Bank risk profile, good corporate governance and firm values in go public banking companies in Indonesia

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ABSTRACT

The latest Bank Indonesia Regulation No. 14/18/PBI/2012 requires the banks to have minimum capital of 8%-14% depending on their own risk profile. Therefore, the main objective of this research is to assess whether the total of inherent risk profile of each bank meets the terms of this regulation. In addition, this study aims to examine the impact of inherent risk profile and GCG on the banking firm value. The sample in this study is determined by purposive sampling method and resulted in 24 banks or 72 observations during 2011-2013. The results showed that 23 banks had low risk and low to moderate risk, and only one bank had moderate risk. The results also showed that inherent risk profile rating is equivalent to capital adequacy. In other words, inherent risk profile of these banks have complied with Bank Indonesia Regulation No. 14/18/PBI/2012. Furthermore, this study indicated that GCG has significant and positive influence on the firm value, while the inherent risk has no influence on the firm value. Overall, this study suggest that go public banks in Indonesia are one of good alternative means of investment for its soundness as reflected by the fulfillment of minimum capital ratio required by the regulator.

A B S T R A K


1. INTRODUCTION

From the investor’s point of view, a company’s value is mostly determined by the level of soundness and its good corporate governance. A company with low level of soundness is a low risk company, since their lower business risk indicates their higher value. Banks with low inherent risk shows their ability in managing risk so that they could maintain their soundness. The banks’ soundness can increase their value for the investors. The evaluation will depend on how the management manages the business activities that will ultimately af-

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fect the soundness of the banks. The soundness of a bank is a bank obligation to preserve it for the majority of banking capital coming from the public. The soundness of a bank will lead to an increased public confidence so that the society will invest more in the bank. This is in line with the latest Bank Indonesia regulation No. 13/1/PBI/2011 Article 2 which states that banks are required to maintain and/or improve the soundness of banks by applying the principles of prudence and risk management in conducting business activities.

Risk management is needed due to the increasing complexity of the external environment and external changes that will affect banking activities. Risk management, which includes risk profile, consists of eight risks such as credit risk, market risk, liquidity risk, operational risk, legal risk, reputation risk, strategic risk, and compliance risk. Risk profile is the base and obligation of bank in the effort to meet minimum capital requirement which is also one of components in a bank soundness assessment. Risk profile is an assessment of inherent risks. This is in accordance with Bank Indonesia Regulation (PBI) No. 13/1/PBI/2011, Article 7 states that the assessment of the risk profile factor is an assessment of the inherent risk and quality of risk management implementation.

According to Mauraga (2011) risk-inherent is the risk that adheres in the banking business activities. Banks that able to manage and calculate inherent risk accurately will find it easier to estimate the impact on capital. Determination of the inherent risk level of each type of risk refers to the general principles of the Soundness Level Assessment of Commercial Bank. Determining the risk inherent level for each type of risk is done by classifying it into level 1 (low), level 2 (low to moderate), level 3 (moderate), level 4 (moderate to high), and level 5 (high). The lower the rank of inherent risk, the lower percentage of capital needed to be provided by the bank. In the contrary, the higher the rank of inherent risk, the higher capital needed to be provided by the bank, which is around the range of 8% - 14%.

According to Husnaini et al. (2014), banks that able to manage, the risks properly will influence the soundness level of the banking system. The lower inherent risk of a bank, the soundness level of the bank will be higher and vice versa. A sound bank is a bank that is not experiencing problems in their operational activities. A high soundness level of a bank will influence the assessment of regulator, communities, investors and all parties. The latest regulations of Bank Indonesia (PBI) No. 14/18/PBI/2012 article 2, paragraph 1 requires a minimum capital of 8% - 14% depending on the risk profile of each bank. The higher the risk, the higher minimum capital needed to provide by the banks. The minimum capital is measured by risk-weighted assets (RWA). High risk also showed business disruption and large financial loss which could impair bank's reputation in all aspects of the business.

Application of Good Corporate Governance (GCG) principle is also a factor in the decision to invest in a company (Suhartati et al. 2013). GCG is applied in banking sector based on a score or value of GCG in banks as determined by Bank Indonesia. This GCG score can provide investors with the information to understand the application of GCG in the bank. This score will show the management quality and the absence of problems that could make the moral hazard for customers and investors. According to SK BI No. 9/12/DPNP in 2008, low score GCG, will show very good quality of management in running the bank's operations which in turn could generate profit for the bank. (Juwenda, et al: 2014). Based on this phenomenon, this study aims to (1) determine the risk profile of the bank with the inherent risk based approach based on Bank Indonesia regulation No. 13/1/PBI/2011 (2) to empirically examine the influence of inherent risk and Good Corporate Governance (GCG) to firm value.

