

# Determinants of Good Corporate Governance in the Banking Industry in Indonesia

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This study aims to identify the determinants and effectiveness of good banking governance practices in Indonesia. Data was collected based on verified theories, while the analysis method was obtained from the presentation of descriptive statistics, and factor analysis using the Structural Equation Model (SEM). Furthermore, the successful application of the principles is influenced by leadership, organisational culture, fit, and proper test. The results show that leadership and organisational culture have a positive and significant effect on the success of good corporate governance practices. Also, the fit and proper test, significantly moderates the relationship between leadership, thereby, making the study and organisational culture useful for bankers in effecting the practice, especially in commercial banks.

**Keywords:** *Bank system, fit and proper, governance*

## Introduction

The issue of Good Corporate Governance has long been unnoticed. However, the 2008-2012 financial crisis led to the failure of a sustainable global system due to the government's inability to contribute a sustainable business to the economy. Hopt (2013) analysed the issue of good corporate governance regarding banks and other financial institutions, in a bid to improve the views on good corporate governance by Lipton and Lorsch (1992), Brownbridge (2002), Khalid and Hanif (2004; 2005), Husain (2005), Fauver and Fuerst (2006), Kanagaretnam *et al.* (2007). According to Hopt (2013), it is essential in financial institutions due to their failure and those of banks resulting in financial crisis.

This study, therefore, aims to identify the determinants and effectiveness of good corporate governance practices in the Indonesian banking industry, particularly in commercial banks. The results enable banking practitioners to apply fit and proper practices, especially in commercial banks.

## Literature Review

Many countries in the world such as Netherlands (1997), Korea (1999), Indonesia (1999) and the Philippines (2001), have followed the footsteps of the UK and America to implement GCG by issuing "National Code on Corporate Governance." In early 1999 and 2001, corporate governance guidelines were issued to banks in the Philippines and Indonesia to form a "National Committee on Corporate Governance," which was changed to the "National Committee on Governance Policy" In 2004, to improve the Bank's performance, protect stakeholder's interest, and increase compliance with laws, regulations and ethical values (code of conduct), banks are required to carry out their business activities based on the good principles of governance (Kamarulzaman et al., 2018; Alimbetov et al., 2016).

However, due to the weak implementation of good principles of governance, banks carried out many deviant practices. According to Nave (2006), the level of success or failure of a business is determined by the leader's leadership style. The movement of companies from mechanical to organic leaves its leaders with the responsibility of its vision and quality, along with good corporate governance practices (Selznick, 1984). Van (2005) stated that all organisations need leadership for guidance. A company leader is someone with the capacity to direct people correctly to achieve its mission and vision while believing in the company's philosophy and values (Stahl *et al.*, 2012). Khan *et al.* (2014) provided an empirical justification which states that leadership ethics, is fundamental in the development of good governance practises as a social process and not as an economic logic. The findings of Widjajanti and Sugiyanto (2015) and Napitupulu *et al.* (2019) stated that leadership influences the implementation of good governance and provides trust to the community (Bakhyt et al., 2018).

Barney *et al.* (2001) stated the close relationship between organisational culture and the formulation of quality determinants under good practices. This finding is also supported by McKenzie (2010) that organisational culture is an important aspect used to determine its practices. A research conducted by Manik (2014) found a significant influence on its culture and organisation, which was strengthened by Lestari and Pamudji (2013) which showed a substantial and positive effect on its application. Furthermore, Thistle and Paramita (2007) stated that the stronger the application of corporate culture, the higher good governance. According to Puspitasari (2011), and Putri (2012), the role of organisational culture is critical in anticipating the opportunistic behaviour of managers in companies. Therefore,

organisational culture needs to be developed towards good corporate culture due to its good impact on a company's performance (Soodmand Afshar et al., 2018).

Another factor that is considered to affect this quality is the process of obtaining bank leaders using the Fit and Proper Test method. A research conducted by Khalid and Nadeem (2004), found that in both developed and developing countries, the quality of good corporate governance practices was determined by critical criteria such as the Fit and Proper Test. This was supported by the research carried out by Singh (2004), Dewing, and Russell (2004) in the UK, Hussain (2005) in Malaysia, Jayasuria (2006) in several Asian countries, and Sanusi (2010) in Nigeria. Similar research was also carried out at Islamic banks, by Wardhany and Arshad (2012) in Indonesia, Malaysia, and Brunei. The results of Hopt's research (2013) concluded that previous research proves the effectiveness of the Fit and Proper test on the implementation of good corporate governance and its practice in banks, which is different from other industries. One component driving the effective implementation of good corporate governance is the process which ensures that bank leaders lead and run the process correctly through fit and proper tests.

In addition, the relationship is strengthened by Putra's research (2014), which stated that internal auditor competencies have a positive influence on its realisation (integrity and competence are indicators of fit and proper test). This finding was strengthened by Andriani and Meuthia (2007), which stated that the competence and independence of the board of commissioners influenced the implementation in a positive direction. This means that a competent and independent board which tends to improve the implementation is an indicator of fit and proper test.

