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The effect of corporate governance and net interest margin on profitability and its implications on firm value

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Abstract

The purpose of this study is to examine the effect of corporate governance and net interest margin on profitability and its implications for firm value. The study was conducted at State Owned Enterprises (*Badan Usaha Milik Negara* - BUMN) Banks in Indonesia. There are four state-owned banks, namely Bank Negara Indonesia, Bank Rakyat Indonesia, Bank Tabungan Negara and Bank Mandiri, so that the sample is the entire population or a saturated sample. The observation period spanned ten years from 2011 to 2020. By applying panel data regression analysis, it was concluded that corporate governance and net interest margin had a positive and significant effect on profitability. The corporate governance, net interest margin and profitability had also a significant positive effect on firm value.

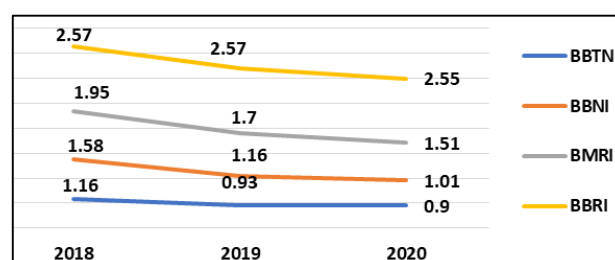
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1. Introduction

Banks are institutions that act as financial intermediaries between surplus units and deficit units. In its activities, the bank obtains margin from the difference between interest income and interest expense. The net interest income generated will ultimately determine the amount of profit earned which is ultimately related to dividend payments to investors. In the signaling theory, dividend payments are seen as good news for shareholders who will determine that the company has prospects for investors' expected returns. This condition will be responded by the market by increasing share prices and firm value.

State-Owned Banks have an important role in the economy in Indonesia, especially as a source of government revenue in financing the budget. Cash dividends donated to the state treasury in 2021 was recorded amounting to Rp. 13.54 trillion (Alfi, 2021) ^[1]. Given this strategic role, the existence of BUMN Banks must be maintained with good performance. However, it seems that in the last few periods, there has been a tendency for the firm value of state-owned banks to decline as presented in Figure 1. According to Raharja (2021) ^[29], declining firm value indicates declining company's performance.



Source: Processed Data

Fig 1: PBV of BUMN Banks in Indonesia for 2018-2020 period

There are various factors considered to have a significant influence on firm value. These factors include profitability. Various studies have been conducted to prove that bank profitability has a significant influence on achieving firm value with various results and conclusions. Regarding ROA, the ratio that calculates how much profit is generated from each asset owned, was conducted by Repi & Murni (2016)^[31] and Halimah & Komariah (2017)^[12] who succeeded in proving that ROA has an influence on achieving firm value. Different results were found by Putra & Chabachib (2007)^[26] and Maimunah & Fahtiani (2019)^[16] which showed that ROA had no effect on firm value.

Meanwhile, profitability is also influenced by various factors, including corporate governance. Corporate governance is an indicator for assessing public trust in banks which is believed to affect bank performance. Corporate governance mechanisms, such as the existence of boards of directors and audit committees, have the effect of significantly increasing profitability (Azmy *et al.*, 2019)^[4]. Other mechanisms, such as bank boards and directors' stake as proxies for corporate governance, have a significant effect on achieving financial performance, as found through a research by Okoye *et al.* (2020)^[19] in Nigeria. Likewise Rahman & Subagio (2021)^[30] stated that a similar conclusion that corporate governance has a positive and significant effect on profitability. While the effect of corporate governance on firm value has been known from the results of several studies that have been conducted. Various and inconsistent results were obtained, including Azaria & Muslichah (2021)^[3] using the audit committee as a proxy, resulting in the conclusion that corporate governance has a significant positive effect on firm value. In contrast to Muammar *et al.* (2019) who used managerial ownership proxies, with the results having no effect on firm value. Meanwhile, Perdana & Raharja (2014)^[22] found that managerial ownership proxies and independent commissioners, has significant positive results between corporate governance and firm value.

