CHAPTER II

LITERATURE REVIEW

A. Theoretical Framework

1. Agency Theory

Banking industry payment which increased rapidly has led to the financial crisis 2007-08 and caused an intense debate on the compensation schemes in banking (Bannier et.al, 2012). Gou et.al (2015) said that the compensation structure of the banking firms is the root of the financial crisis that happened in 2007. CEO and executive in banking industry are widely well-known to be paid high in terms of compensation. The nature of high risk in banking industry has also provoked them to take excessive risk. This phenomenon commonly happens in banking industry. The executive, CEO and the employee are usually take a high risk in order to take a high return. However, these actions will alter their focus on long-term goals to the short-term goals as it can benefit their personal gain. As a result, they usually neglect the long-term goals and the bank performance is at stake. The excess risk-taking in financial institutions can affect not only the bank itself but also creditors, depositors, taxpayers and the financial system as a whole (Bolton et.al, 2015).

Most industry expert distinguish the two underlying compensation problems into two main aspects of agency problem. The first agency problem exists between top executives and the bank shareholders due to limited liability, induced by deposit insurance and by likely bailouts via the taxpayers, banks have an incentive to deliberately take risks that increase expected profits but reduce social welfare (Flannery, 1998; Sironi, 2003; Gropp, Hakenes, and Schnabel, 2011 cited on Bannier et.al, 2012). The second agency problem exists between CEOs and bank shareholders on the one hand and employee such as loan officers, traders, mortgage brokers or investment bankers on the other hand (Clementi et al., 2009 cited on Bannier et.al, 2012).

The second agency problem has a strong relation with the risk exposure on banking. In this research, there are three main risk profiles which usually happen in the nature of banking operation namely credit risk, market risk and liquidity risk. As what has been stated above, the agency problem exists between CEOs and bank shareholders on the one hand and the employee such as loan officers, traders, mortgage brokers or investment bankers on the other hand. Here, the CEOs and banks shareholders stand as a principal. Meanwhile, the employee such as loan officers, traders, mortgage brokers or investment bankers stands as the agents. Since the interest of the principal and agent are usually different, both of the principal and the agent can act in a way to benefit themselves only. The excessive risk-taking which is done by the management is one of the ways so that they can get a bonus from their performance. From the explanation above, it implies that the remuneration systems in bank induce risk-taking on top of what may be desired by the banks owners themselves. In particular, so the argument, inadequate risk adjustments for return have led employees to take the high risk excessively which aren't in line with bank interest (Rajan, 2008; OECD, 2009; Taleb, 2009 cited on Bannier et.al, 2012). Therefore, the negative relationship can be found between risk and the performance at excessive levels. As the level of the risk increases, there will be greater uncertainty which in turn leads to the lower performance.

The agency theory can also explain the relationship between the remuneration and the firm performance. Most of the scholars suggest incentive pay aligns the interests of executives and shareholders by curbing executive opportunism and discouraging risk aversion (Devers et.al, 2007). Under the goal alignment argument, the incentive pay will reduce the opportunism of the executive by motivating them to maximize firm performance. However, even though it is widely known that the executive opportunism can be reduced by incentive pay, a strict interpretation of the goal alignment argument suggests that rather than dispatching executives' self-interest, incentive pay is intended to take advantage of their self-interest by channeling their focus away from extracting opportunistic rents and toward maximizing shareholder wealth (Devers et.al, 2007). More specifically, the incentive pay is aiming at the value-maximizing of the shareholders by motivating the executives. Thus, it will influence the behavior of the executive which in turn affects their performance.

2. Definition of Bank

According to the Law of the Republic of Indonesia Number 10 of 1998 on banking, a bank is a business entity that collects funds from the public in the form of savings and distributes it to the community in the form of credit or other forms in order to improve the level people's welfare. From the definition above, it can be concluded that banking industry has three main activities. They are raising funds, distributing funds, and provide other bank services.

a. Fund Raisers

As a fund raiser, bank has several sources of fund to carry out its function. The first source is from the bank itself in the form of capital deposits on their establishment. The second source of funds originates from the people who use banking services such as savings accounts or deposits. Lastly, the source of the funds can be obtained from financial institutions in the form of Liquidity Credit and Call Money (funds that can be withdrawn by borrowing banks at any time and meet the requirements).

b. Fund Distributors

The funds collected by banks are distributed to the public in the form of credit, purchases of securities, investments, ownerships of fixed asset and etc.

c. Other Bank Services

The bank can perform various activities such as remittances, collection, tourist checks, credit cards and other services as it s in line with their duties as money payment services.

