Chapter I

Introduction

1.1 Research Background

The banking system plays a crucial role in the modern economic world. By collecting personal savings and lending them to businesses, banks are actively involved in capital formation and contribute to economic growth. This process positions banks as key players in facilitating the creation of new capital within a country. (Hersugondo et.,al 2021).

Like Chou and Buchdadi (2016) mentioned, the Indonesian banking sector has faced multiple economic crises during its development, especially the severe crisis in 1998. This crisis led to the collapse of the banking system and many banks failed one after another. In order to address these problems, the Indonesian banking sector began to implement a series of reforms after the crisis, including the revision of regulatory policies on capital adequacy to improve the quality of commercial banks. Through these reforms, the robustness of the banking sector was improved and its ability to cope with future economic fluctuations was enhanced. By 2008, the global economic crisis struck again, yet the Indonesian banking sector showed greater resilience in the face of this volatility. The number of insolvent banks decreased significantly compared to 1998, demonstrating the effectiveness of reform measures and the improvement of the banking system. Finance Minister Sri Mulyani Indrawati also emphasized the important role of the banking sector in supporting economic growth and creating equity. According to the Central Statistical Agency (BPS), in the second quarter of 2018, the

Indonesian economy grew in both production and expenditure, further proving the positive contribution of the banking sector.

Banks are not only responsible for the flow of funds in the economic system but also ensure the healthy functioning of the financial system by improving profitability and providing quality services. Banks allocate the nation's economic resources efficiently by transferring funds from the owners of capital to the borrowers. Ongore and Kusa (2013) stated that the financial services of banks are critical to the functioning of the economy as a whole. According to Jha and Hui (2012), assessing the performance of banks involves looking at how efficiently they utilize their assets, equity, liabilities, income, and management costs.

For economic growth to be stimulated, the banking sector in every country must function in a stable, efficient, and trustworthy manner. In order to achieve this goal, the Indonesian banking system has developed a basic framework called the Indonesian Banking Architecture (IBA), which aims to strengthen the structure of the banking sector and increase competitiveness. The IBA covers the key message of bank categorization, which is categorized by the Bank Indonesia Regulation No. 14/26/PBI/2012 on business activities and office network based on the bank’s core capital, which classifies the Banks are categorized into four business groups (BUKU), with the size of the core capital of each category determining the scope of their business and breadth of services.

Specifically, BUKU 1 has a core capital of less than Rp 1 trillion and is able to carry out rupiah-based fund raising and distribution activities, a limited range of trade finance and correspondent activities, payment systems and e-banking, etc., but is restricted to

limited foreign exchange activities. BUKU 2 Banks have a core capital of between Rp 1trillion and Rp 5 trillion, and are capable of a wider range of business activities than BUKU 1, with the ability to carry out spot and derivatives trading and invest up to 15% in domestic financial institutions. BUKU 3 has a core capital of between Rp. 5 trillion and Rp. 30 trillion, is capable of carrying out all business activities and holds up to 25% stake in domestic and foreign financial institutions, limited to the Asian region. BUKU 4 has a core capital of Rp. 30 trillion and above, is capable of carrying out all business activities globally, and can hold up to 35% stake with the widest scope of business. It can be seen that the size of the core capital has a direct impact on the scope of the bank's business and its ability to provide services: banks in BUKU 1aand BUKU 2 are limited to domestic operations due to their small core capital, while BUKU 3 and BUKU 4 are able to provide international banking services. (Kadang et al., 2021)

Based on this categorization framework, it becomes particularly important to study the Indonesian banking system, especially for BUKU3 and 4 banks. As the largest economy in Southeast Asia, Indonesia exhibits significant economic growth potential and its unique market structure, making the study of its banking system not only revealing the characteristics and challenges faced by emerging market banks, but also providing valuable lessons learned. At the same time, as a representative of developing countries, Indonesia's experience in the development and reform of its banking sector is relevant to other emerging market countries. Studying Indonesian banks not only enriches the theory of bank performance, but also promotes empirical research in related fields and further expands the understanding of the emerging market banking sector in terms of financial stability, policy making and investment decisions.

1.2 Problem Identification

The relationship between financial indicators and bank performance has been widely explored in previous studies. However, this relationship is not constant. Kustiningsih et al. (2020) found that capital adequacy ratio has a significant negative impact on bank performance while Ongore and Kusa (2013) suggested that capital adequacy ratio has a significant positive effect on bank performance Kristianti (2016) stated that the loan to deposit ratio has no effect on bank performance but Li Jingjing (2022), Conversely, concluded that there is a significant negative relationship between loan1to deposit ratio and bank1performance. In addition, Kustiningsih et al. (2020) in agreement with Kristianti (2016) found that there is a significant positive between net interest margin and bank performance. As for non-performing loan, Buchory (2015) concluded that it has no significant effect on bank performance, but Usman and Lestari 's (2019) study showed that non-performing loan has a significant negative impact on bank performance. Hortlund's (2005) study explored to some extent the negative between net profit and return on equity (ROE) relationship.

