

Local Banking and Regional Development: Strengthening the Corporate Governance

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Abstract

Through local autonomy scheme by Indonesian government since 1999, the responsibility of regional development has been granted to local government. Hence, the existence of local bank (Regional Development Bank) should take a larger share in the development. This research will try to prove how local bank could play an essential role to accelerate regional development by implementing good corporate governance (GCG) principles. By analyzing best practice of GCG from local banks in several countries, this research tries to find the best format of local bank's role in order to accelerate regional development, especially in Indonesia. For the existence of local bank in every provinces of Indonesia has a great potential to stimulate the development itself.

Key words: local bank, regional development, corporate governance

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1. Background

Corporate Governance has become a very important subject in supporting economic recovery and a more steady growth. A huge decline caused by crisis in 2008 has confirmed that one of the most fundamental causes was the abandoning GCG principles. Thus, related with crisis, the urgency of GCG principles to be implemented in Banking sectors has been heightened. In concordance with it, by 2006 Bank Indonesia has delivered a regulation on the implementation on GCG in public banks, named Bank Indonesia Regulation Number 8/4/PBI/2006, January 30 2006, about “The Implementation of *Good Corporate Governance* for Commercial Bank”. It was later amended by PBI No. 8/14/PBI/2006 October 5 2006 about “The Implementation of *Good Corporate Governance* for Commercial Bank”.

Through the scheme of the local autonomy implementation by Law number 22 of 1999 about “Local Government”, every region is expected to be more independent in governing. And local development is included in the package. The existence of Regional Development Bank (Bank Pembangunan Daerah – BPD), can be the main supporter in accelerating local development, besides functioning as the other public banks. Hence, it is greatly relevant to observe how far the implementation of GCG has been done in Indonesia and how international best practices could benefit local implementation.

This research will answer the question “*How the implementation of GCG can accelerate local development?*”. By observing implementation of GCG in several countries which are considered as best practice, this research will confirm the importance of GCG in development and provide some important recommendation for GCG practices in Indonesia.

2. Theoretical Review

Those which will constitute theoretical framework for this research are the concept of GCG itself and previous research on GCG in Indonesia as well as other countries.

2.1 Good Corporate Governance

Good Corporate Governance is one set of mechanism which reflects a company’s governing structure that decide the distribution of rights and obligation among many participants in the company⁵. It includes stakeholder, Board of Commissioner, Board of Directors, Managers, employees and other related parties. GCG also affirms that governing a company is a mandate from its establishment and that’s why all related parties must think and act for the best benefit of company. At this point the reflective question on integrity, responsibility and independency is directed to all company’s leaders in Indonesia, including banking sectors which has been leaning on public’s trust and mandate.

⁵ Khomsiyah G. Indaryanto, “Konsepsi Good Corporate Governance” dalam G. Suprayitno, et.al., *Komitmen Menegakkan Good Corporate Governance : Praktik terbaik Penerapan Good Corporate Governance Beberapa Perusahaan Publik di Indonesia*, Jakarta: The Indonesian Institute for Corporate Governance, 2006, Hal.17

Another definition on corporate governance: system consists of a set of rules that define the relationships between shareholders, managers, creditors, the government, and other stakeholders (i.e., their respective rights and responsibilities) and a set of mechanisms that help directly or indirectly to enforce these rules.⁶

Those regulation emphasize that GCG practices in banking sector should be based on five basic principles, which *transparency, accountability, responsibility, independency and fairness*. Transparency is the openness of information on institution's performance, either the punctuality or the accuracy. This is strongly related with the quality of accounting report produced. Accountability is the creation of an effective supervision mechanism, based on distribution of authority, rights and responsibility of stakeholders, commissioners, directors, managers, and auditors. Responsibility is given to any concerned parties, and environment where the company is being operated. Fairness is a certainty for a secured right of stakeholders from any fraud and other deviation. It also provides a clear understanding on every work relation depends on contract between resources provider of company and customers.⁷

2.2 Literature Review

A Consolidated Report on Corporate Governance and Financing in East Asia Executive Summary Report, "The Role of Disclosure in Strengthening Corporate Governance and Accountability", which was prepared for the Asian Development Bank made a research to evaluate the role of corporate governance in the five countries most affected by the Asian financial crisis : Indonesia, Republic of Korea, Malaysia, the Philippines and Thailand. It also includes reviewing the historical development, current state and major weaknesses of corporate governance and financing in the five affected countries, establishing a sound analytic basis for the design and implementation of policy and regulatory reform measures for strengthening the governance and improving the efficiency of financing and investment of the corporate sectors of countries in the region, and identifying areas where interventions by the ADB could be effective.

