

CHAPTER II

THEORETICAL BACKGROUND AND PREVIOUS RESEARCH

A. Theoretical Background

1. Indonesian Banking

a. Understanding Bank

According to Law No. 7 year 1992 on Banking as amended by Act No. 10 of 1998 the meaning of the bank is as follows:

The Bank is a business entity which collects funds from the public in the form of savings and channels them to the public in the form of loans or other forms in order to improve the standard of living of the majority.

The statement above has a high philosophical content. A more technical understanding can be found on the Financial Accounting Standards (SFAS) and Minister of Finance Decree No. 792 Year 1990. The definition of banks under SFAS No. 31 in the Financial Accounting Standards (1999: 31.1) is:

The Bank is an institution which acts as financial intermediary between the parties who have excess funds and parties that need funding, as well as a functioning institution that facilitate traffic of payments.

Meanwhile according to the Minister of Finance Decree No. 792 in 1990 the meaning of the bank is:

"The Bank is an entity whose activities in the financial sector to the collection and disbursement of funds to the public, especially to finance corporate investment."

Based on the above definitions it can be concluded that the bank is a financial institution that's the activities is to raise and distribute funds from and to the community that has a function of traffic expedite payment. In other words the bank is a financial institution which provides credit and basic business services in payment traffic and circulation of money.

According to it transactions, bank can be identified as Non-Bank Foreign Exchange and Foreign Exchange Banks. Foreign Exchange Bank is a bank which can conduct international transactions such as export and import, sale and purchase of foreign exchange, etc. Meanwhile, Non-Bank Foreign Exchange is the bank that cannot conduct international transactions or in other words can only do domestic transactions only (Irmayanto, 2002).

2. Development of the Indonesian Banking

The development of the banking industry in Indonesia can be grouped into four periods, namely the period of rapid growth in the period 1988-1996, the period of crisis followed by a recapitalization program in 1997-1998, the period from 1999 to 2001 and stabilization in the recovery period since 2002 which marked the start growing again the banking industry and changes in the banking industry activity strategy (Mudrajad and Suhardjono, 2002).

a. Period 1988-1996

Issuance of the deregulation package October 27, 1988 (Pakto 88), including a relaxation of capital requirements for the establishment of new banks, has led to the emergence of a number of commercial banks and medium-small scale. At its peak, a number of commercial banks in Indonesia to swell from 111 banks in October 1988 to 240 banks in the years 1994-1995, while the number of rural banks (BPR) rising dramatically from 8041 in 1988 to 9310 BPR in 1996.

On one side of the explosion of the number of banks has encouraged the growth of credit until it reaches an average of 20% per year and provides a significant contribution to economic growth in Indonesia, which at that time reached more than 6%. The momentum of economic development that supported by stability of rupiah exchange rate at that time have also encouraged banks to make loans abroad as one source of funding.

On the other hand, the explosion of the number of banks has also led to Bank Indonesia as the institution responsible for overseeing the banking industry experienced strong pressure to increase the amount of oversight and quality control in line with the increasing number of banks and complexity of banking activities.

b. Period 1997-1998

Rapid growth that occurred in the period 1988-1996 turned back when entering the period 1997-1998 due to financial and banking crisis hit. Starting from the value of the rupiah against the U.S. dollar which has depreciated sharply,

various real sectors and banking activities that get loans in foreign currencies are having difficulty paying back the loans it received. This in turn impact on the emergence of liquidity problems in the banking sector, thereby encouraging banks to raise interest rates to achieve savings of more than 70% in order to attract funds from public and meet the liquidity needs.

The high cost of bank interest at that time was not proportional to the interest income from loans which most of them are categorized in trouble, so the loss of bank capital is large enough and cause solvency problems. At the end of 1998 the NPL ratio (gross) banking industry jumped to 48.6% from 7.2% in 1997 while return on assets and CAR in the year 1998 amounting to minus 18.8% and minus 15.7% or dropped drastically from the previous year amounting to 1.4% and 9.2% (Dasalak, 2005).

Bank Indonesia, the government and international agencies are working hard tackle the crisis, partly by implementing a bank recapitalization cost of more than 400 trillion against seven other banks. Specifically, the steps taken to overcome the financial and banking crisis are:

- 1) Provision of liquidity to banks, known as Bank Indonesia liquidity assistance (*Bantuan Likuiditas Bank Indonesia*).
- 2) Identifying and recapitalization of banks that still have the potential to continue its business activities and the banks that have a significant impact on the banking system.
- 3) Closing troubled banks and consolidating banking industry mergers.

