

CHAPTER I

INTRODUCTION

I.1 Background

According to World Bank, Indonesia is the largest economy in Southeast Asia. The largest archipelago nation of more than 300 ethnic groups, Indonesia as an emerging economy has booked impressive economic growth since overcoming the Asian financial crisis in late 1990s. Today, Indonesia is the world's fourth most populous country, the world's 10th largest economy in terms of purchasing power, cutting the poverty rate by more than half since 1999, to 9.78% in 2020. Prior to the COVID-19 crisis, Indonesia was able to maintain consistent economic growth, recently qualifying the country to reach upper middle income status (*The World Bank in Indonesia*, 2021).

Despite of its status as the largest economy in Southeast Asia, the financial system of Indonesia is still highly reliant on banks compared to its other peers in Southeast Asia. Even though the capital market and bond market have booked significant development in the recent years, their role in financing Indonesian economy remain minor in comparison to banks. The banks control 73% of Indonesia's financial services sector structure as of Q2 2020 based on the publication of (Otoritas Jasa Keuangan, 2020). With this condition, the performance of the banking system will significantly influence Indonesian economy, its society and environment. Economic progress may be impeded if the banks can't play its intermediation role well. When banks can't operate efficiently and only relying on charging high lending rate to improve profitability, the access to financing will be limited for the micro segment of a country. Therefore, understanding the

determinants of the bank's profitability by the policy makers and the bank management team will bring positive impact to the whole economy.

Figure I-1 Indonesia's Financial Services Sector Structure



Source: (Otoritas Jasa Keuangan, 2020)

There is no doubt that banking sector plays an important role in financial stability and the economy of a country, especially during a growth period. As a financial intermediary, the bank collects deposits from public and granting loans and credit facilities to its client to accelerate economic growth. According to (Dietrich & Wanzenried, 2011), the proper operation of a country's economy is highly dependent on its effective and functional banking system. As with many other companies, profitability is considered as indicator on how efficient a banking institution operates (Chen & Liao, 2011). Having said that a profitable banking system is essential to support the economy to survive the negative external shocks.

The Asian Financial crisis of 1997 badly harmed the banks in Indonesia at that time. Most major banks were theoretically bankrupt, and the government was forced to take over many failing banks. The bailed-out action by the government is

to rescue the big banks whose failure might further collapsed the country. The net cost of this rescue action was probably one of the most expensive at the time in Asia which is around 40% of Indonesian GDP (Fane & McLeod, 2002).

Currently, after two decades of the Asian financial crisis Indonesia still see banks as the catalyst for financing economic growth as seen in Figure I-1 above. Therefore, it is essential to have an efficient banking system which can be measured by the bank's profitability. Due to the importance of the bank's profitability, there are a lot of studies in many countries and region which focuses on examining the determinants of the bank's profitability. However, there are not much research relating to that topic relating to listed commercial banking in Indonesia. In this research we will study the bank's profitability using three indicators i.e., Net Interest Margin (NIM), Return on Asset (ROA), and Return on Equity (ROE).

I.2 Research questions

This study intends to answer the question why some commercial banks enjoy better profitability than others in the Indonesian banking industry, to what degree the management decision (bank-specific factor) and external factors (macroeconomic factor) will contribute to the variability of the bank's profitability.

Based on the variables analyzed in this study, then the research questions are as follow:

1. How does the bank-specific factor (asset size, capital adequacy, asset quality, liquidity, deposits, asset management, operating efficiency, leverage) and macro-economic factor (exchange rate, inflation rate, interest rate, GDP growth) influence the Net Interest Margin of the listed commercial banks in Indonesia?

2. How does the bank-specific factor (asset size, capital adequacy, asset quality, liquidity, deposits, asset management, operating efficiency, leverage) and macro-economic factor (exchange rate, inflation rate, interest rate, GDP growth) influence the Return on Asset of the listed commercial banks in Indonesia?
3. How does the bank-specific factor (asset size, capital adequacy, asset quality, liquidity, deposits, asset management, operating efficiency, leverage) and macro-economic factor (exchange rate, inflation rate, interest rate, GDP growth) influence the Return on Equity of the listed commercial banks in Indonesia?

I.3 Purpose of the research

The purpose of the research is to understand the factors which have significant influence on the bank's profitability either in a positive relationship or negative relationship way. This study targets to examine the determinants of profitability in Indonesian banking sector based on two categories: bank-specific variables and macroeconomic variables by using a panel data regression model.

Based on the research questions above, then the purpose of the research can be elaborated below:

1. To test and analyze the influence of bank specific factor (asset size, capital adequacy, asset quality, liquidity, deposits, asset management, operating efficiency, leverage) and macro-economic factor (exchange rate, inflation rate, interest rate, GDP growth) to the Net Interest Margin of the listed commercial banks in Indonesia.

2. To test and analyze the influence of bank specific factor (asset size, capital adequacy, asset quality, liquidity, deposits, asset management, operating efficiency, leverage) and macro-economic factor (exchange rate, inflation rate, interest rate, GDP growth) to the Return on Asset of the listed commercial banks in Indonesia.
3. To test and analyze the influence of bank specific factor (asset size, capital adequacy, asset quality, liquidity, deposits, asset management, operating efficiency, leverage) and macro-economic factor (exchange rate, inflation rate, interest rate, GDP growth) to the Return on Equity of the listed commercial banks in Indonesia.