Apart from corporate governance, another factor that influences profitability and firm value is Net Interest Margin (NIM). NIM is the difference between interest income from loans and interest charges given to depositors. The higher the NIM, the more effective is the collection and distribution of funds to the public which in turn will drive increased profitability. These results have been proven by Priharto, Darto, *et al.* (2022)^[23], Putri & Satrio (2019)^[28] and Oktavianus (2016) who concluded the positive and significant effect of NIM on profitability. Another study by Dewi (2018)^[17] gave different results that NIM has a negative and insignificant effect on profitability. Furthermore, on firm value, research by Olalere *et al.* (2021)^[21] and Iskandar (2021)^[13] prove that NIM makes a significant contribution to increasing firm value, while in the different findings that NIM has no significant effect, are concluded by the studies of Freddy & Toni (2020)^[9] and Yuniarsa & Annis (2020)^[37].

Some of these inconsistent research findings have motivated the re-conduct of this research. The study was conducted to prove again whether corporate governance and NIM have a significant effect on profitability and have implications for firm value. Different from previous research, the object under study is devoted to state-owned banks considering that these state-owned banks have a strategic role for the economy. As stated by Putri & Nailufar (2019)^[27], SOEs have an important role in organizing the national economy in order to

implement the mandate of the 1945 Constitution for achieving people's welfare. In addition, the role of state-owned banks as one of the economic actors, has a systemic impact, so that the existence and good performance of state-owned banks must be maintained.

Literature Review

Signaling Theory

The fact that management is better informed than investors has exposed investors to uncertainty about their investments. This information asymmetry has prompted management to convey the information as a signal of certain events that will affect the firm value in the future, with the hope that investors will respond favorably (Ross, 1977)^[32]. These signals can be conveyed through financial performance, including the company's ability to generate profits and pay dividends. This information is also an important signal for investors because it can explain the condition of the company in the past, present and future prospects. Relevant and reliable information will be of great value to investors in relation to the investment decisions they will make. Therefore, management needs to convey it to reduce information asymmetry.

Agency Theory

Agency relationship occurs when the principal provides contract and delegation of authority to the manager to act and make decisions on behalf of the principal (Jensen & Meckling, 1976)^[14]. In future developments, there will be different interests between the principal and the manager that the principal hopes the manager can maximize the value of his company, while the manager has his own interests, namely maximizing his utility as a manager of the company. This is related to the three assumptions conveyed by Eisenhardt (1989)^[8] that basically, human natures are self-interest, bounded rationality and risk averse, and this is what happens to managers. To reduce the difference in interests between principals and managers, a control mechanism is required to direct activities and ensure the achievement of company goals, which is referred to as corporate governance (Dallas, 2004)^[5].

Firm Value

Firm value is generally associated with the stock market price. This value reflects how much the stock price will be paid by investors, so that the higher the value, the higher the firm value. One measurement that can be used to see how a company creates value is to use price to book value (PBV). This ratio compares the market price of a stock to its book value, which is explained by the following equation (Priharto, Buana, *et al.* 2022)^[24]:

$$PBV = \text{Stock Price Per Share} / \text{Book Value}$$

Corporate Governance

In this study, corporate governance is measured by the Corporate Governance Perception Index (CGPI). The Indonesian Institute for Corporate Governance (IICG) in collaboration with SWA magazine, conducted an assessment of the implementation of corporate governance practices through ranking with a CGPI score as the final result. The assessment includes aspects of compliance, conformance and performance, and the score obtained will indicate the level of trust the company has in the implementation of good

corporate governance. The range of scores based on the assessment categorization is as follows: range 55-69.99: quite reliable; range 70-84.99: reliable; and the range 85-100: very reliable (Priharta & Rahayu, 2019) [25].

