Humanities & Social Sciences Reviews
eISSN: 2395-6518, Vol 8, No 2, 2020, pp 328-336
https://doi.org/10.18510/hssr.2020.8237

THE ROLE OF MONITORING AND BONDING MECHANISMS OF GOOD CORPORATE GOVERNANCE TOWARDS BANKS PERFORMANCE

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Article History: Received on 21st January 2020, Revised on 04th March 2020, Published on 28th March 2020

Abstract

Purpose of the study: This paper aims to examine the effects of the monitoring mechanism and bonding mechanism of corporate governance on the performance of the bank. The monitoring mechanism is divided into an external mechanism, represented by concentrated ownership, and the internal mechanism is represented by the proportion of independent board. Bonding mechanism is measured issuance of bonds as long-term debt financing.

Methodology: This study is predictive and exploratory, so the Partial Least Squares Structural Equation Modeling using a WarpPLS60 application. Researchers use data from 24 banks that constantly has the value of bonds circulated, which from 2011 to 2018. There are consists of 4 state-owned commercial banks, 13 private banks, and 7 regional government-owned banks.

Main Findings: The researcher found that external monitoring mechanisms as measured by ownership concentration, positively and significantly influence the performance at government-owned banks. Internal monitoring mechanism, as measured by the percentage of the number of independent commissioners, positively and significantly affects the performance at all the banks. The bonding mechanism as measured by issuing bonds negatively and significantly affects the performance of all the banks.

Applications of this study: The integrative multi-theory model proposed by the authors in this study is a unique contribution to the intermediary financial literature. Banks seeking to maximize their performance must be balanced with the interests of shareholders and their stakeholders.

Novelty/Originality of this study: The study examined the differences in behaviour and the role of monitoring and bonding mechanisms of corporate governance in state-owned banks and private. The results of this study contribute to the theory of entrenchment and financial intermediation.

Keywords: *Bank Performance, Bond Funding, Bonding Mechanism, Good Corporate Governance, Monitoring Mechanism, Path Analysis.*

INTRODUCTION

Bank ownership in developing countries of Asia including Indonesia and Continental Europe is dominated by concentrated ownership structure. We follow related literature in using the concentration of ownership (e.g. percentage of shareholding of the largest shareholder) (Haque & Shahid, 2016) the majority share ownership is more than 5 percent of the total outstanding shares (Grassaa & Miniaoui, 2018). Anglo-Saxon countries such as Great Britain and the United States of America tend to have dispersed ownership structure (Claessens et al., 2000). This study explored the impact of different categories of ownership concentration. Ownership concentration has no impact on firm performance when measured by ROA (Desoky & Mousa, 2013). In the short term, ownership change is associated with lower ROA (Lindemanis et al., 2019).

In Indonesia, the commissioners adhere to the Two Tiers' continental European legal system. The independent board of commissioners is one of the mechanisms of internal supervision as a supervisor who controls managers so that they do not act opportunistic (Fama & French, 1998). By increasing the proportion of independent boards of commissioners, they could be monitoring of management opportunistic behavior such as manipulating financial statements and fraud (Hermawan, 2011).

The bank acts as an intermediary in meeting long-term funding by issuing primary security (in the form of shares, bonds, securities, etc.). Issuance of bond aims to strengthen the bank financing structure and credit expansion of the firm in the context of business development. Related to the firm's financing needs, the corporate bonds market is made as alternative bank financing for long-term financing (Mukherjee, 2012). The phenomenon of bond issuances in the banking sector in Indonesia is influenced by the improving market perception of risk in the industry as well as the increasing need for capital for financial institutions. Funding growth from bond issuance and Third Party Funds in Indonesia has experienced a decline. The phenomenon of bond funding growth is higher than that of Third Party Funds, which 35.53% in 2011 and experienced fluctuations up and down to reach 16.16% in 2018. The decline in funding growth from Third Party Funds has declined from 19.08% in 2011 to reach 6.89% in 2018. Higher bond costs and lower credit ratings are generally associated with increased income (Ghouma, 2017).

The purpose of this research is to enrich the understanding of the monitoring mechanism and the limitation of the opportunistic behavior of managers to mitigate agency problems. The study will test the effect of an external monitoring mechanism measured with the percentage of concentrated ownership. The researcher found that external monitoring mechanisms as measured by ownership concentration, positively and significantly influence the performance at government-owned banks. Internal monitoring mechanism, as measured by the percentage of the number of independent commissioners, positively and significantly affects the performance at all the banks. The bonding mechanism as measured by issuing bonds negatively and significantly affects the performance of all the banks.

LITERATURE REVIEW

Monitoring mechanism

Corporate governance mechanism is depicted as a firm simple balance sheet model (Ross et al., 2005). The left side is depicted as an internal governance element. Management as agents of shareholders decides which assets will be invested and how to fund the investment. The right side is depicted as external governance elements as a result of the firm's need to gain capital. Empirical research proved that internal and external monitoring mechanism of a firm has a direct relationship with the financial power of a firm (Aguilar, 2016; Outa & Waweru, 2016). Monitoring refers to the effort of the firm's owner to mitigate the manager's opportunistic behavior (Mohamad Nur Utomo et al., 2018). Gillan (2006) divided the mechanism of corporate governance into two, which is the internal and external monitoring mechanism. The internal mechanism comes from the board of commissionaires, internal control, and internal audit function. The external mechanism comes from the stock market, firm's control market, labor market, state status, court decision, and investor activity.

Concentrated ownership as external monitoring

Ownership concentration (OC) is most shares are owned by a small number of individuals or groups so that these shareholders have a relatively dominant number of shares compared to others (Dallas, 2004). The application of the supervisory mechanism is carried out by increasing the number of shareholdings. External governance mechanisms are proxied as ownership concentration (OC), influencing company performance (Gaur et al., 2015; Ozili & Uadiale, 2017). Different levels of ownership concentration in a company affect the implementation of governance (Yasser & Al Mamun, 2015). The structure of share ownership reflects the distribution of power and influence of shareholders on the company's operational activities. The greater the amount of share ownership, the greater its role in controlling and determining the policy direction to achieve company goals (Pergola & Verreault, 2009). Large shareholders can monitor and control managerial activities (Desoky & Mousa, 2013). The concentration of ownership increases control in companies, this is related to increased monitoring of management and reducing the increase in scattered ownership (Shleifer & Vishny, 1986). The concentration of ownership increases control in companies, this is related to increase monitoring of management and reducing the increase in dispersion of the cost of waiver by the manager. Other mechanisms can result in different ownership effects on concentration on performance. With great power, dominant shareholders can take over the welfare of small shareholders (Stulz, 1988). Entrenchment Theory states that a higher concentration of ownership will increase the power of control of company owners, thereby minimizing the power of abuse of managerial control for personal gain and taking over minority stakeholders (La Porta et al., 1999; Leech & Leahy, 1991; Shleifer & Vishny, 1989). Agency problems can potentially harm other parties who do not have control rights (minority shareholders) and can cause performance decreases (Sakawa & Watanabel, 2017).

Hypothesis 1a: Concentrated ownership has a negative effect on bank performance

Board of Independent Commissionaire as internal monitoring

A modern business organization can maximize firm performance by creating a separated management structure. There are two management structure, Board of Directors, that manage the firm through strategic managerial decision; and Board of Commissionaire, which consists of Ordinary Commissionaire and Independent Commissionaire that monitor the direction and path of the firm according to the principles of corporate governance (Sukmono, 2015; M.N. Utomo et al., 2018). Independent commissioners are non-affiliated entities, which are precisely entities without business affiliation and kinship relations with shareholders, with members of the Board of Directors and the Board of Commissioners, and with other company stakeholders (KNKG 2006). Board of Independent Commissionaire (BIC) is one of the elements of an internal monitoring mechanism (Dharmastuti & Wahyudi, 2013; Hermawan, 2011). The investigation results in the relationship between agency theory with the monitoring committee, ownership structure with financial performance are positive, either individually or as interaction (Coles et al., 2001). The forming of a board of independent commissionaires is one of the implementations of corporate governance principles which are independence. Some empirical research about the influence of the board of independent commissionaire of the firm and firm performance (Leung et al., 2014; Lin, 2011; Rashid, 2018; Uribe-Bohorquez et al., 2018).

Hypothesis 1b: Board of Independent Commissionaire positively influence the bank performance

Bonding mechanism by issuing bonds

External financing policy is needed by the firm to fund business opportunities as well as their investments, based on pecking order theory Myers (1984) as a result of a trade-off between two choices of using traditional funding, debt or equity. According to most of the results of financial literature, debt financing has more advantages compared to equity. The firm will receive many benefits from a tax deduction when it chooses to issue debt because the firm tax is calculated after the interest being paid to debt holders (Ross et al., 2008). Debt will have a role in monitoring the firm because firm with high leverage tends to give a positive signal to the market, thus it potentially decrease asymmetrical information between companies and investors which leads to the lower future finance cost (Leland & Pyle, 1977). Corporate Governance is influenced by the amount of long-term debt because debt holders have the motivation to ensure that managers do not follow their selfish behavior (Jensen, 1986).

Bond is one of the bullet loans, the loan payment using a balloon payment mechanism. A balloon payment is a loan with a long-term amortization schedule to pay interest (the coupon) per year, while the principal debt can be paid later at the time of maturity of the loan or according to the agreement. This payment arrangement is one of the advantages for banks that expect large cash flows for their operational needs as an intermediary. Thus the bank can set up funds before the maturity date. This is what distinguishes bond funding from ordinary debt funding, where the payment of installment financing with ordinary debt, including principal and interest, has been agreed upon. Amihud et al. (1999) Were introduced a new governance structure to meet funding through publicly issued company bonds. Companies will have more flexibility in building the desired structure using bond financing (Kwan & Carleton, 2010). Issuance of bonds gives companies the freedom to take corporate action without binding the rules that limit the lenders (Lin et al., 2013). There is a tendency to change the system of dependence on funding from bank-based to market-based (Astrauskaite & Paškevicius, 2014). Issuing bonds have a maturity that remains different from equity financing that has unlimited maturity (Norden et al., 2016).

Hypothesis 2: Bond issuance has a positive effect on bank performance

METHODOLOGY

Data sample

The source of data is a secondary data panel, which is a combination of time series and cross-section. The period of research starts from 2011 to 2018. Sampling criteria are explained as follows: (1) Banks that carry out corporate actions to issue bonds, and have a record of outstanding bonds; (2) Banks that have a majority shareholding of more than 5 percent, and consisting of financial statements and annual report. The data collection technique is the documentation of the Indonesian Central Securities Depository recorded since the beginning of 2000 to June 2018. 40 banks have issued bonds in Indonesia from a population of 134 banks listed in the Financial Services Authority and only 24 banks that constantly has the value of bonds circulated, which from 2011 to 2018. Consists of 4 state-owned commercial banks, 13 private banks, and 7 regional government-owned banks. Therefore, the total of the observed panel data is 192.

Variable Measurement

Independent Variable

Concentrated ownership (OC) is the majority shareholder with characteristics as the controlling shareholder of the company (in this case the bank) who owns at least 5% of the total shares outstanding (Brockman & Olsen, 2013; Core et al., 1999; Cremers et al., 2007; Desoky & Mousa, 2013; Farooq, 2015). In Indonesia, it is regulated in the Financial Services Authority Regulation Number 56/POJK.03/2016 concerning bank ownership. All ownership samples concentrated in this study are a small number of individuals or groups that have a minimum or equal share of 5% in the Banking Sector in Indonesia.

According to the Financial Services Authority Circular Letter Number 13/ SEOJK.03/2017 Independent Commissioners are members of the Board of Commissioners. Then the independent board of commissioners (BIC) is a percentage of the total number of the board of commissioners (Cavaco et al., 2017; Leung et al., 2014; Lin, 2011).

One of the goals of the issuance of debt securities (bonds) is to finance debts that are due (refinancing) (Hansen & Crutchley, 1990; Harford et al., 2015). Issuance of corporate bonds proxied as funding bonds with long term debt (BLTD), where LTD is a long-term debt (more than 1 year) (Benzion et al., 2017). Used the LTD because long-term debt is considered a more stable source of funding, and is less likely to cause defaults in the short term (Jankowitsch et al., 2014). This finding confirms the hypothesis that increases in bonds to Long-term debt is least partly due to the issuance of new bonds, in addition to the long-term outstanding debt. The preference decision for refinancing fixed coupon debt will be considered at interest expense. Variations of this trade-off revealed that companies require savings interest rates for refinancing. A dynamic model of debt refinancing that reveals agency costs. The existence of high yield restrictions increases the value of the company.

Dependent variable

The bank's performance related to the process of fundraising and distribution of funds is assessed based on indicators of profitability. Firm performance is the result of the implementation of all the firm policies, which is measured in a certain period (Djalilov & Piesse, 2016). Bank profitability is measured by using a return on assets (ROA), because as considered it can show bank efficiency in using the assets as the source of investment that can result on profit (Rahman et al., 2017; Sufian & Noor Mohamad Noor, 2012; Terraza, 2015; Yasser & Mamun, 2017). ROA has been used in most studies of bank performance. ROA is an accounting-based indicator of return on assets, calculated as the ratio of net income (before tax) to total assets.

Model Analysis

The analysis technique used in this research is Structural Equation Modelling (SEM) based on variance or Partial Least Squares (PLS), and thus, this technique is also called PLS-SEM (Hair et al., 2013). *PLS-SEM* can work efficiently with small sample sizes and complex models. The selection is given to bootstrapping because this resampling method is stable when the original sampling is more than 100. In this paper, the PLS-SEM model is using WarpPLS60. The hypothesis, each H1 (a, b) and H2, tested by using the following model:

$$ROA = \beta\, Y_1X_1\, OC + \beta\, Y_1X_2\, BIC + \beta\, Y_1X_3\, BLTD + e_2$$

Besides testing the overall sample, this study distinguishes between state-owned banks and private banks to find out if there are differences in behavior.

RESULTS / FINDINGS

Descriptive Analysis

Table 1 presents descriptive data of the research variable and these data include minimum rate, maximum rate, mean rate, and standard deviation. Descriptive statistical test results show that all variables have an average value higher than the standard deviation. It means the overall data has a small variation. The average percentage of the board of independent commissionaire is 56.1%, which is following the regulation of OJK that requires a minimum of 50% of the total of commissionaire members.

Table 1: Descriptive Statistics of Variable Observed

Variable	N	Mean	Max	Min	SD
OC	192	0.717	0.990	0.568	0.145
BIC	192	0.561	0.750	0.333	0.100
BLTD	192	0.514	1.218	0.034	0.292
ROA	192	0.021	0.052	-0.049	0.013

Source: Output WarpPLS6.0

After treating all data, this research will test the bank's performance based on the level of ownership. In this study, a bank performance test will be based on the level of ownership. A bank performance test will be based on the level of ownership. In this bank, both the deed of establishment and capital are owned by the government so that all activities are controlled by the government and all profits are owned by the government. The sample consisted of 4 state-owned commercial banks, 7 regional government-owned banks, and 13 private banks.

Evaluation of Structural Model Using ROA-Based Firm Performance

Table 2 Present the results of evaluating structural models using ROA-based company performance. The adjusted R-squared ROA for all bank samples is the largest, 0.129. Followed by adjusted R-squared results for ROA at government banks 0.112 and adjusted R-squared for ROA at private banks 0.102. The coefficient of determination in linear regression is often defined as how much ability all independent variables in explaining the variance of the dependent variable. Ownership Concentration means the ability variable (OC), Independence Board of Commissioners (BIC), and Bond to Long Term Debt (BLTD) in explaining the variance of Bank Performance (ROA) amounted to 13% in the overall sample bank. This means there is an 87% variance Bank Performance variables (ROA) were explained by other factors. Adjusted R-squared for ROA of the three sample groups is in the weak category because the variance explained by the independent variable is less than 0.250. The Q-squared value for ROA is the three sample groups more than null so it can be said that the model has predictive validity. All variable relationships have effect sizes above 0.02, which fall into the small category.

Test results on the Goodness of Fit (GoF) output indicate that the ROA-based model has very good suitability. Shown by the P-Value for the Average Path coefficient (APC), Mean Square (ARS) and Adjustable-Square (AARS) at a significance level <0.05. Both of the value of Average Block VIF (AVIF) and Average Full Co linearity VIF (AFVIF) is < 3.3, it can be indicated that no multi co-linearity problems were found among exogenous variables. Three groups of samples have a matching value > 0.36 which means that the suitability of the model is included in the large category. Observed indices, such as Symson's Paradox (SPR), R-Squared Contribution Ratio (RSCR), and Non-Linear Bivariate Causality Direction Ratio (NLBCDR), all of these values are above 0.70, which can be considered as no causality problem in the model. Also, the Suppression Statistics Index (SSR) has a value > 0.70, which can be said that this ROA based model is acceptable.

The test results of the direct effect of Concentrated Ownership (OC) on Bank Performance (ROA) in the sample of all banks and the sample of private banks are significant negative. These results are consistent with the hypothesis 1a. The results of OC's direct influence on ROA on a sample of government banks are significantly positive. This result is the opposite of the previous sample, meaning not support hypothesis 1a. The result of the direct effect of the Independence Board of Commissioners (BIC) of the Bank Performance (ROA) in the third sample group was significantly positive. Test results in this study are in line with hypothesis 1b.

The test results of the direct effect of Bond to Long Term Debt (BLTD) on the bank performance (ROA) in the three sample groups are significantly negative. The test results do not support hypothesis 2, which states that the issuance of bonds to meet long-term debt obligations positive effect on the bank's performance.

Table 2: Result of Structural Model Evaluation Using ROA-Based Bank Performance

Description Path	Path Coefficient	Adj. R^2	Q^2	Effect Size	Standard Error
All data samples					
OC→ROA	-0.157**	0.129	0.164	0.075	0.038
BIC→ ROA	0.151**			0.075	0.022
BLTD→ROA	-0.277***			0.075	0.094
APC/ARS/AARS : 0.195 *** / 0.154 ** / 0.129** AVIF/AFVIF/ Goodness of Fit (GoF) : 1.109/ 1.159/ 0.393 SPR/RSCR/SSR/NLBCDR : 1.000 /1.000 / 1.000 / 0.833					
State-owned bank					
OC→ROA	0.177**	0.112	0.207	0.080	0.032
BIC→ ROA	0.210***			0.080	0.055
BLTD→ROA	-0.199***			0.080	0.055
APC/ARS/AARS : 0.195 *** / 0.142 ** / 0.112** AVIF/AFVIF/ Goodness of Fit (GoF) : 1.081/ 1.053/ 0.377 SPR/RSCR/SSR/NLBCDR : 1.000 /1.000 / 1.000 / 0.833					
Private bank					
OC→ROA	-0.234***	0.102	0.174	0.075	0.066
BIC→ ROA	0.223***			0.075	0.060
BLTD→ROA	-0.066*			0.075	0.005
APC/ARS/AARS : 0.174 *** / 0.131 ** / 0.105** AVIF/AFVIF/ Goodness of Fit (GoF) : 1.032/ 1.091/0.362 SPR/RSCR/SSR/NLBCDR : 1.000 /1.000 /1.000 /0.667					

***, **, * denotes significance levels at 0.001, 0.05 and 0.1, respectively.

All estimates influence between variables with a robust standard error.

Source: Output WarpPLS6.0

DISCUSSION / ANALYSIS

The hypothesis statement relevant to this ROA-based model is whether Concentrated Ownership, Independent Board of Commissioners and Funding with bond issuance have a direct effect on ROA. The analysis shows that Concentrated Ownership has a significant negative effect on ROA, and this result supports Hypothesis 1a. These findings are in line with the Entrenchment Theory by La Porta et al. (1999); and Shleifer and Vishny (1989). When the concentrated shareholders in a lot of power to use company resources to advance their interests more than the company. In the concentrated ownership structure, the agency conflict is a conflict between shareholders who have control of the company and the minority shareholders through a pyramid structure. These shareholders ideally function as management monitors, but in reality, top management is usually part of the family, which at the same time they have the power to take over minority shareholders.

Contradictory results were found to occur in a sample of state banks which showed that Concentrated Ownership had 0.177 a significant positive effect on ROA, so it did not support the hypothesis. These results support the research of (Chauhan et al., 2016; Gaur et al., 2015; Ozili & Uadiale, 2017; Shaban & James, 2017). A non-linear test was performed on the results of the rejected hypothesis. Inverted U curve is found, which means the percentage of the concentration of ownership level affects the increase in bank performance to the condition where the concentration of ownership (OC) reaches 83.5%. When the concentration of ownership (OC) exceeds 83.5%, the bank's performance (ROA) experiences a reversal to negative. The results of this study are supported by the study of Altaf and Shah (2018) who found that when the main owner has effective control over the company, the effect on firm performance is inverted U-shaped (figure 1).

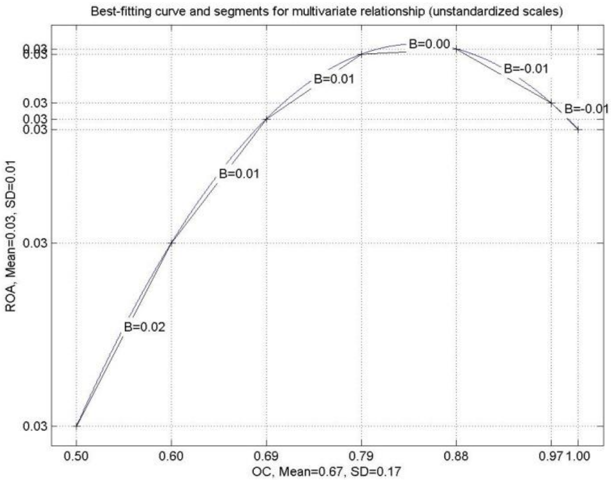

Figure 1: Effect of Ownership Concentration toward Return on Assets.

Source: Output WarpPLS6.0

The analysis shows that the independent board of commissioners has a significant positive effect on ROA, and this result supports Hypothesis 1b. The independent board of commissioners shows the importance of an internal set of independent board members of corporate governance in the financial decision. The higher proportion of independent board members in banks can reduce conflicts of interest and reduce inefficiencies stemming from CEO duality. The positive impact of the independent board of commissioners on greater efficiency and positively related to the efficiency of operating costs on bank revenue, that's means increasing bank profitability. Operating income positively influences net profit, thereby increasing profitability. The role of external supervision is found to be strong evidence of increasing profitability (Uribe-Bohorquez et al., 2018).

The test results of Bond funding to Long Term Debt (BLTD) on the bank performance (ROA) in the three sample groups are significantly negative. The test results do not support hypothesis 2, which states that the issuance of bonds to meet long-term debt obligations positive effect on the bank's performance. Figure 2 presents the U-shape curve is found, which means the effect of Bond to Long Term Debt level affects the decrease in bank performance to the condition where the Bond to Long Term Debt (BLTD) reaches 72%. When the Bond to Long Term Debt (BLTD) exceeds 72%, the bank's performance (ROA) experiences a reversal to positive. Average data Bond funding to Long Term Debt toward Return on Asset on the entire sample is 56% smaller than 72%, so there is the position of the curve is on the decline.

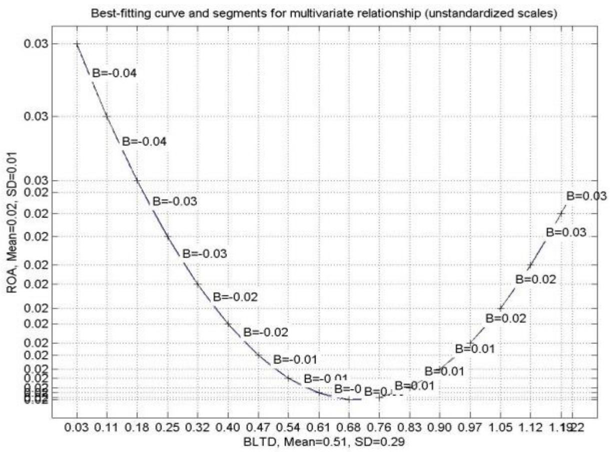

Figure 2: Effect of Bond to Long Term Debt toward Return on Assets

Source: Output WarpPLS6.0

The behaviour of bank financing in Indonesia tends to use other sources of funding from third party funds (DPK) in advance. The amount of debt issued by companies should follow the optimal scale, which can improve the performance of the company. Alternative bank financing through bonds is implemented so that the contribution of banks to the real sector or corporation can be channelled when the contribution of financing through credit is stalled. Bank experienced a trade-off between concentrating funds on a third party (DPK) or to corporate bonds than channelling funds through loans.

CONCLUSION

The effect of ownership is concentrated as a proxy of the external oversight mechanism on bank performance showing different results. It means that the implementation of concentrated ownership in banks with different types of ownership will result in different bank performance. The independent board of commissioners as a proxy of the internal supervision mechanism is proven to have a significant positive effect on bank performance.

The capital structure is determined by the trade-off between the benefits of debt and the cost of debt (Fama & French, 1998). This statement supports the results of this study. The results found a U-shape curve in the relationship of the effect of bond issuance funding on bank performance. The bank will consider operational funding based on the risk of bankruptcy and supervision costs. Banks that are at risk will reduce funding through debt, whereas safe banks are usually more flexible in issuing debt securities.

LIMITATION AND STUDY FORWARD

Based on the conclusions above, it can be suggested for future research that is testing more deeply by using non-linear tests of each variable. Besides, try to use other internal and external monitoring variables and other leverage variables to determine the behavior of banking governance mechanisms in Indonesia.

ACKNOWLEDGMENT

We would like to thank the Indonesia Endowment Fund for Education, abbreviated as LPDP, which is a full-ride Scholarships of Excellence for Indonesian Lecturers (BUDI) from the Indonesian Ministry of Finance and Ministry of Research, Technology and Higher Learning for supporting participation in this international research.

AUTHORS CONTRIBUTION

The author is a doctoral student, was responsible for the design and development of the data analysis. Co-authors who are experienced in writing in reputable scientific journals have greatly contributed to compiling this article. How to arrange a framework of mind that can be accepted logically.

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