THE INFLUENCE OF BANK AND BOARD CHARACTERISTICS: THE CASE OF INDONESIAN COMMERCIAL BANKS

BY

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A dissertation submitted in partial fulfillment of the requirements for the degree of Master of Science in Accounting

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ABSTRACT

The banking industry has a significant role in an economy which serves as an intermediary to mobilize fund from the surplus units to the deficit units. Examining its performance could be beneficial to the stakeholders in assessing its profitability, liquidity and solvency. Good corporate governance is needed to ensure that the banks are accountable and provide reliable information regarding its financial performance. Indonesia as one of the developing countries is heading towards the implementation of good corporate governance. The Board of Commissioners has a foremost function in supervising the company's business activities in Indonesia. This study examined the factors influencing the financial performance of commercial banks in Indonesia. The study argued that financial performance could be influenced by the presence of good corporate governance. Furthermore, the study examined whether the size and the independence of the Board have significant roles in determining banking financial performance of commercial banks in Indonesia. This study examined the financial performance of 30 commercial banks including eight banks which provided both conventional and Islamic banking services and two fully-fledged Islamic banks. The dependent variables of this study comprised eight (8) financial ratios which are classified into three (3) categories namely profitability, liquidity and risk and solvency. The independent variables consisted of two groups i.e. bank characteristics (bank size, bank age, types of banks and Non Performing Loans (NPL)) and Board characteristics (Board size and Board independence). The study found that asset size has a statistically significant relationship with profitability only. Age was found to be a factor influencing profitability and liquidity. However, it did not show a statistically significant influence. In general, the results showed that commercial banks involved in Islamic banking and conventional banks have almost similar financial performance. These results are acceptable since both types of banks operated in the same industry and in the same country. NPL is found to have a statistically negative significant relationship with profitability and liquidity ratios. Lastly, the results indicated that size of the Board has a positive relationship with financial performance, but the study does not support the prediction that independent directors strengthen the company performance. The findings of the study will be useful to academicians, bankers, and regulators. Discussions relating to the factors influencing performance are provided. Other than that, the results suggested that corporate governance guidelines should reconsider determining and stating the number of Board members and composition of Board independence. The regulators should emphasize more on the specific roles of each Board, especially the Board of Commissioners.

ملخص البحث

القطاع المصرفي يلعب دورا اساسيا في الاقتصاد, حيث يخدم كاداة وسيطة تمكن العملاء من الاستثمار.قد يكون فحص ادائة مفيدا للمساهمين في تقدير ربحيتة اوفائدته, السيولة وايضا القدرة على تسديد الالتزامات المالية. الادارة الجيده محتاجة للتاكد من المسؤلية المناطة بالبنوك والتزويد بالمعلومات الموثوق بها عن الاداء المالي. و في اندونيسيا ، باعتبارها إحدى الدول النامية تتجه نحو تنفيذ الإدارة الجيدة للشركات، و أهم وظيفة لمجلس المفوضين هى الإشراف على الأنشطة التجارية للشركة. وتناولت الدراسة العوامل التي تؤثر على الأداء المالي للمصارف التجارية في إندونيسيا. حيث ناقشت الدراسة أن الأداء المالي قد يتأثر بوجود إدارة شركات قوية، بالإضافة إلى ذلك ، بحثت الدراسة ما إذا كان لحجم واستقلالية المجلس دورا هاما في تحديد الاداء المالي للبنوك التجارية في إندونيسيا. بحثت الدراسة الأداء المالي لثلاين (30) بنك تجاريا بما في ذلك ثمانية (8) بنوك تقدم الخدمات المصرفية الاسلامية والتقليدية على حد سواء، واثنين من المصارف الإسلامية البحتة. المتغيرات التابعة لهذه الدراسة تتألف من ثمانية (8) النسب المالية التي تصنف إلى ثلاثة (3) فئات: وهي الربحية ,السيولة, المخاطر والقدرة المالية. وتتألف المتغيرات المستقلة من مجموعتين وهما: خصائص البنك (أي حجم البنك ، و عمر البنك ، وأنواع البنوك والقروض غير العاملة) وخصائص المجلس (حجم مجلس الإدارة واستقلالية المجلس). وجدت الدراسة أن لحجم الأصول علاقة ذات دلالة إحصائية مع الربحية فقط. و تم العثور على أن عمر البنك عامل مؤثر في الربحية والسيولة. ومع ذلك ، فإنه لم يظهرله تأثير ذات دلالة إحصائية. بشكل عام ، أظهرت النتائج أن البنوك التجارية التى تقدم الخدمات المصرفية الإسلامية و التقليدية لها نسب محاسبية مماثلة. هذه النتائج مقبولة حيث كلا النوعين من المصارف تعمل في نفس الصناعة في نفس البلد. و تم العثور على أن القروض غير قابلة التحصيل لديها علاقة سلبية ذات دلالة إحصائية مع نسب الربحية والسيولة. وأخيرا ، فإن النتائج تشير إلى أن لحجم المجلس علاقة إيجابية مع الأداء المالي ، ولكن هذه الدراسة لا تأيد التنبؤ بأن المدراء المستقلين يعززون أداء الشركة.من النتائج التي توصلت إليها الدراسة والتي تعتبر مفيدة للأكاديميين ، والمصرفيين ، والهيئات التنظيمية .
المناقشات متعلقة فقط بالعوامل التي تؤثر في الاداء. وماعدا ذلك، اقترحت النتائج بأن المبادئ التوجيهية لادارة الشركات لابد بأن تعيد النظر في تحديد وتبيان عدد أعضاء مجلس الإدارة ووضعهم .و على المنظمين ايضا التاكيد على ادوارمعينة لكل مجلس,خاصة مجلس المفوضين .

