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THE EFFECT OF CORPORATE GOVERNANCE AND CREDIT RISK TOWARD LIQUIDITY AND PROFITABILITY ON BANKING LISTED IN INDONESIA STOCK EXCHANGE IN 2012-2016

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ABSTRACT

The purpose of this research is to study and explain the effect of corporate governance and credit risk on liquidity and profitability on banking in Indonesia. This study used Generalized Structured Component Analysis (GSCA) to measure the effect of corporate governance and credit risk towards liquidity and profitability. The result of this research showed that the corporate governance has an effect towards liquidity and profitability, the credit risk has an effect towards liquidity and profitability, and the last, the liquidity has an effect on profitability

KEY WORDS

Corporate governance, credit risk, liquidity, profitability, conventional banking.

The Asian Development Bank identified the origins of the economic crisis in Asia, including Indonesia were the lack of implementation of corporate governance, including banking governance (Zhuang, et.al, 2001). This forced many banks to be liquidated. As a follow up, Bank Indonesia regulated the banking governance in Indonesia by passing the regulation regard Corporate Governance and Risk Management (PBI no.4/8/PBI/2006 dan PBI no.5/8/PBI/2003) by creating a sound and strong banking system. However, does the existence of these regulations are able to realize the achievement of sound and strong banking? This compels further investigation in Indonesian banks for both the conventional and sharia systems. This question initiated researcher to examine the effect of Corporate Governance and Credit Risk toward Liquidity and Profitability on the conventional banking after the enactment of these regulations. Previous researchers have shown different results, such as the research by Florinita (2014), Abogun *et al.* (2014), Inam and Mukhtar (2014), which showed that corporate governance has a positive effect on Liquidity, in contrast other researchs show different results, such as Delis *et al.* (2009) and Rajangan *et al.* (2014). Corporate governance has a positive affect on profitability as was exposed by other researchers such as Aggarwal (2013), Ghaffar (2014), and Todorovic (2013), however other studies show differing results, such as Omoniyi *et al.* (2013), and Rashid *et al.* (2010).

Credit risk affects negatively on liquidity as had been revealed by researchers such as Gautam (2016), Megeid (2013), and Alzoubi (2017), while different research showed by Murage and Muiru (2016) and Vodova (2012). Moreover, credit risk affects negatively on profitability as revealed by researchers such as Poudel (2012), Lata (2014), and Kodithuwakku (2015), while the different results showed by Olausi dan Abiola (2014) and Sutrisno (2016). Liquidity has a positive effect on profitability as was showed by Khan dan Ali (2016), Oluwasegun dan Samuel (2015), Ibrahim (2017), while different research as revealed by Nimer et al. (2015 and Dahiyat et al. (2016).

The debate on the result of previous studies about the effect of corporate governance on liquidity and profitability, the effect of credit risk on liquidity on profitability, and the effect of liquidity on profitability also motivated researcher to reexamine the arguments about the impat of corporate governance and credit risk toward liquidity and profitability.

LITERATURE REVIEW

Cadbury Committe (1992) defines corporate governance as the system by which companies are directed and controlled. OECD (2015, 2004) defines corporate governance as

system which involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Through Corporate Governance, the performance of bank is expected to be achieved. Some researchers showed that Corporate Governance can affect on performance. Todorovic, (2013) stated that companies with higher level of implementation of principles of corporate governance and better practice of corporate governance are more profitable and have better performance. Inam and Mukhtar, (2014) stated that Corporate governance is positively associated with profitability and liquidity. Adi *et al.* (20120) stated that the better corporate governance will improve financial performance.

Credit risk is the exposure faced by banks when a borrower (customer) defaults in honouring debt obligations on due date or at maturity (Kolapo, *et al.* 2012). In line with Kolapo's opinion, Brown and Moles, (2014) stated that credit risk can be defined as the potential that a contractual party will fail to meet its obligations in accordance with the agreed terms. Credit failures in banks is not new or a rare occurrence, they affect their liquidity position as well as cash flows and profits (Adeusi *et al.*, 2013). In line with Adeusi's opinion Megeid (2013) stated that liquidity performance tends to decrease with the increase in credit risk levels. Related with profitability, that any increase in the volume of non-performing loans would reduce profitability of banks (Etale *et al.*, 2016). Even, Alalade *et al.*, 2014 state that bank with high credit risk has high bankruptcy risk.