Despite their three main activities, banks also have some specific functions. They can be the agent of trust, agent of development and agent of services.

a. Agent of Trust

The main basis of bank activities is trust, both in collecting funds and distributing funds. If the bank already got the trust from the public, their willingness to save funds in bank will increase. Moreover, the bank will also gain the trust from the debtor and creditor. In this situation, developing the trust is important because all parties want to be benefited for both in terms of fund irregularities, reservoir funds and recipients of the funds.

b. Agent of Development

As an agent of development, bank can be an institution that mobilizes funds for economic development. The economic activities in the monetary sector and in the real sector can not be separated. Both sectors are always interacting and influencing each other. The real sector will not be able to perform well if the monetary sector is not working well. Bank activities enable people to engage in investment activities, distribution activities, and consumption activities of goods and services. All of those activities are aimed for the economic development of a society.

c. Agent of Services

In addition to conducting the collection and funding activities, bank also offers other banking services to the public. The services offered by this bank are closely related to economic activity as a whole. These services may include remittance services, custody of valuables, provision of bank guarantees, and settlement of claims.

In the meantime, here are the functions and tasks of banking in general:

a. Establishing and implementing monetary policy
   1) Establishing a monetary target taking into account the current inflation rate
   2) Conducting monetary control by opening market operations in market (rupiah or foreign currency), determining the discount, establishing the minimum mandatory reserves, as well as arranging and financing the credit
b. Organizing and maintaining a smooth payment system
   1) Carrying out and granting approval or permission for remuneration services
   2) Requiring to prepare and submiting activity reports to payment system service providers
   3) Setting use of payment tool

Regardless of their main function or its derivatives, the main point is about the philosophical objective of the existence of banks in Indonesia. This is very clearly reflected in Article 4 (4) of Law Number 10 Year 1998 which explains, "Indonesian banking aims to support the implementation of national development in order to improve equity, economic growth and national stability towards the improvement of the welfare of the people". In a deeper review of the bank's business activities, the bank should be based on the principle of economic democracy that uses the principle of prudence. This is clearly illustrated, because philosophically the bank has macro and micro functions to the nation's development process.

3. Risk Management

Banking industry has an important role in order to support the economic stability of a country. As what has been stated above, bank has so many functions to support both of the microeconomic and macroeconomic sectors. Thus, only a healthy bank can perform their functions fully. It means that they can fulfill the need of the people and help the government to execute some policies particularly about the monetary. In contrast, unhealthy banks can harm not only themselves but also the financial system as a whole. It happens because banking industry has a high risk exposure and its strong relation with financial failure. Financial crisis is the obvious evident which we can feel directly about the impact. It is either the bank can be the antecedent of the crisis itself or the vice-versa. With its complex operation, banks have to apply the risk management in order to prevent the problem that will arise regarding the risk on their daily operation.

The global financial crisis that has occurred in recent years provides valuable lessons in banking industries. The innovations in banking products, services and activities can pose substantial problems to a bank as well as to the overall financial system unless they provide an adequate risk management. The experience of the global financial crisis has prompted the need for increasing the effectiveness of risk management and corporate governance implementation. The objective is to enable the bank to identify problems early, to follow-up on appropriate and faster improvements, and to implement better corporate governance and risk management so that the bank is more resilient facing the crisis. In principle, bank management and business continuity are the sole responsibility of management of the bank. Therefore, the bank is required to maintain and improve its health level by applying prudential principles and risk management in conducting its business activities including conducting periodic self assessment on its health level and taking effective remedial measures.

