

CHAPTER I

INTRODUCTION

A. BACKGROUND

The banks plays a significant role in all economic activities of a nation. Today Sharia and conventional commercial banks have come to be regarded as instruments of economic growth with social justice. In this role, they have to mobilize savings of the community and channel them into socially productive investments. The banks have two functions, namely primary functions and secondary functions.

The primary functions of a bank can be classified to accept deposits and lending money. One of the most important primary functions of a Sharia and conventional commercial banks is accepting deposits. A major portion of the deposits accepted by the commercial banks are repayable by demand. But other types of deposits are also accepted by the modern banks, namely saving deposits, current or demand deposits, fixed or time deposits. Current or demand deposits are repayable on demand. The deposits repayable on demand are known as demand deposits in the USA and current deposits in the England. Generally, both the terms are used globally. These deposits are usually opened with a minimum

balance prescribed by the bank and any amount can be deposited in the account. These deposits can be withdrawn by the issue of cheque. Generally, no interest is allowed in the current account. These accounts are generally opened by business houses. Saving deposit accounts are maintained by the commercial banks to pool the small savings of low and middle income groups. This is a device to encourage thrift among the persons who earn only a fixed income every month. Certain restrictions are also imposed on the opening and operation of saving deposits account. These restrictions may vary from bank to bank. Usually, all banks restrict the maximum amount that can be deposited in or withdrawn from saving accounts. The number of cheques that can be drawn against the account within a specified period is also restricted. Deposits for a fixed period are also accepted by the commercial banks. In England, these deposits are known by the name fixed deposits and time deposits in the United States. Fixed deposits are advantageous to both the banker and depositor. The depositor prefers this type of deposit because they earned a higher rate of interest or margin. The banker is interested in such deposits because they get the money for a fixed period of time. As the date of repayment is certain, they are able to invest the money for long periods and thus earn a higher return on the investment. Cheque system is not allowed against fixed deposits.

By accepting current and saving deposits, the banks provide a service to the community. First they protect the funds of depository from loss or theft. Secondly, they provide an easy and convenient means of transferring funds through cheques and transfers, and the help the depositors to earn a regular income in form of interest or margin.

Sharia and conventional commercial banks not only accept deposits, but also lend money that they have obtained through deposits to those who needs some money. They provide a channel through which the individual savings can be lent to commerce and industry. They mobilise the idle capital of the nation and make them available for productive purposes. The banks lend money in different forms. They can be either secured or unsecured. The most popular lendings are overdrafts, cash and credits, loans and advances and discounting of bills of exchange. By accepting deposits and lending money, the banks not only act as intermediary between the depositors and the borrowing businessmen, but also they create additional purchasing power. Therefore, the creation of credit is an important function of Sharia and conventional commercial banks.

The modern Sharia and conventional commercial banks, in addition to the primary functions, perform a large number of other functions just to provide additional facilities to its customers. Such functions can also be classified under two heads; agency services and general utility services.

In many cases, the banks act as agents of their customers. As an agent the banker renders the services for example; collection of cheques, drafts, bills and other obligations for their customers, the conduct of foreign exchange business, conduct of stock exchange transactions such as purchase and sale of securities for the customers.

The decline in the quality of the financing portfolio of banks was the main cause of problems in the banking system and in financial in developed economies. Indeed, the increase in financing, underlines the links between macroeconomic and financial shocks and the relationship between the friction in the credit market and the risk of financial instability. The theme of "non-performing financing" (NPF) has attracted more attention in recent decades.

Several studies examined bank failures and find that asset quality is an indicator of insolvency (Demirguc-Kunt, 1989; Barr and Siems, 1994). Banks still have a high level of impaired financing before the bankruptcy. Therefore, the large amount of bad financing in the banking system generally results in a bank failure. The NPF are among the main causes of the problems of economic stagnation. Each failed financing in the financial sector increases the possibility to lead company to difficulty and unprofitability.

The minimization of non-performing financing is a necessary condition for improving economic growth. When non-performing financing retained permanently, these will have an impact on the resources that are enclosed in unprofitable areas. Thus, non-performing financing are likely to hamper

economic growth and reduce the economic efficiency (Hou, 2007). The fluctuations to the financial system can arise from factors specific to the company or macroeconomic imbalances. In general, the researches conducted in the developed economies have confirmed that macroeconomic conditions affect credit risk.

