CHAPTER I

INTRODUCTION

1.1 Background of the Study

Banks play a critical role in sustaining the financial system and promoting economic growth in peripheral economies, much like they do in developed nations. The sector's contribution to gross domestic product demonstrates that the financial sector significantly influences the economic development of nations (Strobbe et al., 2023). Numerous scholarly investigations have been undertaken to examine the influence of firm-specific, industry-specific, and economy-wide factors on bank efficiency (or profitability), as well as the consequences of liberalization, risk, corporate governance, competition, and diversification. This is due to the fundamental role that banking plays in the generation of wealth. Banking intermediation performance in 2023 will grow positively with banking credit growing by 10.38% (yoy), with the highest growth occurring in working capital credit and investment credit at 10.05% (yoy) and 12.26% (yoy) respectively (Otoritas Jasa Keuangan (OJK), 2023).

The bank intermediation function was robust in 2023, thereby supporting economic growth. Credit growth in 2023 reached 10.38% (yoy), which is towards the upper end of Bank Indonesia's 9-11% projection. On the demand side, loan growth increased in line with positive corporate and household sector performance. On the supply side, credit growth was driven by improving risk appetite in the banking industry and adequate liquidity capacity, including the positive impact of liquidity policy by Bank Indonesia, such as the Macroprudential Liquidity Incentives Policy (KLM) and Macroprudential Liquidity Buffer (MPLB). By loan type, credit growth was primarily supported by investment loans and working capital loans at 12.26% and 10.05% respectively. Moving forward, Bank Indonesia expects credit growth to accelerate in the 10-12% range in 2024 in line with the solid domestic economic recovery.

However, it is also critical to effectively handle credit risk and liquidity concerns in order to maintain stability in the banking industry and the overall financial system. Credit risk has the capacity to result in bank default. Since 2008, this risk has led to the global financial crisis (Lopez & Williams, 2014). According to Houque & Tanimul (2015); Imbierowicz & Rauch (2014), there are two factors that cause credit risk, namely microeconomic and macroeconomic factors. The microeconomic aspects include bank liquidity, bank capital, bank size, bank competitors, credit derivatives, corporate governance, and debtor morale, whereas macroeconomic factors consist of inflation, unemployment, interest rates, credit and business cycles and property prices. Therefore, analysis of macroeconomic factors is very important for policy makers to prevent a financial crisis (Canh et al., 2021). On the other hand, conventional contracts apply for funds to pay the proposed credit. Losses due to credit risk can be shown through the size of the Non-Performing Loan (NPL) ratio for conventional banks (Pradana Reza, 2018).

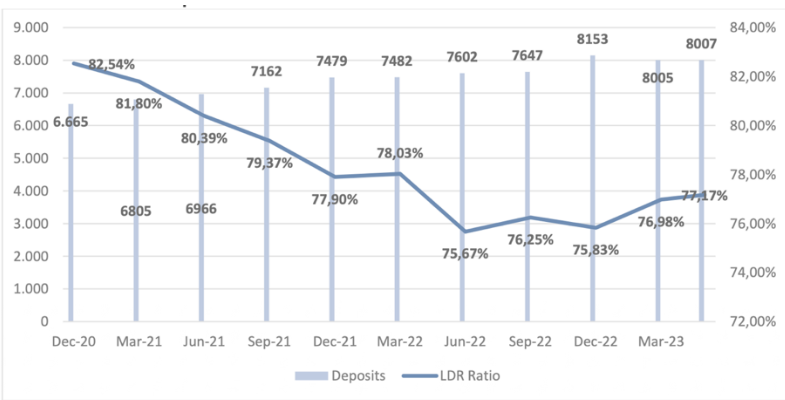

Figure 1.1 Indonesian Banks Deposits and LDR Ratio
Source: Otoritas Jasa Keuangan (OJK), 2023

The banking and financial services industry in Indonesia has demonstrated exceptional fortitude over the last five years, surpassing the initial impact of the pandemic and experiencing substantial expansion in its primary sectors. Since 2020, bank lending has increased steadily, with credit expanding by approximately 9% annually as of September 2023. The expansion is propelled by financing from both commercial and residential sources, which signifies a surge in consumer confidence and economic activity. Over the past five years, the LDR, which indicates the proportion of loans to deposits, has remained relatively stable at 82%. The observed stability signifies that banks have exercised prudence in their risk management practices and that the system maintains sufficient liquidity (Otoritas Jasa Keuangan (OJK), 2023).

Based on the increase in non-performing loans (NPLs) at its prominent banks, the Banker (2021) reported that Indonesia has been among the most severely affected nations in southeast Asia by the Covid-19 pandemic. According to The Banker Database, the NPL ratio of the largest lender in Indonesia, Bank Mandiri, increased from 2.4% to 3.3%, whereas the NPL ratio of state-owned Bank Negara

Indonesia nearly doubled from 2.3% in 2019 to 4.3% in 2020. CNBC (2024) reported that as of the start of the current year, 2024, the proportion of nonperforming loans (NPL) within the banking sector had risen. Gross nonperforming loans (NPL) increased to 2.35% from 2.19% in December 2023, according to data from the Financial Services Authority (OJK), whereas net NPL rose to 0.79% from 0.71% as of January 2024.