2. THEORETICAL FRAMEWORK AND HYPOTHESES

Risk Profile and Inherent Risk
Bank Indonesia Circular Letter No. 13/24/DPNP dated 25th October 2011 on the assessment of soundness level of commercial bank explained that the assessment Risk Profile factors is an assessment of the bank inherent risk. Inherent risk assessment is the assessment on the risk adheres in the business activities of the bank. Determination of the inherent risk level of each type of risk refers to the general principles of the Soundness Level Assessment of Commercial Bank. The determination of the risk inherent level for each type of risk is classified into level 1 (low), level 2 (low to moderate), level 3 (moderate), level 4 (moderate to high), and level 5 (high). The higher the risks profile the greater capital to be possessed by the bank. However, the greater capital owned by the bank does not mean a high risk profile.

The Influence of Inherent Risk and Firm value
Inherent risk is the risk adhered to the banking
business. Lower inherent risk will give signal to
investors that the company can manage the busi-
ness well. The smaller the company risk will in-
crease the firm value. According to Nursatyani
(2011) and Permatasari and Novitasary (2014) that
the credit risk (NPL) negatively influences the fi-
nancial performance of banks. Thus the first hy-
opthesis proposed related to risks inherent influence
on the firm value is:
H1: Risks inherent has negative influence on the
firm value.

**Good Corporate Governance and Firm value**

Bank Indonesia Circular Letter No. 15/15/DPNP in
2013 states that in order to improve the Bank’s per-
formance, protect the interests of stakeholders, and
improve compliance with legislation and regula-
tions, and ethical values generally accepted in the
banking industry, bank is required to conduct its
business based on the GCG principle. According to
Bank Indonesia Regulation No. 13/1/2011 Article
7, paragraph 2, bank needs to apply GCG in every
aspect of business. Each implementation of corpo-
rate governance principles should be in line with
Bank Indonesia provisions regarding good corpo-
rate governance by taking into account the charac-
teristics and complexity of the business.

The banks should ensure its GCG Principles
implementation in the area of transparency, ac-
countability, responsibility, independence and fair-
ness. GCG principles are needed to achieve their
sustainability with regard to the interests of share-
holders, clients and other stakeholders.

According to SK BI No. 9/12/ DPNP in 2008,
low score GCG, will show very good quality of
management in running the bank's operations
which in turn could generate profit for the bank.
Bruno and Claessens (2004) explained that a good
implementation of corporate governance will pro-
vide a positive influence on company performance.
The same result is expressed by Saidi (2007) that
company with good corporate governance tends to
have high market value. Likewise, according to
Tjondro and Wilopo (2011), GCG has positive in-
fluence on Price Earnings Ratio (PER) which indi-
cate that better GCG implementation will cause

**Table 1**

**Operational Definitions of Variables**

<table>
<thead>
<tr>
<th>Independent variables</th>
<th>Operational Definitions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Inherent Risk</strong></td>
<td>Risks adhered to banking business activities. Low level indicates lower inherent risks.</td>
</tr>
<tr>
<td>IR</td>
<td>Level 1: Low (L) = 1</td>
</tr>
<tr>
<td></td>
<td>Level 2: Low to Moderate (LTM) = 2</td>
</tr>
<tr>
<td></td>
<td>Level 3: Moderate (M) = 3</td>
</tr>
<tr>
<td></td>
<td>Level 4: Moderate to High (MTH) = 4</td>
</tr>
<tr>
<td></td>
<td>Level 5: High (H) = 5</td>
</tr>
<tr>
<td></td>
<td>Inherent risk is measured based on the inherent risk level disclosed by the bank. The bank will be assigned a value of 1 - 5 depend on the inherent risk level disclosed. The value of 1 is assigned when the inherent risk level disclosed is Low, assigned a value of 2 when the inherent risk level is Low to Moderate and so on.</td>
</tr>
<tr>
<td><strong>Good Corporate Governance</strong></td>
<td>Score was determined based on the GCG composite value as regulated by Bank Indonesia (PBI No. 13/1/PBI/2011). Small composite value shows better implementation of GCG. The composite value has a range of value with a scale of 1 - 5.</td>
</tr>
<tr>
<td>GCG</td>
<td>Composite Value &lt;1.5: Very Good</td>
</tr>
<tr>
<td></td>
<td>1.5 &lt;Composite Value &lt;2.5: Good</td>
</tr>
<tr>
<td></td>
<td>2.5 &lt;Composite Value &lt;3.5: Sufficient</td>
</tr>
<tr>
<td></td>
<td>3.5 &lt;Composite Value &lt;4.5: Insufficient</td>
</tr>
<tr>
<td></td>
<td>4.5 &lt;Composite Value &lt;5: Poor</td>
</tr>
<tr>
<td><strong>Dependent Variable</strong></td>
<td>Premium value paid by the investor.</td>
</tr>
<tr>
<td><strong>Firm Value</strong> NP</td>
<td>Measured by Tobin’s Q which indicate the potential of a company’s growth (Tobin and Brainard 1968; Tobin 1969)</td>
</tr>
<tr>
<td></td>
<td>Tobin’s Q value &gt;1 indicates higher growth of company and it is worth to invest on the company.</td>
</tr>
</tbody>
</table>