Indonesia's banking sector plays an important role in economic development at the moment. Bank serves as an institution for financial intermediation that is, as an institution conducting the crowd funds from public in the form of savings and channel them back to the community in the form of loans or financing. Financing which is given by the banking sector to the real sector to increase productivity of the real sector. Increased productivity of the real sector can improve the business and investment climate which then increases the national income.

One factor that can be used to indicate the existence of a banking crisis is the level of financing and non-performing credit, therefore, to analyze the factors that determine the level of non-performing financing are important and substantial for financial stability and management of the bank. According to Mankiw (2006), the investment sector is an important sector which is in the circular flow of money in the economy. The following investment sector is a direct link between financial institutions and the real sector, which are goods and services sector. If the ratio of non-performing financing problems is high then the

bank will be more cautious in the practice of the two banking finance portfolio. Economic growth would also be declined because of the activity in the real sector slowly decreased.

Financing in Islamic banks have different principles with conventional bank financing that uses the principle of interest. In Islamic banks, public funds are not used by the bank as a debt to the bank, but it is a deposit of investment funds and the bank acts as investment manager in which the risk is borne by the owner of the mutual funds. Through these characteristics, Islamic banks have the ability to grow the economy better because the funding attached to the real sector and can not be used for speculative venture.

Since the issuance of the new Undang-Undang Bank Indonesia (The Law on Bank Indonesia) in 1999, Bank Indonesia has been given the mandate as the dual monetary authority which can run conventional and Islamic monetary policy. Since then, Islamic banking and finance is growing rapidly (Bank Indonesia, 2012).

Table 1.1 Share of Assets, Third Party Fund (TPF), Islamic Banks financing and Sharia Business Unit to Commercial Bank in 2012, 2013 and 2014 (%)

Indicator	Sharia Bank to Conventional Bank		
	2012	2013	2014
Asset	4,57	4,88	4,89
Third Party Fund	4,57	5,01	5,29
Financing	5,41	5,55	5,63

Source: Bank Indonesia (2015)

Based on the data in table 1.1, the share of assets, third party fund, and Sharia commercial banks financing and sharia business units (Unit Usaha Syariah) in is increased when compared to conventional commercial banks in the same period previous year. In 2013 and 2014, Assets are increased by 0.31 percent and 0.01 percent. Third party fund also increased by 0.440 percent and 0.28 percent. Credit or financing also increased by 0.14 and 0.08 percent.

Meanwhile, Sharia banking commitment to drive the real sector is not only well implemented, but also has cultivated continuously in optimizing its achievement. Financing as efforts of financial institutions in the real sector has received attention from Sharia Bank (Bank Indonesia, 2011). This can be seen in Figure 1.1, the share in third party fund and financing in Sharia banking is almost always balanced, but during 2014 and 2015 financing is more than third-party fund.

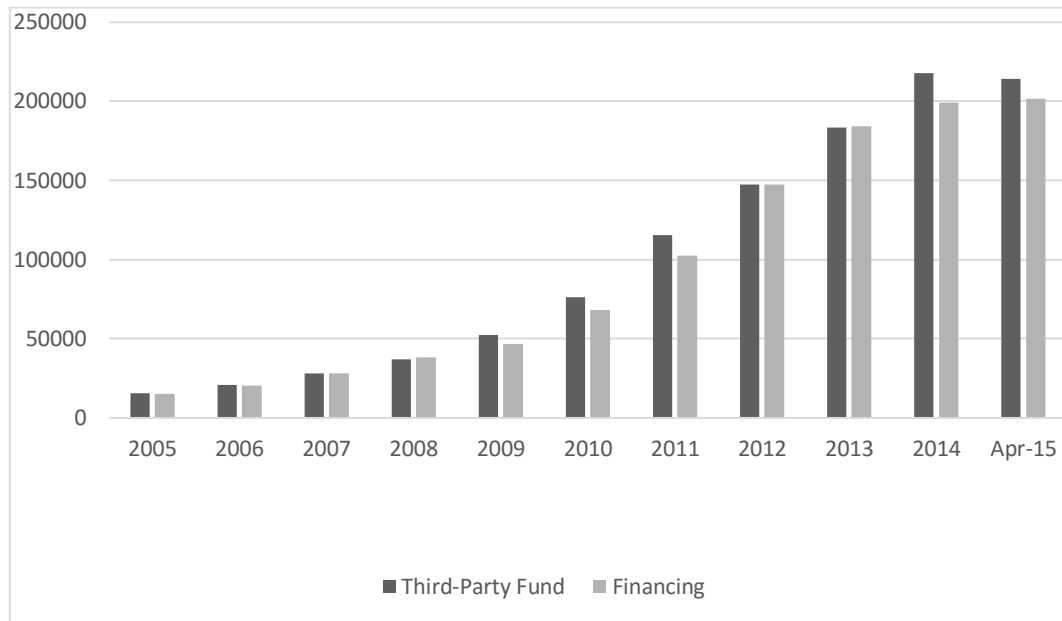


Figure 1.1 Third Party Funds and Commercial Sharia Bank Financing and Sharia Business Units 2003 – April 2015 (billion rupiah)