Based on the explanation above, that credit risk is faced by bank can cause to decrease the bank's liquidity and profitability.

Liquidity is a key issue in the business of banking. Just as the air is fundamental to the existence of man, so also is liquidity to the survival of banks. (Abogun, 2014). Lartey *et al.*, 2013 stated that the liquidity of a commercial bank is its ability to fund all contractual obligations as they fall due. In line with lartey's opinion, Rasul, (2013), stated that Liquidity implies availability of cash that how bank rapidly may convert its assets into cash to meet the need of short term. It is considered as life of the banks. Delis *et al.*, 2009 stated that banks hold liquid assets for two main reasons. First, to satisfy the demand for new loans without having to recall existing loans or realize term investments such as bond holdings and, second, to meet both daily and seasonal swings in deposits so that withdrawals can be met in a timely and orderly fashion. Based on Delis's opinion, liquidity can support profit achievement through satisfying the demand for new loan. Khan and Ali, (2016) stated that there is significant positive relationship between liquidity with profitability of the banks.

Based on the explanation in the above paragraph, the liquidity is important for banks to support the achievement of profit.

Ghaffar (2014) stated that the fundamental feature which should be present in any entity to call it a business is that it should have an intention to earn profit, include banking, so that bank performance is often measured by the level of profits earned by the bank (Sutrisno, 2016). Profitability has essential means for long-term survival of banking business, because the profitability of the business showed good prospects in the future (muthaher, 2014).

The profitability of banking does not occur suddenly but through business processes run by banks, so that profitability was predicted produced from liquidity, credit risk and corporate governance.

Hypothesis:

H₁: Corporate governance (X1) has influence on liquidity (Y1);

H₂: Corporate governance (X1) has influence on profitability (Y2);

H₁: Credit risk (X2) has influence on liquidity (Y1);

H₁: Credit risk (X2) has influence on profitability (Y2);

H₁: Liquidity (Y1) has influence on profitability (Y2).

METHODS OF RESEARCH

This research used explanatory research which describes the influence of the variable exogen to endogen by means of hypothesis testing and was be implemented at the banking

sector in Indonesia with period 2012-2106. The population of this study are the conventional banks only listed in Indonesia Stock Exchange (BEI). Selection process of sample was using purposive sampling method with the number of sample are 30 conventional banks listed on BEI in 2012-2016. The data analysis was performed using Generalized Structured Component Analysis (GSCA). There are four variabels which be used in this research, namely Corporate Governance, Credit Risk, Liquidity, and Profitability.

Figure 1 – Research Model

Table 1 – Variable Classification of Research Model

No	Research Variable		Indicator		
	Variable	Notation	Indicator Name		Label
1	Corporate Governance	X1	X1.1	Dewan Komisaris (Board of Commissioners)	DK
			X1.2	Komisaris Independen (Independent Commissioners)	KI
			X1.3	Komite Audit (Audit Committee)	KA
2	Credit Risk	X2	X2.1	Non Performing Loan	NPL
			X2.2	Loan Loss Provision	LLP
			X2.3	Aktiva Produktif Bermasalah (Adversely Classified Asset)	APB
3	Liquidity	Y1	Y1.1	Loan to Deposit Ratio	LDR
			Y1.2	Aset Likuid to Total Aset	ALTA
			Y1.3	Aset Likuid to Total Deposit	ALTD
4	Profitability	Y2	Y2.1	Return on Asset	ROA
			Y2.2	Return on Equity	ROE
			Y2.3	Net Interest Margin	NIM

RESULTS AND DISCUSSION

Based on the output of GSCA software, the results for FIT and AFIT values can be seen in Table 1.

Table 1 – Identification Goodness of FIT

BUK	Model Fit	
	FIT	0.345
	AFIT	0.342

The analysis result for BUK provide FIT value 0.345, it means that phenomenon on the model can be described by the variables that are used (34.5%), while the remainder 65.5% is explained by another variable that is not included in the model.

