CHAPTER I

INTRODUCTION

1.1 Background of Study

In a country, banks acts as the heart of the economy. The ability of banks to carry out their role in the economy is very important and it is determined by the efficiency and effectiveness of bank management. The strains of global competition, risks faces by bankers and volatile of the global economy make the profit margins are often thin. Moreover, the technological revolution and government deregulation has reduced the barriers to delivered banking services and has evolved the banking industry todays. From simple money changers to financial organizations that offer the widest range of financial services, banks in Indonesia demanded a stable environment, stronger and sufficient capital in executing their role. In response to dynamic changes of bank functions, Bank Indonesia (BI) encourage implementation of infrastructure on the financial system (Darmawi, 2014).

The Indonesia economic reforms since 1998 has opened up a whole lot of challenges to Indonesia's economy. The increasing competition in businesses has prompted Indonesia's bank to choose merger and acquisition as a strategic choice. External business expansion such as acquisition can increase the company's bargaining power (Finkelstein & Cooper, 2018)

The government deregulation in the late 1980s have effected the banking industry's structural changes. This includes the innovation in banking products and services, reducing barriers to entry, the increasing of foreign banks, information technology and internalisations of banking activities (Mirzaei & Moore, 2014). The emerging of the bank industry and its contribution to Indonesia economy has become an important issue. The practice of merger and acquisition in the banking industry is intended to strengthen the core capital and to maintain financial system stability in Indonesia.

Due to the advance in the practice and function of banking institution and government deregulation, the banking industry is being transformed into capital-intensive method (Rose, 1995). The impact of this phenomenoms emphasis on growth in bank size in the belief that banks must be much larger today if they are to be efficient and remain competitive. The competitors of banks are more than just other banks; they include credit unions, pension funds, financial firms and insurance companies.

Merger and acquisition (business combination) are one of popular strategic management in expanding business and improving profit. It cannot be denied that there is a competitive advantage to be a bigger company. A Big company has more opportunities than small companies. Includes the economics of scale, stronger brand recognition and business synergy. In Indonesia, the practice of merger and acquisition has been increasing over years (see figure 1.1). Considering the globalization and the increasing of new companies in market, merger and acquisition may be one alternative for the company to compete competitively.

Figure 1.1 Statistics of Mergers and Acquisitions in Indonesia (1990-2018)

Source: (IMAA, 2019)

Many risks that faced by bank. Credit risk, economy risk, risk of insufficient capital, liquidity risk, operational risk, risk of changes in government policy, competition risk, foreign exchange risk and technology risk (Darmawi, 2014). Hence, banks choose merger and acquisition in order to maintain its existence over the risks mentioned above. This paper will attempt to study the differences of financial performance before and after merger and acquisition related to economy risk and risk of insufficient capital.

The first factor is efficiency proxy by Net Interest Margin (NIM) ratio. The analysation of NIM indicates the economy risk. Economy risk refers to the economic condition that affect interest rate. NIM is used as indicator on how bank's efficiency changed after merger and acquisition.

Another factor is capital adequacy proxy by Capital Adequacy Ratio (CAR). The analysation of CAR indicates the risk of insufficient capital. Bank Indonesia stated that bank must maintain capital adequacy in order to guarantee public funds.

Table 1.1 NIM and CAR in some banking companies

	PT. Bank Permata Tbk			PT. Bank Woori Saudara Indonesia 1906 Tbk		
	Before Merger	After Merger	Balance	Before Merger	After Merger	Balance
NIM	6%	4%	-2%	2%	5%	3%
CAR	12%	15%	3%	22%	17%	-5%

Source: Prepared by writer (2019)

The table showed the comparison of bank's performance of two banks in Indonesia that conducts merger and acquisition. Bank Permata acquires PT. General Electric Finance Indonesia's shares in 2010. On the table, it can be seen that the NIM variable is decreased in the 1 year of bank permata merged and the variable of CAR is increased. It can be summarize that in the comparison of bank performance of 1 year before and after merger and acquisition, resulting a decreasing of management efficiency but increasing the capital adequacy.

In the second comparison, the performance of Bank Woori Saudara Indonesia 1906 which conducted merger with Bank Himpunan Saudara in 2015 shows reverse results. Management efiiciency which is proxy by NIM is increased in the period of comparison in 1 year before and after merger and acquisition and the CAR variable is decreased. It shows a result of merger and acquisition on Bank Woori Saudara Indonesia 1906 has positive impacts towards the increased of management efficiency proxy by NIM and shows that merger and acquisition has negative impact on the capital adequacy.