The concept of investment diversification is considered an intriguing alternative to traditional activities for institutions. The majority of banks today entrust their funds to an asset management firm to invest in predominantly sound businesses. These investments are intended to be expanded and improved over a predetermined timeframe. In addition, these investments may take the form of bonds, private equity, mutual funds, venture capital funds, and so forth.

Therefore, this makes banking industries in Indonesia an interesting study case to learn, and it is significant that this paper examines the correlation between performance, risk, and diversification in the context of varying degrees of financial duress. Specifically, the objective is to investigate the impact of banking-specific factors and macroeconomic variables on banking diversification. Several contributions to the extant literature on the banking sector are made by this study. The relationship between performance, liquidity, credit risks, and investment diversification in conventional banks is examined in this study for the impact of financial duress. This paper will offer a thorough and comprehensive examination of the current literature, as well as an overview of the data, variables, and model specification. Following this, the empirical results derived through the application of Ordinary Least Square (OLS) will be presented. The primary themes and findings will be summarized in the final section of this report. Therefore, the writer decided to do the research study about **"Analysis of Performance, Liquidity and Credit Risks on Banking Diversification on Conventional Banks in Indonesia".**

1.2 Problem Limitation

As there are several limitations in time and resources, the writer will limit the problem's discussion. This research will focus only on several categories mentioned below:

1. Sample of the research will be accumulated from 36 banking companies in Indonesia.
2. The observation period for the study is between 2013 to 2023.
3. The main concepts measured in this study were net loans to total assets ratio (LTA), return on assets (ROA), loan loss provisions ratio (LLP), capital to total assets ratio (CAP), loans due from banks to deposits due to banks (IBR), and natural logarithm of total assets (SIZE) as proxies for bank diversification; the number of directors (BS), proportion of executive directors (EXD), foreign directors (FORD) and women (GD) as proxies for corporate governance; and growth rate of gross domestic product (GDP) and inflation rate (INF) as proxies for macroeconomic factors.

1.3 Problem Formulation

Based on the observation that is done, the writer has formulated the following questions to be answered:

1. Does credit risk negatively influence investment diversification?
2. Does liquidity risk negatively affect investment diversification?
3. Does profitability positively influence investment diversification?
4. Does inflation negatively influence investment diversification?
5. Does GDP significantly affect investment diversification?
6. Does bank size positively affect investment diversification?
7. Does interbank ratio negatively influence investment diversification?
8. Does capitalization ratio positively influence investment diversification?
9. Do director boards' variables positively affect investment diversification?

1.4 Objective of the Research

Based on the formulated problems mentioned above, the objectives of this research are:

1. To address whether credit risk negatively influences investment diversification.
2. To assess whether liquidity risk negatively affects investment diversification.
3. To analyze whether profitability positively influences investment diversification.
4. To examine whether inflation negatively influences investment diversification.
5. To evaluate whether GDP significantly affects investment diversification.
6. To determine whether bank size positively affects investment diversification.

7. To address whether interbank ratio negatively influences investment diversification.
8. To assess whether capitalization ratio positively influences investment diversification.
9. To analyze whether director boards' variables positively affect investment diversification.

1.5 Benefit of the Research

This research has provided several benefits, namely:

1.5.1 Theoretical Benefit

This research is expected to gain theoretical benefits as mentioned below:

1. For writer

This research is expected to accommodate deeper knowledge and understanding to the writer regarding the performance, liquidity and credit risks on banking diversification.

2. For academics

This research is expected to contribute to give deeper understandings and knowledge development regarding the knowledge of investment diversification as an effect resulted from bank performance, liquidity and credit risks.

1.5.2 Practical Benefit

This research is expected to gain practical benefits as mentioned below:

1. **For companies**

This research is anticipated to serve as a consideration material for bank managers to evaluate the likelihood of loan default, thereby enabling them to modify lending policies, enhance loan underwriting processes, and establish suitable interest rates. This minimizes losses and decreases the likelihood of poor loans. Ensure that banks have sufficient liquid assets to satisfy their short-term obligations by conducting a liquidity risk analysis. This mitigates liquidity crises, guarantees uninterrupted operations, and enhances customer confidence. Performance analysis enables banks to assess profitability, asset utilization, and efficiency, thereby facilitating improved resource allocation and operational adjustments.

2. **For public**

The research enhances comprehension and offers additional practical insights into the correlations between Credit Risk, Liquidity Risk, Bank Performance, and Bank Diversifications for the public. This, in turn, allows for improved access to loans for housing, education, and business investments, thereby promoting economic growth and financial inclusion. Additionally, clients may experience increased confidence when conducting transactions with a financial institution that implements sound financial management strategies. The bank's financial health is guaranteed by a transparent analysis of liquidity, credit risks, and performance, which in turn enhances consumer trust.