CHAPTER I

INTRODUCTION

1.1 History of Banking in Indonesia

Banking institutions have been through a long history since the era of Industry Revolution in 18th century up until today in what people call as "millennium era". In Indonesia particularly, the first bank known as *De Bank van Leening* was established by VOC (Vereenigde Oostindische Compagnie – Dutch's East Indian chartered company) in 1746, which also was the first bank to operate in the region of "Nusantara". In 18th century, VOC underperformed and finally experienced bankruptcy. The role of VOC in "Nusantara" then was taken over by the government of Kingdom of Netherlands, including the banks.

On January 24th 1828, "De Javasche Bank" was established in response to the financial condition in Dutch East Indies that had needed to be regulated and organized, as well as answering the demand of businessmen in Java to smoothen their business interests. This bank had been given the right to issue currency on behalf of the government of Dutch East Indie and quickly spreading its operations by establishing branch offices in all over Java region.

After the independence, the government of Indonesia nationalized DJB to be the national central bank by buying 99.4% ownership, considering the importance of the bank in the economy during colonization era. Then, since July

1st 1953, DJB was officially renamed as "Bank Indonesia" and act as the national central bank of Indonesia (Unit Khusus Museum Bank Indonesia: Sejarah Pra Bank Indonesia, 2015).

1.2 Research Background

Reflecting back to the history, banking industry in Indonesia had been through a series of deregulations in search for the aim to develop a healthy, efficient, and competitive banking system. Many things had happened; previously over-regulated banking system had constrained initiatives from banks, and created a stagnant condition in the economy. This situation pushed Bank Indonesia as a central bank to carry out deregulation in the system to meet the demand of the society, business, and economy as a whole.

The first deregulation in the record which was mainly about the allowance for banks to independently set their interest rate had succeeded to develop competitiveness among banks in the industry. Private banks were started to regain back their encouragement to develop their business in a competition with state-owned banks, which previously more privileged by the government. This reaction was expected to grow initiatives from private banks to get involved in developing the nation's economy.

The next breakthrough in Indonesian banking was the allowance for the banks to expand their branch networks. Considering this was an important step taken by the government, the outcome had been successful in promoting the growth of banking industry. It even had been quite worrying since the growth was beyond expectation. The capital inflows from overseas were strong and mostly utilized for financing consumptive economic sector. To keep this phenomenon under control, government then decided to conduct a more tightened regulation that concerned mainly about capital adequacy ratio, productivity, and liquidity of banks in the industry. Banks were expected to have a better risk identification which covered self-regulatory and self-assessment principals (Unit Khusus Museum Bank Indonesia: Sejarah Bank Indonesia, 2015)

Until nowadays, the important role of banking industry to the society is undeniable. Considered vital in payment system as well as facilitating credit and economic growth, the banking industry is one of the most regulated industries overall (Francis and Osborne, 2010). The industry is regulated with several regulations, particularly regarding its capital. Capital regulation takes role to overlook the industry and mandate the institutions to improve the quality and the quantity of its capital (under Basel II) in an objective to be able to absorb shocks and unexpected losses during crisis that could lead to the failure of those banking institutions.

Recently, the case of Bank Mutiara which was involved in an issue regarding capital adequacy might give a sense of caution to the regulators to consider the health of banking institutions in Indonesia especially in terms of their capital. A concern then might rise about what the ideal design of capital requirement is, and it forces the regulators to constitute a more fundamental role of regulatory capital requirement in affecting bank behaviors regarding their capital ratio and to stimulate market perception about current bank's risks. The role is driven by the need to address market failure which involves systemic risk and other negative externalities which is derived from bank failures (Francis and Osborne, 2010).

The first objective of this paper is to examine the effectiveness of capital requirement in affecting capital ratios of banking institutions. The practice of setting a specific capital requirement under the implementation of Basel II provides a slight impression that it confirms the extent to which capital regulation affects bank behavior, particularly in its capital ratio. Moreover, capital adequacy ratio is claimed as one of the important factor to promote stability and efficiency of the financial system by reducing the likelihood of banks to become insolvent (Reserve Bank of New Zealand, 2007). This becomes a particular interest for policymakers and regulators, in addressing problems in recent banking crisis, as well as identifying condition that could threat the financial stability.

It is found that banks do not always respond to capital requirements in a similar fashion. Some banks may alter capital directly (e.g., by raising new capital or by retaining a higher proportion of earnings), while others may alter risk-weighted assets (e.g., on- and off-balance sheet composition) (Francis and Osborne, 2010). These choices may depend on characteristics and financial conditions of a bank (Alfon et al., 2004) and the state of the economy (Ayuso et al., 2002; Lindquist, 2004; Stolz and Wedow, 2005; Jokipii and Milne, 2007). In achieving this objective, the researcher extends previous research to include the extent in which this capital requirement influences organization. This is useful in understanding the impact of policy revisions regarding banks' capital requirement may have on the behavior of the banks in particular.

