# Corporate Governance and Financial Distress in the Indonesia Banking Sector: An Empirical Study

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# Corporate Governance and Financial Distress in the Indonesia Banking Sector: An Empirical Study

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## ABSTRACT

*Studying the relationship between corporate governance, interest rate risk and financial distress is the aim of this study. To examine this relationship, interest rate risk is used as a moderating variable. The variables used in this study are the board of directors and institutional ownership as proxies for corporate governance, and net interest margin is used as a proxy for interest rate risk. The research was conducted on the conventional banking sector listed on the Indonesia Stock Exchange in the period 2015-2019. Sampling of data using purposive sampling method. Data analysis to determine the relationship and hypothesis testing using logistic regression. The results showed that institutional ownership had a negative effect on financial distress at a significance level of less than 5%, while interest rate risk had a negative effect on a significance level of less than 10%, and the board of directors had a negative but insignificant effect. Interest rate risk acts as a moderating variable in determining the relationship between institutional ownership and financial distress. Institutional ownership has an impact on increasing financial distress in banks with high interest rate risk.*

## INTRODUCTION

Financial distress (FD) can be experienced by every company, including companies engaged in the financial sector, such as banking. When the bank experiences problems with corporate governance mechanisms, financial malfunctions, managerial and operational, the company will experience a financial distress (Meher and Getaneh, 2019). In addition, financial distress occurs when the company is unable to generate sufficient income to pay all its financial obligations. The company's inability to generate

sufficient income is due to various factors, leading to inefficiencies in managing company resources because of the global economic crisis.

Banks as companies engaged in the financial sector act as mediation from savings owners to investors, and channel them to industry or those who need capital, in line with continuing development of national and global econmic growth. This condition places the bank as an institution tha is trusted by the customer who hold savings to save their money in the hope of a return that can be generated from these saving. With regards to this problem, banks as financial institutions must be able to generate sufficient income from savings distributed to the customer to cover all operational costs to be free from financial distress. Ness., the role of the banking sector is to use resources wisely to encourage economic growth and bring it to the global competitive.

The main factor that causes bankruptcy is because the bank experiences financial difficulties because the bank cannot meet the demands of the depositors, which in turn makes the bank sick, and goes bankrupt. This is because banks provide loans to customers who have low creditworthiness, which collides with conflict of interest and instability in macroeconomic factors. Loans that have low eligibility cause bad credit, because customers are unable to pay interest and principal loan obligations, causing banks to experience financial distress.

Efficient financial services in the banking sector can only be acheved through proper management of financial distress by bank management (Bariviera et al, 2014). Banks must be able to manage the creditworthiness side property to reduce financial distress and avoid bankruptcy, meaning that banks must implement a strict credit policy. However, this policy has a consequence of decreasing bank income because the amount of loans to customers has decreased. Therefore, there is a trade off or also a conflict of interest between the credit policy and bank income, where a bank with a dtrict credit policy will reduce bank income.

The occurrence of financial distress in banks is not only caused by low ceditwothiness but can also be caused by not optimal good corporate governance mechanisms, such as the number of board directors, institutional ownership, and audit committee attribute, as well as other factors, both internal and external. The non-optimal mechanism of good corporate governance wii lead to earnings management practices that can mislead investors, because in fact the company's profits a not good, but to look good, the management has manipulated it by implementing earning managemen practices.

In general, the quality of good corporate governance can be evaluated based on the principles of openness and transparency, relationships with shareholders and stakeholders, characteristhics of directors, policies, and compliances as well as ownership and control structures (Shahwan, 2015). Good corporate governance practices will strengthen company performance (Black et al, 2006 and Hodgson et al, 2011), and at the same time, these practices will protect companies from financial distress (Wang and Deng, 2006). Banks that have the potential to experience financial distress are indicated by the amount of bank operating income from interest income, which is reflected in the amount of net profit/loss which continues to decline. This condition is closely related to the size of the loan interest rate given to customers, so that changes in interest rate, particularly credit interest, can affect the chances of financial distress. The following Table 1 shows the development of profit/loss in Indonesian banking book 1, book 2, book 3, and book 4 which are listed on the Indonesia Stock Exchange during the period 2015-2019.

