. Hence, it is impossible for the writer to discuss the effect on all of the level including the local bank which is not listed in Indonesia Stock Exchange. The idea of choosing the variable is that the financial industries especially banks have a strong relation with risk exposure. It is known that bank is a high-risk industry. Thus, it is important to investigate firm risk, remuneration and corporate governance toward their

performance. Therefore, it will develop a true picture on how firm risk, governance and remuneration affect bank performance.

C. Research Question

Based on problem identification, the writer formulates the problem as follows:

1. What is the effect of credit risk on bank performance in Indonesia?
2. What is the effect of market risk on bank performance in Indonesia?
3. What is the effect of liquidity risk on bank performance in Indonesia?
4. What is the effect of remuneration on bank performance in Indonesia?
5. What is the effect of the corporate governance on bank performance in Indonesia?

D. Objectives of the Study

The objectives of the study, as follows:

1. To investigate the effect of credit risk on bank performance in Indonesia
2. To investigate the effect of market risk on bank performance in Indonesia
3. To investigate the effect of liquidity risk on bank performance in Indonesia
4. To investigate the effect of the remuneration on bank performance in Indonesia
5. To investigate the possible impact of the corporate governance on bank performance in Indonesia

E. Significance of the Study

1. Theoretically

- a. This research is expected to provide empirical evidence of factors affecting bank performance.
- b. This research is expected to add and develop concepts of firm risk, remuneration and corporate governance on bank performance in Indonesia.
- c. This research is expected to gives additional literature in management accounting regarding the performance measurement, especially in banking industries.

2. Practically

- a. This research is expected to help regulator to improve the regulation regarding the risk on banking industries.
- b. This research is expected to encourage the bank to be detail in managing their risk.