CHAPTER I

INTRODUCTION

A. Research Background

A bank is a financial intermediary that accepts deposits and channels those deposits into lending activities, either directly or through capital markets. A bank connects customers with capital deficits to customers with capital surpluses. Banking is generally a highly regulated industry, and government restrictions on financial activities of banks have varied over time and location. Commercial banks play an important role in the financial system and the economy. As a key component of the financial system, banks allocate funds from savers to borrowers in an efficient manner. They provide specialized financial services, which reduce the cost of obtaining information about both savings and borrowing opportunities. These financial services help to make the overall economy more efficient (Mudrajad and Suhardjono, 2002).

The Banking in Indonesia experienced a tidal period and progressing rapidly after Pakto 88 issuance which allows someone or a company may establish a bank with ease. This becomes an anticlimax after the economic crisis in Indonesia, where the sector is the severe crisis of the banking sector. The weakening of the banking system will lead to dysfunction of the banking system as an intermediary (Dasalak, 2005). Ilyas (1999) suggested that one of the main causes of the crisis that hit Indonesia is fundamentally weakness in economic and financial sectors. The development of the crisis became more severe because it was discovered the existence of a fundamental weakness in the Indonesian economy and systems that is reflected by the inefficiency of the economic management and the business sector and the vulnerability of the financial and banking sector of Indonesia.

This monetary crisis has aware us that the banking sector should be reformed to grow back the image of banking and increase public confidence toward banking sector. This change should be able to realize a lean banking system, have good quality, and remain based on the reliable, careful, and conservative principles. Besides the supervision and regulation, the performance appraisal should really be done by the banking regulatory authority; in this case the central bank that currently assessed less assertive and not transparent. It is important to note because one of the important factors that support a healthy banking system is sound bank (Dasalak, 2005).

The recent economic crisis conditions have an impact on the declining number of banks operating, and many of them which still in operation had their performance decreases. So it is necessary to save the commercial banks and make it become sounder. In addition to the actions or policies adopted by Bank Indonesia, it is also expected the improvements of bank's performance include the improvement of profitability (Wilopo, 2000).

Factors affecting bank profitability also can be sourced from a variety of operating performance that can be shown from some indicators. One of the main source indicators that are used as the basis for assessing the bank is financial statements of the bank concerned. According to the report, it will be counted a number of financial ratios that are commonly used as a basis for assessing bank soundness and profitability (Nasser & Aryati, 2000).

Many parties have strong links with the banking activities, which requires information about the condition and performance of the banking system. One of the information that can be used to give a description of the condition of a bank is the published financial reports yearly.

Financial report is one tool to see the condition and performances of the banking system, which can also be used as a basis for predicting, to support the decision making. To be able to meet the qualifications of useful information, IAI (2002) had set out four principal qualitative characteristics that can be understood, relevant, reliable and comparable. Understandable, meaning important quality of information collected in the financial statements are the amenity to be immediately understood by users. Relevant intention meaning that the information is relevant to the economic decisions that may affect users by helping them evaluate past events, present or future, then confirm or predict the outcome of their evaluation of the past. Reliability means free from the notion of information that is misleading, wrong material and the user can be relied upon as presenting a sincere or honest as they should be presented. Can be compared, meaning that the information must be comparable the other periods, to identify the company's financial position relative to trend.

To be able to interpret accounting information that relevant to the purposes and interests of the user for evaluating the performance of banking, there has been developed a set of analytical techniques that are based on published financial statements. One of these techniques that applied in business practice is financial ratio analysis. The rapid developments taking place in the banking world encourages a lot of research on the financial statements of bank that links between the financial ratios of banks with certain accounting phenomenon, with expectations will be found various uses of banking financial ratios (Dasalak, 2005).