**Table 1.** Development of profit/loss in Indonesian banking (in billion rupiah)

| *Years* | *BUKU 1* | *BUKU 2* | *BUKU 3* | *BUKU 4* |
|---|---|---|---|---|
| | *Last Year's Profi/Loss* | *Profit/Loss for the Year After Tax* | *Last Year's Profi/Loss* | *Profit/Loss for the Year After Tax* |
| 2015 | 767 | 1.570 | 11.114 | 9.948 |
| 2016 | (69) | 861 | 8.949 | 10.327 |
| 2017 | (454) | 716 | 6.409 | 10.298 |
| 2018 | (317) | 700 | 6.324 | 9.225 |
| 2019 | (808) | 457 | 4.989 | 9.001 |

Souece: Indonesian Banking Statistics 2019

Based on the phenomenon of the development of bank profit/loss which is include in the categories of Bank BUKU 1, Bank BUKU 2, Bank BUKU 3, and Bank BUKU 4, the problem in this strudy is whether interest rate risk plays a role in moderating the relationship between corporate governance and the chance of financial distress. The findings from the results of this study are expected to be of interest to academic researchers, practitioners, and regulators who want to find the quality of good corporate governance in the banking sector on the Indonesia Stock Exchange.

## 1. LITERATURE REVIEW

Financial distress is a condition where the company cannot generate sufficient income or profit. In this condition the company cannot fulfill its obligations, so the creditor will refuse to supply the goods. Likewise, financial institutions such as banks will refuse to provide loans to companies. To suppress the occurrence of financial distress requires good corporate governance, the role of the board of directors and institutional ownership as indicators of corporate governance is very important so that the company avoids financial difficulties. The discussion on corporate governance has started since the presentation of papers related to agency problems in companies by Jensen and Meckling (1976). The possibility of a conflict of interest between the shareholder (principal) and management (agent), where management as an agent should act in the interests of the shareholder. The problem occurs because of the separation of ownership and control which creates a conflict of interest between managers and shareholders. As a result, it has attracted many researchers to conduct research and has made significant contributions by investigating the rolr of corporate governance in minimizing these conflicts (Shahwan, 2015).

Agency theory explicitly emphasizes association in which one or more actors engage agents to complete work on their behalf. According to Landstorm (1993) the principles underlying agency theory are that participants are bodies which are rational economic optimizers. This implies that there will be decisions made by the agent that may not reflect the interests of the principal due to the separation of ownership and control between the two parties. This condition will eventually cause agency costs to control their opportunistic behavior (managers). Associations between participants always determine the performance of each company in a dynamic business environment. The Cadbury Report (1992) defines corporate governance as "a system of laws and regulations meant to lead and control enterprises." The primary goal of corporate governance is to provide the best possible service to shareholders (Wajid and Shah, 2017). Better corporate governance will enable organizations to make better strategic decisions and lessen financial strain within the organization. Corporate governance mechanisms include internal mechanisms and external mechanisms. Internal mechanisms, such as the existence of structure a board of directors, managerial ownership, and executive compensation. Markets for corporate control, institutional ownership, and level debt of financing are examples of external mechanisms.

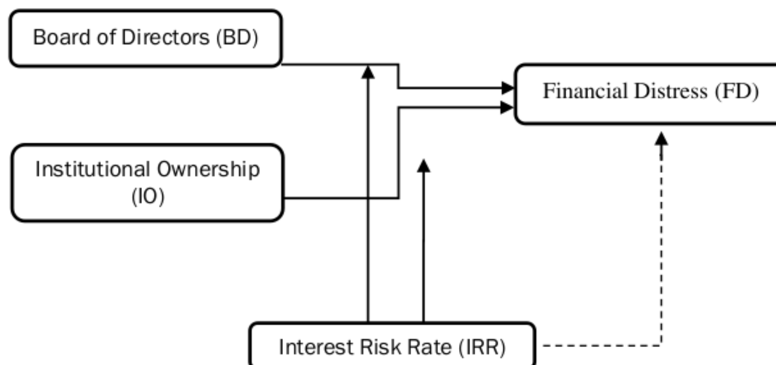
The relationship between corporate governance and financial distress has been the subject of interesting academic discussions since the 1980s (Shahwan, 2015). To validate this relationship, the basic flow of many studies in this area aimed at explaining how the corporate governance mechanism in healthy companies and corporate governance in companies experiencing financial distress, and how its impact on the possibility of default has been widely carried out (Elloumi and Gueyie, 2001., Lee and Yeh, 2004., and Wang and Deng, 2006). Muranda (2006) carried out another study of the Study on financial distress related to the impact of corporate governance mechanisms on the survival of companies in financial distress. A board of directors is essentially a body of people elected to represent shareholders. All publicly traded companies are required by law to have a board of directors as a non-profit organization, and many private companies must also appoint a board of directors. A good relationship between the board of directors as an employer with managers as agents and employees will increase company productivity. As Whitfield and Landeros (2006) point out, it is assumed that a good relationship between employers and workers improves organization. In a modern and competitive company, good management practices ranging from leadership style, politics, culture, structure, board of directors, and technology can increase employee motivation to work towards company goals. The essential features of good governance are competitiveness ensuring due to the training practices (Samoliuk et al., 2021) and communication process improvement (Smeureanu and Diab, 2020).

