

CHAPTER I

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

To develop economic conditions in developing countries such as Indonesia requires the right method because this will help the country to eradicate poverty. Financial institutions include banking and non-banking financial institutions. Financial institutions are institutions that deal directly with the community. hence financial institutions become one of the crucial factors to improve the economy of the community.

The role of financial institutions as a tool to maintain financial stability in the country's economy makes financial institutions a pillar of economic stability. The main resource of financial institutions is bank.

Bank is a financial institution licensed to receive deposits and make loans. It may also provide financial services, such as wealth management, currency exchange, and safe deposit boxes.

According to Indonesian Law Article 10 Year 1998 regarding banking, bank is a corporate entity mobilizing funds from the public in the forms of Deposits and channelling them to the public in the forms of Credit and/or other forms in order to improve the living standards of the common people.

Banks have a strategic role in the economy of a country. As an intermediary, banks play a role in mobilizing public funds used to finance investment activities and provide service facilities in payment traffic. In addition to carrying out the two plans, the bank also functions as a medium in transmitting monetary policy carried out by the central bank.

Bank is also an organization of services for various types of financial services. Banks are known as financial institutions whose main activities are receiving deposits, savings and time deposits.

Based on the function of the bank, the nature of the bank's business is different from manufacturing companies and other service companies. Most of the bank's assets are liquid assets and the assets and assets turnover is very high. The banking business is a business that relies heavily on trust, namely the trust of the community as users of banking services. There are only a few issues related to the condition of unhealthy banks, so people will immediately choose to withdraw their funds from banks, which will further aggravate the condition of the bank.

There are two banking system, Islamic Banking and Conventional Banking. There are several differences between the two banking systems. Conventional banks in Indonesia have existed since the Dutch colonial era, while Islamic banks were officially introduced to society in 1992. Conventional banks are banks that in their activities apply the interest system, whereas Islamic banks are banks that prohibit the interest system and apply the principle of profit sharing. The main difference lies in the return and profit sharing provided by the customer to the financial institution and/or provided by the financial institution to the customer (Rindawati, 2007).

Conventional banks can be defined as in the definition of commercial banks in Article 1 paragraph 3 of Indonesian Law Article 10 Year 1998 by eliminating the sentence "and or based on sharia principles", namely banks that carry out conventional business activities in the activities of providing services in payment. The main profit source of conventional bank is obtained from the difference in deposit interest given to depositors with interest on loans or loans distributed.

Islamic banking has grown unabated since its inception in the mid-1970s. the industry has more and more carved out an enormous slice of the international economic market (Mallin *et al.*, 2014). As one of the fastest growing sectors in the global financial offerings in the past three decades, Islamic banks have become especially vast in many countries, and for this reason have received a huge recognition and credibility worldwide. This

evolution and sizable exercise of Islamic banks have generated activity and discussion among both economists and policy makers about the practicality and viability of Islamic banking model in particular on the return of contemporary financial, in which banks play one of the important roles (Elsiefy, 2013).

The establishment of Islamic banks aims to increase mobilization of public funds which have not been served by the conventional banking system and to accommodate the needs of banking services that are in accordance with sharia principles. With the success of Islamic banks, the government took the initiative to develop a sharia economic system, and as a follow up, the government enacted Law Article 10 Year 1998 which gave banks the opportunity to implement a dual banking system where conventional banks could serve sharia transactions. In response, several conventional banks then opened a Sharia Business Unit (UUS) in running their businesses and established a subsidiary in the form of Islamic banks.

Islamic banks and conventional banks in some respects have similarities, especially in the technical side of receiving money, transfer mechanisms, computer technology used, general financing requirements, and so forth. The difference between Islamic banks and conventional banks concerns in legal aspects, organizational structure, and businesses financed, and work environment.

The first Islamic bank in Indonesia is the Muamalat bank which was established in 1991. Over time, the Islamic bank has developed despite not being too significant. Based on data from the Indonesian statistical center, in 2015 there were only 12 Islamic banks, then in 2016 and 2017 there were 12 Islamic banks in Indonesia. Meanwhile, the first conventional banks in Indonesia were BRI which was established in 1895. Despite its popularity, lately the development of conventional banks has decreased. It can be seen from the Indonesian BPS data, in 2015 there were 106 banks, then in 2016 there were 103 and in 2017 there were 102

banks. From the data described, the data concludes that conventional banks have experienced another year of decline with Islamic banks.

The increasing number of conventional banks that establish Islamic banks as subsidiaries adds to the number of banks in Indonesia. The increasing number of banks has made people and investors confused. The community is confused to take Islamic bank or conventional bank financial products, while investors are confused to place their funds in Islamic banks or conventional banks because investors will certainly place funds in banks that have better performance so that the return is high. In order for the public to determine whether to choose Islamic financial products or conventional financial products and so that investors can decide to invest in conventional banks or Islamic banks, the financial performance of conventional commercial banks and sharia commercial banks needs to be compared.

As bank is one of the financial sectors found on the Indonesian Stock Exchange (IDX), IDX plays an important role for parties that is interested in investing in bank because bank that has go public must publicly issue their share and bonds for investor to purchase as well as their annual report which later turn into a significant consideration for the parties concerned in the bank. The parties interested in the bank include investors, creditors, customers, employees, government, and the surrounding community. Number of stakeholders make the assessment of bank performance becomes very important.