Source: Bank Indonesia (2015)

However, in 2015, financing for consumption is larger than financing for working capital and investment as shown in figure 1.3 through the composition of the financing in commercial sharia banks and sharia business units. The unstable economic conditions in 2013 also affected the share of sharia bank and sharia business units, which focuses on the financing of the consumption sector and micro to maintain liquidity.

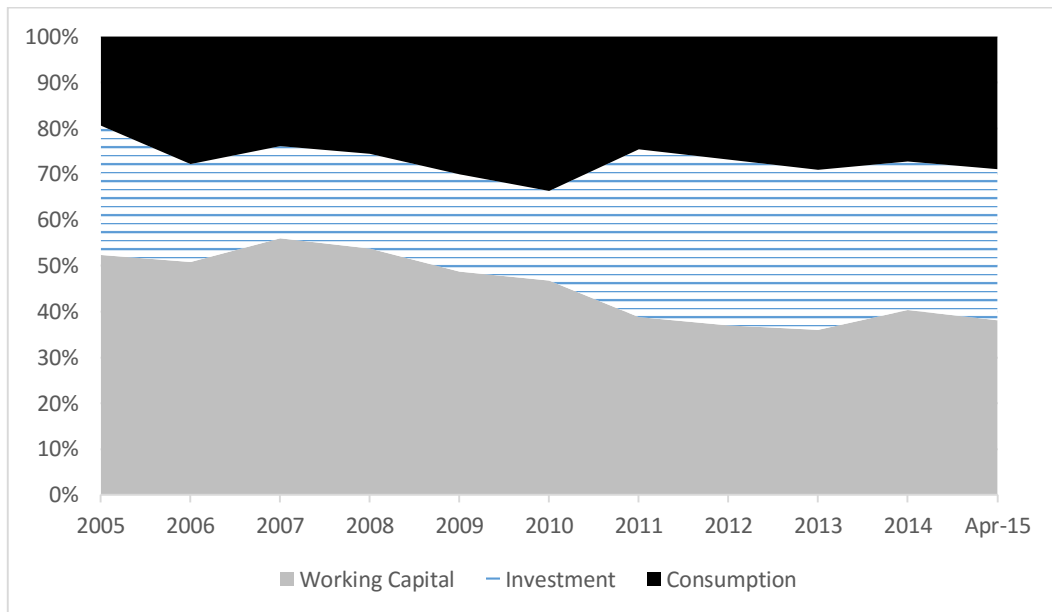


Figure 1.2 Composition of Financing Based on Type of Usage in Commercial Sharia Bank and Sharia Business Units 2005 – April 2015 (%)

Source: Bank Indonesia (2015)

On the importance of financing and money effect multiplier which exerts on the real sector and economic grows in Indonesia, Non-Performing Financing (NPF) became one of the interesting topic especially on the issue of financing in Sharia banking. According to the Dictionary of Bank Indonesia, the Non-Performing Financing (NPF) is problematic financing consisting of financing classified substandard, doubtful and loss. NPF, as well as on the bank NPL conventional, arise due to problems that occur in the process of approval internal financing bank, or after the financing granted. Bank Regulation Indonesia Number 15/2/PBI/2013 stipulates that the safety limit NPLs is 5%.