According to Bank Indonesia Regulation No. 14/26/PBI/2012 dated December 12, 2012, the commercial banks in Indonesia are classified based on their Core Capital size. Based on OJK Regulation Number 14/18/PBI/2021, the core capital of the bank in Indonesia consists of paid-up capital, disclosed reserve, and innovative capital instrument. The classification stipulates permitted activities for each category known as “BUKU” (*Bank Umum berdasarkan Kegiatan Usaha – Commercial Bank based on Business Activities*). The classification is categorized with the name BUKU I, BUKU II, BUKU III, and BUKU IV. The banks which are included in BUKU I have core capital of less than Rp 1 trillion. The banks which are classified as BUKU II has core capital of starting Rp 1 trillion up to Rp 5 trillion. The banks which are classified as BUKU III has core capital of starting Rp 5 trillion up to Rp 30 trillion. The banks which are categorized as BUKU IV have core capital above Rp 30 trillion.

The study will focus particularly on the listed commercial banks in Indonesia categorized under BUKU III and BUKU IV. Based on Indonesia Banking Statistics Vol. 19 No. 6 May 2021, both the commercial banks under BUKU III and BUKU IV contributes to 85.87% of the total banking assets in Indonesia.

Table I-1 Growth of Commercial Banks Assets based on Group of Business Activities (in Billion)

Group of Bank	2018	2019	2020	Mei 2021
BUKU I	71,280	61,798	19,009	-
BUKU II	823,832	905,190	897,206	921,358
BUKU III	2,741,984	2,616,734	2,684,606	2,556,049
BUKU IV	4,114,559	4,628,888	5,179,999	5,392,193
BUKU I Sharia	15,896	17,479	8,241	-
BUKU 2 Sharia	202,212	220,588	132,812	143,909
BUKU 3 Sharia	98,583	112,297	256,019	260,444
	7,997,067	8,501,176	9,158,885	9,273,954

Source: Indonesia Banking Statistics – Vol 19 No. 6 May 2021

I.4 Research Benefits

I.4.1 Theoretical Benefits

The research is expected to complement the various research conducted earlier with the similar topic in other parts of the world. As it focused specifically on Indonesia banking landscape, the research is also expected to provide insight for the next study related to the bank's profitability in Indonesia.

I.4.2 Practical Benefits

The answers to the research questions will provide assistance in recognizing the characteristics of successful Indonesian commercial banks which can support the economy. Next, the bank management may design the policies and react with the external factors accordingly in order to increase the profitability. The result of the study can be used by the banks' management team to draft its budget plan and

its internal bank policy which can maximize the shareholders' value whilst at the same delivering positive contribution to the economy.

The result of the study can be used by investor to evaluate the condition of each bank for consideration when carrying out investment decision.

The result of the study can also be used by the government and policy makers to draft the master plan of their economic strategies to achieve future goals (Mamatzakis & Remoundos, 2003).

I.5 Limitation of Research

The research is conducted based on the limitation defined as of below:

1. The profitability of the banks is defined by three dependent variables only.
2. The profitability of the banks is analyzed using twelve independent variables only. Due to some limitation in obtaining the data, Non-Performing Loan (NPL) is not included in the independent variables. The other common determinants used in the research of the similar topic in Indonesia is BOPO (ratio of operating expense divided by operating income) and LDR (Loan to Deposit ratio). In this research, the author does not use BOPO and LDR but the author uses almost equivalent ratio to represent the function. BOPO function is represented by operating efficiency (total operating expense / total assets) and LDR function is represented by deposits (total deposits / total assets). This is because all bank-specific factors used in this research are related to total assets.

3. The research is conducted using data for the time period of 2015-2019 and sample of 21 banks.
4. Other external factors not included in the research are assumed to be not changing during the research time period (*ceteris paribus*).

I.6 Systematic Writing

This study is arranged with a systematic writing method which consist of five chapters. In each chapter the study is elaborated based on the chapter title. The chapters have interconnected linkage amongst each chapter; therefore, this research should be seen as a complete academic report. The writing of the thesis is structured as follow:

CHAPTER I: INTRODUCTION

The first chapter elaborates the motivation for the research and the explanation of the market phenomenon; the research questions and the used variables; the purpose of the research; the benefits of the research; the limitation of the research and the systematic writing method.

CHAPTER II: LITERATURE REVIEW

The second chapter offers a summary of the fundamental theory which serve as the basis of the research as well as the explanations of each variables used. This chapter also includes the review of prior studies which have been conducted on similar research topic, the conceptual framework, and the hypothesis.

CHAPTER III: RESEARCH METHODOLOGY

The third chapter elaborates the description of the research object, unit of analysis, research type, research variables, population and sample including

sampling determination and sampling method, data collection method, data analysis method, and data panel estimation method.

CHAPTER IV: RESEARCH RESULT AND DISCUSSION

The fourth chapter elaborates the analysis of the empirical research done which consists of the analysis of descriptive statistics, the result of the regression model and its associated discussion about the analysis result.

CHAPTER V: CONCLUSION

The last chapter summarize the conclusion from the analysis, the managerial implication for bankers and governments, and the suggestion for next research.

