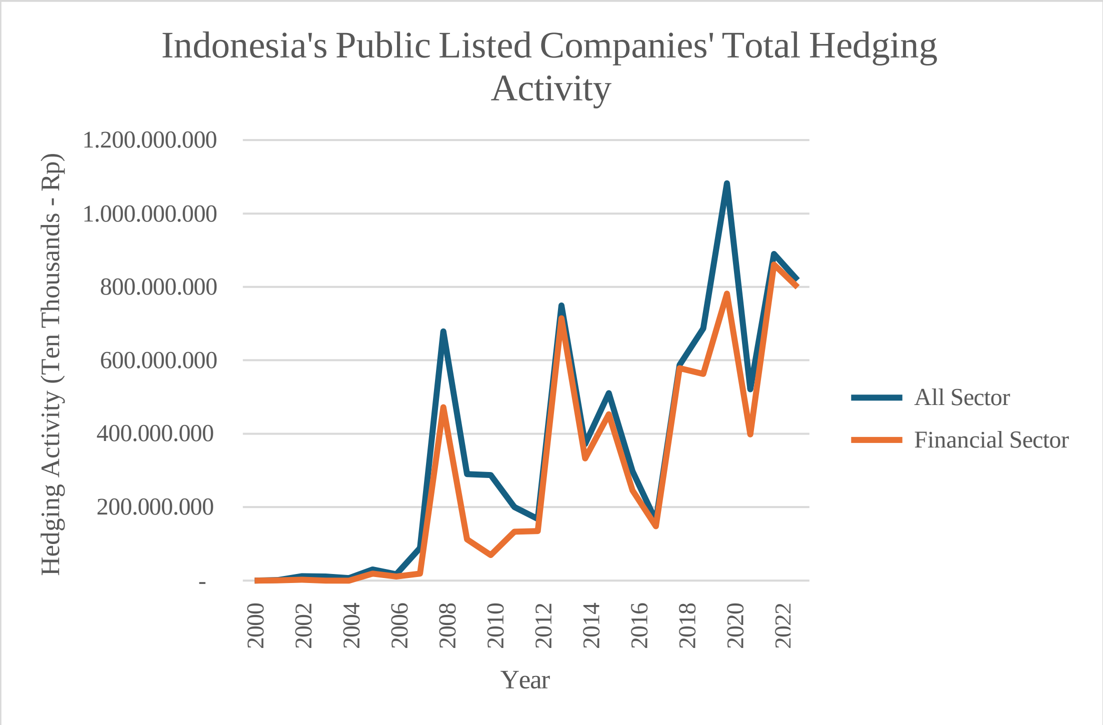
# CHAPTER I

# INTRODUCTION

## 1.1 Background of Study

Risks and uncertainties are inevitable for businesses because they operate in dynamic environments with ever-changing economic, technological, and competitive landscapes. Over the past hundred years, the global financial markets have faced a series of problems that led to both its fall and rise. External factors like market volatility, economic shifts, regulatory changes, and market competition, contribute to risks that are beyond a company's control. Therefore, to minimize the impact of the fluctuating economic condition, companies might decide to use derivative instruments as one of the alternatives in financial risk management, or known as hedging. Contrary to Kahneman and Tversky's Prospect Theory, in which poorly performing companies would tend to be risk-seeking, while well-performing companies would tend to be risk-averse, this is not the case observed in Indonesia, where the companies tend to hedge more (risk-averse behaviour) when they might not be doing well in general during times of crisis. The graph below displayed the trend of spikes in hedging activities conducted by all publicly listed companies in Indonesia Stock Exchange (IDX) and the financial sector as part of the total companies during the times of crisis, such as the 2008 global crisis caused by the US subprime mortgage, the uneven global recovery from the previous crisis and China's economic slowdown in 2013, US-China trade war in 2018, the 2020 pandemic outbreak, and Russian invasion in Ukraine in 2022.

**Figure 1. 1 Graph of Indonesia's Public Listed Company's Total Hedging Activity**




**Source: S&P Capital IQ Pro (processed by author in 2024)**

Looking forward, in order to anticipate another shift in the financial market in regards to the Israel-Iran conflict, an official release was announced by Indonesia's Minister of State-Owned Enterprises, Erick Thohir, in the middle of April 2024, warning State-Owned Enterprises to anticipate the world economic and geopolitical turmoil. The minister appealed that Indonesia's banking sector proportionally sustain a portion of credit that is impacted by the volatility of Rupiah, interest rates and oil prices. Especially for enterprises that plan to establish foreign currency instruments should consider hedging options to minimize the exchange rate fluctuations (www.bumn.go.id).