By analyzing the relevant literature, we can conclude that the impact of various financial indicators on bank performance is often complex and uncertain. This complexity stems from a number of factors, including different banks' business models, market structures, and changes in the external economic environment. Therefore, studying the impact of financial indicators on bank performance is still of great relevance and research value.

This study focuses on internal factors, all Indonesian commercial banks face the same conditions of external factors, therefore banks must enhance their internal factors to

achieve improved performance. Profitability serves as the most suitable indicator for evaluating a bank's performance. According to Moussu and Petit-Romec (2014), most of the banks around the world use return on equity (ROE) as the core indicator of profitability. Whereas, the independent variables use CAR (Capital Adequacy Ratio), LDR (Loan to Deposit Ratio), NIM (Net Interest Margin), NPL (Non-Performing Loans) and NP (Net Profit) to assess the performance of banks.

However, the timeframe of the data selected for this study is from 2008 to 2022, a time period that is unique in that it covers two important global economic events: the 2008 global financial crisis and the 2019 New Crown epidemic. Typically, the direct impact of external economic shocks may last for about a year, while their impact on bank financial data may show up with a lag, lasting for two to three years or even longer. Therefore, by analyzing the data over this period, we can explore in greater depth the role of different financial indicators over different economic cycles and whether their impact on bank performance changes over time.

1.3 Statement of Problem

1. Does Capital Adequacy Ratio (CAR) have a significant impact on Return on Equity (ROE)?
2. Does Loan to Deposit Ratio (LDR) have a significant impact on Return on Equity (ROE)?
3. Does Net Interest Margin (NIM) have a significant impact on Return on Equity (ROE)?

4. Does Non-Performing Loan (NPL) have a significant impact on Return on Equity (ROE)?
5. Does Net Profit (NP) have a significant impact on Return on Equity (ROE)?

1.4 Research Objectives

1. To analyze the impact of Capital Adequacy Ratio (CAR) on Return on Equity (ROE).
2. To analyze the impact of Loan to Deposit Ratio (LDR) on Return on Equity (ROE).
3. To analyze the impact of Net Interest Margin (NIM) on Return on Equity (ROE).
4. To analyze the impact of Non-Performing Loan (NPL) on Return on Equity (ROE).
5. To analyze the impact of Net Profit (NP) on Return on Equity (ROE).

1.5 Significance of Research

1. Bank managers: the management of commercial banks can optimize the bank's internal management strategies with the help of the results of this study. They can adjust the capital structure, control the non-performing loan ratio, improve the net interest margin, etc. according to the impact of different financial indicators on performance, thus improving the bank's profitability and market performance.

2. Customers and the public: Understanding the financial performance of banks can help customers make more informed choices, such as choosing more stable and efficient banks for deposits, loans or other financial transactions. Meanwhile, the public can also use the study to better understand the operations and risks of the banking industry.

3. Investors: Potential investors and shareholders can use the results of the study to assess the financial health of the bank and thus make more informed investment decisions. Understanding which financial indicators have a positive or negative impact on bank performance can help identify banks with high return on investment potential.

4. Other researchers: This study offers empirical evidence for academic research in finance and enhances the theoretical understanding of the relationship between financial indicators and bank performance. In addition, it provides data and methodological references for future related studies and helps scholars to further explore other factors affecting bank performance.

5. University: This study can be used as a literature study in the field of finance.

1.6 Scope and Limitation of the Study

1.6.1 Scope

This study examines five key variables including Capital Adequacy Ratio (CAR), Loan to Deposit Ratio (LDR), Net Interest Margin (NIM)，Non-Performing Loan (NPL) and Net Profit (NP) as a measure of the impact of financial performance of Indonesian commercial banks on their performance. The main objective of the study is to examine whether these financial ratios have a significant impact on the performance of Indonesian commercial banks during the period from year 2008 to year 2022.

1.6.2 Limitation

1、The researchers only used data from annual reports for a fifteen-year period from 2008-2022, thus the results were only valid for that period.

2、This research examines only five variables that affect the performance of commercial banks, which are: Capital Adequacy Ratio (CAR), Loan to Deposit Ratio (LDR), Net Interest Margin (NIM)，Non-Performing Loan (NPL) and Net Profit (NP).