- 4) Establishing special institutions to deal with existing problems in the banking industry such as the formation of National Bank Restructuring Agency (*Badan Penyehatan Perbankan Nasional*).
- 5) Strengthen the authority of Bank Indonesia in banking supervision through the establishment of the Law on Bank Indonesia no.23/1999 which ensures the independence of Bank Indonesia in setting policy.

c. Period 1999-2001

Such a severe banking crisis during the period of 1997-1998 forced the Indonesian government and banks to make improvements in the banking sector in order to stabilize the financial system and prevent the recurrence of crises. Important steps taken in connection with, among other things are:

- 1) Strengthen the regulatory framework with clear implementation plan to meet the 25 Base Core Principles for Effective Banking Supervision who becomes an international standard for bank supervision.
- 2) Improve the payment system infrastructure by developing Real Time Gross Settlements (RTGS).
- 3) Applying Blanket deposit guarantee scheme to protect peoples deposit in the bank.
- 4) Restructure the bad loans, whether conducted by BPPN, the Jakarta Initiative and Indonesia Debt Restructuring Agency (INDRA).
- 5) Implement privatization and divestment program for state-owned banks.

6) Increasing capital requirements for the establishment of new banks.

d. Period 2002-present

Various positive developments in the banking sector since the implementation of stabilization programs, among others are looked at the lending began to increase and product innovation that began running as the development of derivative products (including credit linked notes), as well as the product that cooperate with other financial institutions (mutual funds and banks assurance) . In addition the successful divestment of the banks recapitalization and initial public offering (IPO) of Bank Mandiri and Bank BRI also provides an indication of growing confidence in the market to recover the banking industry in Indonesia. Other positive indicators are also visible from foreign investment that began to flow into Indonesia. The rupiah become more stable and interest rates and the NPL ratio showed a declining trend.

Even if the signs of recovery have appeared, the banking sector has not been able to play optimally in the economy. In this case, the Indonesian banking industry does not yet have sufficient skills and capital to support the expected growth rate of the economy.

Some things that cause the ineffective role of banks in the economy such as the concentration of the banking industry at several large banks, the minimal contribution of small banks in the economy, and the mitigation of capabilities and technology mastery, significant among these banks. This is a reasonable condition

in a country that is doing post-crisis stabilization efforts, however improvement efforts should be made as soon as possible.

Matters relating to the above, the recovery steps are:

- 1) Improve the performance of domestic banks to support economic growth.
- 2) Removing barriers in business competition.
- 3) Improve the effectiveness of supervision (such as the implementation of risk-based supervision and enforcement the capacity).
- 4) Continue the process of privatization of state-owned banks.
- 5) Strengthen good corporate governance standards and transparency to improve investor confidence in the banking system.
- 6) Developing consumer protection mechanisms such as dispute resolution mechanisms set standards to improve consumer trust banking in the banking system.

3. Indonesian Banking Architecture (API)

Indonesian Banking Architecture (API) is a basic framework of the comprehensive Indonesian banking system and provides direction, shape, and order of the banking industry for the range of five to ten years ahead. Policy direction for industrial development in the future of banking defined by API is a vision based on achieving a sound banking system, strong and efficient financial system stability in order to help national economic growth.

Based on foothold of the national banking system and as a continuation of the banking restructuring program which has been running since 1998, Bank Indonesia on January 9, 2004 has launched API as an overall framework for industrial development policy towards Indonesia in the future of banking. The launch of the API is not apart from the efforts of the government and Bank Indonesia to rebuild Indonesia's economy through the publication of the government regulation in accordance with Presidential Instruction No. 5 year in 2003, where the API to be one of the main program.

Focused on the fundamental desire to have a stronger banking sector and implementing API during the last two years, Bank Indonesia felt the need to improve the programs of activities listed in the API. Completion of the API activity programs are not apart from the developments that occurred in national and international economy. Completion of the API programs, among other strategies include more specific about the development of Islamic banking, rural banks, and SMEs in the future so that the API is expected to have a more complete program of activities and includes a comprehensive banking system as a whole related to a Commercial Bank and Rural Banks, both conventional and sharia, and the development of SMEs.

