CHAPTER 1

INTRODUCTION

1.1 Background

At the end of 2015, Indonesian Financial Service Authority issued a new regulation No. 45 on the management of remuneration for commercial banks. With the issuance of this regulation, banks must adjust their remuneration policy for employees, directors, and commissioners in accordance with the provisions and principles in FSAR No 45. Failure to comply with this provision will have an impact on the downgrading of the company's good corporate governance factor. This regulation was issued in connection with corrective actions to correct the unhealthy way of giving bonuses during the world economic crisis in 2007 (Financial Service Authority Regulation number 45/POJK.03/2015).

One of the main factors causing the world economic crisis in 2007 was the tendency of financial institutions to take excessive risks. The risk-taking aims to get good performance in the short term and sacrifice long-term performance. The impact of this excessive risk taking is seen in the financial statements that do not show the actual conditions in the company (Apanpa & Ananaba, 2016). Executives tend to take excessive risks to get the maximum bonus, because usually bonus is based on short-term performance. The executives who prioritize short term performance will result in conflicts of interest with the shareholders. The executives tend to have a short term performance orientation and the shareholders tend to be oriented towards long term performance. From a behavioral perspective, executives take excessive risks because they have optimistic beliefs about economic conditions. Optimistic belief makes executives ignore extreme possibilities that will occur, such as an economic crisis (Akin et al., 2020).

After the economic crisis in 2007, it can be seen how important an effective mechanisms for decision making. Executives as parties who play a role in making decisions must have a sense of responsibility for the decisions they have taken. Such as any risk taking will affect the salaries and bonuses that have been given to executives. In response to the 2007 economic crisis, several policies were made, such as the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 in the United States and The Corporate Governance Code of 2014 in United Kingdom. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 provide a method for companies to recover compensation payments for executives who have made a mistake. For The Corporate Governance Code of 2014 in United Kingdom, requires a company to recover or withhold payments to executives. A policy that can make a company recover or withhold payment of bonuses or benefits is called a clawback policy (Apanpa & Ananaba, 2016).

After the 2007 economic crisis, clawback was introduced as a method to restore investor and public confidence. Usually the company adds clawback in the employment contract. Clawback can be used as collateral for the company in the event of fraud, violations, or decreased profits. In addition, clawback can be used to prevent misuse of accounting information by company executives (Kenton, 2021). Adoption of clawback makes CFO whose compensation is based on firm performance will be more cautious in presenting financial statements. The CFO will avoid restatements of financial statements and overstated earnings. Since it will affect their integrity as a part of company's executives (Kroos et al., 2018). As Thompson & Shroff (2021) pointed out, in the case of a restatement in the financial report, clawback allows the board to clawed-back their executive compensation, because of the misreporting.

Executive remuneration has a significant relationship with firm performance in terms of ROA and ROE. The higher remuneration the directors received, the better the firms perform. Higher remuneration can maintain the quality of the directors and encourage them to work harder. Firm performance has a positive relationship with leverage. This means that an increase in debt for investment produces a maximum return to the company. Greater leverage can be leading a company to a serious problem, because the company is required to pay higher interest rates on loans. If the return on investment is not maximized, the higher the risk of a company failed to pay its debts. This happens if the return on investment is not maximized. It would be worse if this situation occurs when economic conditions are chaotic, such as the world crisis in 2007. Because of that managers need to focus on the executive remuneration, and leverage since these factors have an direct impact on the firm performance (Mohd Razali et al., 2018).

The primary goal of effective corporate governance is to create executive compensation mechanisms and contracts that represent the interest of management and shareholder. To reach the goal the management can create their executive compensation using clawback provision. Chen & Vann (2014) found that board independence, number of the board meeting and number of board member are positively associated with the adoption of clawback. It indicates that firm with strong board tend to adopt clawback. Generally, the indicators to measure the remuneration for executives are risks and performance of the bank, business unit, and executive of a company adjusted to scale and complexity of the bank’s business activities. To have an effective remuneration system, the company needs to have good corporate governance related to the remuneration system. Most corporate governance indicators show a positive significant relationship with the remuneration system.

In Indonesia, governance in providing remuneration for commercial banks has been regulated in the Financial Services Authority Number 45 of 2015. Based on this rules in providing variable remuneration, banks can apply a malus or clawback policy. This policy allows banks to defer payment of variable remuneration to bank executives or to withdraw variable remuneration that has already been paid to the bank’s executives as long as they meet the bank's criteria. Previous research on clawback has generally focused on the consequences of using clawback as a compensation system. There are only few studies focuses on factors that encourage banks to decide to adopt clawback as a remuneration policy. This study will discuss the variables that impact banks' decision to adopt clawback as a remuneration policy, since clawback is not used by all banks in Indonesia. Then this research would examine whether the firm performance and corporate governance affect the decision of banks to choose clawback as variable remuneration payment system.

1.2 Problem Formulation

Based on the described background, the problem formulation of this research is does firm performance and corporate governance affect the decision of bank to choose clawback as variable remuneration payment system.

1.3 Objective of the Study

Remuneration is a factor that can motivate and increase the performance of a manager that will affect the firm performance (Setyawati & Hudayati, 2019). The general indicator to measure the variable remuneration includes the performance of the bank, the executive, and the business unit of the bank. Many studies have found the relationship between directors' remuneration with firm performance and corporate governance. Rarely of them discuss clawback and its relationship with firm performance and corporate governance. Therefore, the objective of this study is to provide empirical evidence of how firm performance and corporate governance would influence the bank to choose clawback as variable remuneration payment system in Indonesia.