Institution ownership refers to the ownership stake in a company that is held by large financial organizations, pension funds or endowments. These nstitutions generally purchase large blocks of a company's outstanding share and can exert considerable influence upon its management. Although many large companies have thousands of individual shareholders, some of these owners will often hold many of the shares. These large institutional traders are typicalla well funded and routinely accumulate millions of shares of single stock.

As the majority shareholder, institutional ownership has a great influence on management, so that institutional ownership is important, because many investors consider that institutional support for securities is a sign of approval, and the institutional accumulation of a share can significantly improve firm performance and share price. Instituional ownership also has a tremendous influence on investors outside the institution in assuring them of the benefits and safety of their investment. In this case, supervision of institutional investors is important to allow managers to focus more on improving firm performance and reducing their own interests, thereby reducing the possibility of financial distress (Cornett el al, 2008). In the banking industry, bank income, which is bank interest income, is very vulnerable to the risk of changes in interest rates. Bank income is a very important factor that affects the financial health of a bank. The increase in profit as measured by net interest income on total income results in reduced financial distress (Gebreslassie, 2015). Thus, the higher the share of interest income from total income, the better the bank's financial health will be. However, the uncertainty of interest rates will lead to a high risk or low bank interest income. Interest risk can also occur due to default from customers, the risk of default from customers shows an indicator of opportunities for financial distress for the bank. Net interest risk is measured by the net interest margin or the interest margin on totla loans and advances or net interest margin (Meher, 2019).

Interest income, as measured by the net interest margin indicator, is an important factor in influencing the chance of financial distress. Banks with high interest rate volatility will also set high credit interest rates to cover the risk of interest rate volatility. With high interest rate, the profit generated by the bank is also high, this condition has an impact on increasing interest margins, by increasin interest margins, it will reduce the chances of financial distress, and vice versa, banks with low interest margins will increase the chances of financial distress. Therefore, the high volatility of interest rates will lead to an increase in the interest rate risk which can increase the chances of financial distress at these banks, sepecially in conventional banks.

In this study, net interest margin is placed as a moderating variable that plays a role in strengthening or weakening the opportunities for financial distress. Banks with low net interest margins will strengthen the opportunities for financial distress, and vice versa. Based on the description above, it can be formulated a hypothesis which states that corporate governance, namely the board of directors and institutional ownership has a negative effect on the chances of financial distress, and interest rate risk moderates the effect of the board of directors and the institutional ownership on the chance of financial distress which can be described in the following research model.




Source: Autor's Model

## 2. RESEARCH METHODS

### 2.1 Data Sample

The sample of research data is conventional banking listed on the Indonesia Stock Exchange for the period 2015-2019. The sampling method used was purposive sampling with criteria: the bank publishes complete financial reports for 2015-2019, the has a board of directors for the period 2015-2019, its share are actively traded on the Indonesia Stock Exchange during 2015-2019.

### 2.2 Data Analysis

To analyze the data used logistic regression which is formulated in the form of an equation as below.

$$Ln\ p/(1-p) = \alpha + \beta_1 BD + \beta_2 IO + \beta_3 IRR + \beta_4 BD*IRR + \beta_5 IO*IRR + e$$

Where:
Ln p/(1-p) = Profitability of banks in financial distress
$\alpha$ = Constanta
$\beta$ = Coefficient of Regression
BD = Board of directors
IO = Institutional ownership
IRR = Interest rate risk
e = Error term

## 3. RESULTS AND DISCUSSION

### 3.1 Hosmer and Lemeshow

The following are the findings of the Hosmer and Lemeshow aptitude test, as displayed in Table 2:

**Table 2.** Hosmer and lemeshow

| Step | Chi-square | df | Sig |
|---|---|---|---|
| 1 | 5.030 | 8 | .754 |

Source: SPSS Logistic Regression Output

The Hosmer and Lemeshow goodness of fit value was 5.030 with a significance value of 0.754, which was greater than 0.05, as shown in Table 2. As a result, the model was found to be capable of predicting the value of its observations and acceptable because it is compatible with observational data.