4. Banking Performance Analysis

As mentioned in the previous section that one of the remedial steps that the priority is to improve the performance of banks to support economic growth,

then this will be explained in part on the performance of banking and how to analyze it.

A fundamental objective of banking business is the optimal gain by giving financial services to the public. For owners of shares invested in the bank aims to gain income in the form of dividends or profits through increased market price of the shares owned.

Banks that can always maintain good performance with particularly high levels of profitability and well able to pay dividends and its business prospects may be growing up and able to comply with prudential banking regulation well, then there is the possibility of the value of shares of the bank concerned in the secondary market will rise. Increase in value of shares and amount of third-party funds is one indicator of increasing public confidence to the bank concerned (Dasalak, 2005).

The trust and loyalty of the owners of bank funds is a factor that very helpful and will simplify the management of the bank to develop a good business strategy. Instead of the owners who lack trust funds at banks, this is certainly not give benefit for the bank because the owners of these funds can attract funds at any time and move it to another bank. Even the owner of this fund can ruin a large bank if the funds that stored in a bank at the same time fully drawn simultaneously.

Evaluating the performance of a particular bank can be done by analyzing its financial statements. The financial statements in the form of bank balance

sheets provide information to parties outside the bank, for example, central banks, the public and investors regarding its financial position description, which further allows external parties to assess the magnitude of risk that existed at a bank. Statements of income give a description of the relevant business development bank. This will be further discussed in the next section.

5. Banking Financial Statement

All Financial Institutions that carry out business activities organized accounting system, which is also referred to the booking system, to record all economic transactions carried out by the financial institution concerned. Least once a year, at the end of the accounting year, the accumulated accounting data is collected into the lane balance. The accounting data collected in the balance of the lane and then processed by way of systematically classifying and arrange it into the form of financial statements (Balance Sheet and Consolidated Profit and loss) (Mudrajad and Suhardjono, 2002).

a. Balance Sheet

Consolidated Balance Sheet of the Bank is arranged in the form of a list that presents a systematic comparison of what is owned by the banks (assets) which also shows the use of funds or investment funds in the period reported, what is the bank's liabilities (debts), and the bank's capital at a time or specific date which also shows the source of funds that existed at the property. Balance equation can be written as follows: $\text{Assets} = \text{Debt} + \text{Equity}$.

1) Bank Assets

The Outline of the bank's assets can be classified into four major groups, namely credit, securities trading, cash and deposits to other banks, and other assets.

2) Debt and Equity

Part of this obligation and the bank's capital funding sources also describe the bank which is divided into two types, namely: (1) debt instruments to third parties, and (2) component of capital (equity component). Debt instruments have different characteristics according to the interest paid, the payment term, whether to get guarantees from the central bank or not, and whether it can be traded in the secondary market or not. While the characteristics of different components of capital, among others, according to the share price, net income paid as a dividend, and others.

b. Consolidated profit and loss

Income statement basically reflects the nature of banking or financial activities of the principal banks, which receive funds from the public storage of surplus funds in various forms; then distribute those funds to the community in form of credit need and provide a wide range of financial services needed communities in the country, among other safety box facilities, travelers checks, credit cards, buying and selling securities and others. General statement of income which is used by banks consist of revenue derived

from interest income from loans granted by banks to customers in various forms. In addition to coming from interest on loans to customers, banks generally earn revenue from noninterest income in the form of investment securities transactions, the provision of banking services, such as money transfer services, such as selling foreign currency, deposit services securities and other banking services.

Which is the cost of bank charges consist of interest cost on several posts of interest expense, operating costs such as salaries, wages and other employees of the various elements of income, the cost of building rent, building maintenance and equipment costs, taxes, depreciation costs, advertising costs and promotion, and others are included in noninterest expense costs.

Once known the value of all revenues and overall cost value profit or loss figures can be found. If the value of total revenue is greater than the value of the total cost for the same period the bank made a profit. Conversely, if the value of total income is less than the value of the total cost of the bank suffered a loss.

In shorter, net income of banks can be written as follows:

$$NI = NII - \text{Burden} - PL + SG - T$$

Whereas:

NII = Net Interest Income

Burden = Noninterest income – noninterest expense

PL = Provisions for loan losses

SG = Securities Gains (Losses)

T = Taxes

Sources of bank revenues come from interest income, non-interest income, and security gains. Expenses in the form of bank interest expense, non-interest expense, provision of loan losses, security losses, and taxes. Source of losses (gains) resulting from transactions in foreign exchange rates and the fluctuation of the debt at the time owned.

c. Statement of commitments and contingencies

Commitments Report reported on the bond or contract of appointment that cannot be canceled unilaterally, and must be performed if a mutually agreed upon terms are met. While the contingency is a claim or potential bank liabilities that depending on the case or whether one or more events in future.

