CHAPTER I

INTRODUCTION

1.1. Background

The bank's executives have high authority to make a decision, especially in a credit application decision to a client. Bank credit is the total amount of credit available to an individual or business unit from a banking institution. In a bank credit application, the bank determines whether the credit is appropriate by evaluating the borrower's credit rating and income, other considerations such as collateral, assets, or how much debt the borrower has.

In a particular situation, bank executives have a role to decide bank credit approval. These executives are dealt with risks associated with material loans. These executives have widely known as material risk takers (MRT). This position is a common language used by the banking sector companies. The appointment of MRT is remuneration committee obligation and regulated on POJK no. 45 about implementation of corporate governance on remuneration for commercial banks. POJK no. 34 (2014) defines the remuneration committee as the committee that is established by the board of commissioner and has the responsibility to advise the board of directors regarding remuneration structure, remuneration policy, and amount of remuneration. The remuneration usually consists of base salary, honorarium, variable incentives, and any other benefits such as variable incentives, official residences, transportations, and other else.

This variable remuneration policy aims to maintain the health of the bank individually through the prevention of excessive risk-taking by the MRT. These policies of this variable remuneration incentives are called clawback and malus. Clawback provision is a method of firms to withdraw or 'claw' the incentives that are has already taken by the executives. Malus is also another policy to hold the payment of variable incentives, and in some cases are called holdback. These methods are effective to decrease accounting restatement, increase the trustworthiness of earnings, and lower audit fees because internal control is less likely to be examined by auditors (Chan et al. 2012). According to POJK no. 45 in 2016 defines malus or holdbacks are policy that allows banks to delay the payment partially or all of the deferred remuneration variables based on certain criteria. Meanwhile, clawbacks is an agreement between the bank and board of directors, board of commissioners in which the boards agree to return variable remuneration received as meets criteria determined by the bank.

After the accounting scandals in the last 1990s by Arthur Andersen and early 2000s by Enron and WorldCom, the Security Exchange Commission (SEC) has enacted Sarbanes Oxley-Act 2002. Section 304 of SOX describes the chief executive officer or chief financial officer shall reimburse the additional compensation before the disobedient of commission financial reporting requirements as a result of misconduct. Therefore clawback and malus provisions reinforce penalties for executives who are manipulated and incorrectly report financial statements. The penalties require the executive to return the incentive compensation received before the hearing. There was a significant decrease in the restatement of financial statements in the post-SOX period rather than the pre-SOX period. SOX has initiated another way to improve the quality of financial reporting by treating executives to expect a net benefit from reducing misstatements due to the adoption of the Malus and clawback provisions.

The clawback and malus provision also deals with the improvement of corporate governance. Addy et al. (2014) finds that clawback and malus exist when the corporate governance of a company is receptive or in process changes the culture of management entrenchment to a monitoring orientation. The management entrenchment appears when the executive puts their interests above of company goals. When the management entrenchment exists, it would harm going concern as the main vision of a company. It also weighs on shareholder value, employee morale, and implementation of good corporate governance (GCG) as a whole. The remuneration committee as a part of the corporate governance body also has the main authority to decide a company to implement and develop clawback and malus provision. The committee will tend to adopt clawbacks and malus when they have interlocks of managements to that using clawbacks and malus before. Similarly, the remuneration committee as a governance body has set a new standard of remuneration policy in the business process.

Since 2009, in the Europe and UK, clawback and malus provision is one of the measurements and requirements of corporate governance measures in the field of banks sector (Quinn and Browm 2013). In the US, clawbacks and malus provision has popular with the mass of research of clawbacks and malus implementation. Since 2005, approximately 80% of a corporation listed in the S&P 500 has implemented clawbacks and malus provision. This number increase because the data are limited to 2016. In some developing countries, India has introduced clawbacks and malus with deferred compensation to decrease excessive risk-taking by the executives and the objective of long term profits. Therefore, the manager tends to maximize their compensation by promoting excessive risk-taking on investments in riskier trading assets, even misstating the reports by cooking the books. However, after implemented the compensation policy, there are findings that the risk is shifting from risk-taking for compensation maximization to risk-taking to avoid financial losses.

In Indonesia, clawbacks and malus provision are introduced in 2015 by Financial Services Authority with POJK No. 45/POJK.03/ 2015 about Corporate Governance Implementation on Remuneration Policy for Bank Industry. The letter suggested that banking companies in Indonesia use clawbacks and malus to compensate their executives. Basically in Indonesia, the periods of clawbacks and malus are one to three years with equity shares or cash as the object of compensation. To the extent that bank companies tend to use malus rather than clawbacks as the compensation policy. Gillan and Nguyen (2016) on their research finds that in some developing countries, malus or holdbacks are more efficient because of its less cost. Gillan and Nguyen (2016) also suggested that firms with higher CEO replacement and frauds on operation are more likely to adopt holdbacks or malus.

As previously explained, malus and clawback are used as tools in controlling excessive risk-taking by MRT. Financial Services Authority Regulation no. 18 / POJK.03 / 2016 stated that the risks associated with variable remuneration consisted of eight risks in the Bank's business activities, namely credit risk, market risk, liquidity risk, operational risk, legal risk, reputation risk, strategic risk, and compliance risk. This is in line with research conducted by Lin (2016) and Chen & Vann (2017) which states that companies that clawback and malus provision have a decrease in overinvestment because corporate executives are more likely to do prudent risk-taking. However, the research conducted by Hirsch et al. (2016) states that clawback and malus make decision-makers tend to invest in riskier investment after the company implements clawback and malus. This shows that the treatment of clawback and malus encourages excessive risk-taking. One of the risks inherent in the Bank's business activities is equity risk which is part of market risk. Equity risk generally takes the form of a decrease in market share prices. In the equity section can also measure the risk of a company by looking at the ratio of equity in total assets. The ratio formed is a reflection of how the financial composition of the company in obtaining assets. The small equity ratio of total assets indicates that the company's assets are formed largely by debt.

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Generally, clawbacks and malus are the remuneration policy that would reduce risks from material misstatements, frauds, management entrenchment, and excessive risk-taking by the executives. Then, in this research would illustrate the relationship of GCG practice on compensation policy whether strong governance would implement clawbacks and malus provision or otherwise. Also, this research explains whether the company tends to adopt malus provision when it has greater risks.

1.2. Problem Formulation

Based on the described background, the formulation of the main focus of research are identify how corporate governance and firm risk-taking of banking companies would influence the tendency to choose malus as executive compensation policies in Indonesia.

1.3. Objectives of the Study

The objective of this study is to give empirical evidence of how corporate governance and firm risk-taking would influence the tendency to choose malus of executive compensation policies in Indonesia.

1.4. Significance of the Study

In previous research, most of the research was conducted at public companies outside Indonesia. Since malus and clawbacks were only implemented a few years ago by OJK. This study will bring new findings related to the application of clawbacks and malus in Indonesia. Corporate governance and firm risk-taking may influence the tendency to choose malus in Indonesia. This research might also find a new perspective that underlies the implementation of malus and clawbacks in Indonesia in the banking sector. Other factors such as the level of religiosity, law enforcement, prevailing norms, habits, may be factors that influence the application of clawbacks and malus in Indonesia which are not considered if the results of the hypothesis are not significant.