Return on Assets

Return on Assets (ROA) shows how much the company's assets contribute to profits achievement. Since most of the bank's assets come from public deposits, the advantage of using ROA in assessing profitability is that this ratio has taken into account the risk level of leverage, so that ROA is considered the main proxy in measuring bank profitability. As stated by Garcia & Guerreio (2016), Zampara *et al.*, (2017) [38] and Naeem *et al.*, (2017) [18], this study uses ROA to measure profitability which is calculated by the following equation:

$$ROA = (\text{Net Profit} / \text{Total Assets}) \times 100\%$$

Net Interest Margins

Net interest margin which shows the difference between interest income and interest expenses, is one of the indicators showing the ability of bank management to manage public deposits and distribute them in the form of productive assets namely, distributed loans. NIM measurement is carried out with the following calculations (Loen & Ericson, 2008) [15]:

$$NIM = (\text{Net Interest Income} / \text{Average Earning Assets}) \times 100\%$$

Thinking Framework and Hypotheses

This study tested two models. The first model uses profitability as the dependent variable with a proxy for ROA, then the second model uses firm value as the dependent variable with a proxy for PBV. The framework for thinking can be seen in Figure 2 below.

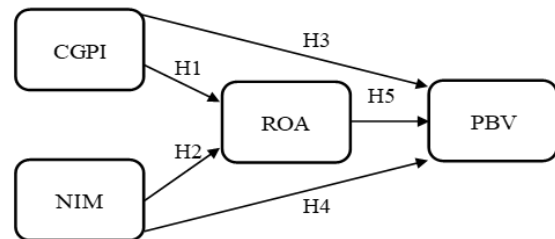


Fig 2: Thinking Framework

Furthermore, based on the previous theory and research that has been described, the research hypothesis can be explained through following table 1.

Table 1: Research Hypotheses

Symbol	Variable	Hypotheses Model 1 ROA	Hypotheses Model 2 PBV
PBV	Price to Book Value	-	-
ROA	Return on Asset	-	H ₅ (+)
CGPI	Corporate Governance	H ₁ (+)	H ₃ (+)
NIM	Net Interest Margin	H ₂ (+)	H ₄ (+)

Methodology

This study uses a quantitative approach which is carried out by means of multiple linear regression analysis, with the following model:

Model 1

$$ROA_{it} = \alpha_0 + \alpha_1 CGPI_{it} + \alpha_2 NIM_{it} + \epsilon_i \tag{1}$$

Model 2

$$PBV_{it} = \alpha_0 + \alpha_1 CGPI_{it} + \alpha_2 NIM_{it} + \alpha_3 ROA_{it} + \epsilon_i \tag{2}$$

Population and Sample

This study seeks to prove whether corporate governance and NIM are variables considered to affect bank profitability and having implications for firm value. The population studied is the State Owned Enterprise Banks in Indonesia. There are four banks for the population, namely Bank Negara Indonesia

(BBNI), Bank Rakyat Indonesia (BBRI), Bank Tabungan Negara (BBTN) and Bank Mandiri (BMRJ), so that the sample is the entire population or saturated sample (Sugiono, 2014).

Data Source

Secondary data used in this study were obtained through website: www.idx.co.id in the form of company financial statements for the period 2011 to 2020, as well as a research report and ranking of the corporate governance perception index 2011-2020 published by the Indonesian Institute for Corporate Governance (IICG).

Results and Discussion

Statistical Data Description

Table 2 below shows a description of the statistical data for each of the variables studied.

Table 2: Description of Statistical Data

	PBV	ROA	CGPI	NIM
Mean	1.824036	2.773000	88.86550	5.986750
Median	1.790000	2.850000	87.85500	5.795000
Maximum	3.340000	5.150000	94.94000	9.580000
Minimum	0.800000	0.130000	84.16000	3.060000
Std. Dev.	0.648268	1.207148	3.011316	1.445363

Source: Processed Data

Firm value with PBV proxy shows a mean of 1.824036, a median of 1.790000, a minimum and maximum value

between 0.800000 which was achieved by BBTN in 2013 up to 3.340000 which was obtained by BBRI in 2011, with a

standard deviation of 0.648268.