Systematic of the statement of commitments and contingencies has been prepared based on the level sequence effects possibility of changes in financial position and results of operations of banks.

d. Consolidated cash flow

Cash Flow Statement is a report which shows all important aspects in the activities of banks, regardless of whether the transaction has a direct effect on cash and cash based during the reporting period.

e. Notes to Financial Statements

A bank is required to disclose in separate notes on net open positions by currency as well as other activities such as activities of the trustee, custodian and credit distribution.

Based on Republic Act number 10 year 1998, every bank must submit a balance sheet and annual income (as audited by public accountants) and the notes there to and other periodic reports to Bank Indonesia in time and form prescribed by Bank Indonesia.

6. Financial Statement Analysis

According to Leopold A. Bernstein, a financial statement analysis process full consideration in order to help evaluate the position company's financial and operating results on present and past, with aim to determine the estimates and predictions are most likely about conditions and company performance in the future (Dwi Prastowo and Rifka Juliaty, 2002).

Analysis of the financial statements includes the application of various tools and techniques analysis of reports and financial data in order to obtain size-size and relationships meaningful and useful in decision making (Dwi Prastowo and Rifka Juliaty, 2002).

The objective analysis of the financial statements themselves by Dwi Prastowo and Rifka Juliaty (2002), among others:

- a. As an initial screening tool in selecting alternative investments or mergers
- b. As a forecasting tool about condition and future financial performance
- c. As the process to diagnose the problem - a problem management, operation or other problems
- d. As a means of management evaluation.

Technical analysis of financial statements is categorized into two methods, namely (Dwi Prastowo, 2002):

1. Horizontal analysis methods, is a method of analysis done by compare the financial statements by several periods so as to known developments and trends. This method consists of 4 analyses, among others:

- a. Comparative analysis (comparative financial statement analysis)

This analysis is done by reviewing the balance sheet, income statement or statements of cash flows sequentially from one period to the next.

- b. Trend analysis

It is a method or technique of analysis to determine the state tendencies finances, did show tendencies remain, rising or even fall. A useful tool for comparison of long-term trend is trend index number. This analysis requires that a reference base year for all the posts that are usually given

the index number 100. Because the base year become a reference for all comparisons, the best option is the year where normal business conditions.

c. Cash flow analysis

It is an analysis of changes in the amount of cash or to determine the sources and the use of cash during the period particular. This analysis is primarily used as a tool to evaluate sources of funding and use of funds. Cash flow analysis provided insight about how companies obtain funding and use source of funds. Although the simple analysis of cash flow statement provides a lot of information about the sources and uses of funds, it is important to analyzing cash flow in more detail.

d. Gross profit analysis

It is an analysis to determine the causes of changes in gross profit an enterprise from period to period or changes in gross profit a period in which budgeted.

2. Vertical analysis methods, is a method of analysis done by analyzing financial statements in certain periods. This method consists of 3 analyses, among others:

a. Common Size Analysis

Is an analytical method to determine the percentage of investment in respectively - their assets to total assets, also to know its capital structure

and cost composition that occur associated with the number of sales. The analysis emphasizes the common size on 2 factors, namely:

1) The source of funding, including the distribution of funding between the obligations smooth, non-current liabilities and equity.

2) The composition of assets, including the amount for each - each current assets non-current assets.

b. Breakeven analysis is analyzed to determine the level of sales that must be achieved by a company so the company does get lose, but also not making a profit. With the break-even analysis will also know to varying degrees of profit or loss for different levels sales.

c. Ratio analysis. Ratio analysis is a way to analyze financial statements expresses mathematical relationships between a numbers with the number of other or comparisons between one post with another post.

7. Health Assessment of Banks by CAMELS Method

To assess the health of a bank can be viewed from various aspects. The assessment aims to determine whether the bank in a sound condition, adequate sound, less sound, and no sound, so the Bank of Indonesia as a supervisor and builder banks can provide referrals how the bank should run well or even cease operations.