Bank management needs to pay attention to several principles in risk management. This can be done by identifying internal and external factors that can increase the risk or affect the financial performance of the bank at this time and in the future. Thus, the bank is expected to be able to detect early on the root of bank problems and to take effective and efficient prevention and repair measures.

Risk profile factor assessment is an assessment of the inherent risk and quality of risk management implementation in bank operational activities. There are eight types of risk: Credit Risk, Market Risk, Operational Risk, Liquidity Risk, Legal Risk, Strategic Risk, Compliance Risk, and Reputation Risk. In assessing the risk profile, banks shall also take into account the scope of risk management implementation as stipulated in Bank Indonesia regulation concerning application of risk management for commercial banks.

a. Credit Risk

Credit Risk is a risk due to failure of debtor or other party in fulfilling obligation to bank. Credit risk is generally found in all bank activities whose performance depends on the performance of the counterparty, the issuer or the borrower's performance. Credit risk can also be attributable to the concentration of funding to a particular debtor, geographic area, product, type of financing, or field of business. This risk is commonly referred to credit concentration risk and shall also be taken into account in the inherent risk assessment.

In assessing the inherent risk of credit risk, the indicators used are the composition of the asset portfolio and the level of concentration, quality of provision of funds and adequacy of reserves, strategies for provision of funds and sources of provision of funds and external factors.

b. Market Risk

Market risk is a risk on the balance sheet position and the administrative account including derivative transactions, due to changes in market conditions, including the risk of changes in the option price. Market risks include interest rate risk, exchange rate risk, equity risk and commodity risk. Interest rate risk can come from both the trading book position and the banking book position. Implementation of risk management for equity and commodity risk shall be applied by banks which consolidate with subsidiaries. The scope of the trading book and banking book position shall refer to the provisions of Bank Indonesia concerning the minimum capital requirement with respect to market risk.

In assessing market risk, the indicators used are portfolio volume and composition, potential loss of interest rate risk and business strategies and policies.

c. Liquidity Risk

Liquidity risk is a risk due to the inability of the bank to meet the obligation from sources of cash flow financing or high quality liquid assets that can be mortgaged, without disrupting the activities and financial condition of the bank. This risk is also called the funding liquidity risk. Liquidity risk can also be caused by the inability of the bank to liquidate assets without being subject to material discounts due to the absence of an active market or severe market disruption. This risk is called market liquidity risk.

In assessing the inherent risk of liquidity risk, the parameters used are the composition of assets, liabilities, and administrative account transactions, the concentration of assets and liabilities, vulnerability to funding needs and access to financing sources.

4. Remuneration

One of the factors contributing to the world economic crisis in 2007 was the high bonuses due to the achievement of the targets set by ignoring the risks that will arise in the future. Thus, it endangered the financial condition of the bank unless the Bank is able to absorb such losses. The corrective action to correct the unhealthy bonus practice was then on the agenda of the global financial system reform program and on September 25, 2009 the Financial Stability Board issued principles for sound compensation practices. The reform program aims to prevent the emergence of moral hazard and prudential elements in the management of the bank, maintain the health of the bank individually and mitigate the existence of excessive risk taking by decision makers. Indonesia as one of the G-20 members committed to adopt these principles in the form of regulation. In line with the implementation of Basel II especially Pillar 3 (Market Discipline), banks are required to disclose more transparent information to the public and market participants in particular with regard to remuneration to encourage discipline and for stakeholders to provide a fair assessment.

Remuneration can be defined as a payment granted to members of the Board of Directors, Board of Commissioners and / or Personnel whether it is fixed or variable, in cash or non-cash, in accordance with their duties, authorities and responsibilities. Fixed remuneration is a remuneration which is not related to performance and risk, among others basic salary, facility, housing allowance, health benefit, education allowance, holiday allowance, and pension. Remuneration associated with risks that include the type of key risk used in implementing the remuneration, criteria for determining the types of major risks, including those for difficult risks measured, the impact of the main risk determination on the variable remuneration policy and changes in the determination of the main types of risk compared to last year and the reasons, if any.