Some key features found in five countries are all the five economies have concentrated corporate ownership; creditors in general have little input into companies' management and decision making, and their role in corporate governance is weak; boards of directors is seen as an ineffective oversight mechanism in safeguarding interests of all shareholders for the reason of the dominance of family-based controlling shareholders and also because of the lack of effective mechanisms that could provide checks and balances; capital markets are not well developed in most East Asia countries. In the affected countries, except Malaysia, internal finance amounted to no more than 30 per cent of total finance, and external finance dominated corporate financing. They are also other findings related to the quality of corporate governance and financing across five countries. It was stated that Malaysia scores higher than the other four countries, which appears to be consistent with experiences of these five countries during the financial crisis. The

⁶ The Second Asian Roundtable on Corporate Governance The Role of Disclosure in Strengthening Corporate Governance and Accountability

⁷ G. Suprayitno, et.al., "Komitmen Menegakkan Good Corporate Governance", Jakarta: The Indonesian Institute for Corporate Governance, 2006, Hal.48

relatively good performance of the Philippines appears to have been the result of prudent banking practices set in place after the financial crisis of the early 1990's in this country. Secondly, especially in Malaysia, but also in the other four countries, even before the outbreak of the Asian crisis, the governments initiated some measures to strengthen and modernize the regulatory framework for the corporate sector and capital markets. The basic regulatory structure for the corporate sector in these countries appears to be in place, although there are gaps and loopholes, and some areas need to be modernized. The major problem in the legal and regulatory framework appears to be that of poor enforcement.

Some recommendations from this research for further reforms are : (i) corporate ownership structure; (ii) corporate internal control and shareholder protection; (iii) external monitoring and discipline; (iv) capital market development and corporate financing; and (v) regulatory structures. It is important to stress that these recommendations are not intended to be prescriptive and comprehensive. But the best is that each country should formulate its own reform plan and implement measures that suit its specific conditions.

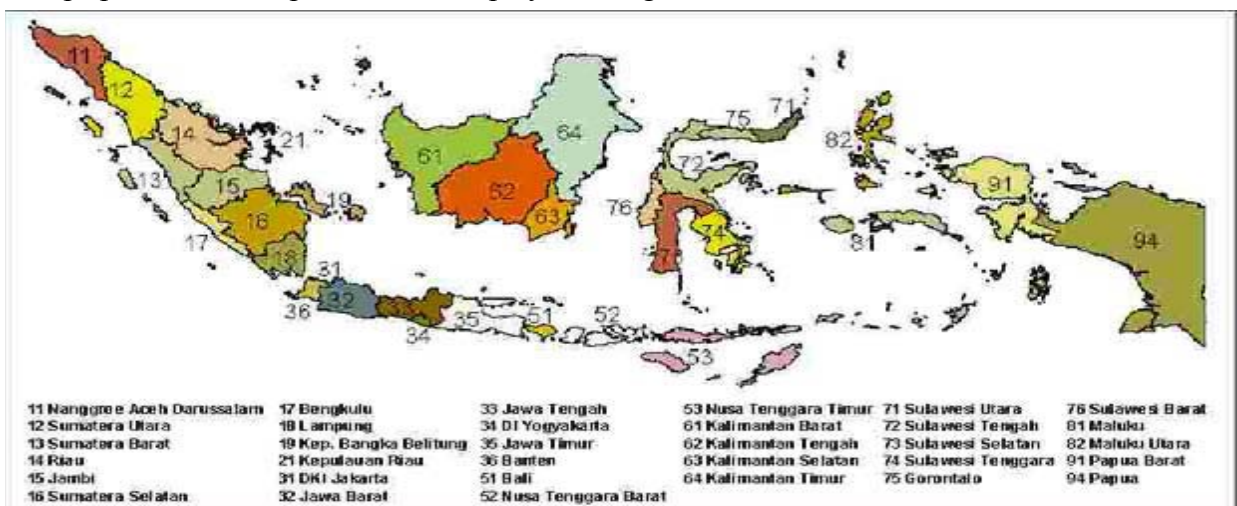
3. Methodology and Procedure

In this section, the methods employed in the study in testing the research hypotheses are described. The specifics of data collection, and the methods applied to empirically assess the proposed framework are described. The first procedure, we use a cross-sectional data approach to analyze the relation between the implementation of GCG and banking performance. The second, we elaborate the implementation of GCG in several countries. The last, we try find the best practices of GCG in BPD in order to accelerate the regional development.