Under the provisions of the Law on banking, Bank Indonesia has issued a Circular Letter No. 26/5/BPPP dated May 29, 1993 which regulates the

procedures for assessing bank soundness. This provision is revised regulations issued by Bank Indonesia Circular Letter. 23/21/BPPP dated February 28, 1991. Bank soundness valuation method above, then known as CAMEL.

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 mean more components or ratios are judged, including the addition of new components of Sensitivity to market risk (S). As a financial institution which also took over the risk in the management of public funds, sensitivity to market risk is banking principles that cannot be denied (Budi Hermana, 2007).

In the banking industry, these ratios are sorted again and used by Bank Indonesia to measure the soundness of banks or commonly said to be a CAMELS financial ratios. In this case the performance of the bank's criteria is measured capital adequacy, asset quality, management aspects, profitability, liquidity and sensitivity to market risk. Machfoedz (1999) suggested that the technique cannot be applied fully (only based on financial ratios used in the performance measurement aspects of capital, asset quality, management, earnings, liquidity and sensitivity to market risk) but tailored to the availability of existing data. Rinaldi et al (1995) says that cannot be implemented fully CAMELS because the basic

aspects which form the basis of banking health assessment cannot be traced from the bank's financial statements.

The writer tried to get the formula for the calculation of CAMELS based on existing regulations and find a reference that will be used in this study is the calculation of CAMELS based Bank Indonesia Regulation number 6/10/PBI/2004 12 April 2004 and Bank Indonesia Circular Letter dated May 31, 2004 No.6/23/DPNP on guidelines for the calculation of financial ratios. Based on these six aspects will be known soundness of banks in the sample. While the recapitulation of the factors considered and their respective weights can be known based on the procedures bank rating set by Bank Indonesia and will be included in the appendix along with the data of each ratio in CAMELS. Each aspect is the CAMELS:

a. Capital

Capital Adequacy, which is showing the ability of banks to maintain sufficient capital and management ability of banks to identify, measure, and monitor and control the risks arising that, may affect the amount of bank capital. Capital Adequacy calculation is based on the principle that every investment has risks that must be provided to a certain percentage of the amount of capital (risk margin) of total investments. Based on Pakfeb 1991, banks are required to meet Minimum Capital Investment Obligations, or known by the CAR (Capital Adequacy Ratio), which is measured from a certain percentage of risk-weighted assets (RWA). In line with the standards established by the Bank of the Internal

Settlements (BIS), against all banks in Indonesia are required to provide a minimum capital of 8% of RWA. While the notion of capital here is: (1) capital for banks which founded and headquartered in Indonesia consists of core capital and supplementary capital, and (2) a foreign bank branch offices in capital consists of net fund the headquarters and branch offices outside Indonesia. Fulfillment of minimum capital adequacy ratio of 8% is applied gradually, that is equal to 5% at the end of March 1992, 7% at the end of March 1993, and 8% at the end of December 1993.

According to Bank Indonesia Circular Letter No.6/23/DPNP, capital components considered include:

- 1) Adequacy of Capital Adequacy Ratio or *Kewajiban Penyediaan Modal Minimum (KPMM)* to the applicable regulations;
- 2) The composition of capital;
- 3) Future trends / KPMM projections;
- 4) Asset classified as compared with bank capital;
- 5) Bank's ability to maintain the need for additional capital derived from profits (retained earnings);
- 6) Bank capital plan to support business growth;
- 7) Access to capital resources; and
- 8) The financial performance of its shareholders to increase the capital of the Bank.

b. Assets quality

Assets quality (quality of productive assets) shows the quality of assets in connection with the credit risk faced by banks due to its lending and investment funds in the portfolios of different banks. Any investment of funds in the bank earning assets quality assessed by determining the level of collectability, namely whether the current, Substandard, Doubtful or Loss. Contrasting levels of collectability is necessary to know the level of earning assets of the minimum reserves that must be provided by banks to cover the risk of possible damages. Based Pakfeb 1991, banks are required to reserve at least 1% of all productive assets plus: (1) 3% of earning assets classified as substandard, (2) 50% of earning assets classified as doubtful, and (3) 100 % of earning assets classified as loss. Assessment of the health level of productive assets of a bank based on the assessment of the quality of productive assets and quantified based on two ratios, namely: (1) the ratio of classified assets to total earning assets, and (2) reserve ratio of earning assets to total assets that classified. According to Bank Indonesia Circular Letter No.6/23/DPNP, asset components are evaluated including:

- 1) Earning assets compared to total earning assets;
- 2) The debtor outside the core of related party loans compared to total loans;
- 3) Development of the productive assets of a troubled / non-performing assets compared to productive assets;
- 4) The adequacy of allowance for possible losses on earning assets (PPAP);
- 5) The adequacy of policies and procedures of productive assets;
- 6) Review system (review) internal to productive assets;

- 7) Documentation of productive assets; and
- 8) The handling performance of earning assets.

c. Management

Management shows the ability of the bank manager to identify measure, monitor and control the risks that arise through policies and business strategies to achieve the target. Based Pakfeb 1991, the management of a bank is required to properly manage the bank in accordance with the regulations prevailing in the banking sector to the banks soundness. The success of the bank management is based on qualitative assessment of management that includes several components. Component consists of capital management, asset quality management, general management, profitability and liquidity management that include 250 whole aspects. Bank management may be classified as healthy if at least meet 81% of all these aspects.

Assessment of management factors, among others, performed by evaluating the following components:

- 1) General management;
- 2) Implementation of risk management systems; and
- 3) Bank compliance regulations and commitments to Bank Indonesia and / or other parties.

d. Earnings

Earning shows not only the quantity and trend of earnings but also the factors that affect the availability and quality of earnings. The success of the bank

based on a quantitative assessment of bank profitability as measured with two ratios are weighted the same. The ratio consists of: (1) the ratio of profit in the last 12 months of business volume in the same period (Return on Assets or ROA), and (2) operating expenses to operational revenue ratio in a period of 12 months. A bank can be included in a healthy qualification if: (1) the ratio of profit to the business volume reaches at least 1.2%, and (2) the ratio of operating expenses to operating income does not exceed 93.5%.

According to Bank Indonesia Circular Letter No.6/23/DPNP, the components of earnings are assessed include:

- 1) Return on assets (ROA);
- 2) Return on equity (ROE);
- 3) Net interest margin (NIM);
- 4) Operating Costs compared to Operating Income (BOPO);
- 5) Growth in operating income;
- 6) The composition of the portfolio of earning assets and revenue diversification;
- 7) The application of accounting principles in the recognition of revenues and expenses; and
- 8) Operating profit outlook.

e. Liquidity

Liquidity indicates the availability of funds and sources of bank funds on current and future. Bank liquidity arrangements are intended primarily to bank at

any time to meet the obligations that must be paid. Based Pakfeb 1991, banks are required to maintain the liquidity that is based on two ratios with equal weight. Ratios are: (1) the ratio of net liabilities of call money on the current assets of cash, demand deposits at Bank Indonesia, Bank Indonesia Certificates, Money Market and Securities in the amount by other banks, and (2) the comparison between the credits when given to party funds, including borrowings with period of more than three months. Bank liquidity can be classified healthy if: (1) call money on the ratio of the net current assets of less than 19%, and (2) the ratio of loans to third-party funds of less than 89.8%.

According to Bank Indonesia Circular Letter No.6/23/DPNP quantitative and qualitative assessment of the liquidity factors, among others, performed by evaluating the following components:

- 1) liquid assets of less than one month compared with liquid liabilities of less than one month;
- 2) 1-month maturity mismatch ratio;
- 3) Loan to Deposit Ratio (LDR);
- 4) 3-month forecast of future cash flow;
- 5) dependence on funds between banks and depositors core;
- 6) policy and liquidity management (assets and liabilities management / ALMA);
- 7) The ability of the Bank to gain access to the money market, capital markets, or other funding sources; and
- 8) The stability of third party funds (TPF).

f. Sensitivity to market risk

According to Bank Indonesia Circular Letter No.6/23/DPNP, the components of the sensitivity to market risk is assessed include:

- 1) Capital or reserves established to cover fluctuations interest rates compared to potential losses as a result of the fluctuations of (adverse movement) interest rates;
- 2) Capital or reserves established to cover fluctuations exchange rates compared to potential losses as a result of fluctuations (adverse movement) in exchange rate; and
- 3) The adequacy of market risk management system implementation.

According to Budi Hermana (2008) the proxy for Sensitivity to market risk is such as capital or reserves established to cover the fluctuations in interest rates compared to potential losses in exchange rates. In other word the Capital Adequacy Ratio can be a proxy for Sensitivity to market risk.