Meanwhile, variable remuneration is a remuneration associated with performance and risk, including bonuses or other similar forms. Performance measurement associated with remuneration include the review of the remuneration policy associated with performance appraisal, methods of linking individual remuneration to bank performance, work unit performance and individual performance and a description of the method used by the bank to state that agreed performance cannot be achieved so that adjustment of remuneration is required and the amount of remuneration adjustment if the condition occurs.

5. Corporate Governance

In order to improve the Bank's performance, protect the interests of stakeholders, improve compliance with prevailing laws and regulations and the ethical values prevailing in the banking industry, banks are required to carry out their business activities in accordance with GCG principles. According to POJK number 55 year 2016, implementation of GCG in banking industry should be based on five basic principles as follows:

a. Transparency. Transparency is openness in expressing material and relevant information and openness in executing decision process;

b. Accountability. Accountability is the clarity of the function and implementation of the bank's organ liability so that its management runs effectively;

c. Responsibility. Responsibility is the suitability of bank management with prevailing laws and regulations and sound bank management principles;

d. Independency. Independency is the professional management of the bank without the influence / pressure of any party; and

e. Fairness. Fairness is the justice and equality in fulfilling the rights of stakeholders arising under the applicable laws and regulations.

According to Indonesian Institute for Corporate Governance, good corporate governance is defined as the structure, systems and processes used by the board of commissioners and the board of directors to provide long-term and sustainable value-added for the company. Good corporate governance in the perspective of sustainability in the CGPI program is defined as a system and mechanism that directs and controls the company in realizing the sustainability of a company oriented on economic, social and environmental aspects. The company's sustainability aspect relates to the sustainability of business growth by committing itself to value creation as well as efforts related to upholding human dignity, preserving the natural environment and remaining economically profitable.

According to Indonesian Institute for Corporate Governance, CGPI program uses three scopes of GCG implementation in the perspective of sustainability, among others:

a. Compliance, which is to ensure compliance system and corporate governance mechanisms against various laws and regulations in maintaining the sustainability of companies oriented in economic, social and environmental aspects.
b. Conformance, which is to ensure the alignment of corporate governance systems and mechanisms against norms, ethics and values in ensuring the sustainability of companies oriented in economic, social and environmental aspects.
c. Performance, which is to ensure the ability of the system and corporate governance mechanisms that help realize the company's goals in achieving sustainability of the company-oriented economic, social and environmental aspects.

The focus of the good corporate governance assessment in a sustainability perspective includes the following:

a. Developing initiatives to develop strategies and policies for the implementation of corporate governance to realize the sustainability of companies that are oriented towards social, environmental and economic aspects.

b. Implementing strategies and policies for the implementation of corporate governance to realize the sustainability of companies oriented in social, environmental and economic aspects.

c. Conducting supervision and evaluation of corporate governance policies and policies to achieve sustainable corporate-oriented social, environmental and economic aspects

d. Improving and updating of corporate governance policies and policies to achieve sustainable corporate, social, environmental and economic orientation

CGPI assessment covers 13 aspects of good corporate governance implementation in the perspective of sustainability in the company. The involvement of corporate organs (Board of Commissioner and Board of Director) has an important role in every aspect that is developed. For participants from sharia financial institutions, the involvement of corporate organs also includes the role of the Sharia Supervisory Board. In detail the aspects and indicators assessed in CGPI can be explained as follows:

a. Commitment

In accordance with the good corporate governance theme in a sustainability perspective, the aspect of commitment can be taken to be the sincerity of the Board of Directors and Board of Commissioners to build a good corporate governance dedication continuously to realize the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically. The commitment aspect indicators include:

1) The sincerity of the Board of Directors and Board of Commissioners establish and develop a sound corporate governance policy continuously to realize the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically.
2) The sincerity of the Board of Directors and Board of Commissioners establish and develop the completeness of good corporate governance structure continuously to realize the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically.
3) The sincerity of the Board of Directors and Board of Commissioners establishes, monitors and evaluates good corporate governance system continuously to realize the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically.

b. Transparency

In accordance with the GCG theme in the perspective of sustainability, the aspect of transparency can be interpreted as a seriousness of the Board of Directors and Board of Commissioners to build a system of corporate disclosure and information disclosure continuously in order to realize the sustainability of companies that uphold the dignity of humanity, preserve the natural environment and benefit economically. Transparency aspect indicators include:

1) The sincerity of the Board of Directors and Board of Commissioners to build a system of corporate material information disclosure continuously to realize the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically.
2) The sincerity of the Board of Directors and Board of Commissioners to build a system of corporate information disclosure continuously in order to realize the sustainability of companies that uphold human dignity, preserve the natural environment and benefit economically.

c. Accountability

In accordance with the GCG theme in the perspective of sustainability, the aspect of accountability can be defined as the seriousness of the Board of Directors and Board of Commissioners to establish a system of clarity of duties and authorities and mechanism of accountability continuously in order to realize the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically. Indicators of accountability aspects include:

1) The sincerity of the Board of Directors and Board of Commissioners establish a system of continuous clarity of duties and corporate organ and management authority to realize the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically.
2) The sincerity of the Board of Directors and the Board of Commissioners establishes a mechanism of accountability of the authority and execution of the duties of corporate organs and management continuously in order to realize the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically.

d. Responsibility

In accordance with the GCG theme in the perspective of sustainability, the aspect of responsibilities can be defined as the sincerity of the Board of Directors and Board of Commissioners to develop a system of compliance with internal laws and regulations and social and environmental responsibility continuously in order to realize the sustainability of companies that uphold human dignity, natural environment and economically profitable. Responsibility aspect indicators include:

1) The sincerity of the Board of Directors and the Board of Commissioners establishes a system of compliance with internal legislation and internal regulations to ensure the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically.

2) The sincerity of the Board of Directors and Board of Commissioners builds a system of social and environmental responsibility continuously to realize the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically.

e. Independence

In accordance with the GCG theme in the perspective of sustainability, the aspect of independence can be interpreted as the seriousness of the Board of Directors and Board of Commissioners to establish a system of independence and objectivity of business continuously in order to realize the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically. Independence aspect indicators include:

1) The sincerity of the Board of Directors and Board of Commissioners establish a system of independence in managing conflict of interest continuously in order to realize the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically.

2) The sincerity of the Board of Directors and Board of Commissioners establishes objectivity in the continuous implementation of the business in order to realize the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically.

f. Justice

In accordance with the GCG theme in the perspective of sustainability, the aspect of justice can be defined as the seriousness of the Board of Directors and Board of Commissioners to establish an equal, reasonable and proportional system of treatment to internal and external corporate stakeholders continuously in order to realize the sustainability of companies that uphold human dignity, and economically profitable. The aspects of justice include:

1) The sincerity of the Board of Directors and the Board of Commissioners establishes an equitable, fair and proportional treatment system for internal corporate stakeholders to sustain the company that upholds human dignity, conserves the natural environment and benefits economically.

2) The sincerity of the Board of Directors and Board of Commissioners establishes an equitable, fair and proportional treatment system for the company's external stakeholders continuously in order to realize the sustainability of companies

that uphold human dignity, conserve the natural environment and benefit economically.

g. Leadership

In accordance with the GCG theme in sustainability, the leadership aspect can be defined as the seriousness of the Board of Directors and Board of Commissioners to build corporate leadership system continuously to realize the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically. The indicators of leadership aspects include:

1) The sincerity of the Board of Directors and Board of Commissioners to build corporate leadership system continuously to realize the sustainability of companies that uphold human dignity, preserve the natural environment and benefit economically.
2) The sincerity of the Board of Directors and the Board of Commissioners develops a quality of interaction among leaders and their members that fosters the orientation of change, forward-looking, and principled persistence in order to realize the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically.

h. Capability

In accordance with the GCG theme in sustainability, the aspect of capability can be defined as the seriousness of the Board of

Directors and Board of Commissioners to build a system of organizational and management capabilities continuously to realize the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically. Capability aspect indicators include:

1) The sincerity of the Board of Directors and Board of Commissioners builds an organization's capability system continuously to realize the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically.
2) The sincerity of the Board of Directors and Board of Commissioners builds a system of management capabilities continuously to realize the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically.

i. Strategy

In accordance with the GCG theme in sustainability, the strategy aspect can be defined as the seriousness of the Board of Directors and Board of Commissioners to formulate the direction and ideals of the company and ensure its continuous achievement in order to realize the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically. Strategic aspect indicators include:

1) The sincerity of the Board of Directors and Board of Commissioners formulates the direction and ideals of the company in the form of corporate vision and mission continuously in order to realize the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically.