3.1. Source of Data

In order to analyze the corporate governance in regional development bank, we have compiled the GCG Assessment Report from several BPD that have implemented the GCG system during 2008. There are 20 BPD from provinces in Indonesia, those are Bank Aceh, Bank Sumatera Utara, Bank Nagari, Bank Riau, Bank Sumsel, Bank Bengkulu, Bank Lampung, Bank Jambi, Bank DKI Jakarta, Bank Jabar, Bank Jateng, Bank DIY, Bank Jatim, Bank Bali, Bank Kaltim, Bank Kalsel, Bank Kalteng, Bank Kalbar, Bank Sulsel, Bank Sulteng, Bank Sultengg, Bank Maluku, and Bank Papua.

Map spread of those provinces is displayed in Figure 1.



3.2. Component of GCG

The implementation of good corporate governance is very urgent in accelerating bank performance, protecting the stakeholder interest and improving the compliance of law and regulation. Formally, the implementation of GCG has been formulated in management policy as mentioned in GCG implementation guidance. Those are five basic principles such as transparency, accountability, responsibility, independency and fairness.

3.3. Model Specification

Some of literatures use univariate and multivariate logistic regression analysis, or multiple linear regression to test the firm value ownership (Weirin in Leng, 2005). This paper implementing the cross-sectional time series standard multiple regression. The empirical model is formulated as:

$$ROE = \beta_0 + \beta_1TRAN + \beta_2ACC + \beta_3RESP + \beta_3IND + \beta_4FAIR + \beta_4\lnSIZE + e$$

Where, ROE = Return on equity ratio
 TRANS = Transparency
 ACC = Accountability
 RESP = Responsibility
 IND = Independency
 FAIR = Fairness
 SIZE = Size of Asset

This model use the asset of local banking as a control variable. Then, to minimize the multicollinearity effect of the model, we transform the assets as the natural logarithm.

4. The Results

4.1. Empirical Results

The results are summarized in Table 1. Using the Return on Equity (ROE) as the dependent variable, three significant variables were obtained at the 10% significance level. The estimated value of the Adjusted R² was 0.93, which implies that about 93% of the variation in earnings could be explained jointly by the six independent variables. The F-statistic (0.00) is significant at all levels. Then the standard error of regression was 1.533. Thus, overall, the model is fairly strong since the R² value, the explanatory power of the model was quite high.

Table 1. Results of the cross-sectional model of regression analysis using ROE as dependent variable

Independent variable	Coefficient	T statistic	P-value
ACC	1.163514059	1.43130885508	0.175941067158
FAIR	0.241878009	0.12612422938	0.901563347189
IND	1.932671241	2.92565747586	0.011811475217
RESP	2.310612292	3.43533216511	0.004431162315
TRANS	4.135522414	2.09073621394	0.056758396899
lnSIZE	-0.57827319	-1.0326310674	0.320605701135
R ²	0.958553	Probability(F-stat)	0.000000000
Adjusted R ²	0.939424		
S.E. of regression	1.533359094		

The three statistically significant variables are IND, RESP and TRANS. The significant findings relate to the following three independent variables:

1. IND

The estimated coefficient for this variable is 1.93. This is statistically significant at 5% level, and can be interpreted as: everything else constant, companies that have an independency can improve ROE by 1.93 %. The results indicate that an independency in organizing the company has significant influence over company earnings. Since the BPD has no conflict of interest with the province's government.

2. RESP

The resulting coefficient is 2.31. The parameter estimate is highly significant. It can be interpreted as: 1% increase in responsibility variables leads to a 2.31% increase in ROE.

3. TRANS

The results show that transparency does influence earnings. The estimated coefficient for this variables is 4.13. This is interpreted as: the more transparent the company, the better the earnings. Since the companies are monitored by every stakeholder, so the manager will always organize the firm in right track.