1.7 Definition of Terms

a) Return on Equity (ROE)

Return on Equity (ROE) is a measure of a company's ability that shows the ratio of profits earned by the company to the money invested by shareholders. In simple terms, higher ROE means that the company is making a better return on its shareholders' investment, which usually indicates that the company is using its resources more efficiently to generate profits (Ongore and Kusa, 2013).

b) Capital Adequacy Ratio (CAR)

Capital Adequacy Ratio is the performance ratio of a bank which reflects its ability to withstand losses in the face of a crisis. In general, the higher the capital adequacy ratio, the better the bank's ability to cope with a crisis. In addition, CAR also affects the profitability of a bank as it determines whether the bank can expand into risky, high-returning business areas (Ongore and Kusa, 2013).

c) Loan to Deposit Ratio (LDR)

The Loan to Deposit Ratio is used to measure the extent to which a bank's stable funding covers its loans. When banks make more loans with stable deposits, they are exposed to the risk of a funding gap. This affects bank liquidity and credit availability and could put pressure on economic growth if a large number of banks experience

funding gaps. LDR calculation can be done by dividing the total loan by the total deposit in a certain period of time (Mabwe & Jaffar, 2022).

d) Net Interest Margin (NIM)

Net interest margin measures the difference between a bank's interest income and the interest it pays to lenders, expressed as a proportion of its interest-earning assets. Net interest margin reflects the cost of bank intermediation and the efficiency of the bank (Ongore and Kusa, 2013).

e) Non-Performing Loan (NPL)

The Non-Performing Loan ratio reflects the bank's ability to assume the risk of loan repayment by the borrower. After disbursing the loan, the bank needs to continuously monitor the utilization of the loan, as well as the borrower's ability and compliance in meeting the repayment obligations. If the borrower fails to repay the loan on time, the profitability of the bank will be affected. (Kristianti, 2016).

f) Net Profit (NP)

Net profit, also known as net income, is the amount of revenue that remains after all costs and expenses are deducted for a given period of time. Net Profit can be used to distribute dividends to common stockholders or as retained earnings to be continued and reinvested by the company (Jayathilaka, 2020).

1.8 Research Structure

The research structure of this study is:

The chapter I primarily outlines the research background, problems, and objectives of this paper. The chapter II reviews the existing literature and identifies the variables of this study. The chapter III details the research methods, data collection, and analysis techniques employed. The chapter IV focuses on applying the methods outlined in Chapter III to collect data, perform analysis, and present the results. The chapter V concludes with a summary and recommendations based on the study's findings.

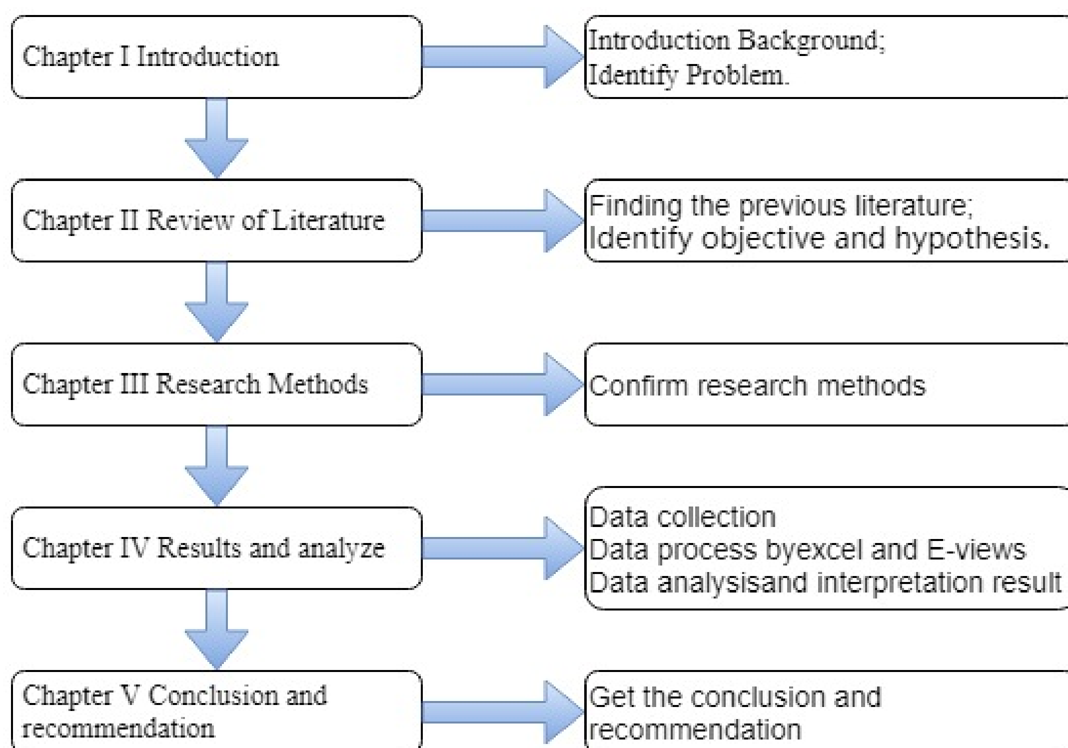

Figure 1.1 Research Framework adjusted by researcher, 2024