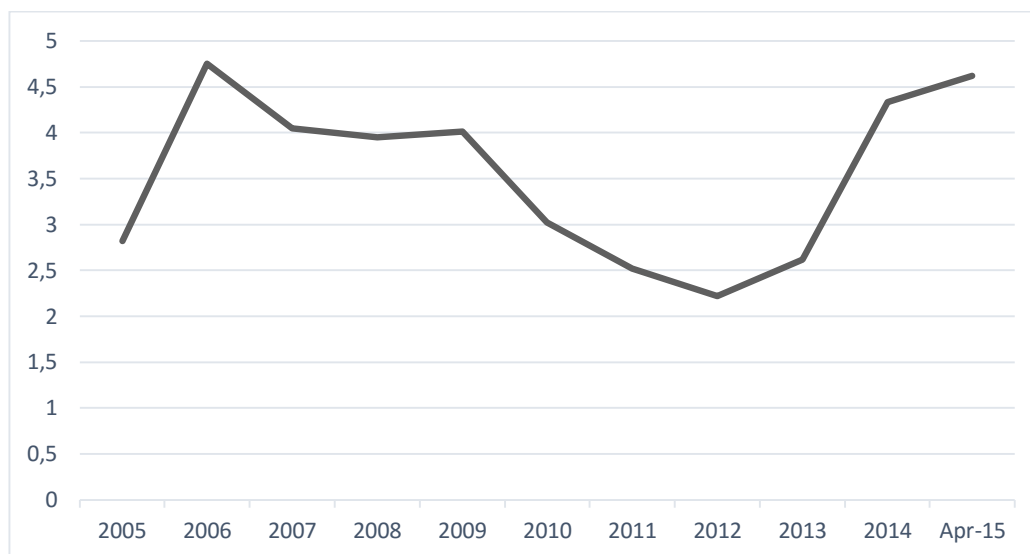


Figure 1.3 Non-Performing Financing (NPF) of Sharia Commercial Banks (Bank Umum Syariah) and Sharia Business Unit (Unit Usaha Syariah) 2005 – April 2015

Source: Bank Indonesia (2015)

Figure 1.3 shows the level of NPF in Sharia Banks suffered fluctuations in 2005 until April 2015 but still below the limit of provision at east 5 percent. Assesment of the NPF is useful for measure the level of financing issues faced by banks. The higher the NPF then the more it indicates that the quality of financing performed is increasingly unhealthy.

Analyzing the factors that determine the level of financing problem is an important and substantial for financial stability and bank management. In addition, the level of financing problems can be used to indicate the existence of banking crises (Reinhart and Rogoff, 2010). Therefore, this study focuses on the determinants of the level of NPF in 10 sharia banks in Indonesia, which is derived from the bank's internal factors and macroeconomic factors.

B. LIMITATIONS OF THE STUDY

The boundaries in this study are as follows:

1. Sharia bank selected in this study, namely Bank BNI Syariah, Bank Mega Syariah, Bank Muamalat Indonesia, Bank Syariah Mandiri, BCA Syariah, Bank BRI Syariah, Bank Jabar Banten Syariah, Bank Panin Syariah, Bank Victoria Syariah and Bank Syariah Bukopin.

2. The data used to measure the level of financing problems of Sharia banks obtained from the financial statements of banks publication during the period 2011 – 2015. The data is taken from the financial ratios each bank's quarterly published on the website of Bank Indonesia.

3. The level of financing problems as the dependent variable in this study is measured by using the ratio of Non-Performing Financing (NPF).

Coverage of the independent variables in this study were using macroeconomic indicators focused on the rate of inflation. Whereas independent variables using the bank's internal indicators focused on the level of profitability as measured by return on Equity (ROE) and the level of capital adequacy as measured by the Capital Adequacy Ratio (CAR).

C. PROBLEM FORMULATION OF THE STUDY

Brief description of background of the problems mentioned above provide foundation to formulate research questions, namely:

1. How does the fluctuation on the bank's internal variables, namely, Return on Equity (ROE) and the Capital Adequacy Ratio (CAR) and variable namely macroeconomic inflation rate to the level of non-performing Financing (NPF) on Sharia banking in Indonesia?

2. Which factors that most affect the level of NPF in sharia bank in Indonesia, whether macroeconomic factors or internal factors from bank?

D. PURPOSES OF THE STUDY

Based on the research questions that have been described, thus the purpose of this study are:

1. To analyze the effects of fluctuation on the bank's internal variables, i.e., Return on Equity (ROE) and the Capital Adequacy Ratio (CAR) and macroeconomic variables, namely the rate of inflation on the level of Non Performing Financing (NPF) ratio on Sharia banking in Indonesia.

2. To analyze the factors which most influence on the level of Non Performing Financing (NPF) of Sharia banking in Indonesia, whether macroeconomic factors or bank's internal factors.

E. BENEFITS OF THE STUDY

This study is expected to provide useful information for interested parties, among others:

1. This study is useful to improve the knowledge and ability to identify the determinants of the NPF.
2. Being literature for further researches with the same theme about NPF determinants and impact on economy growth.
3. The results of this study are expected to provide an overview for government and related agencies in establishing a policy that associated with the level of NPF.