Institutional Ownership and Firm Performance: Evidence from Bank Capital

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ABSTRACT

Governments have increasingly liberalized their policies in recent years to attract foreign investment, as they have witnessed a favorable impact – both direct and indirect – on target country firms and economic development. The effect of multiple large shareholders on firm performance cannot be considered in isolation, however, as the institutional and developmental conditions vary across countries. The objective of this research is to determine the influence of institutional ownership to firm performance especially in Bank Capital. This research uses quantitative methods and linear regression analysis. The results of the analysis show that there is no effect of institutional ownership on ROA and ROE at Bank Capital for the period December 2012 – December 2019. There is no effect of institutional ownership on the performance of Bank Capital because the percentage of institutional ownership less than 50% so the contribution does not have much effect on the company’s strategic decisions.

Introduction

Governments have increasingly liberalized their policies in recent years to attract foreign investment, as they have witnessed a favourable impact – both direct and indirect – on target country firms and economic development (Lindemanis et al., 2019). Foreign investors may transfer their expertise in processes, research and development abilities, managerial approaches, and technology, which results in productivity gains in the companies acquired (Piscitello & Rabbiosi, 2005). Most previous empirical studies differentiate between foreign and domestic acquirers as a group, while more recent literature reveals that foreign acquirers are not homogeneous and their origin does matter for firm performance (Bris & Cabolis, 2008; Chen, 2011).

Empirical evidence undermines the traditional assumption of dispersed ownership in modern corporations by showing that ownership concentration is a common pattern globally (Borisova et al., 2015; Gonzalez et al., 2017). Companies characterised by dispersed ownership are prone to experience principal-agent conflicts between
executives and shareholders (Fama & Jensen, 1983). Ownership concentration and the identity of firms’ primary large owners matter for corporate governance because of principal–principal agency problems (Kumar & Zattoni, 2017), or Type II agency problems, which may affect firm performance (Martínez-García et al., 2021). The effect of multiple large shareholders on firm performance cannot be considered in isolation, however, as the institutional and developmental conditions vary across countries (Palaiologos, 2017). Institutional factors shape cross-national differences in corporate ownership patterns, such as ownership concentration and the identity of the main shareholders (Morgan et al., 2009). Emerging economies are characterized by weaker formal institutions than developed countries as well as different informal institutions (Armitage et al., 2017).

**Literature Review**

Ownership is an elemental concept which, though applied in different legal systems, remains in essence unchanged (Beckett, 2019). It also assumes connectivity between the forms, yet legal systems have developed independently of each other, and what constitutes “ownership” in one does not derive its meaning from any other or from a common hub (Beckett, 2019). State ownership entails important advantages for firms, such as “patient capital” for long-term investments, exclusive rights to operate in certain industries or geographical areas, networks with foreign governments, and other resources typically not available to private firms (Lazzarini & Musacchio, 2018). State ownership may entail agency conflicts that negatively affect the willingness of SOEs to pursue business objectives that a core tenant of agency theory is that conflicts of interest create agency costs that reduce efficiency and ultimately the financial performance of companies (Aguilera et al., 2021). State owners are also often pictured as less capable owners that expose SOEs to heightened agency problems (Goldeng et al., 2008). Previous research attributes an important monitoring and activism role to shareholders (Goranova & Ryan, 2014). SOEs invest less than private companies in internationalization and R&D, strategies often regarded as risky, but that generally enhance firm performance in the long run (Tihanyi et al., 2019). State owners often pursue social and political objectives, frequently at the expense of business motives, and tend to be less capable owners in terms of monitoring management and implementing competitive strategies, SOEs are expected to trail behind privately-owned firms in terms of financial performance (Aguilera et al., 2021).

Empirical evidence is inconclusive on whether the relationship between state ownership and firm performance is positive or negative in line with such principal–principal problems (Wang & Shailer, 2018). The relationship between state ownership and firm performance in emerging East Asian economies is influenced by the quality of a country’s institutions (Boubakri et al., 2018). A weak formal institutional environment with low legal protection for investors enhances the agency problems between majority and minority shareholders (i.e., principal–principal problems), forcing shareholders who have an interest in a firm to increase their ownership position to overcome institutional voids while serving as a substitute for the market.
for corporate control (Martínez-García et al., 2021). The rentier economy through which the state defines and balances power among business family elites, state’s intervention in markets, and economic and social development role of the state (Fainshmidt et al., 2018).