### 3.2 Chi Square Test

Chi-square testing carried out by comparing value of the -2 log likelihood. In accordance with the provisions, the regression model is good if the test results have decreased. The results of the -2 log likelihood test can be seen in Table 4 below.

**Table 3.** Likelihood Test Result

| *Iteration* | | *-2 Log likelihood* | *Coefficients* |
|---|---|---|---|
| | | | *Constant* |
| Step 0 | 1 | 112.352 | -1.503 |
| | 2 | 108.838 | -1.892 |
| | 3 | 108.776 | -1.952 |
| | 4 | 108.776 | -1.954 |
| | 5 | 108.776 | -1.954 |

Source: SPSS Logistic Regression Output

The results of the chi-square test in Table 3 above indicate that the use of the regression model for this analysis is good and the hypothesis is in accordance with the data. The decrease in the -2 log likelihood value in Table 4 as follow is presented as the chi-square value in the omnibus coefficient model test.

**Table 4.** Omnibus Tests of Model Coefficients

| | | Chi- square | df | Sig |
|---|---|---|---|---|
| Step 1 | Step | 25.984 | 5 | .000 |
| | Block | 25.984 | 5 | .000 |
| | Model | 25.984 | 5 | .000 |

Source: SPSS Logistic Regression Output

Based on Table 4, the chi-square value is 25.984 with a level of significance less than 1 percent. Thus, it shows that corporate governance (board of directors and institutional ownership), interest risk risk and moderating variables explain the variation in opportunities for financial distress.

## 3.3 Cox and snell's R Square and Nagelkerte's R Square

The results of Cox and Snell's R Square and Nagelkerke's R Square can be seen in Table 5 below.

**Table 5.** Cox and Snell's R Square and Nagelkerke's R Square

| Step | -2 Log likelihood | Cox & Snell R Square | Nagelkerke R Square |
|---|---|---|---|
| 1 | 82.792[a] | .164 | .311 |

a. Estimation terminated at iteration number 7 because parameter estimates changed by less than 0.00.

Source: SPSS Logistic Regression Output

As shown in Table 5, the nagelkerke R square value is 0.311 or 31.10%. These results indicate that 31.10% of board of directors and institutional ownership as a corporate governance, interest rate risk and moderating variables explain the possibility of financial distress, the rest are caused by external factors not included in this model.

## 3.4 The 2x2 Classification Table

The strength of the regression model in predicting the possibility of a bank having the potential to experience financial distress is shown from the results of the 2x2 classification test. In Table 6 below, the results of the test are shown.

**Table 6.** The 2x2 Classification

| *Observed* | *Predicted* | | |
|---|---|---|---|
| | FD | | *Percentage Correct* |
| | .00 | 1.00 | |
| Step 0 FD .00 | 127 | 0 | 100.0 |
| 1.00 | 18 | 0 | .0 |
| Over Percentage | | | 87.6 |

Source: SPSS Logistic Regression Output

The regression model correctly predicted 127 or 100 percent (127/127) of the banks with a healthy state or no financial difficulty, according to the 2x2 categorization table displayed in Table 6. The regression model correctly predicted 127 banks out of 145 bank samples, or 87.6%. This high percentage result supports the conclusion that there is no statistically significant difference between predicted and observational data, indicating that the regression model utilized is effective.

## 3.5 Statistical Test Results

Table 7 below shows the results of statistical tests for hypothesis testing on the variables used in the model.