The Minimum CAR for Indonesian Bank is regulated by Basel II Accord that becomes standard for Indonesian banking. Basel II Accord is a parameter of the banking rules that apply internationally and has been issued by the banking oversight committee since last year. Committee consisting of officials of central banks and banking regulators have been met at the Bank for International Settlements in Basel, Switzerland.

Basel II is a representation of a major revision of international standards sufficient capital ratio (CAR), which was introduced in 1988. Some things that

become the new benchmark is a minimum CAR requirements by 12 percent with additional calculation of the risks that impact on the decline in CAR. However, Indonesia is gradually implementing the provisions thereof. Operational risk is one of three types of risk in Basel II regulations. Previously, the bank has applied for credit and market risk.

After calculating these three risks, then the bank must implement the third pillar of Basel II, namely the transparency of the bank. The third pillar related claims against the bank supervisory assessment of the condition of the bank management. So, if banks already meet the CAR say 8 percent, the superintendent must be able to see the 8 percent standard was appropriate or not. There must be supervisory judgment.

Indonesian Banking will have no trouble following the new rules. Currently 60 percent of bank capital in Indonesia has entered the tier one category. This means that banks have capital above the core BI requirements, namely a minimum of 40 percent of the total CAR. Thus, if the G20 will decide the tier 1 banks have 50 percent of the CAR, no problem.

Burhanuddin Abdullah (2006), stressed three things to do banking. First, learn and understand the prerequisites and the infrastructure in the concept of Basel II. "The ability of banks in implementing risk management is an absolute thing. " In the Basel II rules, banks explicitly allocate capital for operational risk. There is separate weight to the ability of banks to manage credit risk.

Second, each bank needs to perform gap analysis in accordance with his understanding of the concept of Basel II. They must know where his position today, and what steps must be prepared.

Third, banks were asked to study the impact of Basel II's capital adequacy ratio (CAR). If in the preparation is no bank that was not able to meet the requirements of Basel II, they were asked to accelerate the consolidation program. Basel II was introduced in 2004 as a refinement of the 1988 Basel Accord (Basel I). The goal is ensuring the stability and health of the financial system by increasing the risk sensitivity in the calculation of bank capital. Basel II also emphasizes the internal supervision and market discipline.

Along with the implementation of Basel II, banks will be directed CAR to 12 percent. In fact, if market risk, credit risk, and the overall calculated risk, CAR of 16 percent is the figure who became the best practices.

B. Previous Research about CAMELS Ratio

Previous research related to financial ratios has been carried out, such as research conducted by Machfoedz (1994) entitled "*Financial Ratio Analysis and the Prediction of Earnings Changes in Indonesia*." The study sample of 84 companies listed on the Jakarta Stock Exchange, financial reporting data from the years 1989, 1990, 1991 which is used to calculate financial ratios, and data from the years 1990, 1991, 1992 used to calculate changes in earnings. The financial ratios include 47 ratios formed into nine groups, namely: Short Term Liquidity, Long Term Solvency, Profitability, Productivity, Intensiveness Investment,

Leverage, Return On Investment, and Equity. By using selection MAXR determined the best ratios and generate five groups covering 13 ratios. Results of analysis used to test the first hypothesis showed that of 13 financial ratios as independent variables, nine of them are significant. The results support the first hypothesis that the financial ratios useful in predicting changes in earnings. Results of regression analysis to test the second hypothesis indicate that the coefficient of dummy variables to represent small and large firm size is not significant. The third hypothesis indicates that the changes in financial ratios associated only with changes in short-term profit, not by long-term changes. Testing the fourth hypothesis, namely the relationship between financial ratios is used for state companies with earnings changes is also performed by regression analysis. The results showed that a significant ratio of operating income to sales.