Bank's soundness can be judged by several indicators. One of the main sources of indicators used as the basis of valuation is the financial statements of the bank concerned. Based on a report will be counted a number of financial ratios that commonly used as a basis for assessing bank soundness. Financial ratio analysis allows management to identify the principal changes in the trend number, and relationship and the reason changes. Results of financial statement analysis will help to interpret a variety of key relationships and trends that could provide the basis of considerations concerning the potential success of the company's future (Almilia, 2005).

Some researches of the financial ratios of banks are Sinkey, 1978. Sinkey did the research about the financial ratios in predicting the financial condition of banking. The other researcher is Thomson, 1991 who found that the ratio of the CAMEL (Capital, Assets, Managements, Earnings, Liquidity) as a proxy variable of financial condition of banks is a significant factor associated with the possible bankruptcy of the bank for a period of four years before the bank bankruptcy.

CAMEL ratio is used to assess the soundness of banking companies. CAMEL generally uses five aspects of assessment, namely: 1) capital, 2) assets, 3) management, 4) earnings; 5) liquidity (Almilia, 2005). These five aspects are using financial ratios. This shows that financial ratios can be used to assess bank soundness. Empirically, the level of business failure and bankruptcy of banks by using financial ratios CAMEL model can be tested as has been done by some researchers. Thomson (1991) examined the benefits of CAMEL financial ratio to predict bank failures in the USA in the 1980s by using logit regression statistical tool. Whalen and Thomson (1988) found that CAMEL financial ratio is quite accurate in preparing bank ratings, and in Indonesia Surifah (1999) examine the benefits of financial ratios for predicting bankruptcy of the bank by using the CAMEL model.

Since 2004 through CAMEL rating components contained in Bank Indonesia Regulation number 6/10/PBI/2004 April 12, 2004 and its implementation according to the provisions of Circular Letter of Bank Indonesia No.6/23/DPNP May 31, 2004 there are new elements in the CAMEL that is Sensitivity to market risk (S). When compared to the previous health assessment system with CAMEL method, the current system is more comprehensive, or it could be mean more components or ratios to be judged, including the addition of new components of Sensitivity to market risk (S). As a financial institution which also took over the risk in manages the public funds, sensitivity to market risk is banking principles that are not negotiable (Budi Hermana, 2007).

Machfoedz Mas'ud (1994) has conducted research on financial ratio analysis and prediction of earnings changes in Indonesia. The research conducted by Mas'ud Machfoedz was about financial ratio analysis and the prediction of earnings changes in Indonesia. With MAXR method Machfoedz selected financial ratios that amounted to 47 ratios. Machfoedz test the hypothesis by using regression analysis, t-test, and the logit model. Statistical analysis showed that financial ratios are useful to predict earnings one year ahead, but not useful for the prediction of more than one year. Company size is not a significant factor in this study, only for short-term changes, and only one ratio (operating income to sales) that have a marginal benefit for the Indonesian government.

Other research is the research conducted by Zainuddin and Hartono (1999) which examined the benefits of financial ratios to predict earnings growth. Results from these studies indicate that changes in financial ratios on the construct of financial capital ratios, assets, earnings, and liquidity are significant in the banking company's earnings growth forecast for the next one year period, but not for the next two years.

However, the findings from research that has been done are in fact still far from adequate if what we want is a formal construction of the theory of financial ratio analysis. This is apparent from the results of research that still tends to be inconsistent. Some research even contradictory to the other. For instance: Capital Adequacy Ratio as the proxy of Capital investigated by Bahtiar Usman (2003) indicates no significant effect of CAR on bank earnings (EAT). The results Bahtiar Usman (2003) contrary to research conducted by Zainudin and Jogiyanto (1999) and Suyono (2005) which shows the influence significant positive association between CAR to ROA. With the research gap of Bahtiar research Usman (2003), and Jogiyanto Zainudin (1999) and Suyono (2005) it is necessary to do further study about influence of Capital Adequacy Ratio on ROA. The other inconsistency is Non Performing Loan (NPL) as the proxy of Assets that is investigated by Bahtiar Usman (2003), shows that the NPL has no significant effect on bank earnings (EAT), which is the former of ROA. The results from Bahtiar Usman (2003) are contrary to research conducted by Zainudin and Jogiyanto (1999) which NPL variable showed a significant negative effect on ROA. With the research gap from research Bahtiar Usman (2003) and Jogiyanto and Hartono (1999) it is necessary to further study the influence of NPL to the ROA.

