# CHAPTER I

# INTRODUCTION

## A. Background

Banking institution serves as a financial intermediary between the parties who have excess funds (surplus units) and those who lack funds (deficit units) thus, the capacity is called volume of financing (Ahmad, 1994). Through banks, the excess funds are distributed to the parties in need and provide benefits for both parties. Banks accept deposits from the public (third-party funds) and then distribute them back in the form of credit (Karim, 2006). Banks play important role in developing countries such as Indonesia, not only act as a source of financing but also to influence the business cycle in the overall economy.

According to law No. 7 of 1992 on banking, it is explained that Indonesia is adopting dual banking system, conventional banking which is based on interest rate while Islamic banking is based on profit-loss sharing system. Moreover, its law also explained about the permission for conventional banking to open Islamic business unit. It shows that government began to support the development of Islamic banking to participate and support economic growth in Indonesia. Then, by the legalization of law No.21 of 2008 which regulates about Islamic banking in Indonesia which has giving a great opportunity for Islamic banking to developing a variety of Islamic banking products that offered to customers (Latifah, 2015).

The principles of the Qur'an and hadith regarding banking have been appeared in Islamic banking operations. Especially the basic philosophy and considerations in developing and formulating Islamic banking concepts. Because adherence to the principles of the Qur'an will guarantee the justice and balance required by banks and will keep commercial activities on the right track. So that Islam really becomes a superior people. As indicated by Allah in Surah Ali-Imran (3:110),

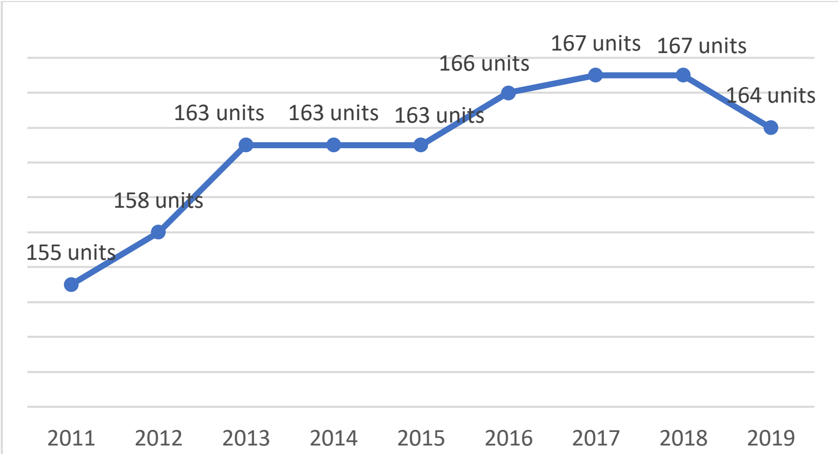
كُنْتُمْ خَيْرَ أُمَّةٍ أُخْرِجَتْ لِلنَّاسِ تَأْمُرُونَ بِالْمَعْرُوفِ وَتَنْهَوْنَ عَنِ الْمُنْكَرِ وَتُؤْمِنُونَ بِاللَّهِ ۗ وَلَوْ آمَنَ أَهْلُ الْكِتَابِ لَكَانَ خَيْرًا

لَهُمْ ۚ مِنْهُمُ الْمُؤْمِنُونَ وَأَكْثَرُهُمُ الْفَاسِقُونَ

*"You are the best of the nations raised up for (the benefit of) men; you enjoin what is right and forbid the wrong and believe in Allah; and if the followers of the Book had believed it would have been better for them; of them (some) are believers and most of them are transgressor".*

According to (Azizy, 2004), *khayr ummah* will be fulfilled if three conditions; first being able to invite goodness after being able to show good achievements, secondly preventing evil after being able to avoid ugliness and disorder, and the third having faith in Allah. These three criteria are the foundation of Sharia Bank in its operational activities.

The current development of Islamic banking in Indonesia is gradually increasing. Based on data from (OJK, 2019) shows that the market share of Islamic banking in Indonesia is around 5.94%, which dominated by Islamic Banks with 64.62% market share, followed by Islamic Business Unit (UUS) and Islamic Rural Banks (BPRS) with 32.86% and 2.52% respectively. The presence of the Islamic Rural Banks (BPRS) in Indonesia further adds to the name list of Islamic banks, as they in the banking system in Indonesia are a financial institution fulfilling public's need for Islamic financing transactions. BPRS is experiencing an ever-increasing development, causing the increasing number of BPRS to emerge which creates a very tight competition among BPRS.