Another study conducted by Agus Endro Suwarno (2004) on "Benefits Information Financial Ratios Predict Changes In Net Income (Empirical Study On Manufacturing Companies go public on the Jakarta Stock Exchange)." The data used is data coherent cross time and place (pooled Time Series). The study using purposive sampling with total sample of 42 manufacturing companies to forecast changes in earnings in 2000, samples of 39 manufacturing companies to predict changes in earnings in 2001, and the sample of 49 manufacturing companies to forecast changes in earnings in 2002. The selection of ratios is using stepwise regression methods. Hypothesis testing is using multiple regression, t test, and F-test. Results obtained from the study showed the first hypothesis, namely the

financial year 1999 ratio to predict significant change in earnings in 2000. The financial ratio is long term liabilities to shareholders equity, operating profit to profit before taxes, and net income to sales. The result of the second hypothesis showed a significant three financial ratios to predict changes in earnings in 2001, which is inventory to working capital, net income to net worth, operating profit to profit before taxes, while the ratio of cost of goods sold to net sales was not significant. The third hypothesis indicates that the financial ratios Operating profit before taxes and profit after taxes to fixed assets is not significant for predicting changes in earnings in 2002.

Zainudin and Jogiyanto (1999) conducted a study entitled "*The Benefits of Financial Ratios in Predicting Earnings Growth: An Empirical Study of the Banking Companies Listed on the Jakarta Stock Exchange.*" This research examines the benefits of financial capital ratios, assets, earnings, and liquidity in the banking company's earnings forecast Growth. The number of samples obtained for fiscal year 1990 until the year 1992 totaled 15 companies, while the number of samples for the fiscal year 1993 until the year 1996 was 22 companies. The study uses regression analysis and Analysis of Moment Structures. Results of analysis of AMOS (Analysis of Moment Structures) showed that the construct of financial capital ratios, assets, earnings, and significant liquidity in the banking company's earnings growth forecast for the next one year period. While for the next two years found in the fact that the level of individual financial ratios is not significant in predicting profit growth.

Research Altman (1968) included a control group of successful companies. Altman uses a sample of 66 firms, which consisted of 33 bankrupt companies and 33 companies are not bankrupt. By using multivariate discriminant analysis, Altman found that the financial ratios of liquidity, solvency, and profitability can be useful in predicting bankruptcy of firms with a decreasing level of accuracy along with the length of the prediction period. In the prediction period of one year before the company went bankrupt, financial ratios are useful for predicting bankruptcy in the 95% level of accuracy which decreased to 76% in the period two years before bankruptcy, 48% for a period of three years, 29% for a period of four years, then rose again 36% for the five years before the company went bankrupt.

Other studies have been done Nur Fadjrih Fun (2000), entitled "*The ability of Financial Ratios in Predicting Earnings (Establishment of Financial Ratios as a Discriminator)*." The data used is data that is available in the financial statements in 1995 and 1996, published in the companies listed on the Jakarta Stock Exchange and the samples were determined by purposive sampling. The analysis method is the discriminator analysis used to identify the financial ratios that can recognize changes in earnings. The purpose of financial ratio analysis is to determine the most efficient in discriminating changes in price. There are five ratios which are significant, dividends / net income, sales / total assets, long-term debt / total assets, net income / sales, and investment in property, plant, & equipment / total uses. Dividends ratio / net income is the most discriminant ratio,

whereas the ratio of investment in property, plant, & equipment / total uses at least discriminant.

Research conducted by the Warsidi and Bambang Agus Pramuka titled *"Evaluation of usefulness of Financial Ratios Earnings In Predicting Changes in the Future: An Empirical Study of Companies Listed on the Jakarta Stock Exchange."* This research examined the usefulness of financial ratios to predict changes in earnings in the future. Tests conducted using a random sample of 54 companies listed on the Jakarta Stock Exchange. By using stepwise variable selection method, regression analysis of 49 financial ratios for the known linear relationship with changes in earnings one year, two years, and three years to come. The results showed that seven financial ratios proved significant for use as a predictor of change in earnings one year ahead.

Penman (1992) did research on the company in 1482 until 1677 for a period of 11 years, from 1973 to 1983. Results showed that the financial statements present information relevant to evaluating changes in earnings. The results also indicate items of financial statements in addition to earnings and financial reports several years ago related to the persistence of earnings changes.

C. Hypothesis Development

Based on the above theoretical basis, the authors develop hypotheses and develop it by looking at several studies that analyze the financial ratios of CAMELS as mentioned above.

Based on the previous research, the writer sees that yet there is no research that specifically proves whether there is a significant impact between CAMELS financial ratios with Bank performance that use Return on Assets (ROA) as the proxy. Therefore, the writer tried to find out if there is a significant impact between financial ratios according to the CAMELS with ROA.

To prove this, the writer developed a hypothesis to be tested in this study as follows:

Ha: CAMELS financial ratios have an impact to the Return on Assets.