According to the Indonesian Institute of Accountants (IAI, 1995), corporate performance can be measured by analyzing and evaluating financial statements. Information position and financial performance in the past is often used as a basis for predicting the financial position and performance in the future and other things that immediately attracted the attention of the user such as payment of dividends, wages, price movements of securities and the company's ability to meet its obligations when due. Performance is an important thing to be achieved by any company anywhere, because the performance is a reflection of the company's ability to manage and allocate its resources.

According to Sofyan (2003), banking performance can be measured by using the average lending rate, the average deposit interest rate, and the profitability of the bank. Furthermore in his research stated that the interest rate savings is a weak measurement of performance and cause problems, so that in his research conclude that profitability is the most appropriate indicator to measure the performance of a bank. Performance that use the profitability measurement used is the rate of return on equity (ROE) for firms in general and the return on assets (ROA) in the banking industry. Return on Assets (ROA) focuses the company's ability to obtain operating earnings in the company, while Return on Equity (ROE) measures only the investment returns earned from business owners in the business (Mawardi, 2005). Thus, in this study ROA is used as a measure of banking performance.

The reason for choosing Return on Assets (ROA) as a proxy for bank performance is that the ROA is used to measure the effectiveness of firms in generate profits by using the assets owned. ROA is the ratio between the profits before tax to total assets. Profits are the principal measure of the overall success of the company's. Earnings will affect the company's liquidity position, the company's ability to get a loan and equity financing. The greater the ROA shows the better performance of the company, because the greater the level of returns (Ang, 1997).

According to Dendrawijaya (2003), the larger ROA of the bank then the better the bank's position in terms of asset usage. With the achievement of high profits, then investors can expect gains from dividends, because in fact in conventional economics, the investment motive is to obtain high profits. Signal by the increasing of the ROA ratio will impact positively on the perception of investors in assessing the company. So the ratio of ROA will also affect to changes in the banking company's stock price. Based on these reasons ROA is be used as an indicator of bank performance in this study. In the context of this problem, this research is intended to conduct further testing of empirical findings on financial ratios, particularly the impact between the CAMELS banking ratio on ROA.

If the CAMELS financial ratio proved to have significant relationships with the ROA, this finding will be a quite useful knowledge for the users of financial statements of banks. On the contrary, if CAMELS financial ratio turned out to have no significant relationship to the ROA, the results of this research will strengthen the evidence about the inconsistency of previous empirical findings.

The roots of thinking of the research the writer come from Zainuddin and Hartono (1999) and Dasalak (2005). The differences between study compared with the research of Zainuddin and Hartono (1999) and Dasalak (2005) is as follows:

1. Zainuddin and Hartono (1999) research dependent variables is the change in relative earnings, whereas in this study as dependent variable is bank

performance that use ROA as the proxy with the goal to measure the effectiveness of firms in generate profits by making use of assets owned.

2. David Dasalak (1999) research dependent variables is the Return on Equity whereas in this study the dependent variable is Return on Assets
3. Bank samples analyzed in Dasalak (2005) is a bank registered in IDX with 100 billion of assets to 10 trillion, where as in this study the sample is the bank with assets Rp 1 trillion to Rp 50 trillion rupiahs according to the classification issued by API.
4. Both Zainuddin and Hartono (1999) and Dasalak (2005) use CAMEL for the research but in this study the writer use CAMELS.