ROA financial performance has a mean of 2.773000, a median of 2.850000, a minimum to a maximum of 0.130000 with achieved by BBTN in 2019 up to 5.150000 obtained by BBRI in 2012, with a standard deviation of 1.207148.

Corporate governance with the CGPI proxy has a mean of 88.86550, a median of 87.85500, the minimum to maximum value range is 84.16000 obtained by BBRI in 2011 up to 94.94000 achieved by BMRI in 2020, with a standard deviation of 3.011316.

NIM's financial performance has a mean of 5.986750, a median of 5.795000, with a minimum and maximum value between 3.060000 generated by BBTN in 2020 up to 9.580000 achieved by BBRI in 2011, with a standard deviation of 1.445363.

Multiple Linear Regression Analysis

Based on data processing with multiple linear regression using the SPSS version 25 program, the results are obtained as shown in table 3 below:

Table 3: Multiple Linear Regression Test Results

Independent Variable	ROA		PBV	
Constant	-7.438		-5.909	
CGPI	0.063		0.066	
	0.053	***	0.002	*
NIM	0.763		0.213	
	0.000	*	0.016	**
ROA			0.226	
			0.026	**
F test	0.000	*	0.000	*
Adjusted R ²	0.772		0.723	

Source: Processed Data

Significant at α : * 1%; ** 5%, *** 10%

Based on table 3, the regression equation for both models can be described as follows.

Equation 1

$$ROA = -7.438 + 0.063*CGPI + 0.763*NIM + \varepsilon_i \quad (3)$$

Equation 2

$$PBV_{it} = -5.909 + 0.066*CGPI_{it} + 0.213*NIM_{it} + 0.226*ROA_{it} + \varepsilon_i \quad (4)$$

Effect of CGPI on ROA

CGPI has a significant positive effect on ROA. As a bank owned by the Government of the Republic of Indonesia, the community considers the four banks as safe and trusted places for customers. This principle of prudence is because it is supervised by the government and the community which encourages the management of public funds to be always in good risk management. With high public trust, public savings funds can be channeled through loans, so that banks are able to create profits which will ultimately be able to increase profitability. These results are in accordance with the proposed hypothesis and are in line with the results of the study by Okoye *et al.* (2020) ^[19] and Rahman & Subagio (2021) ^[30] who concluded that corporate governance has a positive and significant effect on profitability.

Effect of NIM on ROA

NIM has a positive and significant influence on ROA. As an indicator of NIM performance achievement, it has been proven to have an impact on increasing profits. These results indicate that the higher the net interest income, the higher the profitability. This study is in line with the findings of Santoso (2021) ^[33], Sari & Suryono (2016) ^[34] and Anggriani & Suryaningtias (2017) ^[2]. Therefore, the results of the study have proven the proposed hypothesis.

Effect of CGPI on PBV

CGPI on firm value as measured by PBV, has a positive and

significant influence. Good governance is proven to be able to create structures, systems and mechanisms that guarantee the rights and obligations of stakeholders equitably to encourage business processes and achieve good financial performance. Stock market prices and firm values are increasing in response to these conditions. The research findings strengthen the study results of Hidayat *et al.* (2018) ^[11], Perdana & Raharja (2014) ^[22], and Azaria & Muslichah (2021) ^[3] who come to the same conclusion that corporate governance has a significant effect on increasing firm value. Therefore, the research findings are in line with the proposed hypothesis.

Effect of NIM on PBV

NIM has a positive and significant effect on PBV. The market responded well to the achievement of a higher NIM by increasing share prices. This situation provides good news for investors and other stakeholders to increase the value of the company. The results of this study are in line with the findings of Iskandar (2021) ^[13] and Olalere *et al.* (2021) ^[21] who concluded that NIM has a positive and significant effect on firm value. The research results have proven to support the proposed hypothesis.