Through information obtained from IDX Fact Book, it can be seen how the number of issuers has been increased as recorded from 2015 to 2017.

Table 1.1 Developments in the number of Issuers Sub-Sector Bank Year 2015 – 2017

Period	2015	2016	2017
Number of Listed Shares: Banks	40	40	43
Number of Listed Bonds: Banks	7	16	19
Total Issuers	47	56	62

Source: IDX Fact Book 2015-2017

Performance banks are assessed based on how the company's management performs all its tasks. Performance banks can be seen through financial statements that are regularly issued by banks that have go public. The information contained in the financial statements is information in the form of numbers that are records of transactions that occurred during one period. To know the meaning of the numbers that exist in the financial statements required an analysis tool. The analytical tool used is usually the analysis of financial statements in the form of financial statement ratios.

The major financial objective of the conventional banking system is to achieve maximization of the shareholder's wealth through interest differential. Therefore, differences of this kind of banking need to be analyze further because in the midst of increasingly fierce competition, banks in Indonesia are still dominated by conventional banks. This raises the question whether Islamic banks can compete with conventional banks that dominate banking in Indonesia. Therefore, this also supports the importance of comparing performance between Islamic banks and conventional banks.

In 2011, a research conducted by Siti Rochmah Ika and Norhayati Abdullah concluded that the study found no major difference in financial performance between Islamic banks and conventional banks except that Islamic banks are generally more liquid than conventional bank. Then in 2011, a research conducted by Rahma Ukhty concluded that there were no significant differences between Islamic banks and Conventional Banks, although there was a significant difference in liquidity. Then in 2013, a research conducted by Ria Tuzi Damayanti concluded that when put against four other conventional banks, Bank Syariah Mandiri is relatively superior in CAR, ROE, LDR, NIM, and OER ratios with significant value. Later in 2015, a research conducted by Mukdad Ibrahim concluded that conventional banks are having higher degree of liquidity, profitability,

management capacity, and capital structure than Islamic banks. Lastly in 2017, a research conducted by Seli Dwi Atikah Sari concluded that there's no significant difference between Islamic banks and Conventional banks because seeing from each return on asset and return on equity, both banks has an overall good performance.

Based on the description above, the writer interested in conducting a research titled **“A Comparative Study of Financial Performance between Islamic Banks and Conventional Banks Listed on Indonesia Stock Exchange”**.

1.2 PROBLEM LIMITATION

Based on the background of the problem above, it can be determined that the problem limitation of this research is as follows:

1. Variables that will be used in this study are limited to profitability, liquidity, solvency, efficiency, and asset quality.
2. This study will only use data from banks listed on Indonesia Stock Exchange.
3. This study will use data from banks for three years period from 2015 to 2017.

1.3 PROBLEM FORMULATION

Based on the background of the problem as mentioned above, the author formulates the problem as follows:

- a. Does it have significant differences in profitability between Islamic banks and Conventional banks?
- b. Does it have significant differences in liquidity between Islamic banks and Conventional banks?
- c. Does it have significant differences in solvency between Islamic banks and Conventional banks?
- d. Does it have significant differences in efficiency between Islamic banks and Conventional banks?

1.4 OBJECTIVE OF RESEARCH

Based on the problem formulation above, the objectives of this research are:

1. To analyze the significant difference in profitability for Islamic banks and conventional banks
2. To analyze the significant difference in liquidity for Islamic banks and conventional banks
3. To analyze the significant difference in solvency for Islamic banks and conventional banks
4. To analyze the significant difference in efficiency for Islamic banks and conventional banks
5. To analyze the significant difference in asset quality for Islamic bank and conventional banks

1.5 BENEFIT OF THE RESEARCH

1.5.1 THEORETICAL BENEFIT

This result of this research is expected to be a useful source of information in understanding and explaining the differences of financial performance between Islamic banks and conventional banks.

1.5.2 PRACTICAL BENEFIT

The practical benefits from this study are:

- a. For writer, with this research hopefully the writer can expand their knowledge regarding this study.
- b. For banks, hopefully this research is able to help banks to maintain and improve their performance in the future.
- c. For investor, hopefully this research is able to help investor with their investing decision.

1.6 SYSTEM OF WRITINGS

Chapter I: Introduction

This chapter explains the background of the problem and why the researchers chose this theme. In addition, this chapter also contains problem limitation, problem formulation, research objective, benefit of the research, and systems of writing.

Chapter II: Literature Review and Hypothesis Development

This chapter contains theoretical background which briefly describes about bank, conventional bank, Islamic bank, and financial performance. This chapter also contains previous research, hypothesis development, research model, and framework of thinking.

Chapter III: Research Methodology

This chapter describes in detail about the method used in this research. This chapter contains research design, population and sample, data collection method, operational variable definition and variable measurement, and data analysis method.

Chapter IV: Data Analysis and Discussion

This chapter contains general view of “research object” and data analysis and discussion.

Chapter V: Conclusion

This chapter contains the conclusion, implication, and recommendation of the research.