Bank's Risk and Economic Value Added: Empirical Evidence on Indonesian Banking Industry

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Submitted by:

Maudy Fitria Wijayanti

NIM. 12030115120077

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THESIS APPROVAL

Author Name : Maudy Fitria Wijayanti

Student Number : 12030115120077

Faculty/ Departement : Economics and Business / Accounting

Thesis Title : Bank's Risk and Economic Value Added: Empirical Evidence on Indonesian Banking Industry

Thesis Supervisor : Puji Harto, S.E., M.Si., Akt., Ph.D

Semarang, March 12th 2019

Supervisor

(Puji Harto, S.E., M.Si., Akt., Ph.D)
NIP. 197505272000121001

ii

SUBMISSION

Author Name : Maudy Fitria Wijayanti

Student Number : 12030115120077

Faculty/ Departement : Economics and Business / Accounting

Thesis Title : Bank's Risk and Economic Value Added: Empirical Evidence on Indonesian Banking Industry

Has been presented and defended in front of the Boards of Examines on March 20th 2019.

The Boards of Examines:

1. Puji Harto, S.E., M.Si., Akt., Ph. D ( )

2. Dr. Etna Nur Afri Yuyetta., M.Si.,Akt ( )

3. Surya Raharja, S.E., M.Si., Ph.D., CA ( )

Declaration of Originality

I, Maudy Fitria Wijayanti stated that the undergraduate thesis with the title “Bank’s Risk Behavior and Economic Value Added: Empirical Evidence on Indonesian Banking Industry”, is the result of my own writing. I am fully responsible for my undergraduate thesis.

Semarang, March 12th 2019

Maudy Fitria Wijayanti
NIM. 12030115120077

MOTTO AND DEDICATION

Sesungguhnya Allah tidak akan mengubah keadaan suatu kaum sebelum mereka mengubah diri mereka sendiri (Quran 13:11)

Tuhanmu tidak meninggalkanmu, dan tidak pula membencimu (Quran 93:3)

I dedicate this thesis for:

My dearest Mom and Dad

Family Of Akuntansi Undip

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Maudy Fitria Wijayanti
NIM. 12030115120077

ABSTRACT

The aim of this study was to analyze the effect of bank risk on bank performance. Bank risks in this study were consists of eight risks required in Peraturan Bank Indonesia No. 11/25/PBI/2009 are operating risk, market risk, credit risk, liquidity risk, compliance risk, legal risk, strategy risk, and reputation risk. Bank performance is seen through the Economic Value Added. The population in this study were all commercial banks in Indonesia. The total sample used was 82 companies selected by purposive sampling method. The analysis technique of this study used multiple regression analysis with SPSS 22. The results of the study showed that operational risk, credit risk, compliance risk, and legal risk have a significant negative effect on EVA. Liquidity risk, market risk, and strategic risk have insignificant negative results on EVA. While Reputation risk has a significant positive effect on EVA. Together, bank risk has a significant effect on EVA.

Keywords: Operational Risk, Market Risk, Credit Risk, Liquidity Risk, Compliance Risk, Legal Risk, Strategic Risk, Reputation Risk, Economic Value Added

ABSTRAK

Penelitian ini bertujuan menganalisis pengaruh risiko bank pada kinerja bank. Risiko bank dalam penelitian ini terdiri dari delapan risiko yang diwajibkan dalam Peraturan Bank Indonesia No 11/25/PBI/2009 yaitu risiko operasi, risiko pasar, risiko kredit, risiko likuiditas, risiko kepatuhan, risiko hukum, risiko strategi, dan risiko reputasi. Kinerja bank dilihat melalui Economic Value Added. Populasi dalam penelitian ini adalah semua bank komersial di Indonesia. Total sampel yang digunakan sebanyak 82 perusahaan yang dipilih dengan metode purposive sampling. Teknik analisis penelitian ini menggunakan analisis regresi berganda dengan SPSS versi 23.Hasil dari penelitian menunjukkan risiko operasional, risiko kredit, risiko kepatuhan, dan risiko hukum berpengaruh negatif signifikan pada EVA. Risiko likuiditas, risiko pasar, dan risiko strategi menunjukkan hasil negatif tidak signifikan pada EVA. Sedangkan Risiko reputasi menunjukkan pengaruh positif signifikan pada EVA. Secara bersama-sama risiko bank berpegaruh signifikan pada EVA.