Effect of ROA on PBV

ROA has a positive and significant effect on PBV. The higher the ROA reflects the good performance that encourages investor demand to own shares which in turn increases the stock market price and firm value. This finding is in line with the study of Utami, *et al.* (2021) ^[36], Halimah & Komariah (2017) ^[12], Iskandar (2021) ^[13], and Debora (2021) ^[6] who concluded that ROA has a significant influence on increasing firm value. The hypothesis proposed has been proven by the results of this study.

Based on the description and discussion above, the results of hypothesis testing on the regression model 1 and model 2 can be summarized as shown in the following table 4.

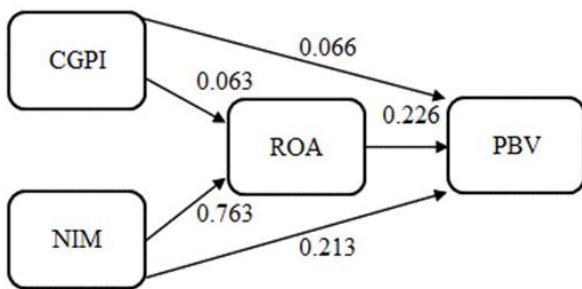
Table 4: Result of Hypothesis Test

Independent Variable	Model 1		Model 2	
	ROA	Hypothesis	PBV	Hypothesis
CGPI	+ / Significant	Proven	+ / Significant	Proven
NIM	+ / Significant	Proven	+ / Significant	Proven
ROA			+ / Significant	Proven

Source: Processed Data

Direct and Indirect Effects

To find out the direct and indirect effects of the CGPI and NIM variables through ROA on PBV, it can be seen in Figure 3 below:



Source: Processed Data

Fig 3: Direct and Indirect Effects

Effect of CGPI Through ROA on PBV

The direct effect of CGPI on PBV is 0.066. Meanwhile, the indirect effect of CGPI through ROA on PBV is 0.063 multiplied by 0.226, which is 0.014. Thus the total effect exerted by CGPI is the direct effect plus the indirect effect which is equal to 0.08. Furthermore, based on the calculation results, it is known that the value of the indirect effect is smaller when compared to the value of the direct effect.

The Effect of NIM Through ROA on PBV

The direct effect of NIM on PBV is 0.213. Meanwhile, the indirect effect of NIM through ROA on PBV is 0.763 multiplied by 0.226, which is 0.172. Therefore, the total effect given by NIM is the direct effect plus the indirect effect which is equal to 0.385. Furthermore, based on the calculation results, it is known that the value of the indirect effect is smaller when compared to the value of the direct effect.

Conclusion

Based on the conducted tests, it is proven that corporate governance and net interest margin have a significant positive effect on profitability. It is also proven that corporate governance, net interest margin, and profitability have a significant positive effect on firm value. This finding has practical implications that companies should maintain good governance and increase net interest margins by managing public financing and funds effectively and efficiently to increase profitability. High profitability will attract investors so that the firm value increases. Theoretically, the results of this study have strengthened agency theory that with good governance, it can reduce agency problems and agency costs, as well as create organizational management in a transparent, accountable, responsible, independent and fairness. In addition, good organizational performance which is reflected in the net interest margin and return on assets, can provide a positive signal for investors to increase the the firm value. It

is acknowledged that this study has limitations, including the small number of samples and does not include other factors that affect the profitability and value of the company. It is recommended that further research be carried out by grouping the banks, for example based on the type of Private Bank, Regional Development Bank, Foreign Bank, Mixed Bank, or based on the type of Conventional Bank and Islamic Bank. For the variables studied, public savings, financing, and operational costs to operating income can be used or by adding macroeconomic variables such as economic growth, foreign exchange rates, money supply, interest rates, and others.

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