On the comparison above, the decreased percentage of NIM and CAR indicate the practice of merger and acquisition is not always increasing the company's performance. By this circumstance, the researcher is intended to analyze the impact of merger and acquisition on financial performance with the object of the study is banking industry in Indonesia. Ratio analysis carried out to examine financial performance of acquirer firms or parent company. The study measure and compare the before and after M&A in term of management efficiency in generating profit and capital adequacy. In this study, the efficacy measured by ratio of Net interest margin (NIM). Interest has become the primary sources of bank's income, so it is crucial to calculate the net interest margin of bank's before and after merger. Stronger capital will affect the future bank performance, to examine the capital adequacy of bank after M&A, the researcher use Capital Adequacy Ratio (CAR).

In this paper, the research pursue examine approach to address the difficult issue of the firms' decisions on merger in the respect of current and expected changes in firms' financial performance. Based on some researchs gap and contrary findings regarding to the factors of profitability and capital requirements of the bank after merger and acquisition, this led to an interest in further investigation in the impact of merger and acquisition in company's efficiency and capital adequacy. Therefore, the researcher is interested to do research with the title **"A Comparative Study of the Efficiency and Capital Performance of Indonesian Bankings After Mergers and Acquisitions."**

1.2 Problem Limitation

As there are many other perspectives that can be applied on this study, a problem limitation to define the boundaries of the problem that has been discussed is crucial to be made:

1. The research used samples of financial sector company of bank only. Moreover, the selected samples are banks that execute merger and acquisition deals in the period of 2008 to 2015.
2. The comparison between financial performance before and after merger and acquisition of 3 years has been analyzed.
3. This research is conducted to examine the effect of merger and acquisition on financial performance through efficiency and capital adequacy proxies.

1.3 Problem Formulation

Based on the description in the background that has been disclosed above, the formulation of the problem are as follows:

1. Does merger and acquisition affect the company's financial performance? (comparative study with the differences of net interest margin before and after merger and acquisition)
2. Does merger and acquisition affect the company's financial performance? (comparative study with the differences of capital adequacy ratio before and after merger and acquisition)

1.4 Objective of The Research

The objectives of the research that are made to solve the problem found which are:

1. To identify the differences of bank's efficiency performance measured by net interest margin after mergers and acquisitions.
2. To identify the differences of bank's capital performance measured by capital adequacy ratio after mergers and acquisitions.

1.5 Benefit of The Research

1.5.1 Theoretical Benefit

1. To the academics, this study will help to build knowledge on the effect of merger and acquisition as a strategy to improve bank's financial performance. The study will contribute to the existing knowledge on M&A.

2. To the scholar, this study provide basis for advance researchers in relation to the further research on the effect of M&A on financial performance. This study provide basis for further researchers to gain insight and investigate the research gap not addressed by this study.

1.5.2 Practical Benefit

1. To the financial company, this study will help the manager of the company to evaluate the M&A strategy in their industry. This study also expected to give information of the prevailing findings of financial performance after M&A so that the company can use it as a reference in their decision.
2. For the public, this research will improve the knowledge about merger and acquisition strategy chosen by banking industry in improving bank performance and the motives behind the M&A deals..

1.6 Systems of Writing

In order to understand more about this applied research project, therefore the materials listed in this study will be grouped into five sub-chapters with the following systematic sampling below:

CHAPTER I: INTRODUCTION

In the first chapter, explains the general information of the topic and the interest. This chapter contains background of the study which indicates the problem and reason for the research. Problem limitation which outlined the limitation of the study. Problem formulation refers to the statement of the effect of merger and acquisition on profitability and capital adequacy. Section of objectives of the research, benefit of research and the last is system of writing.

CHAPTER II: LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

In chapter, shows the solid theory, concepts and empirical evidences of prior researches. This sections contains elaborations of theoretical background, previous research, hypothesis development, research model and framework of thinking.

CHAPTER III: RESEARCH METHODOLOGY

In the third chapter discusses about research design, data collection method, population and sample, operational variable definition and variable measurement and data analysis method.

CHAPTER IV: DATA ANALYSIS AND DISCUSSION

In the fourth chapter contains general description of research object, data analysis includes descriptives statistic, result of data quality testing, result of hypothesis testing and discussions.

CHAPTER V: CONCLUSION

The final chapter summarises the findings of M&A practices on banking industry. This chapter also provides the recommendation section. This section contains conclusion, implication and recommendation.