Source: Statistics of Islamic Banking 2019

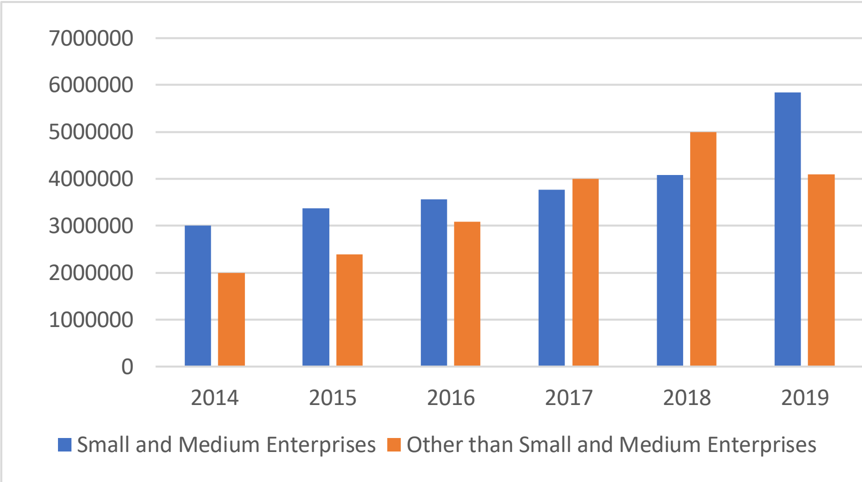
**FIGURE 1.1.**

Number of BPRS Based on Location in Indonesia

Figure 1.1 illustrates that the number of BPRS in Indonesia generally increased from year to year except the unfortunate decreased occurred in 2019 by 3 numbers. Deputy Director of Credit for Rural Banks and Small Medium Enterprises of Bank Indonesia said that financing banks had to be liquidated because there were too many financing problems (Kompasiana, 2019). For this reason, BPRS needs to improve and evaluate the performance and management of banks as well as other problems that occur at BPRS.

Financing become the main source for providing profit in Islamic banks. It is the provision of money or bills that can be equated with it, based on an agreement or agreement between the bank and other parties financed to return the money or bill after a certain period time with compensation or profit sharing. In conventional banking the term financing is known as credit. Bank credit has an important meaning in economic growth and highlights the situation when banks actively spur innovation and future growth by identifying and funding productive investments (Sipatuhar & Siregar, 2017).

According to (Faaza, 2019), Islamic rural bank generally has the same function as commercial bank that will channel from surplus side to deficit side customers. However, the market segmentation of Islamic rural bank is different from its counterparty. The bank will focus on Small Medium Enterprises (SMEs) financing which also concerns not only to financial aspect but also social aspect. This is also in accordance with the role of the BPRS, improving economic welfare.




Source: Statistics of Islamic Banking 2019

**FIGURE 1.2**

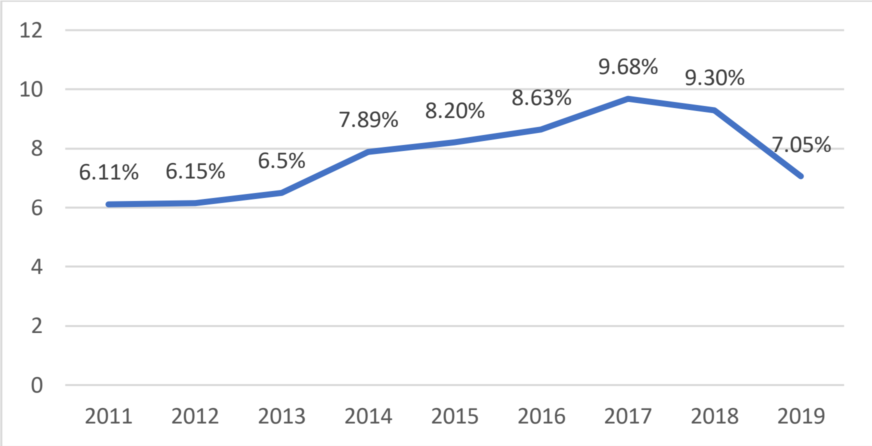
**BPRS Financing Based on Financing Groups**

It can be seen in Figure 1.2 which illustrates that the financing disbursed by BPRS for the small and medium business sector is higher than the financing disbursed to other than Small Medium Enterprises. The highest amount of financing distributed is in 2019 which is IDR 5.841.290 billion. During 2014-2019 the growth of both financing however generally increased.