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Science in Accounting.

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Abdul Rahim Abdul Rahman
Supervisor

I certify that I have read and read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Science in Accounting.

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Khaliq Ahmad
Dean, Kulliyyah of Economics and
Management Sciences

DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Rochania Ayu Yunanda

Signature……………………….. Date…………………………..

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Dedicated to

My Beloved Parents

Ibu Azkal Uyun and Ayah Mohammad Yusuf

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LIST OF ABBREVIATIONS

AGE	Age of bank
BCA	Bank Central Asia
BNI	Bank Negara Indonesia
BoD	Board of Directors
BoC	Board of Commisiones
BRI	Bank Rakyat Indonesia
BSIZE	Board Size
BSM	Bank Syariah Mandiri
BSMI	Bank Syariah Mega Indonesia
CASR	Capital Adequacy Ratio
CDR	Cash Deposit ratio
CG	Corporate Governance
DER	Debt Equity Ratio
DTAR	Debt to Total Assets Ratio
e.g.	*(exempligrantia)*: for example
et al.	*(et alia)*: and others
etc.	*etcetera*
GCG	Good Corporate Governance
GDP	Gross Domestic Products
i.e.	*(id est):* that is
INDP	Independent members of BoC
LDR	Loan to Deposit Ratio
NED	Non-Executive Directors
NPL	Non-performing Loan
OECD	Organization of Economic Cooperation and Development
PER	Profit Expense Ratio
ROA	Return on Assets
ROE	Return on Equity
SIZE	Assets Size
TYPE	Types of Banks

CHAPTER 1

INTRODUCTION

Knowing the factors which can improve financial performance is very crucial in every industry. The banking industry has a significant role in a country as an intermediary of the economic activities where they mobilize funds in the economy. Examining its financial performance could be useful for the stakeholders to assess its liquidity and solvency. On the other hand, good corporate governance will ensure that the banks are accountable and provide reliable information regarding its financial performance for decision making purposes of the stakeholders. The board of directors as an important element of corporate governance has a primary function in supervising the company's business activities. Indonesia is one of the developing countries which is interesting to be examined. The banking industry in Indonesia has been growing for the past few years. However, the development of corporate governance is relatively new in Indonesia compared to other developed countries. However, Indonesia is heading toward the implementation of good corporate governance. The present research examines the factors that influence financial performance and investigates the impact of the board of directors on the performance.

Historically, commercial banks have been playing a vital role in performing the functions of payment mechanism, intermediation, and providing other financial services (Hassan, 1999). Of the three abovementioned functions, intermediary is the foremost activity. This significant function provides a remarkable contribution in the economic development of a country. Economic development involves investments in various sectors of the economy. The banks do not only collect funds but also serve as an intermediary to the customers to invest their funds.

Commercial banks mobilise deposits from the public and make investments in certain projects. People who have surplus income and savings conveniently invest it with banks because the banks allow interest on the money placed as deposits. Then, the banks grant loans and credits to the public and to the business community at a higher rate of interest. Performing the function of a payment mechanism, commercial banks make collection and payment of cheques and bills on behalf of the customers. The banks transfer money from one place to another and from one branch to another branch and even from one country to another. They may also collect interest and rent on behalf of customers as well as make payments for purchases of goods, rent, interest, insurance premium, and so on. Commercial banks may act as agents or correspondents on behalf of customers for other banks and financial institutions. In addition, commercial banks can issue letters of credit, provide customers with facilities of foreign exchange, and offer safe deposit boxes.