2) The sincerity of the Board of Directors and Board of Commissioners ensures the achievement of the company's vision and mission continuously to realize the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically.

j. Risk

In accordance with the GCG theme in a sustainability perspective, the risk aspect can be defined as the seriousness of the Board of Directors and Board of Commissioners to establish a risk management system and risk culture continuously to realize the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically. Risk aspect indicators include:

1) The sincerity of the Board of Directors and the Board of Commissioners establish a continuous risk management system to realize the sustainability of companies that uphold human

dignity, conserve the natural environment and benefit economically.

2) The sincerity of the Board of Directors and Board of Commissioners builds a culture of risk continuously to realize the sustainability of a company that upholds human dignity, conserves the natural environment and benefits economically.

k. Ethics

In accordance with the GCG theme in the perspective of sustainability, ethical aspect can be defined as the seriousness of the Board of Directors and Board of Commissioners to establish the company's ethical guideline continuously in order to realize the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically. Indicators of business ethics aspects include:

1) The sincerity of the Board of Directors and Board of Commissioners stipulates the company's business ethics guidelines continuously to realize the sustainability of companies that uphold human dignity, conserve the natural environment and benefit economically.

2) The sincerity of the Board of Directors and Board of Commissioners stipulates the guidelines of the ethical behavior of the members of the company continuously in order to realize the sustainability of a company that upholds human dignity,

conserves the natural environment and is profitable economically.

l. Culture

In accordance with the GCG theme in sustainability, the cultural aspect can be defined as the seriousness of the Board of Directors and Board of Commissioners to build a system of values that helps all people to manage the important aspects and impacts for corporate stakeholders continuously in order to realize the sustainability of companies that uphold human dignity, preserve the natural environment and economically profitable. Cultural aspect indicators include:

1) The sincerity of the Board of Directors and the Board of Commissioners builds a value system that helps all people to manage significant aspects and impacts for corporate stakeholders continuously in order to realize the sustainability of companies that uphold the dignity of humanity.
2) The sincerity of the Board of Directors and Board of Commissioners builds a value system that helps all people to manage significant aspects and impacts for corporate stakeholders continuously in order to realize the sustainability of companies that conserve the natural environment.
3) The sincerity of the Board of Directors and Board of Commissioners builds a value system that helps all people to

manage the important aspects and impacts for corporate stakeholders continuously in order to realize the sustainability of economically profitable companies.

m. Sustainability

In accordance with the GCG theme in the perspective of sustainability, the aspect of sustainability can be defined as the seriousness of the Board of Directors and Board of Commissioners to realize good corporate governance continuously by upholding human dignity, conserving the natural environment and benefiting economically. Sustainability aspect indicators include:

1) The sincerity of the Board of Directors and Board of Commissioners provides the benefits and impacts of the strategy and system of upholding human dignity in realizing good corporate governance continuously.
2) The sincerity of the Board of Directors and Board of Commissioners provides the benefits and impacts of the strategy and system to conserve the natural environment in realizing good corporate governance continuously.
3) The sincerity of the Board of Directors and Board of Commissioners provides the benefits and impacts of the economically profitable corporate strategy and management system in realizing good corporate governance.

