

CHAPTER I

INTRODUCTION

1.1 Background

Islamic banking was virtually unknown 30 years ago. It has been operated in 55 countries with the amount of deposit over \$100 billion. There are more than 200 Islamic banking institutions which have been operated around the world. Islamic banking institution is one of the fastest growing in financial services market in the Islamic world (Vernados, 2005).

Indonesia is the largest moslem population in the world who need banking services based on islamic principles. In 1991, MUI established the first Islamic bank in Indonesia, namely Bank of Muammalat Indonesia. BMI began operating on May 1, 1992 whilst Islamic banks has not received attention optimally in the national banking industry at that time and accordingly slows the growth of Islamic banking. This is caused by the absence of a basic law on Islamic banking operation that was clearly visible on legalization No. 7 of 1992 pertaining to the banking. (Syafriada and Abror, 2011).

According to law NO. 7 of 1992 concerning banking, it explained that Indonesia adopt a dual banking system, namely conventional banking that implements interest rete, and Islamic banking that implements profit-loss sharing system. Moreover, it helps conventional banks to open shariah business unit. It shows that the government began to support the development of

Islamic banking in order to participate and support economic growth in Indonesia. After the legalization of law No.21 of 2008 regulating Islamic banking in Indonesia, it has provided a great opportunity for Islamic banking to develop a wide range of Islamic banking products offered to customer.

In addition, Islamic banking showed a good performance in the face of global economic crisis. It can be demonstrated by a high growth of Islamic banking financing with non-performing financing (NPF) below 5 percent. Islamic banking in 2009 were increased by 14 percent, 33.3 percent in 2008 and 47.3 percent in 2009. Thus, Islamic banking is more resilient and stable than conventional banking during economic crisis (Bank of Indonesia).

The development of Islamic banking in Indonesia for 10 years was growing rapidly. It can be seen from the total amount of Islamic banking in Indonesia reaching 22 Islamic banking in 2005 which consist of 3 Islamic commercial banks, 19 Islamic business units and 92 of Islamic rural banks with total offices of 550. The total amount of Islamic banking in 2015 is 12 Islamic commercial bankings, 22 Islamic business units and 164 Islamic rural banks with total offices of 2944 offices. According to the data, the growing of Islamic banking is in line with the increase of asset total and financing. It can be seen on table below:

Table 1
The growth of Islamic Banking in Indonesia

Year	Total of Asset	Financing	Non-performing financing
2011	127.19	102,655	2.52%
2012	179.04	147.505	2.22%
2013	229.5	184,122	2.62%
2014	260.36	199,330	4.33%
T2015	272.39	201,526	4.62%

Source: Bank of Indonesia

Table 1 illustrates that the total asset of Islamic banking was IDR 127.19 billion followed by financing with IDR 102.655 billion in 2011. In 2012, the total asset was IDR 179.04 followed by financing with IDR 147.505 billion. There was an increase in asset and financing respectively IDR 51.85 billion and IDR 44.85 billion. Total asset in 2013 was IDR 229.5 billion and financing was IDR 184.122 billion. On the other hand, the total asset in 2014 was 260.36 followed by financing IDR 199.330 billion. There is an increase in assets and financing respectively IDR 50.32 billion and IDR 36.617 billion. While, an increase of asset and financing in 2014 was IDR 30.86 billion and IDR 15.009 billion respectively. The total asset in 2015 was IDR 272.39 billion and the total financing was IDR 201.526 billion in 2015. The increase of total asset in 2015 was IDR 12.03 billion followed by the increase of financing IDR 2.196 billion. Thus, the increasing of total asset on Islamic banking goes smaller year by year. It gives impact on the decline of financing in Islamic banking caused

by the economic slowdown conditions. The impact of lower economic growth caused by several factors such as the depreciation of exchange rate has an impact on higher the inflation rate and the unemployment rate. The high levels of unemployment rate caused by the decline in production due to high production costs. The decline of production has an impact on bankruptcy so the effect on NPF's in the banking sector.

Table 1 illustrates that the total NPF in 2011 was 2.52 percent and 2.22 percent in 2012. It shows there was a of 0.3 percent in 2012 but there was an increase of NPF in 2013 of 0.41 percent to 2.62 percent. The highest rise of NPF in 2014 was 1.71 percent with total NPF was 4.33 percent. In 2015, the total NPF was 4.62. It means the decline of NPF is 0.29 percent. Therefore, the total of NPF relative increases from year to year.

The main activities of the banks are a loan where there is a major role in economic growth. This is because of loans granted to entrepreneurs will be used in order to increase production activities, thus it can increase income of the company. On the other hand, consumer loans used to buy consumer goods that can meet their needs (Soedarto, 2004).

The existence of islamic banking in Indonesia can have a positive impact in enhancing the stability of the banking system. The main goal of Islamic banking is to encourage economy growth such as providing financing to the real economic sector in the framework of equality of social welfare. (Damayanti, 2013).

Non-performing financing (NPF) reflects probable losses will arise over the distribution of funds by bank. Increase on financing will give impact on the probability on increase financing. Thus, high non-performing financing (NPF) makes bank need to establish a cash reserve on a larger problem loans. This condition makes reduce on bank earnings. A decline on bank earnings will influence the decrease of capital owned by bank.

The impact of non-performing financing can be influenced by internal factor and external factors. Internal factors derived from the credit policy are determined by the banks such as credit on products or financing that provided to customers, while the external factors are the phenomenon of global and national economy.