\[
Q = \frac{MVE + D}{BVE + D}
\]
better performance of the stock market as measured by PER. Peni and Vahamaa (2011) concluded that banks with strong governance have higher profitability while Chitan (2012) revealed that the presence of GCG committee will improve the performance of banks. Therefore, the second hypothesis is proposed as follows:

H2: Good Corporate Governance has positive influence on the firm value.

3. RESEARCH METHOD

Research Design
This study is a descriptive and associative research. Descriptive research provides a description whether the risk profile of each bank and the level of minimum capital owned by the bank have already in line with Bank Indonesia regulation. Associative research examines the influence of inherent risk and good corporate governance on firm value.

Sample
The population in this study is banking company listed on the Indonesian Stock Exchange (BEI) during 2011-2013. The sample in this study is determined based on purposive sampling method. To be included in the sample of this study, a bank should fulfilled several predetermined criteria such as: (1) Commercial banks listed on Indonesia Stock Exchange (BEI) during 2011-2013. (2) Reported and published annual financial statements for the fiscal year of 2011-2013. (3) Reported good corporate governance and inherent risk for the fiscal year of 2011-2013. Based on these criteria, the study obtained 24 banks as sample of this study or 72 observations for three years of research period.

Operational Definition of Variables
The independent variables are inherent risk and good corporate governance while the dependent variable is the firm value. The definition of each independent and dependent variables are described in Table 1.

4. DATA ANALYSIS AND DISCUSSION

The data were analyzed by both descriptive analysis and statistical analysis. Descriptive analysis was performed to describe the bank inherent risks the minimum capital owned by the bank. It also describes whether the minimum capital owned by the bank is in accordance with the inherent risk as stated in Bank Regulation No. 14/18/PBI/2012, which requires minimum capital of 8% - 14%. Meanwhile the statistical analysis in the form of multiple linear regressions was performed to test the first and second hypotheses. The model used to test the hypotheses of this study is proposed as:

\[ NP_j = b_0 + b_1IR_j + b_2GCG_j + \varepsilon_j. \]  

(1)

Whereby:

- \( NP \) = Firm value
- \( IR \) = Inherent risks
- \( GCG \) = Good Corporate Governance.

Results and Discussion

Descriptive Statistics
Table 2 shows descriptive statistics of all variables. It can be seen that the average of company value (TQ) is > 1 which means the bank included in the sample could provide prosperity to the sharehold-

### Table 2

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>IR</td>
<td>72</td>
<td>1.917</td>
<td>.048</td>
</tr>
<tr>
<td>GCG</td>
<td>72</td>
<td>1.887</td>
<td>.586</td>
</tr>
<tr>
<td>TQ</td>
<td>72</td>
<td>1.199</td>
<td>.811</td>
</tr>
</tbody>
</table>

Valid N (listwise) 72


### Table 3

<table>
<thead>
<tr>
<th>Model</th>
<th>Standardized Coefficients</th>
<th>T</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>I (Constant)</td>
<td></td>
<td>1.428</td>
<td>.158</td>
</tr>
<tr>
<td>IR</td>
<td>-.084</td>
<td>-.735</td>
<td>.465</td>
</tr>
<tr>
<td>GCG</td>
<td>.295</td>
<td>2.570</td>
<td>.012</td>
</tr>
<tr>
<td>F = 3.743</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sig = 0.029</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Adjusted R Square = 0.072</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The data were analyzed by both descriptive analysis and statistical analysis. Descriptive analysis was performed to describe the bank inherent risks the minimum capital owned by the bank. It also describes whether the minimum capital owned by the bank is in accordance with the inherent risk as stated in Bank Regulation No. 14/18/PBI/2012, which requires minimum capital of 8% - 14%. Meanwhile the statistical analysis in the form of multiple linear regressions was performed to test the first and second hypotheses. The model used to test the hypotheses of this study is proposed as:

\[ NP_j = b_0 + b_1IR_j + b_2GCG_j + \varepsilon_j. \]  

(1)

Whereby:

- \( NP \) = Firm value
- \( IR \) = Inherent risks
- \( GCG \) = Good Corporate Governance.
ers the company's growth higher. Inherent risk (IR) showed an average value of 1.917, which means the risk is still low (low) and tend to low to moderate (quite low). This illustrates the inherent risk that the bank is able to manage business risk, which means banks that go public a decent place to invest. A composite score of governance (good corporate governance - GCG) shows the average value of 1.887, which means governance of banks into the sample well.