As one of Islamic bank that serves in the microfinance level, Islamic rural bank will also face the same challenge to address risk. According to (Chapra & Khan, 2009) there are several kinds of risk faced by Islamic banking such as liquidity risk, market risk, operational risk and credit risk. Credit risk is risk that caused by failure of counterparty to fulfill their obligation which is called as non-performing financing. Bank is very concern about credit risk; mostly bank is doing credit as the main business.

Credit risk is the major contributor for the bank; it is causing the condition deteriorated because the loss-value is bigger, thereby reducing bank capital rapidly. Indicators reflected credit risk in Islamic banking is Non-Performing Financing (NPF). Non-Performing Financing is the ratio between financing with total financing extended by Islamic banks.

The magnitude ratio on both Non-Performing Loan (NPL) and Non-Performing Financing (NPF) which is allowed by Bank of Indonesia is five percent (5%). If it exceeds 5%, it will affect the bank's health performance.




Source: Statistics Islamic Banking 2019

**FIGURE 1.2.**

Non-Performing Financing in BPRS Indonesia

Based on Figure 1.2 BPRS experiencing the increase in terms of financing, those indicates that the public has made good use of the existence of the BPRS. On the other hand, the increase in financing was also followed by the deteriorating quality of financing. Figure 1.3 illustrates that from 2011 to 2019, the NPF of BPRS has exceeded the maximum NPF standard set by Bank Indonesia. The highest occurred in 2017 which is 9.68%.

Credit or financing analysis greatly determines the quality of Islamic banking earning assets. This is because the risk of financing can hinder the performance of a bank. A good financing analysis will improve the quality of earning assets in Islamic banking. Vice versa, poor financing analysis will reduce the quality of productive assets. If this is not managed properly, it will decrease the level of public trust in the bank (Susilo, 2017).

According to (Siamat, 2005), factors that cause non-performing loans/ financing from a bank perspective caused by internal factors and external factors. Internal factors relate to the policies and strategies carried out by the bank, such as poor financing administration, information and supervision systems, irregularities in the implementation of financing procedures and others. For external factors, caused non-performing financing related to customer business activities such as decrease in customer business profit, a macroeconomics variable effect such as high lending rate, Inflation and Gross Domestic Product.

Based on internal factors, FDR describes a bank's ability to provide financing obtained from third party funds. Research conducted by (Solihatun, 2014) indicates that FDR has a significant positive effect on NPF. It defined that the increase in financing distributed will increasing the risk as well. This occurs because it has proportional amount of funds distributed. The results of this study were different from (Melianda, 2019) which found that no significant results related to the effect of FDR on the NPF.

Another internal variable is CAR, it is the ratio of the amount capital owned by banks. Capital is very important factor for banks in the development of Small Business Enterprises and accommodating the risk of loss, especially the risk on financing provided to its customers. Research results according to (Jaenal, 2017) show that CAR has a negative and significant effect on Non-Performing Financing (NPF) which indicates that when capital owned by banks is high, the NPF value is low. This contradicts to the research conducted by (Maidalena, 2014) which shows that CAR has a positive effect, so if the CAR value is high, then NPF will have a high value as well.

Variables from the external factors of the bank are inflation and Gross Domestic Product (GDP). Inflation is one of macro variables indicator which interpreted as a situation where there is an increase in prices (absolute) for a long period of time, followed by the decreasing value of a country's currency (Khalwaty, 2000). High inflation can have a negative impact on the economy of a country, one of which is a decrease in the purchasing power of the people, that caused the declining level of sales in the company. If the level of sales at the company decreases, then this has an impact on the return obtained by the company. Returns obtained by the company will be smaller, causing disruption to the company in paying credit/financing installments provided by the bank. Disruption financing installments can cause the quality of financing to deteriorate, so as to increase the value of the NPF. Thus, can be concluded that the higher the inflation rate, the higher the NPF level will be (Taswan, 2006). Based on previous research from (Masthuroh, 2015) the inflation has a positive and insignificant effect on NPF. This is contrary to the research of (Setiawan, 2013) which states that inflation has a negative effect on the level of NPF.

The variable Gross Domestic Product (GDP) shows an indicator of economic growth, which is an important measure in explaining direct economic performance, it is the performance of economic actors who provide goods and services including the banking industry (Akbar D. , 2016). The sluggishness of economy caused low GDP. Low GDP indicates the low public income caused by a decrease in economic productivity carried out by economic actors. The intended economic actors are entrepreneurs or producers and consumers. Entrepreneurs as the producers will certainly expect a lot of goods to be produced in accordance with the existing economic conditions.