The objective of this first chapter is to present an overview of the study. The chapter begins with an introduction, highlighting the background of the study. It is followed by the motivation of the study. The following section presents the objectives of the study which is later followed by the significance of the study. The last section outlines the organization of the dissertation.

1.1. BACKGROUND OF THE STUDY

Indonesia is the largest archipelagos state in the world consisting of approximately 17,500 islands, and it is the fourth most populous nation with 225.3 million inhabitants. There are about 300 ethnic groups throughout the islands (www.naric.uk.org). Indonesia is the world's largest Muslim population where more than 88% of the inhabitants are Muslim. Besides that, Indonesia is the largest economy in Southeast Asia and a member of the G-20 major economies. The Gross Domestic Product (GDP) for 2008 was Rp.4,951,356.7 billion which means it increased around 25.3% of GDP in 2007. http://en.wikipedia.org/wiki/Indonesia - cite_note-85 The GDP was produced by a few industrial sectors consisting of agriculture, mining, manufacturing, electricity, construction, trade, transportation and communication, banking, finance and real estate services, and also other services (Central Bureau of Statistics, 2009).

In recent years, the banking industry has become more competitive among several industries and has been growing. This is proven by the banking assets which have increased during the last five years. From 2004 to 2009, conventional banking assets increased 99%, while Islamic banking assets increased incredibly up to 283.3%. The increments are in line with the number of bank offices which have grown to 62%. However, the number of banks decreased. It was 133 in 2004 and 121 in 2009 due to bankruptcy, liquidation, and mergers. Year after year, GDP in the banking sector has been increasing. It was Rp. 88,287.4 billion in 2005 and Rp. 125,515.4 billion in 2008 (Central Bureau of Statistics, 2009). It increased 42.17% within four years. The Jakarta Stock Exchange records that there are at least six banks listed in LQ 45, the list of the best stocks.

Bank Indonesia as the central bank has a very important function in promoting financial stability through the supervision of banking practices. The recent major initiatives to promote financial stability include the issuance of Indonesian Banking Architecture (IBA) as a comprehensive and basic framework for the Indonesian banking system. Besides that, Basel II implementation has commenced since 2008. All commercial banks are required to meet capital requirements. It is expected that by 2010 the Basel II framework will be fully applied. A Financial Safety Nets (FSN) has also been promoted to encourage a healthy and efficient banking system as well as effective regulation and supervision. In addition, a Credit Bureau, a body organising and maintaining the credit data of banks' customers, has been developed to facilitate banks to improve their credit quality. All the initiatives show Bank Indonesia's responsibility to evaluate and ensure bank performance.

Evaluations of bank performance are important for many stakeholders i.e., depositors, bank managers and regulators. In a competitive financial market, bank performance provides a sign to depositors and investors whether to invest or withdraw funds from the bank. Similarly, it gives direction to bank managers whether to improve its deposit services or loan services to enhance its finance ability. Regulators are also interested to know for its regulation purposes. Bank performance can give them hints whether or not to issue regulations related to banking policy. Therefore, knowing the factors leading to bank performance is required.

Being consistent with the agency theory, better firm performance is achieved due to the fact that good governance practices provide better monitoring and better protection to shareholders (Che Haat et al., 2008). It means that corporate performance is also determined by the quality of corporate governance. Independence and the number of the board members as part of corporate governance may affect its soundness. Hence, the board of directors plays significant a role in influencing corporate performance.

Indonesia has different terms for board of directors. It adopts a two-tier board system, namely the Board of Commissioners (BoCs) and the Board of Directors (BoDs). In addition, the chairman of BoCs cannot serve as the CEO/President Director of the bank. The Board of Commissioners (BOCs) substitutes the traditional role of a Board of Directors (BODs). The Board of Commissioners is responsible collectively for overseeing and providing advices to the Board of Directors and ensuring that companies implement the GCG. The Board of Commissioners is responsible for overseeing management, risk management, internal control, communication, and social responsibility while the Board of Directors function as the executive management running the business (Indonesian Code of CG, 2006). For that reason, after the term “Board of Commissioners” used in the study refers to the board of directors as discussed and understood in prior studies.

