Indonesian Journal of Sustainability Accounting and Management
ISSN 2597–6214 | e–ISSN 2597–6222
DOI: 10.28992/ijsam.v7i2.986

Implementation of Corporate Governance on Environmental Performance and Bank Risk in Indonesia

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Abstract: This study aims to examine the effect of corporate governance on environmental performance and the effect of environmental performance on bank risk in Indonesia from 2017 to 2021. Corporate Governance is measured by the board of directors and independent board, environmental performance is measured by the GRI Standard environmental category, and bank risk is measured by Non-Performing Loan (NPL). The research approach uses a quantitative approach that uses secondary data, namely annual financial reports, annual reports, and published bank sustainability performance. The total research population consists of 43 banks listed on the Indonesia Stock Exchange with a saturated sampling technique. The analytical tool used is path analysis. The results showed that corporate governance has a positive effect on bank environmental performance and environmental performance has a negative effect on bank risk. This study provides theoretical implications, namely deepening understanding of the relationship between CG practices and bank commitment to environmental sustainability, analyzing the relationship between environmental responsibility commitment and bank risk from the perspective of stakeholder theory. The practical implication is that companies must have programs and strategies to improve the bank's environmental performance and banks need to include environmental risk in loan assessment. This study has an originality value of CG implications on environmental performance and bank risk in the observation period of the COVID period and the issuance of 51/POJK.03/2017.

Keywords: bank risk, corporate governance, environmental performance, stakeholder theory.

Article info: Received 10 December 2022 | revised 27 July 2023 | accepted 30 August 2023

Recommended citation: Pradnyani, N. L. P. S. P., Suartana, I. W., Sari, M. M. R., & Budiasih, I. G. A. N. (2023). Implementation of Corporate Governance on Environmental Performance and Bank Risk in Indonesia. *Indonesian Journal of Sustainability Accounting and Management, 7*(2), 518–526. https://doi.org/10.28992/ijsam.v7i2.986

INTRODUCTION

Major changes in global climate conditions have led to increased public awareness about corporate environmental disclosures. The responsible actions taken by managers to improve and protect the environment as a whole are also consistent with the interests of the company (Cormier & Magnan, 2013). One of the industries that is concerned about environmental protection is banking. The bank's concern for environmental performance is influenced by management of the company. Corporate governance is part of a strategy to increase business success and corporate accountability. Banks that have greater sensitivity to environmental issues prevent the creation of a negative reputation associated with debtors who cause environmental damage (Weber, 2012) and can reduce the reputational damage caused by the financial crisis in the banking system as a whole (Venturelli et al., 2018). The phenomenon in the report entitled "Bankrolling Climate Change" shows that the 20 largest commercial banks in the world are among the factors most responsible for the coal industry's emissions, because banks provide 74 percent of total funding to the industry (Schücking et al., 2011).

In Indonesia to deal with the impact of environmental problems, the government through Otoritas Jasa Keuangan (OJK) made regulations to deal with the possibility of climate change which could worsen bank loan portfolios and create systemic risks to financial stability. POJK 51/POJK.03/2017 concerning the Implementation of Sustainable Finance for Financial Service Institutions, Issuers and Public Companies regulates specifically and is binding for all actors in the financial services sector in order to create a financial system that applies sustainable principles. Indonesian Banking Statistical Data for 2020 shows that Non Performing Loans (NPL) tend to show an increase, in January 2020 the NPL of Indonesian banks showed 2.77 percent and in December it increased to 3.06 percent. This problem is certainly interesting, is it because of the Covid-19 pandemic or because of the rules issued by the government? Banks should not act for their own interests but for stakeholders and benefit stakeholders. The emphasis of stakeholder theory on the strategy of building and maintaining stakeholder relationships in a sustainable manner is the key to corporate performance (Freeman, et al. 2021). The complexity of the bank's business is increasing so that more and more stakeholders are involved. Banking stakeholders need to understand the impact that banks have on the environment and society, and understand how much awareness and responsibility banks have in recognizing and optimizing related impacts and risks.

Several studies show that the implementation of governance with socially responsible banking strategies to create value, has a significant impact not only on shareholders, employees and suppliers, but also on all other stakeholders, and especially customers (Maignan, 2001; Sun & Price, 2016). Another opinion states that banking activities are not directly related to the environment, but banks play an important role in reducing climate change by not issuing financing to industries that are not environmentally friendly (Gangi et al., 2019). Direct involvement of banks in green practices (such as adopting energy efficiency initiatives) is a way to generate environmental benefits (Esteban-Sanchez et al., 2017; Matute-Vallejo et al., 2011). An environmentally responsible bank not only generates benefits for the world community, but also achieves the bank's strategic objectives and overcomes bank risks.