B. Literature Review and Hypotheses Development

1. Firm Risk and Bank Performance

a. Credit Risk and Firm Performance

The previous study done by Purwoko and Sudiyatno (2013) investigated about the factor which influences bank performance. The factors included in this study are operating efficiency, credit risk, market risk, capital and liquidity. The results showed that credit risk has a negative influence on bank performance. They argued if the level of credit risk is high it will increase the cost for productive asset allowance and other assets. Thus, bank will bear some losses and as a result their performance will decrease. This condition requires management of bank to have further analysis in giving loan to the debtor or other third parties (Purwoko and Sudiyatno, 2013). Moreover, Margaretha and Zai (2013) also did the same study as Purwoko and Sudiyatno (2013). With the same variables included, they provided the same result. They also found that credit risk has a negative influence on bank performance. They said that the higher credit risk, the worse the credit quality of the bank is. Hence, the losses which are borne by bank will influence their daily operation and lead to the decrease in profit (Margaretha and Zai, 2013). Other evidences are found by Ekinci (2016) in Turkey and Arif and Anees (2012) in Pakistan. Both of them show the same result which stated that credit risk has negative influence on bank performance.

Credit risk is risk due to failure of debtor or other party in fulfilling obligation to bank. Hence, if the party cannot fulfill their obligation to pay the bank, it will influence the daily operation of bank. Moreover, the bank has to bear losses because of the incapability of the debtor to pay. Thus, the performance of the bank will also decrease. Credit risk can be measured by NPL (Non Performing Loan). The higher value of NPL, it indicates that the bank has a low quality of credit. It means that the credit risk will increase and the bank will bear more losses. To conclude, credit risk has a negative influence toward bank performance.

H_{1a} : Credit risk has a negative influence toward bank performance.

b. Market Risk and Firm Performance

The previous study done by Purwoko and Sudiyatno (2013) investigated about the factor which influences bank performance. The factors included in this study are operating efficiency, credit risk, market risk, capital and liquidity. The results showed that market risk has a positive influence on bank performance. Market risk shows the ability of management to manage their productive assets in getting net interest. Thus, the higher net interest, the less chance of bank in a bad condition is. In this condition, it will also increase the bank performance. On the other hand, Margaretha and Zai (2013) also do the same study as Purwoko and Sudiyatno (2013). With the same variables included, they provide the same result. They also found that market risk has a positive influence on bank performance. They said that the higher net interest, the more effective management in placing their assets in the form of credit is. Hence, the return on assets of bank will increase and their performance will be better. Another evidence is found by Ekinci (2016) in Turkey which stated that market risk has positive influence toward bank performance.

Market risk is the risk on the balance sheet position and the administrative account including derivative transactions, due to changes in market conditions, including the risk of changes in the option price. Market risk can be measured by NIM/Net Interest Margin (Net Interest Income divided by Productive Asset). NIM is used to measure the bank's management capability in generating interest income by looking at the bank's performance in lending, since the largest portion of the bank's operating income comes from the credit interest difference disbursed with the deposits received. The greater the NIM indicates the more effective the bank in the placement of its assets in the form of credit, so the bank's performance will increase. To conclude, market risk has a positive influence toward bank performance.

H_{1b} : Market risk has a positive influence toward bank performance.

c. Liquidity Risk and Firm Performance

The previous study done by Margaretha and Zai (2013) investigated about the factor which influences bank performance. The factors included in this study are operating efficiency, credit risk, market risk, capital and liquidity. They found that liquidity risk has positive influence toward bank performance. They argued if the ability of bank to distribute the third party fund is high then it will increase the profit of bank. However, this condition can be realized if only bank could distribute the credit fund effectively. Thus, they will not face the high number of non performing loan. Another evidence is found by Chorteas et.al (2011) which stated that liquidity risk have positive and significance influence toward performance.

Liquidity risk is the ability of the bank to meet the obligations due from sources of cash flow financing or high quality liquid assets that can be mortgaged, without disrupting the activities and financial condition of the bank. Liquidity risk can be measured by LDR (Loan to Deposit Ratio). An increase in LDR means that loan disbursements are getting bigger so that profits will increase. With the more number of loans provided, then the interest income received even more. This will affect the performance of banks that will also increase. This also indicates the level of public confidence to the bank is increased. The higher the LDR ratio indicates that the higher the liquidity of the bank so the liquidity risk becomes lower and the bank performance becomes higher. To conclude, liquidity risk has a positive influence toward bank performance.

H_{1c} : Liquidity risk has a positive influence toward bank performance.