1.2. MOTIVATION OF THE STUDY

The Asian financial crisis in 1997 raised an interest in conducting profound research on the importance of banking performance and efficiency. Many economists believe that banking failure caused the financial crisis in Asia in 1997; started with the short term liquidity problem created by the international financial markets (Yaumidin, 2007). This financial crisis caused bank runs to occur at that time. Bank runs happen when the customers immediately withdraw their funds because of fears that the bank cannot punctually pay the funds in full amount. Bank run which occurred in late 1997 was not much different from other countries and even banking crisis in Indonesia left a more severe impact on the economy. The banking crisis in Indonesia was suspected to be the result of government policy to suspend the operation of 16 banks in November 1997 (Simorangkir, 2006; Ariyanto, 2004; Tabalujan, 2001). This policy reduced public trust in national banking. It led to the withdrawal of substantial funds and transfer of funds from banks which were considered weak to banks that were considered strong. As a result, some banks previously classified as healthy banks were affected by the decreasing level of public trust. This condition was aggravated by the depreciation of the rupiah value which dramatically dropped. The lowest point was reached on 17 June 1998, one year after the onset of the financial crisis, Rupiah reached the lowest point at Rp16,900 per US dollar (Tabalujan, 2001; Kameyama et al., 2005) and the economy shrunk by 13.7%. These problems did not only weaken the bank liquidity conditions, but also deteriorated the profitability and solvency of banking industry.

The financial crisis passed and the economy gradually grew. However, it was quite affected by the global crisis in 2007. Globally, this crisis was predicted to cause the world economic growth to decline at an average of 5% for developing countries (Parewangi, 2009). It was no exception for Indonesia in general. This gives a negative effect on the Indonesian currency, as reflected by the Rupiah which reached 9,500.00 per US dollar. It also threatened national exports and foreign investment, and the uncertainty of commodity prices affected the inflation rate. However, the national banking performance was relatively unaffected. It was because national banking did not own a high level of problematic securities (Bank Indonesia, 2008). The impact of global crisis shown in the increased prices gave different impacts to the regional economy. In general, the entire region experienced sharply declining GDPs (Parewangi, 2009). Therefore, this study aims at examining the factors influencing the current performance of Indonesian commercial banks after the global crisis.

Indonesia is one of countries that allows a dual banking system in which Islamic banking services are offered together with conventional banking products. As one of developing countries, Indonesia which pays attention to promoting Islamic banks is worthy of analysis. As the most populous Muslim country in the world and with the development of Islamic banking system in the country, it is expected that the demand for Islamic banking services are likely to increase. At least six banks are consistently listed in the category of LQ 45, stocks with the highest price. Indonesian

Banking Statistics per December 2009 proves the remarkable growth of Islamic banking assets. However, the total assets of Islamic banks only reach 1.89% of conventional banking assets. Islamic banking assets are very low as compared to conventional banks. According to Indonesian Banking Statistics as per July 2009, the growth of assets of Islamic banks has increased 283.3% during the past five years, while conventional banking assets increased 99%. Islamic banking assets were 12,527 (in billion Rupiah) in 2004, and 48,014 (in billion Rupiah) in 2009. Nevertheless, the amount is too small as compared to the conventional assets which reached 2,534,106 (in Billion Rupiah) in 2009 and 1,272,081 (in billion rupiah) in 2004. It is motivating to study the performance of commercial banks involved in Islamic banking and those which are not. Hence, evaluating the performance of different types of banks could give a view of Indonesian banking performance.

The banking sector is operated mainly based on the third party funds. Banking is not like other sectors which mainly involve management and shareholders. It involves more parties, such as customers, other banks and also government through the central bank. If the bank faces critical problems, many parties will suffer. Hence, good corporate governance is required to guide banking operations. Corporate governance plays a significant role to determine company performance. In 1999, the Organization of Economic Cooperation and Development (OECD) issued its influential OECD Principles of Corporate Governance, intended to assist member and non-member countries in their efforts to evaluate and improve the legal, institutional and regulatory framework for better corporate governance (Khanchel, 2007). OECD defines corporate governance as relationships between a company's management, its board, its shareholders and other stakeholders (Schachler, 2007). It is a set of rules regulating the roles and responsibilities of stakeholders, management, and board of directors of a company and determining how that company is operating.

The presence of strong governance standards ensure that the business environment is fair and transparent and that companies can be held accountable for their actions. Conversely, weak corporate governance leads to mismanagement and corruption. Kurniawan and Indriantoro (2000) reported that a survey by Pricewaterhouse Coopers in 1999 showed that among a dozen countries in the Asia-Australia region, Indonesia ranked very low in the perceived standard of disclosure and transparency. In addition, Indonesia also ranks very low in accountability to shareholders, board processes and auditing and compliance.