Based on the description above, this study entitled The Impact of CAMELS Financial Ratio on Bank Performance: An Empirical Study on the banks with capital between 1 trillion rupiah to 50 trillion rupiah in 2005-2009.

B. Problem statement

Based on the descriptions above and explanations on the background, the writer formulates the following issues:

1. Do CAMELS financial ratios have an impact on the Return on Assets (ROA)?

C. Scope of The Problem

In order to limit the scope of the discussion on the issue and to obtain a clearer direction for the writer in discussing this problem so the writer has set limit on the following issues:

1. This research will only be conducted on the banks with capital between 1 trillion in capital to 50 trillion rupiah in accordance with the classification issued by BI in the APIs and that have a financial statement for year 2005-2009.
2. A financial ratio measured in this study is the CAMELS financial ratio which is represented by the aspect of Capital, Assets, Management, Earning, Liquidity and Sensitivity to Market Risk.
3. Return on Asset (ROA) will be used as the proxy for bank performance because ROA can be used to measure the effectiveness of firms in generate profits by using of assets owned
4. In this research the writer will use Capital Adequacy Ratio (CAR) as the proxy for capital factor (C), Non-Performing Loan (NPL) and Provided Provision to Required Provision (PPAP) as the proxy for productive assets (A), Net interest Margin (NIM) as the proxy of management (M). Return on Equity (ROE) and Cost to Income Ratio (BOPO) as the proxy for Earning (E). Loan to Deposit Ratio (LDR) as the proxy for liquidity (L), and CARS: dummy variable derived from CAR represents the Sensitivity to market risk

5. For the proxy of Sensitivity to market risk, the writer will use CAR 12 % for the standard. Along with the implementation of Basel II, banks will be directed CAR to 12 percent. But According to Burhanuddin Abdullah (2006) CAR of 16 percent is the best practices. When the CAR is more than 12 % it will be considered as less risky or less sensitive to the change of currency and the other risks, but when the CAR is less than 12 % it will be considered as riskier or sensitive to the risk.
6. For the proxy of management the writer uses Net Interest Margin (NIM) because Management aspects in this study that judge the impact of CAMELS with performance of banks cannot use the pattern set by Bank Indonesia, but proxies with profit margins (Riyad, 2003). The reason is that all activities which include management of a bank's capital management, asset quality management, general management, profitability management, and liquidity management will ultimately affect earnings and comes down to profitability respectively

D. Objective of The Research

As described above, that the study is intended to examine the impact of the CAMELS financial ratios on Return on Assets (ROA)

E. Benefit of the Research

The benefit of this research study hopefully will be able to:

1. For the writer

   This study is important to make a better understanding about banking soundness appraisal and trained intellectual power that is expected to sharpen the power of scientific thought and to increase scientific competence in the disciplines served.

2. For Reader and investor

   This research is expected to provide a broader knowledge of the community who involved in the financial business world, especially potential investors in the national banking system. This research expected to provide a broader knowledge about the impact of CAMELS financial ratios on ROA in the banking system with assets of 1 trillion up to 50 trillion rupiah.

3. For Development of the theory

   This research can be a reference in order to support subsequent researchers, especially in relation to the study of banking soundness appraisal and CAMELS ratio.

F. Research Report Outline

The writing is divided into five chapters, which are:

Chapter I Introduction

This chapter will discuss the introduction about the research. The introduction consists of research background, problem statement, scope of the research, objective of the research, benefit of the research, and research report outline.

Chapter II Theoretical Background and Previous Research

This chapter contains the related theoretical background, previous research and the hypothesis development.

Chapter III Research Methodology

This chapter describes the population and sample used in this research, data and data gathering, variable and variable measurement, method of analysis and hypothesis testing.

Chapter IV Data Analysis

This chapter provides and presents the data analysis and discusses the result obtained in this study.

Chapter V Conclusion and Suggestion

This chapter consists of conclusion, limitation of the research, and suggestion for further research.