According to the Financial Services Authority Regulation No. 27 /POJK.03/2016 Concerning the Assessment of Capability and Compliance for Financial Institutions, there is a tendency to transfer the Fit and Proper process to bank management as implemented by developed countries. Many studies have examined its determinants; however, no study has been conducted to investigate in accordance with leadership and organisational culture in the banking industry. Therefore, this study is based on the above review, and the hypotheses proposed are as follows:

H1: Leadership has a positive and significant influence

H2: Fit and proper tests significantly moderate the relationship between leadership and good corporate governance's quality

H3: It is influenced by Organisational culture.

H4: Fit and proper tests significantly moderate the relationship between organisational culture and good corporate governance's quality

H5: Fit and proper test has positive and significant influence



## **Methodology**

This is a verification and descriptive research which is based on a number of theories. The analysis method starts from the presentation of descriptive statistics to factor analysis and calculation based on Structural Equation Model (SEM).

In addition, the research is descriptive and used to obtain empirical evidence of latent exogenous variables, namely leadership, organisational culture, as well as Fit and proper moderating variable. Also, the endogenous latent variable is the quality of good corporate governance.

The object of this study is to ensure that national commercial banks operating in Indonesia operate on good corporate governance. Therefore, data were obtained from primary sources through questionnaires and interviews from 115 respondents of the management of each bank using the Likert scale on questionnaires and Structural Equation Model (SEM) analysis tools.

## **Results and Discussion**

The suitability of the measurement model is tested to determine the research capability. The value of absolute, incremental, and parsimonious fit measures are used to determine the suitability of the entire model. Table 1 shows the measurement model of a good fit.

**Table 1:** Fit Model Measurement Test

<i>Goodness of Fit (GOF)</i>	<i>GOF Size</i>	<i>Value</i>	<i>Description</i>
<b><i>Absolute Fit Measures</i></b>			
<i>Chi-square</i>	The smaller the better	108.26	<i>Fit</i>
<i>Standardised RMR</i>	$\leq 0,05$	0.049	<i>Good Fit</i>
<i>RMSEA</i>	$\leq 0,08$	0.000	<i>Good Fit</i>
<i>ECVI</i>	The model ECVI value is close to saturated ECVI value	9.26	<i>Good Fit</i>
<b><i>Incremental Fit Measures</i></b>			
<i>NNFI</i>	<i>Marginal fit</i> $0,8 \geq \text{GOF} \leq 0,9$	1	<i>Good Fit</i>
<i>NFI</i>		1	<i>Good Fit</i>
<i>GFI</i>		1	<i>Good Fit</i>
<i>AGFI</i>		0.99	<i>Good Fit</i>
<i>RFI</i>		0.99	<i>Good Fit</i>
<i>IFI</i>		1.00	<i>Good Fit</i>
<i>CFI</i>		1.00	<i>Good Fit</i>
<b><i>Parsimonious Fit Measures</i></b>			
<i>Model AIC</i>	The model ECVI value is close to saturated ECVI value	880.26	<i>Good Fit</i>
<i>Saturated AIC</i>		1056	
<i>Independence AIC</i>		29467	
<i>Model CAIC</i>	The model CAIC value is close to saturated CAIC value	2325	<i>Good Fit</i>
<i>Saturated CAIC</i>		3033	
<i>Independence CAIC</i>		29587	
<b><i>Other GOFI</i></b>			
<i>Critical "N"</i>	$\geq 200$	294.87	<i>Good Fit</i>