As a practical example, two of Indonesia's government owned companies have decided to opt for hedging decisions in order to compensate for its local currency depreciation. Despite both of the corporation's steady growth and performance, a 25% hedging policy was enforced in regard to their net liabilities. Indonesia's Deputy Minister of State-Owned Enterprises mentioned that demands in the concerned year increased quite significantly, yet a 25% hedging decision was a must (www.cnbcindonesia.com).

Instinctively, the presence of these derivative products should invite more controllable and predictable financial markets; however, in the book "Deciphering Markets and Money", Jukka Gronow argued otherwise. Instead of simplifying the mitigation of market risks, the topic in question has become a lot more esoteric and causes the related policy questions to be more complicated. As long as the economy runs, brand new market risks will constantly be created and be promoted with the presence of these market tools - as the risks concerned are not only being actively searched for, but also actively manufactured and traded (Gronow, 2020).

Similar to the prompts that bring about further regulation changes and government intervention in Indonesia financial market, due to the increasing concern on the amount of illegal money lending cases in the early 1960s (Mcleod, 1994) and Indonesia's decision to exit the United Nations, the purchasing power of rupiah plummeted more than double (a 119% inflation rate) and GDP (Gross Domestic Product) contracted by 2,24% by 1963 (www.cnbcindonesia.com). Consequently, in 1998 the monetary crisis occurred. As Rupiah depreciated tremendously against U.S. dollars - starting at Rp 2.500 (August 1997) to Rp 16.900

(January 1998) per U.S. dollar. At the same time, Indonesia inflation erupted, reaching up to a rate of 77% as prices soared uncontrollably (www.cnbcindonesia.com).

About 15 years later, it was reported in Bank Indonesia's Report of Indonesia's Economy that the economies of two of the largest emerging markets, China and India, weakened significantly. Due to China and India being the largest commodity importers in the world, commodity prices dropped sharply multiple times. This led to a global capital shift where capitals of the weak emerging markets (including Indonesia) were shifted to most of the developed countries - causing great pressure towards the exchange rates of Indonesia (www.bi.go.id). Following the outbreak of COVID-19 from China in late 2020, Indonesia refused to restrict society activity during the early days of the outbreak. As a result, poverty increased by 10,19% causing Indonesia's economy to contract by up to 5,32% between the years 2020 and 2021 (www.cnbcindonesia.com).

Despite the market instability, the trend maintains a constant growth, as more and more hedging activities are done by the year. This increase in interest of hedging activities is particularly true and most evidently done by the financial sector. Financial institutions, according to Kieso et al. (2019), often use derivatives as they are influenced by fluctuations in interest rates when engaging in borrowing and lending activities. They are also the considered as the primary players for derivatives besides large companies. Thus, considering the amount of market fluctuations that had occurred, there seems to be no guarantee in telling where the direction of the market is months from now. With the market having such an ever-changing characteristic, the use of these derivatives are very much needed for the general profit seeking entities, to anticipate for disastrous losses, making hedging decisions a relevant research subject nonetheless.

As one of Indonesia's stepping stones to provide the much needed leverage for sustainable economic growth, the financial sector, as of November 2023, written in the press release PR No: 105/BEI.SPR/11-2023, Indonesia's financial sector constituted 11,8% of the total companies listed in IDX (Indonesian Stock Exchange) - reaching up to roughly 104 listed companies (www.idx.co.id). In a recent monthly OJK's (Otoritas Jasa Keuangan) Board of Commissioners meeting, it was reported that the banking sector recorded a 12,4% year over year (July 2024) growth in regard to its credit distribution amount. The insurance, guarantee and pension fund sector contributed a 1,11% year over year (July 2024) industry asset growth, whereas the development of the financing institution, venture capital companies, microfinance institutions and other financial services institutions sector reported a 10,53% year over year (July 2024) on its financing receivables. Overall, the report concluded a positive trend and growth of Indonesia's financial sector shown amidst the global uncertainties due to geopolitics and the global economic slowdown - indicating the sector's resilience and constant growth in facing economic uncertainties (www.ojk.go.id).

Based on the research conducted by Hetrina et al. (2020) titled *"Analisis Faktor-faktor yang Mempengaruhi Keputusan Hedging dengan Kualitas Laba sebagai Moderasi pada Industri Manufaktur di Indonesia Tahun 2014-2017"*, the same variables, growth opportunity as a determinant of hedging decision and earnings quality as a moderator to growth opportunity, are used in this research. The result of Hetrina et al. (2020) research proved that the presence of Growth Opportunity and Earnings Quality motivated firms to apply Hedging Decisions. There was, however, a limited amount of research conducted in recent years discussing the moderation of Hedging Decisions with Earnings Quality. Thus, it is the initiative of the writer to apply a moderation on the concerned variable alongside Hetrina et al. (2020).