**Table 7.** Statistical Test Result

| | | *Variables* | | | | | |
|---|---|---|---|---|---|---|---|
| | | *B* | *S.E* | *Wald* | *df* | *Sig* | *Exp(B)* |
| Step 1[a] | BD | -.549 | .673 | .665 | 1 | .415 | .577 |
| | IO | -.002 | .001 | 4.761 | 1 | .029 | .998 |
| | IRR | -.019 | .011 | 2.914 | 1 | .088 | .981 |
| | BD_IRR | .000 | .001 | .036 | 1 | .849 | 1.000 |
| | IO_IRR | .028 | .012 | 5.631 | 1 | .018 | 1.029 |
| | Constant | 17.376 | 9.683 | 3.220 | 1 | .073 | 35186048.247 |

a. Variable(s) entered on step 1: BD, IO, IRR, BD_IRR, IO_IRR

Source: SPSS Logistic Regression Output

As shown in Table 7, the board of directors has a beta coefficient of -0.549 with a significance level of 41.5% or greater than 5%, so the board of directors has no effect. While institutional ownership has a beta coefficient of -0.002 with a significance level of 2.9% or less than 5%, so that institutional ownership as expected has a negative effect on financial distress. Interest rate risk has a beta coefficient of -0.019 with a significance level of 8.5% or less than 10%.

The interaction between the board of directors and interest rate risk has a beta coefficient of 0.000 with a significance level of 84.9% or greater than 5%, thus interest rate risk does not moderate the influence of the board of directors on financial distress. The interaction of institutional ownership and interest rate risk has a beta coefficient of 0.028 with a significance level of 1.8% or less than 5%, thus interest rate risk moderates the effect of institutional ownership on financial distress, and this result is in line with predictions.

## 3.6 Discussion

Based on the results of hypothesis testing using logistic regression, it is proven that the board of directors has a negative effect on financial distress, but the effect is not significant. Thus, the existence of aboard of directors does not minimize the possibility of financial distress, which means that the results of

this study are not in line with agency theory. The existence of aboard of directors does not guarantee adequate control over manager. The existence of a board of directors does not reduce the opportunistic and selfish behavior of managers, so that decision making is inconsistent and do not in line with the interest of shareholders.

The findings of this study are in accordance with research from Moghaddam (2016) which did not find any influence of the board of directors of financial distress. The findings of this study are also inconsistent with the results of research by Hassan al-Tamimi (2012), which found a positive relationship. Likewise, the results of this study are inconsistent with research by Li at al (2008), which found a negative relantionship between board size and board composition on financial distress.

Other findings in this study are that institutional ownership is proven to have a negative impact on financial distress. Thus, the existence of institutional ownership minimizes the possibility of opportunities for financial distress. The results of this study indicate that institutional ownership as the majority shareholders can reduce the opportunistic and selfish behavior of managers, so that managers in making policies are consistent and in line with shareholders interests.

The results of this study are consistent with research from Mangena and Chamisa (2008), and Khurshid et al (2020), who found a negative effect of institutional ownership (IO) on financial distress. However, the results of this study are not accordance with the results of research by Donker et al (2009), and Indarti et al (2021), which did not find ant effect of institutional ownership on financial distress.

The moderation results show that the interaction between the board of directors and interest rate risk has no effect on financial distress, and this result is not as predicted. This condition indicates that interest rate risk does not moderate the effect of the board of directors on financial distress. Thus, interest rate risk does not strengthen the existence of the board of directors in influencing financial distress.

Other moderation test results show that interaction between institutional ownership and interest rate risk influences financial distress, and this result is in accordance with the predictions. Therefore, interest rate risk moderates the influence of institutional ownership on financial distress. Thus, interest rate risk strengthens the existence of institutional ownership in influencing financial distress, so that the possibility of financial distress is reduced.

## CONCLUSION

This study examines the relationship between corporate governance and financial distress, and places interest rate risk as amoderating variable in determining the possibility of financial distress in the banking sector industry in Indonesia. It is known that the board of directors has do not effect on financial distress, because the existence of the board of directors cannot control managers, so the policies taken are not in line with the interests of shareholders. Furthermore, institutional ownership, as we know, has a negative effect on financil distres. Thus, the greater the instituional ownership of shares will reduce the possibility of financial distress because institutions with many shares have the power to influence and control managers.

Interest rate risk acts as an intervening variable of institutional ownership that can strengthen institutional ownership in reducing the possibility of financial distress occuring. Thus, interest rate risk becomes a power for institutional ownership to influence managers in making decision that are in line with shareholder interests.

Apart from the contributions that can be given, this research also has several limitations, so that it needs further development and refinement in further research. The limitation of this study is that it only uses two indicators of corporate governance, while there are still several indicators of corporate governance that can determine financial distress, such as managerial ownership and independent commissioners. In addition, this study also does not use external corporate governance mechanisms that affect audit quality and opinions that can also determine financial distress. Therefore, it is hoped that in future studies to consider these variables.

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