4.2. Best Practices from Several Countries

International development in corporate governance could provide us a complement yet relevant background. In a report by Bank Indonesia's representative office in Singapore⁸, it was noted that series of financial fraud in developed countries had initiated a commitment to implement GCG principles seriously. Some of the countries are England, United Stated of America, Australia, Hong Kong and Singapore. Those countries also made regulations and/or laws as guidelines for GCG. They also perform reviews on the guidelines. In all countries, there are institutions which standardize and control the implementation of GCG. Therefore the evaluation has been institutionalized well. Below is the summarized description of GCG best practices in those five countries from the report by Bank Indonesia Representative Office in Singapore (2004) "**Perkembangan dan Pelaksanaan Good Corporate Governance di Beberapa Negara dan Perbankan Singapore**" or "**Development and Implementation of Good Corporate Governance in Several Countries and Singaporean Banking**".

1. United Kingdom

GCG regulations in UK was triggered by Enron Scandal in 1990s. In 1998 government issued GCG-related regulations: Combined Code 1998 and Directors' Remuneration Report Regulation in 2002 to prevent repetition of such incident. The Combined Code provides specific regulations on:

- Role of the Board
- Role of the Chairman
- Role of Non-Executive Director
- Senior Independent Director

⁸ Kantor Perwakilan Bank Indonesia Singapore, "Perkembangan dan Pelaksanaan Good Corporate Governance di Beberapa Negara dan Perbankan Singapore", Singapore: KP BI Singapore, 2004.

- Independency
- Recruitment and Appointment
- Relations with Shareholders
- Remuneration system
- Professional Development

At the other hand, Directors' Remuneration Report Regulations 2002 regulates that every companies in UK which are registered in London Stock Exchange, New York Stock Exchange and NASDAQ, also European Economic Area must submit Directors' Remuneration Report as an integral part of Company's Annual Report.

On its development, GCG regulations in UK has been through several revisions. July 2003, The Financial Reporting Council (FRC) established a new Combined Code on CG. The changes were from review and recommendations from a research by Derek Higgs and Sir Robert Smith. Some of the important changes are:

- an open, fair, firm election of Board of Directors
- a new and clear job description of non executive directors
- to separate chief executive and chairman
- to increase a good relation among chairman, independent senior directors, non-executive director, and majority shareholders
- to give a new definition for "independency"
- to develop induction program and also professionalism of directors
- to perform evaluation on the performance of directors individually and also Board of Directors once a year
- to make a proposal on how to clarify responsibility of non-executive Directors
- to strengthen the role of Audit Committee in monitoring company's financial report, to enhance the independency of external supervisor, to review financial management and other risks.

2. United States

The US Congress issued Law "Sarbanes Oxley" in 2002 in order to deal with several scandals in Wall Street. The law is also known as Public Company Accounting Reform and Investor Protection Act 2002. Different with Europe's approach, US prefers regulation by law which demands a higher standard and transparency. It also requires accountability directly from CEO, higher independency degree in Board of Directors. The Law also imposes a strong punishment for criminals, either in form of fine or jail. Sarbanes Oxley also prohibit public company to give personal loan to their directors and executive officers.

Still in the frame of Sarbanes Oxley, every public company must create its own audit committee to arrange internal as well as external monitoring system. However, the role of audit committee can be performed by Board of Directors.

There is a CG Compliance Checklist due to perform the evaluation. This encompasses questions related with:

1. how far BOD understand the law "Sarbanes Oxley"
2. how far companies implement CG policy

3. the awareness of BOD on the importance of CG committee
4. the need to establish audit committee
5. the need to submit financial report and other reports
6. the need for internal controls

This checklist is also equipped with action plan to follow up every unanswered question.

3. Australia

GCG implementation in Australian is under ASX Corporate Governance Council with its guidelines “The council’s Principles of Good Corporate Governance and Best Practice Recommendations”. It is also regulated under The Corporate Law Economic Reform Program (CLERP 9 Bill). The council will give and implement recommendations to GCG practices in Australia to comply with international best practice standard. It has several programs, some are:

1. to create GCG best practice principles and recommendations to supervise institutions which is obliged to implement GCG on standards by their own chose
2. to review and give inputs
3. to publish recommendations guideline and consider the relevant points with international models
4. to provide the regulators suggestions when there is a call for law amendment
5. to provide information for investors and public

As for CLERP 9 Bill, the purposes are to tighten the framework of financial report, to design measurement in order to enhance regulations related with audit, to improve reporting mechanism by public companies. The bill has also been amended in 2003 with purpose:

1. to set several measurement to increase the accountability and credibility of financial report by increasing the quality of independent supervisor
2. to enhance the implementation of all regulations towards companies with poor GCG revise several reports to shareholders and to increase their roles
3. to do measurement to implement a better risk management
4. to stress a better implementation on continued reporting mechanism

It is believed that the implementation of GCG in government and private sector will keep increasing especially in public service.