If GDP is low or decreases, it will have an impact on decreasing the level of consumer purchases so that producers will reduce the level of production of goods and services. If this happens, the profits obtained by the producer will shrink. This caused producers to be disrupted in paying off the installments of financing provided by the bank. Such conditions can disrupt the smooth financing of banks. The previous study conducted by (Firmansyah, 2015) stated that Gross Domestic Product (GDP) has a significant negative effect on Non-Performing Financing (NPF). However, contradicts research conducted by (Rindang, 2019) shows that GDP has a positive effect on NPF.

**TABLE 1.1.**

Condition of FDR, CAR, Inflation and GDP in Indonesia

| Year | NPF (%) | FDR (%) | CAR (%) | Inflation (%) | GDP (Billion Rupiah) |
|---|---|---|---|---|---|
| 2015 | 8.20 | 120.06 | 21.47 | 3.35 | 8,982,517,1 |
| 2016 | 8.63 | 114.4 | 21.73 | 3.02 | 9,434,613,4 |
| 2017 | 9.68 | 111.12 | 20.81 | 3.61 | 9,912,928,1 |
| 2018 | 9.30 | 111.67 | 19.33 | 3.13 | 10,425,397 |
| 2019 | 7.05 | 113.159 | 17.99 | 2.72 | 10,949,244 |

Source: Statistics Islamic Banking 2019 and BPS 2020

Table 1.1 shows that FDR is decreased in 2015 up to 2017. This decreasing value, apparently makes the value of NPF is increase. If related to the theory, the relationship between FDR and NPF is positive, which means it is contradicts to the theory. In the CAR variable, it can be seen that in 2018 and 2019 is decreased while the variable of NPF is also decreased. When linked to the existing theory, the relationship between CAR and NPF is negative which means it is not in accordance with the theory. The variable of Inflation in the past three years has in line with the decreasing and increasing value of NPF. It shows that there is a positive relationship between Inflation and NPF which related to the theory. The increasing variable of GDP in the past 2 years is followed with the decreasing NPF variable that shows negative relationship between GDP and NPF. It is related to the existing theory, however in 2015, 2016 and 2017 the increasing GDP is not followed with the decreasing NPF which is it contradicts to the theory.

Based on the description above, it can be said that not every aspect is in accordance with the existing theory, added with the results of research on factors affecting financing problems still diverse and varied. Therefore, the researcher is interested in researching on: “Analysis the Determinants of Non-Performing Finance (NPF) on Islamic Rural Banks (BPRS) in Indonesia”.

## B. Research Objectives

Based on the background description above, the objectives to be studied are as follows:

1. How Financing Deposit Ratio (FDR) affect Non-Performing Financing (NPF) in Islamic Rural Banks in Indonesia?
2. How Capital Adequacy Ratio (CAR) affect Non-Performing Financing (NPF) in Islamic Rural Banks in Indonesia?
3. How Inflation affect Non-Performing Financing (NPF) in Islamic Rural Banks in Indonesia?
4. How Gross Domestic Product (GDP) affect Non-Performing Financing (NPF) in Islamic Rural Banks in Indonesia?

## C. Research Purpose

Based on the research objectives above, the purpose of this study are as follows:

1. To determine the effect of Financing to Deposit Ratio (FDR) on Non-Performing Financing (NPF) in Islamic Rural Banks in Indonesia.
2. To determine the effect of Capital Adequacy Ratio (CAR) on Non-Performing Financing (NPF) in Islamic Rural Banks in Indonesia.
3. To determine the effect of inflation on Non-Performing Financing (NPF) in Islamic Rural Banks in Indonesia.
4. To determine the effect of Gross Domestic Product (GDP) on Non-Performing Financing (NPF) in Islamic Rural Banks in Indonesia

## D. Research Benefit

1. This research is expected to provide benefits in developing Islamic economics and give the contribution to the development of Islamic banking in the future, and able to provide information or references for further research.
2. This research is expected to be suggestion for related institutions in determining policies regarding Islamic banking, especially those related to credit or financing risk.

## E. Research Limitations

The research limitations in this study are as follows:

1. The scope of this research is based on the factors that influence Non-Performing Financing (NPF) as a measure of credit risk in Islamic Rural Banks in Indonesia.
2. The study used a monthly data from January 2015 to December 2019

   The variables used in this study include Non-Performing Financing (NPF), Financing to Deposit Ratio (FDR), Capital Adequacy Ratio (CAR), Inflation, and Gross Domestic Product (GDP).