Opinions that strengthen the relationship between the environment and bank risk are first, if banks incorporate environmental sustainability criteria into their lending policies, then information risk is reduced. Banks will be able to overcome adverse selection and moral hazard problems, which are one of the main causes of non-performing loans in banks (Goss & Roberts, 2011). Second, banks that are more environmentally friendly can also achieve a higher level of operational efficiency, thereby contributing to bank risk reduction. Third, by implementing environmentally friendly measures, banks can improve their reputation and customer loyalty (Aramburu & Pescador, 2019; Gatzert, 2015; Ruiz et al., 2016), which will result in lower cost bank funding and greater funding stability (Bassen et al., 2006; El Ghoul et al., 2011).

Much research has been conducted on Environmental Performance and Implementation of Corporate Governance, but research on CG mechanisms, disclosure of environmental performance and impact on bank risk in Indonesian banking during the pandemic after the mandatory implementation of OJK Regulation No.51/POJK.03.2017 has not been much. There are three main differences that distinguish bank governance from other companies; 1) a wider range of stakeholders, including depositors and creditors; 2) The opacity and complexity of the bank's business, (Devriese et al., 2004; Graham et al., 2005; Mullineux, 2006) and, 3) a unique supervisory system in the form of a supervisory bank, deposit guarantor and a comprehensive banking legal and regulatory body (Alexander, 2006). This study contributes to the literature on the application of corporate governance as measured by the board of directors and independent commissioners, environmental performance is measured using the GRI standard and bank risk is measured by NPL.

METHODS

This study uses a positivism paradigm with a quantitative approach that examines research phenomena based on scientific methods to fulfill scientific principles, namely concrete/empirical, objective, measurable, rational, systematic, and replicable/repeatable. This study examines the phenomenon of banking corporate governance (CG) implementation and its impact on environmental performance and bank risk. Banking has an obligation to implement bank environmental performance referring to the bank's obligations to OJK regulation Number 51/POJK.03/2017 concerning the Implementation of Sustainable Finance. Banks that issue loans without regard to the social and environmental impacts of the company's economic activities will face bank risk problems

The type of data used in this study is quantitative data, namely annual financial reports and bank sustainable financial performance for the observation period, namely 2017–2021. Based on the time aspect, this research data is in the form of combined data (pooling) between time series and cross sectional, because the research was conducted at all the same bank companies, with the same instruments, at unequal time intervals, namely 2017–2021.

Corporate governance (CG) is a set of procedures and processes that help banks to be regulated and directed with certain criteria (Dibra & Bezo, 2021). CG is measured by the independent board of directors and commissioners (Gangi et al., 2019). The choice of measurement of the board of directors is due to the fact that the board of directors is the party that determines the policies and strategies of the company in the short and long term (Intia & Azizah, 2021). Management of the company by the board of directors with clear duties and responsibilities will improve environmental performance. Selection of an independent board of commissioners because an independent board of commissioners is a party that is not affiliated with the business and family of shareholders, members of the board of directors and other commissioners, as well as with the company itself (King, 2016). The existence of an independent board of commissioners can guarantee that the company can run the company mechanism effectively and in accordance with applicable laws.

Environmental performance (EP) is a bank's performance that is reported in annual reports and sustainable financial reports that provide data and information about bank practices, both directly and indirectly related to environmental protection (Gangi et al., 2019). Environmental performance is measured by the standard GRI environmental categories, namely: materials, energy, water and effluent, biodiversity, emissions, effluent and waste, environmental compliance and environmental assessment of suppliers.

Credit risk (CR) is the risk due to the failure of other parties to fulfill obligations to the bank including credit risk due to debtor failure, credit concentration risk, counterparty credit risk and settlement risk (POJK No.18/POJK.03/2016). Credit risk is measured using the Non Performing Loan (NPL) indicator. The calculation formula is as follows (Madugu et al., 2020):

$$\text{NPL} = \frac{(\text{Total non performing loans})}{(\text{Total outstanding loans})} \quad \ldots\ldots\ldots\ldots\ldots\ldots\ldots (1)$$

RESULTS AND DISCUSSION

The estimated significance parameter will provide information about the relationship between research variables. The basis that can be used to test the hypothesis is to test the output of the hypothesis test on the path coefficient using the initialization procedure.

Table 1 Bootstrapping Calculation Results

	Original Sample (O)	Sample Means (M)	Standard Deviation (STDEV)	T Statistics (|O/STDEV|)	P Values
Corporate Governance → Environmental Performance	0.186	0.185	0.060	3,100	0.002
Environmental Performance → Bank Risk	0.644	0.650	0.049	−13,265	0.000

Source: processed secondary data, 2022

Based on the bootstrapping calculation results in Table 1, the results of this study show: 1) Corporate Governance shows a positive and significant influence on environmental performance. This result is shown in Table 1 with a p-value of 0.002 <0.05 with a t-statistic of 3,100>1,960 and a positive original sample of 0.186. The results of this test indicate that hypothesis 1, which states that sustainable banking has a positive effect on environmental performance, can be accepted. This means that, the higher the corporate governance practices, the bank's environmental performance increases; and 2) Environmental performance shows a negative and significant influence on bank risk. This result is shown in Table 1 with a p-value of 0.000 <0.05 with a t-statistic of 13.265> 1.960 and a negative original sample of 0.644. The results of this test indicate that hypothesis 2, which states that environmental performance has a negative effect on credit risk, can be accepted. This means that, the higher the environmental performance practices, the lower the bank risk.

The results of the study show a p-value of 0.002 < 0.005, this indicates a more effective CG mechanism that positively influences the improvement of bank environmental performance. This result is consistent with Hypothesis H1. The results of this study indicate that an increase in CG practices is related to a higher level of bank commitment which affects the improvement of environmental performance. This research indicates that CG as measured by the board of directors shows that the board of directors is increasingly implementing CG strictly to ensure higher standards of environmental protection. The board of directors plays a positive role in influencing strategies and programs aimed at improving the bank's environmental performance. The informative role of the board of directors influences voluntary disclosure of environmental performance. This role occupies the function of directors who utilize employees to stabilize environmental performance. The board of directors coordinates across various departments thereby helping employees to maintain scope of work and attention to environmental performance tasks. The board of directors who are sensitive to the environment influence bank performance by utilizing environmental performance so that it is attractive to investors. Investors want to ensure that the appointed board of directors pays attention to environmental opportunities and risks, thereby affecting the overall well-being of the company. This finding is consistent with the research link The board of directors coordinates across various departments thereby helping employees to maintain scope of work and attention to environmental performance tasks. The board of directors who are sensitive to the environment influence bank performance by utilizing environmental performance so that it is attractive to investors. Investors want to ensure that the appointed board of directors pays attention to environmental opportunities and risks, thereby affecting the overall well-being of the company. This finding is consistent with the research link The board of directors coordinates across various departments thereby helping employees to maintain scope of work and attention to environmental performance tasks. The board of directors who are sensitive to the environment influence bank performance by utilizing environmental performance so that it is attractive to investors. Investors want to ensure that the appointed board of directors pays attention to environmental opportunities and risks, thereby affecting the overall well-being of the company. This finding is consistent with the research link thereby affecting the welfare of the company as a whole. This finding is consistent with the research link (Jo et al., 2015), whereas contrary to the agency perspective (Barnea & Rubin, 2010; Friedman, 1970). The results of the analysis show that the involvement of the bank's environment is not a pathological form of over investing which must be avoided through an effective CG mechanism.

CG as measured by an independent board of commissioners shows that governance solutions are accepted as positive and effective towards the bank's environmental commitment. These results indicate that independent boards of commissioners have less vested interests in business and could have a more significant role in implementing strategies to protect the interests of various stakeholder groups. Improvement of CG with monitoring from an independent board of commissioners and subduing the opportunistic behavior of managers. An independent board of commissioners can pressure banks to engage in activities that support environmental performance to ensure conformity between organizational actions and social values or organizational legitimacy. This is contrary to the view that effective CG will limit the commitment to implementing environmental performance for the benefit of shareholders. On the other hand, the attitude of a democratic independent board of commissioners has contributed to increasing bank attention to the environment. The independent board of commissioners has an impartial conduct and has no personal advantage in business operations. Thus, this independent board of commissioners takes an honest participation in organizational decision-making.

The results of this study are in line with the government's expectation that building sustainability can be achieved by taking into account the interests of all parties. The existence of the Covid-19 Pandemic which caused disruption and shifted various previous life arrangements so that companies work together from shareholders, employees, to the end consumer. Effective governance practices can only be realized if there is a shared awareness to apply GCG principles, starting from the grassroots to the level of strategic decision makers. A bank's greater sensitivity to the environment reflects a more effective implementation of CG. Banks that are more committed to the environment tend to outperform banks that pay less attention to environmental responsibility. Reducing costs and environmental risks can support bank stability (Alipour et al., 2019). In line with the broader view of CG (Lashgari, 2004), and contrary to the opinion that the implementation of CG to reduce the agency problem between ownership and management.

The results of the study show that the p-value is $0.000 < 0.05$ the effect of environmental performance on bank risk which states that H2 is accepted. This research shows that the increasing involvement of banks in environmental protection has an impact on reducing bank risk. These results indicate that banks that are more involved in environmentally friendly actions may be more efficient in their use of resources. Banks' environmental performance may be positively related due to the rapid technology life cycle and increasing consumer awareness of greenery. This action results in operational efficiency, because prevention of environmental risks can generate economic value. However, banks are financial intermediaries that not only provide money but also influence how money is invested by borrowers. In this case, bank has a relevant social impact. Their modes of financing can stimulate economic activity in ways that take into account environmental concerns (Scholtens, 2009).

A bank's level of concern for the environment may reflect additional requirements, such as lower environmental risk, relating to how an entrepreneur designs and manages a business (Weber, 2012). Banks' increased concern for the environment can be reflected in the selection of more sustainable and competitive companies equipped with a higher capacity for stakeholder influence (Barnett, 2007) and high quality of earnings, high levels of transparency, and high moral standards (Lopatta et al., 2016). These factors help banks to reduce adverse choices arising from information gaps that cause adverse selection and moral hazard caused by information gaps on the part of bank managers. The bank's sensitivity to the environment helps improve the bank's reputation and customer loyalty (Deng & Xu, 2017). Reputation is the main asset for banks, which base their business on trust (Pérez & del Bosque, 2015). By enhancing its reputation, banks can enjoy several competitive advantages (Dell'Atti et al., 2017).

Consistent with stakeholder theory, a bank with a good reputation earns the trust of customers (Venturelli et al., 2018). People tend to save money in banks with a stronger reputation. Banks that have a high reputation also have the opportunity to pay lower deposit rates, which has the potential to increase intermediation margins. These economic benefits reflect a green premium for environmentally friendly companies (Mason, 2012). Moreover, banks with an environmentally friendly approach are more sensitive to the interests of society. Bank social legitimacy supports economic legitimacy, banks can inspire trust among stakeholders (Alipour et al., 2019). This desire offers leading banks the opportunity to increase their market share and charge higher interest rates and commissions than less well-known banks. Greater attention to the environment is a proxy for the bank's vision of long-term profitability and higher service quality. All of these factors can contribute to reducing bank risk.

CONCLUSION

The results of this study indicate that the first implementation of governance that is more effective improves the environmental performance of banks. Second, an increase in the bank's commitment to providing environmental care has an impact on reducing bank risk. This study provides theoretical implications by adding to the literature to deepen understanding of the relationship between CG practices and bank commitments to environmental sustainability, analyzing the relationship between commitment to environmental responsibility and bank risk. This research practically provides several implications. First, the results of CG research have a positive effect on environmental performance. This implies that the board of directors has programs and strategies to improve the bank's environmental performance. The board of directors should strive to carry out environmental responsibility and improve the quality of the bank's environmental reporting as a mechanism for increasing profitability. To achieve this, the board of directors can create an environmental performance appraisal system that the bank's involvement in a business model that cares about the environment will generate a sense of trust from the public so that the bank can increase its competitiveness. Implementation of CG through the role of an independent board of commissioners as supervisors of regulatory mechanisms. An independent board of commissioners ensures that bank management can coordinate and integrate bank performance so that banks provide timely information, while reducing the dispersion and non-uniformity of environmental performance disclosures. Second, the results of the study show that environmental performance has a negative effect on bank risk. Poor environmental performance causes uncertainty in the company's production capacity and earnings, so that banks need to include environmental risk in loan assessments. In addition, green companies are less likely to face loan requirements. When a bank wants to provide collateralized loans to environmentally friendly companies, the collateral value is relatively lower compared to the size of the loan, the bank can consider the terms of the contract by taking into account environmental performance when making a lending decision. In addition, green companies are less likely to face loan requirements. When a bank wants to provide collateralized loans to environmentally friendly companies, the collateral value is relatively lower compared to the size of the loan, the bank can consider the terms of the contract by taking into account environmental performance when making a lending decision. In addition, green companies are less likely to face loan requirements. When a bank wants to provide collateralized loans to environmentally friendly companies, the collateral value is relatively lower compared to the size of the loan, the bank can consider the terms of the contract by taking into account environmental performance when making a lending decision. The practical implication of this research is to provide information and consideration for management to focus more on GCG, environmental performance disclosure and corporate credit risk. The higher the management of the company, the better the environmental performance. Banks that disclose environmental performance that gets wide attention from business people and the business world not only improve the company's image in the eyes of stakeholders but CSR disclosure has become a global issue. The development of bank performance in Indonesia is an attraction for investors, both local and international investors, so that it can improve the investment climate in Indonesia and will certainly further increase the value of the company. This research is still limited to the application of CG with the size of the board of directors and independent board, further research can add other proxies such as the board of commissioners, audit committee so as to make more comprehensive research.

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