Professional managers with little equity in the firms they run pursue their own interests at the expense of shareholders (Jensen & Meckling, 1976). Related work extends this perspective by examining whether diversification reflects managers’ self-interested pursuit (Bethel & Liebeskind, 1993; Hoskisson et al., 1994). Governance mechanisms such as boards of directors can monitor managers more effectively (Dalton et al., 1999) and if control mechanisms such as stock options induce these managers to align their interests with those of shareholders (Rajagopalan, 1997). Large shareholders have both a strong incentive to monitor managers and the power to discipline them by this logic (Chang, 2003). Several studies have found that firms with concentrated ownership have higher performance (Kang & Shivdasani, 1995; Shleifer & Vishny, 1986; Short, 1994; Thomsen & Pedersen, 2000). Companies can expropriate value from minority shareholders (Almeida & Wolfenzon, 2006; Fan et al., 2011).

Comparative analysis reveals that ownership concentration may be associated with the control leverage provided by the use of pyramidal structures (Zattoni, 1999) and dual class shares (Harris & Raviv, 1988), adopted separately or jointly (Barontini & Caprio, 2006). Pyramids consist of multiple layers of ownership relationships characterised by mutual cross-shareholdings (Patel et al., 2002; Perkins et al., 2014). Pyramidal structures are formed by a number of companies linked with capital ties, strengthened by interlocking directorates and tied with financial and investment policies which constitute relations of control (Zattoni, 1999). The ultimate owner maintains control over a large group of companies via indirect ownership (Bertrand et al., 2002), which lowers the risk from concentrated ownership (Demsetz & Lehn, 1985).

LaPorta et al. (1999) challenge the standard agency theory argument with their finding that, even in wealthy countries, controlling shareholders – usually families or the state – are present, and that many family members are both owners and managers. Accordingly, the positive relationship between ownership concentration and performance may generalize only to countries that have efficient capital markets and well-developed governance mechanisms such as the US. For most countries, the separation of ownership and management has yet to take place.

Other studies focus on not only the ownership concentration per se but also the identities of concentrated owners (McConnell & Servaes, 1990; Thomsen & Pedersen, 2000). They argue that many owners (banks, institutional investors, and other companies) are intermediate agents for final owners and have quite different incentives and risk preferences. Concentration of ownership by institutional investors, which are subject to scrutiny over their own performance, leads to better firm performance and there is disagreement on the role of family owners (Chang, 2003). Family owners are more risk averse and thereby destroy firm value (Thomsen &
Pedersen, 2000), while family owners reduce agency costs and thereby increase firm value (Fama & Jensen, 1983; Shleifer & Vishny, 1986).

Cross-shareholding may also not be an effective monitoring tool (Chang, 2003). The impact of concentrated ownership on firm performance is weaker in France, where high ownership concentrations are more common and most of the dominant owners are banks, non-financial corporations, or the government (Gedajlovic & Shapiro, 1998). They treated group-affiliates as if these firms were independent and did not address the possibility that family owners might use affiliate ownership to maintain control, although these studies included affiliate ownership as an ownership category explaining firm performance (Chang, 2003).

One of the earliest studies shows that higher concentration increases the profit rates of the banks (Short, 1979). Bourke (1989) can be regarded as one of the pioneering empirical analysis of overall profitability of CBs, which in general use ROA and/or ROE as performance measures and models overhead costs, capital ratios, liquidity-risk and external factors (concentration, ownership, interest rates) as the determinants of profitability and finds internal factors and concentration as the positive determinants of overall bank profitability. Reiterating Bourke's study for the banks operating in the European Union (EU) countries, Molyneux & Thornton (1992) employ ROE as a profitability measure and confirm the results of the Bourke's analysis. Capital to asset ratio has a positive effect on the profitability of the banks in the EU region (Goddard et al., 2004). Focusing on the bank ownership as foreign or domestic, the positive effect of capital adequacy ratios on the bank performance confirmed while reporting the negative impact of cost to income ratio on the performance (Pasiouras & Kosmidou, 2007), and the study concludes that GDP growth and inflation have opposite effects on ROA for both domestic and foreign banks. Focusing on the performance of Greek banks by employing a GMM method, it concluded that ROAs of Greek banks are mostly determined by bank-level variables (Athanasoglou et al., 2008). Using the GMM methodology, a large sample including the data of 10,165 commercial banks from 118 countries for the period between 1998 and 2012 analyzed (Dietrich & Wanzenried, 2014).