The results of identification of path coefficient of each variable can be seen in Table 2.

Table 2 – Estimation Result and P value of path coefficient

Path Coefficients					
Influence	Estimate	SE	CR	P	Description
X1->Y1	0.626	0.052	12.04 [*]	0.000	Significant
X1->Y2	0.360	0.101	3.57 [*]	0.000	Significant
X2->Y1	0.285	0.054	5.32 [*]	0.000	Significant
X2->Y2	-0.367	0.065	5.66 [*]	0.000	Significant
Y1->Y2	0.132	0.062	2.12 [*]	0.036	Significant

The effect of corporate governance (X1) on liquidity (Y1). GSCA analysis results obtained an estimate value 0,626 and CR value 12,04^{*} and P value 0.000 with significant level of 0.05, so hypothesis 1 which states that corporate governance has influence on liquidity is accepted. The direction of the effect is positive, it means that the more the corporate governance, the better the liquidity.

This outcome confirms previous research such as Florinita (2014), Abogun et al. (2014), Inam and Mukhtar (2014) and also supports the Agency Theory.

The effect of corporate governance (X1) on profitability (Y2). GSCA analysis results obtained an estimate value 0,360 and CR value 3,57^{*} and P value 0.000 with significant level of 0.05, so hypothesis 2 which states that corporate governance has influence of profitability is accepted. The direction of the effect is positive, it means that the more the corporate governance, the better the profitability.

This outcome confirms previous research such as Aggarwal (2013), Ghaffar (2014), and Todorovic (2013) and also supports the Agency Theory.

The effect of credit risk (X2) on liquidity (Y1). GSCA analysis results obtained an estimate value 0,285 and CR value 5,32^{*} and P value 0.000 with significant level of 0.05, so hypothesis 3 which states that credit risk has influence on liquidity is accepted. The direction of the effect is positive. It is an important result in this research that credit risk has a positive effect on liquidity. Credit risk should tend to decrease liquidity. This outcome doesn't confirm previous research such as Gautam (2016), Megeid (2013), and Alzoubi (2017), but confirms the findings of Murage and Muriu (2016).

The effect of credit risk (X2) on profitability (Y2). GSCA analysis results obtained an estimate value -0,367 and CR value 5,66^{*} and P value 0.000 with significant level of 0.05, so hypothesis 4 which states that credit risk has influence on profitability is accepted. The direction of the effect is negative, it means that the more the credit risk, the lower the profitability.

This outcome confirms previous research such as Lata (2014), Kodithuwakku (2015), Etale *et al.*, (2016) and Poudel (2012).

The effect of liquidity (Y1) on profitability (Y2). GSCA analysis results obtained an estimate value 0,132 and CR value 2,12^{*} and P value 0.036 with significant level of 0.05, so hypothesis 5 which states that liquidity has influence on profitability is accepted. The direction of the effect is positive, it means that the more the liquidity, the better the profitability.

This outcome confirms previous research such as Lata (2014), Kodithuwakku (2015), Etale *et al.*, (2016) and Poudel (2012).

CONCLUSION

The results of the study indicate that corporate governance in the conventional banking has an effect on the performance of liquidity and profitability. The corporate governance mechanism can improve supervision of the performance of the Board of Directors in terms of achieving profitability. This result shows that PBI regarding GCG has been able to influence on banking performance.

The results of the study show that credit risk in the conventional banking has an effect on profitability, the better the management of credit risk will affect the increase in profitability. This result shows that PBI regarding risk management has been able to influence on banking performance.

The results of the study show that liquidity has an effect on profitability. Management must be able to optimize its liquidity to support the achievement of profitability.

SUGGESTIONS

Based on result from this research, FIT values for BUK and BUS provide FIT are 0.345. It shows that phenomenon on the model can be described by the variables that are used (34.5%), while the remainder 65.5% is explained by another variable that is not included in the model. It means there is opportunity to add another variable in order to increase possibility for obtaining the higher FIT values.

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