4. Hong Kong

Government of Hong Kong, The Securities and Futures Commission (SFC) and The Hong Kong Stock Exchange (HKSE) have prepared draft named A Corporate Governance Action Plan 2003. It is to identify the priority areas on CG. There are also four Corporate Reporting Sub-Committee which are responsible for making special recommendations on GCG implementation by The Standing Committee on Company Law Reform (SCCLR).

The SCCLR was basically established to review and give some advises on law reform in companies. The HKSE is mainly responsible in CG consultation, together with SFC,

especially those related with corporate financial adviser. The blueprint of SFC adopts best practices of OECD countries.

Some major development by Hong Kong in GCG practices, are:

1. a proposal by the SCCLR to strengthen the rights of minority shareholders as decided by Companies Bill 2003
2. HKSE has changed The Listing Rules in order to improve CG in listed companies
3. the SCCLR has made new research on new consultation to follow up proposal to improve regulations in directors management, increasing transparency of reports by companies and strengthening the rights of shareholders

In dealing with Enron scandal, Hong Kong government didn't take drastic measures like US government did. The regulators and law makers in Hong Kong has prepared sustainable proposals and started to improve GCG implementation since two 2002. Thus we can conclude that Hong Kong has given a quick responses in providing market's needs.

5. Singapore

In case of Singapore, the Corporate Governance Committee was established on March 2001 and later followed by the establishment of Council on Corporate Disclosure and Governance (CCDG) on August 2002. Listed companies in Singapore are required to implement CG and subject to question on deviations from GCG Code. Government of Singapore considers GCG important to strengthen Singapore's position in business and finance sector. There has been formed Council on Corporate Disclosure and Governance (CCDG) whose term of references are:

1. to decide accounting standard in Singapore
2. to strengthen framework of reporting and its standard according to international best practice
3. to evaluate and enhance framework of GCG and to promote GCG practices in Singapore by international best practices

Further, the Government also created accounting standard known as Financial Reporting Standards (FRSs) which refers to International Accounting Standards. Since 2003, listed companies in Singapore must submit financial report by standard of FRSs. CG evaluation is performed by CCDG which will report to Financial Minister. The evaluation is executed with scorecard evaluation which is constituted by 75 questions. On evaluation towards 3 local banks and 20 foreign banks in Singapore, especially in their remuneration system and "Audit and Accountability" implementation, it reveals the fact that local banks implement GCG principles better than foreign banks. However, foreign banks have a more independent remuneration committee than local banks'. Local banks still lack of transparency in remuneration policy.

4.4. Channeling the GCG, Growth and Development

Some literatures and findings (i.e., Tellez. 2009; Claessens. 2003) have identified several channels through which corporate governance affects growth and development:

- The first is the increased access to external financing by firms. This in turn can lead to larger investment, higher growth, and greater employment creation.
- The second channel is a lowering of the cost of capital and associated higher firm valuation. This makes more investments attractive to investors, also leading to growth and more employment.
- The third channel is better operational performance through better allocation of resources and better management. This creates wealth more generally.
- Fourth, good corporate governance can be associated with a reduced risk of financial crises. This is particularly important, as financial crises can have large economic and social costs.
- Fifth, good corporate governance can mean generally better relationships with all stakeholders. This helps improve social and labor relationships and aspect such as environmental protection.

All these channels matter for growth, employment, poverty, and well-being more generally. Empirical evidence using various techniques has documented these relationships at the level of the country, the sector, and the individual firm and from the investor perspectives

5. Conclusion and Policy Implications

There were major significant findings in this study. Out of the six independent variables that were hypothesized to influence ROE, three were found to have a significant impact on ROE. This finding has some policy implications. The three independent variables which were found to be significant are:

1. The independency of management
2. The responsibility of the companies in overcome the every single aspect related the company
3. The transparency of the policy. Since the transparency can minimize the moral hazard and corruption opportunities in managing the company.

Based on best practices of GCG in several countries, there are some key problems faced by all countries. Those are related with:

1. Board of Directors : the composition, determination and independency, leadership, nomination committee, election and length of period of BOD, double position in Director level, evaluation of BOD, etc
2. Remuneration : remuneration committee, reporting on remuneration
3. Audit and Accountability : Audit Committee, Internal Audit, Internal Monitoring and Risk Management, Financial Report Certification,

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