Indonesia was hit by the economic crisis which led to a rise in world oil prices and high inflation in 2005. When oil price subsidy was rising doubled of 30 percent on March 2005 and 100 percent in October 2005. It was causing the inflation rate to reach 17.11 percent in December 2005. In 2008, crisis was caused by sub prime mortgage in America and rising of oil price was not controlled. The impact of crisis is decreasing on consumption and export, declining on purchasing power and declining on foreign demand along with the economic slowdown (Hermawan, 2008).

The development of economic in the world is causing economy crisis in the world from 2008 until now. It makes the changing in the macroeconomic policy toward the economic stability condition. One of the macroeconomic

indicators is the value of exchange rate. The price of exchange rate is caused by demand and supply in the money market. Indonesia has been adopted freely floating system on the exchange rate system. It means that the value of rupiah to other foreign currencies is determined by market mechanism. The changing of exchange rate can influence the economic development in any sector, one of them are banking sector because of it is related on the funding has been given to the customers.

Moreover, the movement of exchange rate can give effect to inflation. Inflation will give influence the performance of banking such as funding. This condition will give effect to bank's profit and the ability of customers to repay their debt. Thus, exchange rate and inflation can give impact to banking performance such as non-performing financing.

Any macroeconomic condition and real sector cause unfavorable impact on financial system in Indonesia. The dominant mechanism of monetary policy in influencing the real sector in Indonesia is banking sector. The effectiveness of monetary policy was instrumental in carrying out banking functions as an intermediary and central bank functions as a controller of monetary stability. Stable banking system and monetary system are the two aspects are interlinked with each other. Stable banking system is generally reflected by healthy banking condition and function of banking intermediation in mobilizing public savings to be channeled in the form of financing to the real sector. If this condition is

good then the velocity of money and the monetary policy transmission mechanism in the economy which largely takes place through the banking system is also able to run well.

In addition, a decrease in bank financing is causing a decline in the real sector for investment such as long-term investment in the form of fixed assets, and short-term investments in the form of working capital, so it can lead an economic downturn and also trigger a high credit risk that is reflected on non-performing financing (Priatmadja, 2011).

Based on previous research, Bucur and Dragomirescu (2014) found that money supply and foreign exchange market rate negatively affect credit risk. Purwanto (2011) found that financing negatively effect credit risk, while Ekanayake and Azeez (2015) found that inflation negatively effect credit risk and lending rate has positive effect on credit risk.

Based on above discussion, it is necessary to identify the determinants of non-performing financing which is the main goal for this study. The purpose of this research is to determine factors affecting non-performing financing on Islamic banking period 2011-2015

1.2 Problem statement

This study aims to find out analysis of the influence of macroeconomic and bank-specific determinant of non-performing financing (NPF) on Islamic bank in Indonesia during the period of 2011 until 2015. It can be seen from

macroeconomic variables; namely inflation, exchange rate, Jakarta Islamic Index (JII) and money supply (M2), and bank-specific determinant, namely total financing.

1.3 Research problem

- a. How does the effect of long-term and short-term relationship between inflation, exchange rate, Jakarta Islamic Index (JII), money supply (M2) and total financing impact on non-performing financing in Islamic banks?
- b. Does non-performing financing give positive or negative responses to the shock of inflation, exchange rate, Jakarta Islamic Index (JII), money supply (M2) and total financing in Islamic banks?

1.4 Research objective

- a. Analyze the long-term and short-term of inflation, exchange rate, Jakarta Islamic Index (JII), money supply (M2) and total financing impact on non-performing financing in Islamic banks.
- b. Analyze the positive or negative response of non-performing financing (NPF) to the shock on inflation, exchange rate, Jakarta Islamic Index (JII), money supply (M2) and total financing in Islamic banks.

1.5 Research contribution

- a. For researcher, this study aims to increase knowledge and understanding about determinant factors of non-performing finance of macroeconomic variables and internal factor on Islamic banks.
- b. For banking, it can be used as information to give financing to debtors and avoid NPF.
- c. For government, it can be considered as information for making regulation and stabilizing the economic performance.
- d. For customer, it can show and increase the knowledge on determinant macroeconomic and bank's behaviour factors on non-performing financing in islamic banking.
- e. For other researcher, it can be used as references to conducting research about determinant factors of non performing financing (NPF) on Islamic banking.

1.6 Researcher Plan

This study will explain and be divided into several chapters in clear way and systematic. The systematics are below:

Chapter I, Introduction; this chapter generally describes researcher's aim. It consists of background, problem limitation, research problem, research objective and research plan.

Chapter II, Literature Review; this chapter includes the theory related with this study consisting the theory of Islamic banking, non-performing

financing, inflation, exchange rate, jakarta islamic index (JII) and also money supply (M2). This chapter also includes the previous research from other researcher who conduct similar research with difference object, researchers framework and hypothesis to conjecture the analysis of the study.

Chapter III, Research methodology; this chapter contains the definition of variables that used in this research, data and sources, the methodology of reserach is Vector Error Correction Model (VECM) which is used as a analysis tool.

Chapter IV, Overview and research findings; this chapter will examine the relationship between each variables in the short-term and long-term. Moreover, this chapter will explain the analyzing result based on previous research and theoritical framework.

Chapter V, Conclusion; this chapter contains of conclusion from the research, suggestion for policy maker in indonesia and suggestion for the next researcher.