Islamic banking profitability are measures and significantly affected by bank-specific factors such as gearing ratio, asset management, deposit ratio, and NPL ratio and external factor such as consumer price index (Shah Khan et al., 2014). A panel data analysis of five profitability measures has made and the study concludes that all types of funds collected through current, saving, or investment accounts are positively related to the profitability of Islamic banks (Haron, 2004) and the level of interest rates, inflation and bank size have significant positive impacts on the profits of both conventional and Islamic banks. The profitability of African IBs for the period from 1999 to 2009 examined and find that bank capital and size (positive), operation cost (negative), economic growth, inflation and banking industry concentration (positive) are significant determinants of the profitability (Kasman et al., 2010).
The relationship between the ROE and the efficiency factors of 78 Islamic banks from 25 countries for the period covering 1992 to 2009 analysed and the fixed effect estimation results indicate that more profitable banks have higher operation costs, higher equity to asset ratio (Ahmad & Noor, 2010). Operating expense, nonperforming loans are negatively and banks size positively related to ROA for 25 IBs from 12 countries (Masood & Ashraf, 2012). The Generalized Method of Moments technique for dynamic panels using bank-level data for 42 Asian countries over the period 1994 to 2008 applied to investigate the impacts of bank capital on profitability and risk, and ignoring influence factors, the extant literature presents an ambiguous impact of bank capital on profitability (risk), however, when the effects from the influencing factors are taken into consideration, three conclusions are reached (Lee & Hsieh, 2013). First, along with the change in the categories of banks, investment banks have the lowest and positive capital effect on profitability, whereas commercial banks reveal the highest reverse capital effect on risk; second, banks in low-income countries have a higher capital effect on profitability; banks in lower-middle income countries have the highest reverse capital effect on risk, while banks in high-income countries have the lowest values; third, banks in Middle Eastern countries own the highest and positive capital effect on profitability (Lee & Hsieh, 2013).

How capital influences profitability and risk in the context of Islamic and conventional banking in Gulf Cooperation Council (GCC) countries has analysed (Hasnaoui & Fatnassi, 2019). It achieves this through structure-conduct-performance, moral hazard, and regulatory hypotheses and with the generalised method of moments (GMM) technique for dynamic panels using bank-level data from 85 banks for the 2003-2011 period, Hasnaoui & Fatnassi (2019) found that highly capitalised Islamic banks generate low profitability, while in contrast, highly capitalised conventional banks generate high profitability; secondly, highly capitalised GCC banks (both Islamic and conventional) to be characterised by greater risk found, and additionally, all profitability and risk variables demonstrate persistence. Far East & Central Asian banks have the largest reverse capital effect on risk, while the lowest value occurs in Middle Eastern countries' banks and the persistence of profit is greatly affected by different profitability variables, and all risk variables show persistence from one year to the next (Lee & Hsieh, 2013).

**Method**

This research uses quantitative methods (Bajpai, 2018). The population in this study is Bank Capital because this research is a case study and the choice of Bank Capital because research is rarely done on it. This study uses data on quarterly financial reports and Bank Capital's annual reports obtained from the bankcapital.co.id page. This study uses the period December 2012 – December 2019.

This study uses linear regression analysis (Bajpai, 2018), because it uses one independent variable and two dependent variables. The independent variable in this
study is the institutional ownership. The dependent variable in this study is return on assets (ROA) and return on equity (ROE).

The operational definitions of variables in this study are as follows:

The institutional ownership : percentage of institutional shares shown in the quarterly financial statements

ROA : ROA figures shown in the quarterly financial statements

ROE : ROE figures shown in quarterly financial statements

The research’s framework is as follows:

The regression equations are as follows:

\[ Y_1 = a_1 + b_1X + e_1 \]
\[ Y_2 = a_2 + b_2X + e_2 \]

Explanation:

\[ Y_1 = \text{ROA} \]
\[ Y_2 = \text{ROE} \]
\[ X = \text{institutional ownership} \]
\[ a_1, a_2 = \text{constant} \]
\[ b_1, b_2 = \text{regression coefficient} \]
\[ e_1, e_2 = \text{error} \]

Result and Discussion

The result of the regression analysis on \( Y_1 \) (ROA) is as follows:

Table 1. The effect of institutional ownership on ROA
Table 1 shows that sig = 0.087 which means that there is no influence of institutional ownership on ROA in Bank Capital for the period December 2012 – December 2019. The regression equation is Y₁ = -0.013 – 0.323X

Table 2. The effect of institutional ownership on ROE

The results of the analysis show that there is no effect of institutional ownership on ROA and ROE at Bank Capital for the period December 2012 – December 2019. This research’s results are in line with previous researches (Chang, 2003; Connelly et al., 2012; Craswell et al., 1997; Demsetz & Villalonga, 2001). There is no effect of institutional ownership on the performance of Bank Capital because the percentage of institutional ownership less than 50% so the contribution does not have much effect on the company's strategic decisions.

Conclusion

The results of the research show that there is no effect of institutional ownership on ROA and ROE at Bank Capital for the period December 2012 – December 2019. There is no effect of institutional ownership on the performance of Bank Capital because the percentage of institutional ownership less than 50% so the contribution does not have much effect on the company's strategic decisions. Managerial implication of this research is Bank Capital must increase the percentage of institutional ownership to
improve performance. Future research should investigate about other variables that affect firm performance, such as corporate social responsibility. The research’s contribution is identifying shares of the institutional in the company that associate with its performance. This study has limitations in terms of the time span of the study. Future studies should use a longer time span.

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References