2. Remuneration and Bank Performance

The previous study done by Lee and Isa (2015) explored the relationship regarding the directors' remuneration, governance and performance in Malaysian banks. The result showed that there is positive association between director's remuneration and bank performance. Another study done by Sigler and Porterfield (2011) in Australia showed that there is a positive and significant link between CEO compensation and bank performance. Aggarwal and Ghosh (2015) also investigated the correlation between director's remuneration and performance from two different perspectives, investor and accounting. The increase of director's remuneration has so significant relation with firm's performance from an investor's perspectives. On the other hand, there is a positive correlation between the two variables based on accounting perspectives. Logasvathi et al. (2013) tried to seek the determinants of compensation of the BOD in banks of the growth triangle countries namely Indonesia, Malaysia and Thailand. The result shows that tenure, operating expense, total assets, BOP and experience have significant relationship in determining BOD compensation in all of the three countries.

The relation between remuneration and firm performance can be explained by agency theory between the principle and agent. Agency theory postulates that because people are self-interested they will face some conflicts on issues in order to engage in cooperative endeavors (Aggarwal and Ghosh, 2015). Executive remuneration is one of the mechanisms to align the interest between the managers and shareholders. The design of remuneration packages which based on the performance is particularly attractive to control the management. Jensen (1993) cited on Aggarwal ad

Ghosh (2015) argue that the director's personal wealth should be put at stake to design an effective compensation package. Thus, the remuneration can motivate the management to act in the firms' interest so that they can maximize the firm value and the shareholders' wealth.

H_2 : Remuneration has positive influence toward bank performance.

3. Corporate Governance and Bank Performance

The previous study done by Dong et.al (2016) investigated the relationship between governance, efficiency and risk taking in Chinese banking. They found a positive impact between the governance and the efficiency on bank. Their evidence said that the board independence is associated with bank's higher profit efficiency and they found an opposite result for the dual leadership of the executive directors. However, Akbar et.al (2016) found an opposite relationship between corporate governance and firm performance in the UK. The previous study done by Ahmed and Ndayisaba (2016) investigate the relationship between CEO remuneration, risk-taking and corporate governance structures in Australian financial firms. In terms of corporate governance and the CEO remuneration, they found that the large board structure is being more sensitive to CEO remuneration. The reason is that the top executive officers are being encouraged by short-term incentives to invest in short-term and risky investment. On the other hand, they also investigate the relationship between corporate governance and risk-taking. The results show that the level of CEO risk-taking can be reduced if the board members make the

CEO remuneration in the form of long-term incentives such as stock options. The previous study did by Nahar et al. (2016) explored the relationship between the risk governance and bank performance in Bangladesh. They choose Bangladesh as their sample since they are include in developing countries which the risk governance system is characterized by having less effective rule and regulations. The component of risk governance consists of the existence on risk management unit, risk disclosure and the number of risk committees. The result shows that there is a significant relationship between risk governance and bank performance. Utama and Musa (2012) examined the causality between corporate governance practice and commercial banks performance in Indonesia. The result showed that corporate governance positively influence bank performance but not vice versa. On the other hand, Pasic et al. (2016) also developed a positive relationship between corporate governance and bank performance in Slovenia and Poland. Both of them show positive impacts but only Slovenia which showed a significant influence. Another study done by Orazalin at al. (2016) also depicted a positive relationship between corporate governance and bank performance in Russia before and after crisis period.

There are some theories exist to explain the relationship between corporate governance and firm performance. According to Al-Saidi and Al-Shammari (2013) on their research of board composition and bank performance in Kuwait, there are three theories namely agency theory, stewardship theory and resource theory. However, this research will use agency theory as the main theoretical framework. From the perspective of agency theory, the corporate governance is the adequate monitoring mechanism to reduce the agency problem that happens between shareholders and management. Since bank has a unique characteristic, the good corporate governance also can reduce the agency cost that happens among shareholders and between debt-holders and firms. Thus, by having good corporate governance, the shareholders can have an effective oversight towards the management. Besides, the monitoring effect can enhance the corporate transparency and control of the banks' operation. As a result, it will also increase the firm value.

H_3 : Corporate Governance has positive influence toward bank performance.

C. Research Model

The model of this research is as follows: