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BANKING REGULATION AND FINANCIAL PERFORMANCE (INSTITUTIONAL THEORY PERSPECTIVE)

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ABSTRACT

A research aims to examine the effect of banking regulation toward financial performance. The banking regulation was measured by using a proxy of Corporate Governance, risk disclosure and capital adequacy as measured using a minimum Capital Adequacy Ratio (CAR) with institutional theory perspective. The financial performance was measured by a Return on Assets (RoA). The research used SPSS version 20. An analysis tool used was multiple linear regression to examine the effect of banking regulation toward financial performance. The research used secondary data which obtained from officially published annual report of the company. These samples included 32 companies of the banking industries listed in Indonesia Stock Exhange in period of 2010-2014. The research proves that the Corporate Governance and Capital Adequacy Ratio are positively effected on financial performance although the risk disclosure does not affect the bank's financial performance. The implication of research indicates that the management of the bank based on the principles of Corporate Governance and fulfillment of minimum capital provides the evidence that can reduce a risk of business and investment in banks and boost financial performance. The risk information does not give confidence to the community on investment in the bank. So, it does not contribute to improve the financial performance.

KEYWORDS

banking regulation, corporate governance, risk disclosure, minimum capital adequacy, financial performance.

INTRODUCTION

The research aims to examine the effect of bank regulation toward financial performance with institutional theory perspective. The banking regulation in this research is the terminology which used to describe the compliance of banking to Indonesia Bank Regulation (IBR). This research focuses on the compliance of banking in the three regulations. It consisted of; (1) Corporate Governance which abbreviated as CG; (2) Disclosure of risk; and (3) Minimum Capital Adequacy Ratio (CAR)..

The research is based on decline phenomenon in financial performance of bank as a result of non-compliance with the regulations. The decrease case in the bank's financial performance in Turkey showed that non-compliance toward regulations are negatively impacted the decrease of bank's financial performance (Ozkan, Katmai Balsari and Varan, 2014). Also, a similar case occurred in Indonesia that was Bank Mega Ltd, PLC in 2011 which suffered a loss of 598 Billion Rupiah due to embezzlement caused by a weak internal control and non-compliance with regulations' (Suarapembaruan.com 2011). The incident resulted in the decrease in financial performance of Bank Mega Ltd, PLC.

FIGURE 1.1: THE DECLINE IN FINANCIAL PERFORMANCE OF BANK MEGA LTD, PLC

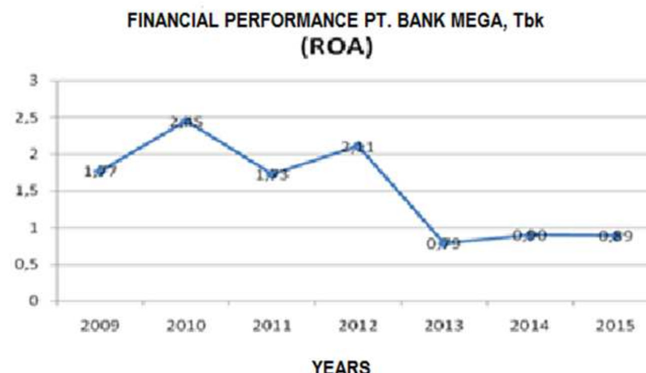

Figure 1.1 showed that a decline in financial performance, Bank Mega Ltd, PLC, during the period of 2012-2015 (after the case of Bank Mega Ltd, PLC). Another fact was shown by the results of the Indonesian Supreme Audit Institution for the management of 17 Indonesian Regional Development Bank and the Indonesian Citizen Credit Bank during the period of 2011 to 2013. The findings found that 80 cases due to the weakness of the internal control system and 133 cases due to non-compliance with the regulations that affected the bank's financial performance (finansial.bisnis.com, 2014).

The financial performance information is needed for the community in terms of avoiding high-risking the bank (Hunjak and Jacovevic, 2001). Meanwhile, the regulators, the information of bank's financial performance is helpful to assess compliance with the regulations set (Taswan, 2010). For investors, the information of financial performance is very useful to assess the performance and the success rate in managing the bank's management (Westen and Copeland, 1992; Booth, Cornett, and Thracian, 2002). Thus, the higher level of bank's compliance toward regulations, the smaller risk faced. With the lack of risk faced indicates that the bank is able to use and manage the assets efficiently. The higher level of bank efficiency, the higher financial performance of the acquired bank got (Naceur and Omran, 2011).

The difference of this research with a variety of previous study lies in compliance with banking regulations in developed countries and countries that have bank regulation good, but it does not much research that explains about the compliance of banking regulations in developing countries, especially in Indonesia. There are two reasons why the researchers conducted the research in Indonesia:

a. The past research conducted in many developed countries and has a degree of compliance with bank regulations were good (For example, Pasiouras, Tanna, Zopounidis, 2009; Hagendorff, Collins, and Keasey, 2010;Naceur and Omran, 2011; Altunbas, Manganelli, Marques-Ibanez 2011; Vallascas and Keasey, 2012; Demirgüç-Kunt, Huizinga, 2012; Sum, K. 2015; Ozkan, Balsari and Varan 2015); and
b. The limited similar studies in developing countries (For example, Ahmad and Hassan, 2007; Oladejo, Oladehinde and Oladipupo, 2011)

Based on the explanation above, the research is structured to provide an overview of compliance with bank regulations to improve financial performance. This research focuses on aspects of the bank's compliance with banking regulation. The banks follow the rules and norms to create legitimacy in society (Pfeffer and Salancik, 1978). It was reaffirmed by Scott (1995) that an organization legitimacy obtained through: 1) comply with the existing regulations; and 2) comply with existing systems. It shows that the importance of the role of institutions (regulator) to ensure that the management is able to manage the accountable company and reflect the role of the institution as part of the environment that may affect the company.

LITERATURE REVIEW

INSTITUTIONAL THEORY

According to North (1991), the institution or institutions are the rules (constraints) created by man to organize and form the interaction of political, social and economic. It is also supported by Scott (1998) who stated that the institution is a social structure that has reached the highest resistance and consisting cultural cognitive, normative and dynamic regulative. These elements affect together with the activities in providing stability in social life. An effort to provide the stability of an institution needs to consider the elements such as rules, norms, cultural benefits, roles and resources, basis and resources.

In performing its duties, the institution must have a useful function for some parties interested in the company. According to Rodrik (2003), there are four functions of institutions in relation to supporting the performance, namely:

1. Market creating is the institutions that protect rights property and ensure the implementation of the contract;
2. Market regulating is the institutions in charge of addressing market failure that institutions regulate the problem of externalizes, economies of scale and the imperfection of information for reducing transaction costs (for example, the regulatory body for telecommunications, transport and financial services);
3. Market stabilizing is the institutions that keep the inflation low rate, minimize the macroeconomic instability and control the financial crisis (for example, central banks, foreign exchange system, monetary and fiscal authorities); and
4. Market legitimizing is the institutions that provide social protection and insurance, including arranging for the redistribution and manage conflict (for example, the pension system, insurance for unemployment and other social funds).

Based on the explanation above, it can be concluded that the institutions that could affect the bank management are institutional environment. This institution deals with the creation of the rule of law (especially property rights), the constitution, legislation, judiciary and bureaucracy. This institution is expected to create formal rules of a good (first-order economizing). Organizations follow the rules and norms to create the legitimacy of the company and community (Pfeffer and Salancik, 1978).

FINANCIAL PERFORMANCE

According to Malik and Nadeem (2014), financial performance can be defined as it measures the financial position of a company over a specified time period to know how efficiently a company is using its resources to generate income. Meanwhile, Brigham and Gapenski (2006) states that the financial performance reflects the company's ability to manage and allocate resources. Thus, the financial performance demonstrates the effectiveness and efficiency in the use of resources for getting revenue. The important financial performance assessment was conducted by the company's management, shareholders, creditors, regulators, and stakeholders, because it involved the distribution of wealth between them (Adams and Tehran, 2011).

The improvement of financial performance is an achievement, to the expectations of the owners of the company. It is expected to improve the welfare of the owners (Pasternak and Rosenberg, 2002). The financial performance is the result of a policy manager in managing the company and assessment of financial performance, which in turn evaluate the company's goals.

BANKING REGULATION

According to Stigler (1971), the regulations are some policies that govern the market based on the strength of the government's power. Meanwhile, Chang (1997) argues that the regulation is a service to the community with the goal of efficiency. Another opinion came from Demirguc-Kunt and Detragiache (1998) who improved the regulatory environment that can prevent a banking crisis. In the line with them, Supriyanto (2006) argued that the higher capacity of regulatory compliance, the better the bank's efforts to overcome the threat of trouble continuance efforts, so that the effect on the financial performance. According Taswan activities (2010), the banking industry needs regulation in this regard due to:

a. Banking institutions besides aiming for national business also mandated that welfare people. To that regulation would force banks act fairly and boost the prosperity of the people;
b. Equation interests of stakeholders. Bank operates for the public that serve the public. Stakeholders' interests take precedence because it has an interest in the survival of a bank;
c. Bank is an institution of trust. Stakeholders feel safe to invest in banks based confidence in the management of the bank; and
d. Bankruptcy or liquidation of the bank may cause a domino effect, if it occurs would disrupt the national banking system and the national economy.

Furthermore, according to Dendawijaya, L., (2009), the bank regulation made aims to: 1) safety is to prevent the market failure and deposits withdrawal by public result in a loss to the bank, 2) Stability is related to the goal of macroeconomic stabilization or maintain the stability of macro economy, 3) Structure is the issue of competition and efficiency bank.

Related the regulation, the banking industry in Indonesia’s regulation issued by Indonesia Bank. It has the mandate in accordance with Article 29 paragraph (1) of Act 7 of 1992 for the banks guidance and supervision and then given the authority and duty to conduct banks training and supervision to make efforts in both preventive and repressive. Nevertheless, in accordance with Law No. 21 Year 2011 on the Financial Services Authority (FSA), in the 2014, the bank supervision on the original by Indonesia Bank would shift to the Financial Services Authority (FSA).

Based on the 30 of PBI, this research focuses on the three regulatory compliance of banking, namely PBI regarding (1) Corporate Governance, (2) risk management, and (3) capital adequacy. It is expected to provide information about the banking industry compliance with Indonesia Bank regulation to improve financial performance.

METHODOLOGY

RESEARCH PURPOSES

1. Knowing the effect of compliance practices of Corporate Governance to the financial performance of the banking industry which are listed in the Indonesia Stock Exchange.
2. Knowing the influence of compliance risk disclosures on the financial performance of the banking industry which are listed in the Indonesia Stock Exchange.
3. Knowing the influence of compliance with the minimum capital requirement affect the financial performance of the banking industry which are listed in the Indonesia Stock Exchange.

HYPOTHESIS

H1: There is a positive influence on the financial performance of corporate governance.
H2: There is a positive influence on the financial performance of risk disclosure
H3: There is a positive influence on capital adequacy ratio of financial performance.

RESEARCH METHODS

The research is explanatory variables to examine the influence of Corporate Governance, disclosure of risk and Capital Adequacy Ratio of the bank's financial performance. The population in this research is the banking industry listed in Indonesia Stock Exchange 2010-2014. This research used the banking industry due to the banking company in Indonesia, Corporate Governance, has been specially arranged through Indonesia Bank Regulation No.8 / 14 / PBI / 2006 on Corporate Governance in the Indonesian banking industry. In addition to these regulations, there is a special treatment for the banking industry regarding the application of risk management in accordance with the Indonesia Bank Regulation No.11 / 25 / PBI / 2009 on the implementation of risk management. In this research, the sample frame used is the annual report listed banks in BEI period 2010-2014. This is consistent with the observation period during the research after the implementation of the Indonesia Bank Provisions No.11 / 25 / PBI / 2009 on the implementation of risk management.

FINDINGS AND ANALYSIS

TABEL 1: DESCRIPTIVE STATISTICS

Variabel	Minimum	Maksimum	Mean	Median	Std. Dev
CG	0,73	0,98	0,88	0,90	0,57
RD	0,50	1,00	0,77	0,77	13,45
CAR	9,41	28,29	16,24	15,78	3,55
ROA	-1,64	5,15	1,91	1,79	1,19
Ln_Credit	33	751996	54668	17048	80157

Variabel Description:

CG : *Corporate Governance,* was measured by index of CG
RD : *Risk Disclosure*, was measured by PBI items
CAR : *Capital Adequacy Ratio*, is the minimum capital adequacy based on PBI
ROA : *Return on Asset*, was measured by ratio of net income to total asset
Ln_Credit : *Lending amount by the bank per year*

From the table above, it shows that the financial performance of the banking industry listed in Indonesia Stock Exchange has an average value of **1.91**. This value is categorized as **good.** It is because the level of compliance with banking regulations proxies by corporate governance, disclosure of risk and capital adequacy has good value (see table 1). Thus, the improved financial performance of the banking industry in Indonesia is influenced by an increase in the banking regulation.

TABLE 2: INFLUENCE OF CORPORATE GOVERNANCE, RISK DISCLOSURE, CAPITAL ADEQUACY RATIO THE FINANCIAL PERFORMANCE

Variabel	Koefisien Regresi	*T-Test*	Sig
CG	3,090	1,930	0,056**)
RD	-0,13	-0,169	0,866
CAR	0,046	1,803	0,074**)
Ln_Credit	0,027	0,358	0,721
ToB	-1,039	-3,928	0,000***)
years_2011	0,098	1,210	0,232
years_2012	0,023	0,293	0,770
years_2013	-0,074	-0,931	0,353
years_2014	-0,662	-2,886	0,005***)
R *Square*	0,199		
Adjusted RSquare	0,176		
F	8,650		
Sig	0,000		

***) : significance α = 1 %
**) : significance α = 5 %
*) : significance α = 10 %

From the results of processing the data to test the hypothesis, the model chosen is fit it is due to have a value of ANOVA highest at 40.459 and p-value of **0.000**, which means that this model is a model that is most significant for predicting the effect of banking regulation proxies by the adherence of corporate governance, disclosure of risk and capital adequacy ratio of financial performance proxies by return on assets in the banking industry.

The coefficient of determination (R2) in this research will use Adjusted R2 value, because the number of independent variables more than two. Adjusted R2 value indicates the number **0,199,** it shows that **19.9%** ROA can be explained by the variation of three independent variables, and the remaining **80.1%** can be explained by other variables outside the model.

Based on ANOVA test, the values obtained Whiting **8.650** with a significance of **0.000,** meaning that the significance level is less than **0.05**. It can be said that the regression model can be used to estimate the ROA.

The variable Corporate Governance (CG) with coefficient t values of **3.090** and **1.930** with a significance of **0.056** indicates that corporate governance positively affects financial performance. The significance value less than **0.05** so significant. Thus proving, there is the influence of corporate governance on financial performance. This means that the hypothesis 1 (H1) is supported.

The variable risk disclosure (RD) with coefficient **-0.13** with t values of **-0.169** and significance **0.866** show that risk disclosure no effect on the financial performance. The significant value well above **0.05** so insignificant.

The results of this research do not support the hypothesis 2 (H2). The test results showed capital adequacy ratio (CAR) coefficient **0,046** with t values of **1,803** and significance **0,074** show that capital adequacy ratio effect on financial performance. The significance value is far below **0.05** so significant. The results support the hypothesis 3 (H3). Ie control variable amount of credit (Ln_Credit) shows results results ρ value equal significance level of **0.05** and above **0.721** coefficient value of **0.027**. These results show evidence that there is no influence of the amount of bank lending to financial performance. The test results showed that there were negative influences types of banks (ToB) on financial performance with coefficient of **-1.039**. The level of significance value of **0.000 ρ** under **0.05**. While the control variable amount of credit (Ln_Credit), the test results showed no effect of the number of credit (Ln_Kredit) on financial performance with a coefficient of **0.027**. The significance level of **0.721** ρ value above **0.05.**

Testing is done with four dummy in addition to the base year, the dummy in 2011, 2012, 2013 and 2014. The test dummy in 2011 showed no effect on the financial performance. This can be seen in Table 4.5 above that the coefficient **β4 worth 0.096** with ρ value equal to **0.232.**

A dummyin 2012 showed no visible effect on the financial performance of the coefficient β5 worth **0,023** is not proven by ρ value equal to **0.770**. The dummy in 2013 also showed no effect of (a) the financial performance. This is evident from the coefficient β6 worth -0.074 with ρ value equal to **0.353**. Meanwhile, tahun_2014 dummy control variables, the test results show there is a negative influence on the financial performance dummy tahun_2014 with coefficient of **-0.662**. The level of significance value of **0.000** ρ under **0:05**. The effect means that the average financial performance in 2014, **66.2%** lower than the average financial performance in 2010.

The influence of the control variables are the type of Bank (ToB) to the bank's financial performance results showed a significance level of **0.000** ρ value under **0:05.** The test results show there is a negative influence on type of Bank (ToB)) on financial performance with coefficient of **-1.039**. This result proves that this type of ownership can effect of reducing the bank's financial performance.

CONCLUSION

This research proves compliance with corporate governance practices positive effect on financial performance. The banking industry is capable of meeting the implementation of corporate governance practices reflect the bank's management carefully (Prudent). Management provides believe carefully to stakeholders on the management of the bank in accordance with existing regulations can further improve financial performance. This research demonstrates compliance risk disclosure does not affect the financial performance. The bank industry is an industry that is high risk that disclosure of risks is mandatory disclosure should be reported in the annual report, but stakeholders have not been used optimally information about the risks, during the bank is following the rules and minimal risk, stakeholders do not use it to explain the variation in financial performance, This research proves compliance with capital adequacy ratio positive effect on financial performance. The capital adequacy ratio already corresponded to the regulations provide assurance to stakeholders about the adequacy of capital owned bank to support assets that contain or produce risks that could further improve financial performance.

SUGGESTION

Further, the research can be used a qualitative approach, so that all information disclosed and can provide an overall picture of the compliance of the banking industry in Indonesia. Subsequent research using samples with large quantities that the entire banking industry in Indonesia, it is in order to obtain evidence that can be generalized and Opera about the behavior of the banking industry compliance. Using other proxy refers to the compliance with Bank Indonesia regulations.

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