Inherent Risks
Low inherent risk indicates bank soundness. Most banks included in the sample shows low and low to moderate inherent risk, which is Bank Mutiara. Inherent risk profile of bank included in the sample is in line with the capital adequacy of risk-weighted assets but only one bank had capital above the minimum standard set by the regulator (Bank Indonesia) which is Bank Mutiara in 2011. Bank Mutiara had the highest level of inherent risk for three years in a row compare to other banks. The risk level of Bank Mutiara was at level 3 or in moderate level of risk. Therefore Bank Mutiara should provide a minimum capital in the range between 10% and 11% of risk weighted assets, while the minimum capital provided is only 9.41%. In 2012 and 2013, the minimum capital of Bank Mutiara increased above the minimum capital required by Bank Indonesia. Overall, the bank included in the sample has minimum capital above the standards required by Bank Indonesia.

Hypotheses Testing Results
Influence of Risk Inherent on Firm values
Hypothesis testing results of analysis based on multiple linear regression model (as provided in Table 3) showed that the inherent risk has no influence on the value of the company. It can be seen from t value of -0.735 with significance level of 0.465, which reject the first hypothesis. The negative direction of risk inherent coefficient indicates the lower the risk inherent, the higher the value of the company. This result contradicts with Ratih (2011), Nursatyani (2011) and Permatasari and Novitasary (2014). This could be due to the bank risk assessment results which is consist of a combination of 8 (eight) risks such as credit risk, market risk, liquidity risk, operational risk, legal risk, legal risk, strategic risk, compliance risk and reputation risk.

Eight risk was assessed based on two criteria, inherent risk rating and the implementation of risk management. This means that even though the total of inherent risk is low but not followed by the application of good risk management, will not result in low total of inherent risk either. Based on data from the study, most of the bank in the sample showed moderate credit risk and market risk event though the total risk is still low. This indicate the risks posed largely resulted from the inability of debtors to meet their credit obligations or the amount of non-performing loans and the risk caused by changes in market conditions.

Influence of Good Corporate Governance (GCG) on Company’s values
The second hypothesis testing results of analysis as shown in Table 3 show that GCG has significant and positive influence on the value of the company. It can be seen from t value of 2.570 with a significance level of 0.012, which accepted the second hypothesis. This means that, when the GCG is properly implemented, it will lead to higher value of the company. The average value of GCG implementation shows a composite score of 1.887 which means banks included in the sample has properly implemented GCG. This finding is consistent with the results Bruno and Claessens (2004), Saidi (2007), Tjondro and Wilopo (2011) and Peni and Vahamaa (2011) which found bank with good corporate governance enhance corporate value.

The above evidence can be explained by the agency theory that the company who transparently and fully disclosed their information would reduce the asymmetry of information between management and shareholders. Low information asymmetry provide investors with certainty regarding the management accountability to shareholders so that investors could appropriately value the company. The improvement of corporate governance implementation from year to year shows the bank's ability to account the funds obtained from the public or third parties, thus increasing investor confidence of the bank itself. Based on these results, it can be concluded that GCG could also be taken into consideration for investment decision.

5. CONCLUSION, IMPLICATION, SUGGESTION, AND LIMITATIONS
This study aimed to determine the risk profile of banks with inherent risk approach and also to empirically examine the influence of inherent risks and Good Corporate Governance (GCG) on the firm value. The results of this study indicate that: 1) Overall, all banks included in the sample have low and low to moderate total of inherent risk. Inherent risk will affect the minimum capital to be provided
by the bank. Inherent risk is in line with the minimum capital to be provided by the bank based on the conditions set by the regulator (Bank Indonesia). All banks included in the sample have minimum capital above the standards as required by Bank Indonesia.

Only one bank, which is Bank Mutiara that had minimum capital below the standards set by the regulator (Bank Indonesia) in 2011. Therefore Bank Mutiara should provide minimum capital of 10% and less than 11% of risk weighted assets due to the moderate level risks inherent, while it only could provide minimum capital of 9.41%. 2) Assessment of the influence of inherent risks and GCG on the value of the company shows that inherent risk has no influence on the value of banking company. However, the correlation coefficient shows a negative direction as predicted, which means low risk inherent will increase the firm value.

The study also provides evidence that GCG has significant and positive influence on the company’s value, which means good implementation of GCG will increase the firm value as shown by the average value of GCG implementation. 3) Overall, it can be concluded that the banks that listed in Indonesia Stock Exchange could be a good alternative place to invest as indicated by the results of this study. The result shows the soundness of those banks as indicated by the required minimum capital provided were above the minimum capital required by the regulator (Bank Indonesia).

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