This study contributes to the previous research in two ways. First is the evaluation of the extent to which banks' response rate (to change in capital regulation) depends on various bank-level characteristics. Second contribution is the examination of how regulatory capital influences bank's choice of capital ratios which in this case is related to the quality and quantity of the bank's capital itself.

1.3 Problem Statements

After reviewing the described research background, the researcher comes up with three main research questions:

1. In terms of capital ratio, how do banks in Indonesia respond to changes in the amount of minimum regulatory capital requirement set by Bank Indonesia in accordance with Basel II accord?
2. Does this response also influenced by characteristics of the bank (size, composition of capital structure, risk, and exposure to market discipline)?
3. How does the quality of capital affect banks' choice of risk-based capital ratios?

1.4 Scopes of the Research

In order to limit the discussion on the issues and acquire clearer direction for researcher in the research, some boundaries are made on the following issues:

1. Commercial banking statistics sampled in this research is under the implementation of Basel II accord in 2009-2013. In determining the period range of the research, the researcher refers to the regulation of Bank Indonesia No. 10 /15/PBI/2008 which specifies that the accommodation of Basel II accord would start to be implemented on January 1st 2009; and also regulation of bank Indonesia No. 15/12/PBI/2013 which specifies that Basel III accord as the continuation of Basel II accord would start to be implemented in Indonesia on January 1st 2014. Those two regulations helped the researcher to figure out that Basel II accord had been experienced for 5 years, which was from 2009 to 2013.
2. The data used in this research are the overall data of commercial conventional banks in Indonesia which is classified into several groups according to their industry. The researcher decided to use this kind of data due to its availability and also it supported the true intention of the researcher to carry out a research that can be more accurately representing the true condition of banking sector in Indonesia.
3. Commercial banking statistics used in this research are issued by Otoritas Jasa Keuangan (OJK).

1.5 Originality of Writing

The research is based on a previous research which had been done in the past. This research is a replication of a study with a similar topic entitled “On the

Behavior and Determinants of Risk-Based Capital Ratios: Revisiting the Evidence from UK Banking Institutions" by William B. Francis and Matthew Osborne. The researcher decided to replicate and conducted this study using Indonesian commercial banks with the title "The Factor and Behavior of Risk-based Capital Ratios of Commercial Banks in Indonesia in Accordance to Basel II Accord".

The author compiled this research on his own except where otherwise indicated. All writing, analysis, and conclusion in this research are conducted and explored by the author.

1.6 Objectives and Benefits of the Research

1.6.1 Objectives of the Research

Based on the problem statements, the objectives of this research are listed as followings:

a. Finding out the mean of response in terms of capital ratio which Indonesian banks have regarding changes in the amount of minimum regulatory capital requirement set by Bank Indonesia in accordance with Basel II accord.

b. Investigating whether banks' responses are influenced by banks' characteristics (size, composition of capital structure, risk, and exposure to market discipline).

c. Investigating the effect of capital quality on bank's choice of risk-based capital ratios.

1.6.2 Benefits of the Research

a. The investors

This research will help the investors in the observation of capital regulation in Indonesia and learning more about the mean of response that banks will take regarding changing capital requirement, thus developing risk awareness in their investments.

b. The author

This research will give more knowledge to the author regarding the behavior and determinants of risk-based capital ratio of Indonesian banks.

c. The other researchers

Other researchers can use this research as the reference for further exploration on the similar topic and discover different things that the author had not included in this research.

d. The readers

The readers will gain more knowledge on issues related with risk-based capital ratios of Indonesian banks.

1.7 Writing Systematic

CHAPTER I INTRODUCTION

This chapter consists of history of banking in Indonesia, background of the research, problem statements, scopes of the research, originality of writing, objectives of the research, benefits of the research, and writing systematic.

CHAPTER II THEORITICAL BACKGROUND AND PREVIOUS RESEARCH

This chapter consists of the theoretical background, previous research findings, and hypothesis development.

CHAPTER III RESEARCH METHODOLOGY

This chapter describes sample used, data and data gathering, data analysis, variable and variable measurement, method of analysis and hypothesis testing.

CHAPTER IV DATA ANALYSIS

This chapter provides and presents the analysis of data, also discusses the result obtained from the observation.

CHAPTER V CONCLUSION AND SUGGESTION

This chapter consists of conclusion, limitations of the research, and suggestions for the further research.