Chapter I

INTRODUCTION

1.1 Background

Banking industry has played a crucial part in building systems of Indonesia's economy and finances because it served as an intermediary institution; an institution that is able to channel back the funds held by surplus economic units to economic units that require or deficit funding. Their intermediation roles are the catalyst for economic growth. This function is an important bond in the doing business as it relates to the provision of funds as an investment and working capital for the business units in implementing the production function. Hence, in order to run smoothly the banking institutions had to work well (Susilo et all, 2000).

The efficient and effective performance of the banking industry over time is an index of financial stability in any nation. The extent to roommates a bank extends credit to the public for productive activities accelerate the pace of a nation's economic growth and its long-term sustainability. This lending activity is financed with short term deposits put in their account in exchange of different financial services banks are able to provide. The balance sheets of banks are structured on the asset side with long terms loans funded on the liability side with short term deposits, debts raised on the financial markets (bonds) and on the interbank market, and finally equity provided by shareholders.

Rate of deterioration of bank’s health caused by very diverse factors; the main factor that almost all banks are facing the swelling number of non-performing loans and bad debts; the increasing number of non-performing loans and bad debts arises lately, worsened the impact of the current banking difficulties. Recently, the term healthy or unhealthy banks becoming more popular; Actual event, such as the merger of banking and is always associated with the liquidation of the bank earlier. Thus a bank would require an analysis to determine its condition after performing operations within a specified period. The analysis conducted here is a rating of the bank. Soundness of a bank is a bank's ability to conduct normal banking operations and is able to meet all its obligations well in ways that conform to the applicable banking regulations (Wardani, 2009).

Increased competition in the Indonesian banking actually began with Indonesian banking transparency initiated by the issuance of a policy package on June 1, 1983 (Pakjun) with the aim to modernize banking. This was then proceeded with a policy package October (Pakto) on October 27, 1988, which provided convenience in permitting the establishment of new banks, including the opening of a branch office. At that time, with funds of Rp 10 billion alone, an investor was able to establish a new bank (Deni and Djoni, 2004), and this led to a significant increase in the number of banks.

An increasing number of banks in the banking sector have the potential to encourage businesses to be more competitive and improve the efficiency and health of banking. But for Indonesian banks, mostly private banks were owned by big businessmen before the Asian crisis; consequently, when such businesses required substantial funding, they tended to mobilize public funds through their banks for business interests (of the group/groups). This meant that the original intent of Pakto 88 to channel public funds to the community, shifted to the distribution to the group so there was a potential Lending Limit violation (LLL), (Deni and Djoni, 2004). This condition weakened the banking industry infrastructure, and consequently amidst the international financial market turmoil which began with the exchange rate crisis in Asian countries, Indonesian banks were not able to survive. These conditions resulted in the deepening crisis of confidence in the rupiah and national banks, especially after the revocation of business licenses of 16 banks in November 1997.

The economy crisis showed that the national banking industry does not have institutions with a strong banking infrastructure support, hence fundamentally still need to be strengthened to be able to handle the internal and external shocks. The weak fundamentals of national banking are a major challenge not only for the banking industry in general, but also for the authority of Bank Indonesia as the supervisor (Mubarokah, 2007). For instance in the case of Century Bank - the case that also dragged in the Indonesian legal institutions , as well as the KPK , Police , and the House of Representatives. Early stages, CIC Bank suffered note that indicated problems with the securities of foreign exchange rates around two trillion rupiahs , which does not have a rating , long-term , low-interest , and difficult to sell . BI suggested merger to address the bank's irregularities. In 2004, CIC bank's merger with Pikko Bank and Danpac Bank and which later changed its name to Bank Century. Foreign securities continue to fester in the merged bank's balance sheet. On 11th May 2009 Bank Century was out of BI’s special supervision. On 3rd July 2009 the parliament began to sue the Bank Century because the Bank Century’s bailout costs were too much. On 21st July 2009 LPS inject Rp630 billion. On 18th August 2009 Robert Tantular was accused of eight years in prison and a fine of Rp50 billion subsidiary five months of confinement at the Central Jakarta District Court. Earlier on August 15th, the management of Bank Century sued by 2.2 trillion rupiahs. On 3rd September 2009, Indonesian Police Chief told the House of Representatives to continue to pursue Tantular assets of U.S. $ 19.25 million, and Hesham Al - Warraq and Rafat Ali Rizvi of U.S. $ 1.64 billion .On 10th September 2009 Robert Tantular was sentenced to 4 years in prison and Rp 50 billion. Therefore, in anticipation of the advent of the financial crisis due to crimes that threaten the survival of the banking business of a bank, an early warning system is needed because at this point, the development and growth of the banking company are so many, in the hope that the banking company in Indonesia to achieve the goals that have been set (VivaNews, 2008; Masrun 2008).