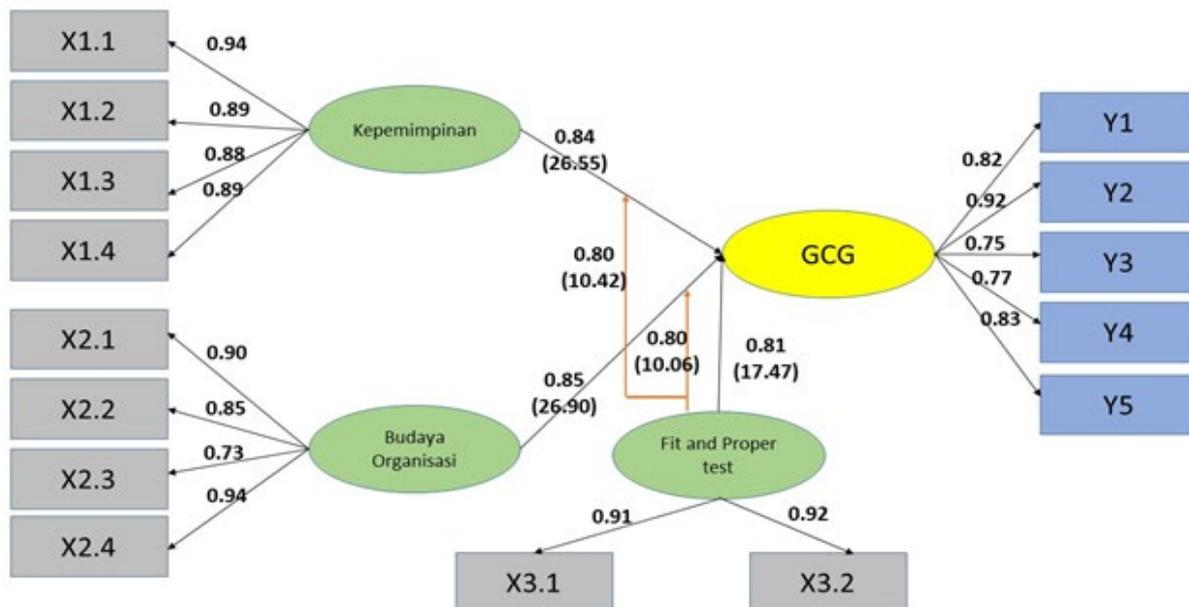
It determines the level of validity using the SLF and t-value, which is  $\geq 0.5$  for Standardised Loading Factor (SLF), and  $\geq 1,645$  for t-value. Furthermore, it tests the validity of each leadership, organisational culture, and fit indicator using SLF and t-values While the level of reliability is determined using the value of construct reliability (CR) and variance extracted (VE) with  $\text{CR} \geq 0.70$  and  $\text{VE} \geq 0.50$ . Based on table 2, the path diagram data processed shows that each indicator variable is reliable.

**Table 2:** Validity and Reliability

Indikator	Standardised Loading Factor	ei	t-value	CR	VE
X1.1	0.94	0.12	22.71	0.9746	0.7941
X1.2	0.89	0.20	23.74		
X1.3	0.88	0.22	22.10		
X1.4	0.89	0.20	23.47		
X2.1	0.90	0.20	23.86		
X2.2	0.85	0.28	23.36		
X2.3	0.73	0.47	17.21		
X2.4	0.94	0.11	23.75		
X3.1	0.91	0.12	17.37		
X3.2	0.92	0.12	18.05		

The results of testing the model in Figure 1 using LISREL 8.70 show the direct influence of leadership on significant and positive good corporate governance where  $t\text{-value } 26.55 > t\text{-table } 1.96$  ( $\alpha = 5\%$ ). A coefficient of 0.84 reflects a positive relationship with good corporate governance. Therefore,  $H_1$  is accepted. The model results are in accordance with research conducted by Manik (2014), Khan *et al.* (2014), Widjajanti and Sugiyanto (2015) and Napitupulu *et al.* (2019) which stated that there is a positive and significant influence between leadership on good corporate governance.

**Figure 1.** Research Model



The fit and proper test moderating effect test results show the significantly moderate relationship between leadership and good corporate governance using a coefficient of 0.80,

with a t value of 10.42. The t-table of 1.96 indicates that the fit and proper test significantly increase the influence of corporate leadership. Therefore, H<sub>2</sub> is accepted.

The test results show the direct influence of organisational culture with a t-value 25.90 > t-table 1.96 ( $\alpha = 5\%$ ), which obtained a coefficient of 0.85. Therefore, H<sub>3</sub> is accepted. The model results are in accordance with the research conducted by Barney *et al.* (2001), Widuri and Paramita (2007), McKenzie (2010), Puspitasari (2011), Putri (2012), Lestari (2013), and Manik (2014).

The fit and proper test moderating effect test results show the significantly moderate relationship between organisational culture and good corporate governance. The coefficient is 0.80 with a calculated t value of 10.06, T-value greater than > t-table 1.96 and a fit /proper test increase of organisational culture. Therefore, H<sub>4</sub> is accepted.

Based on the results of testing the effect of fit and proper test on good corporate governance, the significant and positive t-value 17.47 > t-table 1.96 ( $\alpha = 5\%$ ). The coefficient of 0.81 reflects a positive relationship with good corporate governance. Therefore, H<sub>4</sub> is accepted. The results of this study are consistent with research conducted by Putra (2014), and Andriani and Meuthia (2007) which stated that fit and proper tests have a positive and significant effect on good corporate governance.

## **Conclusion**

The findings of this study are consistent with the need for Indonesia's regulatory banks to focus on the determinants of good corporate governance. It is necessary to implement a fit and proper process with the aim of acquiring competent and independent leaders capable of increasing public confidence in banks, which is the economic logic of society. High organisational culture tends to be in line with the implementation of good corporate governance in banks and anticipated opportunist behaviour of managers. The implementation of fit and proper activities is an effort to realise good corporate governance. Therefore, the integrity and competence included in the fit and proper indicator are a filter in every expected outcome selection process.

This study is limited to relatively focus on commercial banks with data obtained from 115 respondents. Further research, should, therefore, investigate good corporate governance in other banks such as Islamic banks, foreign exchange banks, and rural banks using other variables or methodology not examined in this study.

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