In terms of sector, the writer has chosen the financial sector, which none of the previous researchers that was referenced discussed. Researchers who looked into Growth Opportunity as an independent variable towards Hedging Decisions were mostly conducting the research on the manufacturing sector such as Hetrina et al. (2020), Seok et al. (2020), Mirdha et al. (2023), Pangestuti et al. (2020), (Larasati & Wijaya, 2022), Fajri et al. (2023), Meridelima & Isbanah (2021), Sasmita & Hartono (2019), Sudiarta & Setyawan (2022), Yustika et al. (2019), and Verawaty et al. (2019). On the other hand, Herawati & Abidin (2020) and Pertiwi & Mahardika (2022) conducted their research on State-Owned Enterprises, while Setiawan & Mahardika (2019) looked in the automotive sector. The mining sector was research by Jayanti & Yadnya (2020), Nugraha & Khoiruddin (2022) and Marhaenis & Artini (2020). Lastly, Dharmiyanti & Darmayanti (2020) & Wahyudi et al. (2019) looked into the non-financial sector, while only Nabiilah (2021) researched the agriculture sector and Nanda et al. (2022) in the consumer goods sector. With that being said, the effect of the independent variable Growth Opportunity on Hedging Decisions was rarely researched on the financial sector.

Keeping in mind that most of Indonesia's hedging activities were conducted by the financial sector of Indonesia's publicly listed companies, the writer has decided to contribute the research of Indonesia's financial sector.

Additionally, to ensure the result of this research reflects the actuality of the market situation and business condition, the chosen period of the research covers a span 5 (five) years that is starting from the year 2019 to 2023. During this period, the amount of hedging activities had experienced 2 spikes that were due to global situation. Another reason that constitutes the choice of year was in order to acquire both updated and reliable data in regard to the research's field of observation. The period of research was chosen in hope that it could provide an empirical prediction regarding hedging activities in case another global situation would occur.

To process the data collected, based on the past research, Logistic Regression was commonly used. Other researchers such as Nugraha & Khoiruddin (2022) used Linear Regression, while Pangestuti et al. (2020) used Logistic Regression with Stepwise method to interpret the concerned data. To the writer's greatest concern, it is the best option to use Logistic Regression in order to predict the probability of the dependent variable that is of nominal data by using the independent variables.

With the previously stated ideas and reasons, it piqued the writer to conduct a study, entitled**: "THE INFLUENCE OF GROWTH OPPORTUNITY TOWARDS HEDGING DECISIONS WITH EARNINGS QUALITY AS A MODERATOR"**.

## 1.2 Problem Formulation

Considering the aforementioned background of the study, the problem in this study that can be identified is as follows:

1. Does growth opportunity have an influence on hedging decisions in financial companies listed on the Indonesia Stock Exchange?
2. Does the addition of earnings quality as a moderator to growth opportunity affect the influence on hedging decisions in financial companies listed on the Indonesia Stock Exchange?

## 1.3 Objective of the Research

The objective of this research is to analyze on:

1. The influence of a firm's growth opportunity on hedging decisions tendency in financial companies listed on the Indonesia Stock Exchange.
2. The influence of a firm's growth opportunity, moderated by its earnings quality, on hedging decisions tendency in financial companies listed on the Indonesia Stock Exchange.

## 1.4 Benefits of the Research

Below are the benefits of this research to different audiences:

1. Academical Benefit

The results from this study are hoped to become a base for future readers and researchers to understand the effect of growth opportunity on hedging decisions tendency with earnings quality as a moderator in the financial sector. The writer hopes that this study would be further researched to improve the limitations that this study might have, in order to achieve a more accurate result.

2. Practical Benefit

The writer hopes that this study and its suggestions could bring insights and awareness to the financial companies, thus allowing the companies of the sector to self-evaluate accordingly, as well as adding to their understanding of the effect of their growth opportunity, as well as the moderating role of earnings quality, on hedging decisions tendency.

## 1.5 Problem Limitation

To ensure a clear and sustained focus in this paper, below are the limitations to the problem formulated in this research made in this paper:

1. The variables that are used in this research are limited to hedging decisions as the dependent variable, growth opportunity as the main independent

variable, earnings quality as a moderator, and liquidity, dividend policy, firm size, and leverage are used as control variables. This research does not take into account other variables that might influence hedging decisions.

2. The geographical region scope of this research is limited to Indonesia.

3. The object of research used is limited to financial companies listed on the Indonesia Stock Exchange (secondary data), with criterion stated in the following chapters.

4. The period used for this research is limited to 2019 to 2023.

5. The indicator used for each variable is limited to 1 indicator per variable.