Functions of a banking company is how a company can utilize sources of funding and existing resources to be able to function optimally so that the banking company is able to maintain the viability of the company's own business under any circumstances. Early detection of banking conditions it is possible for banks to undertake anticipatory measures to prevent the financial crisis promptly handled. The survival of the banking business of an enterprise can be seen and measured through healthy or not by analyzing the financial statements the financial statements. The financial report is a tool to obtain information about the financial condition and operating results have been achieved by the banking company within a specified period. One such technique is popular business practice is applied in the analysis of financial ratios. Banking company financial ratio analysis is useful in order to know the level of profitability, the level of risk, and prediction of bankruptcy. Results of financial statement analysis will help interpret various key relationships and trends that can provide basic considerations regarding the potential future success of the company.

In assessing the performance of the banking companies generally use five aspects of assessment, namely:

Capital, capital provides a cushion to fluctuations in earnings so that bank can continue to operate in periods of loss or negligible earnings. It also provides a measure of reassurance to the members that the organization will continue to provide financial services. Likewise, capital serves to support growth as a free source of funds and provides protection against insolvency. While meeting statutory capital requirements is a key factor in determining capital adequacy, the bank's operations and risk position may warrant additional capital beyond the statutory requirements. Maintaining an adequate level of capital is a critical element.

Assets, asset quality rating is a function of present conditions and the likelihood of future deterioration or improvement based on economic conditions, current practices and trends. The examiner assesses bank's management of credit risk to determine an appropriate component rating for Asset Quality. Interrelated to the assessment of credit risk, the examiner evaluates the impact of other risks such as interest rate, liquidity, strategic, and compliance.

Management; is the most forward-looking indicator of condition and a key determinant of whether a bank possesses the ability to correctly diagnose and respond to financial stress. The management component provides examiners with objective, and not purely subjective, indicators. An assessment of management is not solely dependent on the current financial condition of the bank and will not be an average of the other component ratings. Reflected in this component rating is both the board of directors' and management's ability to identify, measure, monitor, and control the risks of the bank's activities, ensure its safe and sound operations, and ensure compliance with applicable laws and regulations. Management practices should address some or all of the following risks: credit, interest rate, liquidity, transaction, compliance, reputation, strategic, and other risks.

Earnings; The continued viability of a bank depends on its ability to earn an appropriate return on its assets which enables the institution to fund expansion, remain competitive, and replenish and/or increase capital. In evaluating and rating earnings, it is not enough to review past and present performance alone. Future performance is of equal or greater value, including performance under various economic conditions. Examiners evaluate "core" earnings: that is the long-run earnings ability of a bank discounting temporary fluctuations in income and one-time items. A review for the reasonableness of the bank's budget and underlying assumptions is appropriate for this purpose. Examiners also consider the interrelationships with other risk areas such as credit and interest rate

Liquidity; scrutinizes institution liabilities like interest rate, payment terms, tenor etc. It also evaluates fund availability to meet its credit demand and cash flow requirements (Sarker, 2005, p8). Risk of liquidity is curse to the image of bank. Bank has to take a proper care to hedge the liquidity risk; at the same time ensuring good percentage of funds are invested in high return generating securities, so that it is in a position to generate profit with provision liquidity to the depositors.

Which all of the five elements commonly called CAMEL; Capital aspects include the CAR, assets aspects include NPL, earning aspects include NIM, and BOPO, while the liquidity aspect including LDR and reserves. Four of the five aspects of each capital, assets, management, earnings, liquidity were assessed using the finance ratio. This suggests that financial ratios useful in assessing the financial condition of the banking company. Study both financial ratios individually or as a construct for assessing performance and testing of power relationship with the financial ratios financial performance of banks, according to observations researchers rarely done. This is based on several reasons, among others; banking finance companies financial ratio is slightly different from similar financial-other companies. This is evidenced by the Financial Accounting Standards Banks are regulated specifically in the Statement of Financial Accounting Standards No. 31(IAI, 1995).

On 1 January 1997, a sixth component, 'S' (sensitivity to market risk), was included in the CAMEL rating system. Researchers have argued that the CAMEL(S) ratios can help evaluate the financial conditions of a bank, its management quality and its compliance with regulations. That is, the ratios can be used as an effective tool to identify a bank's problems (McKee 2000; Estrella et al. 2000; Shah and Murtaza 2000; Mongid 2000).