Bappindo, the state owned development bank had been having problems for many years and in the late 1980s was discovered to have a large number of non-performing loans, but the bank was allowed to continue its operations (Pangestu, 2003). Bank Duta went public with fraudulent financial statements when it was suffering large foreign exchange losses due to currency speculation. The other Indonesian banking cases such as Bank Bali, Bank Global and current case of Bank Century in 2008 have proven the needs for better governance. In order to be effectively and ethically governed, businesses need not only possess good internal governance, but also a sound institutional environment. Therefore, elements supporting the better practices of corporate governance are required to be observed. Later on, corporate governance standards and regulations must be translated into practice.

As the banking sector in Indonesia is growing, it needs particular guidelines to ensure that the growth will not be stagnant. Corporate governance as a set of guidelines is expected to lead the banks to a better performance. The board of directors plays significant roles in influencing company performance. However, prior studies focusing on relationship between board of directors and performance provide conflicting results as well. For example, a large board can be dysfunctional (Khanchel, 2007), whereas Belkhir (2009) provides evidence that board size has a positive relationship with performance. On the other hand, the Indonesian Code of Corporate Governance does not mention specifically the number regarding to board of commissioner members. Therefore, this research investigates the influence of both bank and board characteristics on financial performance.

1.3. OBJECTIVES OF THE STUDY

The objectives of the study are:

a. To examine the current performance of commercial banks in Indonesia

   Examining the current performance of commercial banks can provide the latest picture of the banking sector in Indonesia. It will show their financial performance in terms of profitability, liquidity, risk and solvency. The study analyses a number of commercial banks. The accounting year 2008 was chosen because it is the latest year which the banks provide their published annual reports. In addition, it can provide the performance of the banking sector immediately after global crisis hit the worldwide economy in 2007. Financial ratios are used to measure the performance in the three levels i.e., profitability, liquidity, and risk and solvency.

b. To investigate the factors influencing the performance of commercial banks

   The performance of the banking sector may be influenced by some factors. Knowing the factors may lead the banks to improve their performance drivers. Therefore, the study aims at finding out the factors determining performance.

Previous studies (Sufian and Parmann, 2009; Siddiqui, 2008; Ascarya and Yumanita, 2008; Park et al., 2006; Papadopoulos, 2004; Isik and Hassan, 2003; Samad and Hassan, 1999) used bank characteristics to explain how they affected performance. Following past literature, the study tests whether asset size, age, types of banks and also the level of non-performing loans can be determinants of banking performance.

c. To examine the role of the Board size and the Board independence in influencing banking financial performance

   The Board of Commissioners has a significant role in directing and supervising company activities. The Board should be objective so they can ensure transparency. Accordingly, this study also aims at examining whether or not the role of the Board of Commissioners influence the performance of commercial banks. The Indonesian Corporate Governance 2006 does not clearly mention the effective number of both the number of Board members as well as the percentage of independent directors. Hence, the study attempts to verify whether the size and independence of the Board have a significant role in determining banking performance.

1.4. SIGNIFICANCE OF THE STUDY

This study examines the banking industry and expects to contribute to banking practices, on both literature and also banking practice and policy. First, it is to provide a view of current performance of commercial banks in Indonesia. Examining commercial banks' performance in 2008 can give a picture of the current banking performance. This study will provide an overview of the general performance of Indonesian commercial banks. It will show their financial performance in terms of three categories, which are profitability, liquidity, risk and solvency. These three categories are common measures of banking performance.

Second, it will suggest some factors which may influence banking performance. The study examines the factors influencing banking performance. It examines whether asset size, type of banks, and age affect performance. Banks can improve their practice and help them to set better policies if they know the factors that can lead to better performance.

Third, it provides findings that can be used to improve Indonesian banking regulation. This is important because the study assumes that certain regulations may be required if the risk, liquidity, or other ratios are different between two types of banks. In addition, the study also examines the roles of the Board of commissioners. The Board has a significant role in controlling and supervising the bank's activities. It should be objective to ensure transparency. Knowing whether or not Board size and Board independence matter in the banking industry may allow the regulators to mention the size of the Board and the percentage of independent members.

1.5. THE ORGANISATION OF THE DISSERTATION

The structure of the thesis will be as follows:

Chapter 1: **Introduction**. The introduction highlights the background of the study, objectives of the study, motivation of the study, and significance of the study.

Chapter 2: **Financial Performance and Corporate Governance of Commercial Banks: A Review of Literature.** This chapter discusses financial performance measurements. The next section provides the discussion on bank characteristics and how they influence financial performance.