The application of the CAMEL(S) ratio system for evaluating the health of commercial banks have been growing both local and internationally. At international level, several academic studies Examined whether and to what extent private supervisory information is useful in the supervisory monitoring of banks. With respect to banks predicting failure, Barker and Holdsworth find evidence that CAMEL(S) ratings are useful, even after controlling a wide-range of publicly available information about the condition and performance of banks (Barker, D., and Holdsworth , D., 1993). Cole and Gunther Similar examined a question and found that CAMEL(S) ratings contain useful information (Cole, RA and Gunther, JW, 1998).

As CAMEL(S) is used to predict the health and soundness of a bank to prevent the default, bonds are also had the same difficulties; both of them had a chance to become default. In 2009 the phenomenon of bond default (default risk) occurs in some companies that are quite popular in public. PT. Mobile-8 Telecom Tbk, has failed to pay two times for a coupon of 15 March 2009 and 15 June 2009 with USD 675 billion worth of bonds maturing March 2012. Davomas Abadi Tbk PT, bonds worth 235 million dollars for 2011 has failed to maturity of 13.09 million dollars paid for the coupon 5 May 2009. PT Central Protein prima which is the biggest shrimp producers and processors in Indonesia has failed to pay of 17.9 million dollars (Kompasiana, February 9, 2010).

Credit rating agencies (CRA) issue credit worthiness estimation that assist to triumph over the information asymmetry flanked by those who are issuing debt instruments such as bonds, and those who are investing their money in these instruments. Credit rating agencies have a foremost impact on the financial markets. Ratings issued by CRA are closely tracked by investors, borrowers, issuers and governments. It is indispensable that they time and again provide top-quality, sovereign, and objective credit ratings. Credit rating market is dominated by three outsized agencies operating globally: namely they are Standard & Poor's, Moody's Investors Service and Fitch Ratings. In Indonesia there are two credit rating agencies, namely PT. PEFINDO (Pemeringkat Efek Indonesia) and PT. Kasnic Credit Rating Indonesia. But In 2007, PT Kasnic Credit Rating Indonesia was acquired by Moody's Corporation and renamed PT Moody's Indonesia. In this research, PEFINDO was chosen. As PEFINDO object only rate corporate debt securities, while PT Kasnic providing services ranking bonds, commercial paper, collateralized bonds, and general bonds (Rahardjo, 2003).

This research analyzes the key to predict Indonesian bank's bonds rating using the CAMEL ratios to ensure the soundness of the bank. So basic background above, this study raised the title **"The influence of the financial performance analysis (CAMELS) on Banks bond's rating in Indonesia".**

1.2 Limitation of study

This study focused only on the analysis of CAMELS in Indonesia bank bond's ratings from the year 2008-2012 where the data using the 17 banks listed on the Indonesia Stock Exchange and the rating of the bonds issued by PT PEFINDO.

1.3 Problem Formulation

According to the background of the thesis, here is some identification of the problems:

1. Does CAR have effect on bond ratings?
2. Does NPL have effect on bond ratings?
3. Do LDR have effect on bond ratings?
4. Does BOPO have effect on bond ratings?
5. Does IER have effect on bond ratings?

1.4 Purpose of the Thesis

Along with the identification of the problems of the thesis, the main purpose of the thesis is to:

1. Know whether CAR has effect on bond ratings
2. Know whether NPL has effect on bond ratings
3. Know whether LDR has effect on bond ratings
4. Know whether BOPO has effect on bond ratings
5. Know whether IER has effect on bond ratings

1.5 Benefits of the Thesis

1) Theoretical Benefits

i. Understand more about the financial performance and its ratio that might impact the probability of the bonds rating.

ii. As reference material for other researchers to conduct further research in the same field.

2) Practical Benefits

i. As input and information materials for banking institutions in specific decisions regarding the financial performance and bonds rating in Indonesia

ii. As the facilities to the reader to understand the complexity of business, risk profile, the methodology, bank's bond rating, and mechanism in the Bank subordinated bonds and implementation limited public offering

1.6 Systematic of writing

This thesis is divided into 5 chapters. Chapter 1 is an Introduction that contains the background of the problem to be studied and planned research to be done. Chapter 2 Literature forms which contains a description of the concepts or theories are used as the basis for making this thesis. Chapter 3 is a Data and Methodology, which contains the design and programming procedures in it. Chapter 4 is a system implementation, which contains an explanation of how the design in Chapter 3 is implemented. Chapter 5 Conclusions, Limitation and Recommendations, which contains the conclusions obtained after research done in this thesis. This chapter also contains suggestions for the development of this thesis.

Besides containing the main chapters, this thesis also provide: Abstract, Table of Contents, List of Tables, List of Figures, Reference list and Appendix.