Kata Kunci : Risiko Operasi, Risiko Pasar, Risiko Kredit, Risiko Likuiditas, Risiko Kepatuhan, Risiko Hukum, Risiko Stratejik, Risiko Reputasi, Economic Value Added

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CHAPTER I
INTRODUCTION

1.1 Background

The bankruptcy impact of Bank Century in 2008 has decreased the customer trust of the people to the bank. The decrease of the trust to the bank because a customer could not take their deposit. In addition, the negative publication related to the bankruptcy of Bank Century raises the opinion that each bank has the same problems (Yuliza & Sari, 2013). This makes the name of bank in Indonesia is bad.

The performance of Bank Century in 2007 was good because the operating income was Rp 56.945 million. This was an increase from the previous year which was only Rp 35.594 million. In addition, assets owned by Bank Century in 2007 showed a figure of Rp 14.509.632 million. While, Equity report of Bank Century in 2007 showed the bank's wealth of Rp 1.160.629 million (Annual Report of Bank Century, 2007).

However, the bank which was established in 1989 went bankrupt because the bank failed to manage the risks. The risk consists of operational risk and compliance risk. Unmanaged bank operational risk caused in misappropriation of customer funds up to Rp 2.8 Trillion and failure of clearing which caused customers being unable to make transactions both cash and non-cash. The failure of compliance risk management is indicated by the non-compliance of the Reserve Requirements Ratio (RR) ratio set by Bank Indonesia (Maryono 2008 in tribunnews.com). This encourages regulators, auditors, and risk assessors encouraged the implementation of better risk management in each company.

Risk management is a structured process to identify, measure, monitor, and control of risks. Tursoy (2018) defines risk management is the development and implementation of a plan to face possible losses. Peraturan Menteri Keuangan No. 191/PMK/09/2008 states risk management is a systematic approach to determine the best action in uncertainty conditions.

In Indonesia, the banking sector realizes that risk management is very important and must be applied. This is supported by Peraturan Bank Indonesia No.11/25/PBI/2009 which discusses Application of Risk Management at Commercial Banks, where banks are required to conduct an assessment using a risk approach. There are eight risks that must be assessed by the bank, that are a credit risk, liquidity risk, operational risk, market risk, compliance risk, legal risk, strategic risk, and reputation risk.

According Kasmir (in Makmunah, 2016) operational risk is a possible losses from malfunctioning internal poses, human error, system failure that affect the bank operations. Hanafi (2006) defines operational risk is losses arising from operational activities do not running well. Operational Risk is a risk arising from the failure of the company's internal system.

Hanafi (2006) states market risk is a risk due to market price movements. Market risk is the risk of loss in the on or off balance sheet position arising from market price movements. Market risk includes interest rate risk, exchange rates, and equity.

Haneef, et al.(2012) argue credit risk is a payments of principal loan and interest not carried out on time or cannot be fully recovered. Credit risk is a risk arising from the bank activities to distribute funds to its customers. Credit risk occurs because customers are unable to fulfill loan and interest.

Elfandi, et al.(2015) reveals that liquidity has long been recognized as a threat to banks, so banks must manage their liquidity risk to deal with liquidity shocks at any time. Liquidity Risk is a risk arising from the inability of banks to provide funds to fulfill their short-term liability at maturity (in Attar, 2014).

Hanafi (2006) defines compliance risk arises because banks do not fulfil such banking regulations. Compliance risk arises because the bank does not implement the prescribed regulations. In Indonesia, banks are required to comply with the rules made by Bank Indonesia.

Georgia (2014) states legal risk is the risk arising from legal actions and the absence of supporting provisions, such as breach of contract. Legal risk is the possibility of losses arising from unexpected changes in regulations. Legal risks can occur due to violations of contracts and involvement of illegal activities.

Yushita (2008) argues strategic risk is the risk associated with long-term business decisions taken by bank directors. Strategic risk is a risk caused by mistake business decisions. Strategic risk can also occur because of competitors have new products in the banking market.

Miklaszewska & Kil (2016) defines reputation risk is loss due to lost of image or reputation due to operational failure and other events. Reputation risk

comes from negative bank news that has a negative impact on external parties. Examples of reputation risk are poor governance, bank culture and bank services, which creates negative opinions on customers.

Risk management facilitates management to make decisions. Through risk management, banks can determine business strategies in order to improve their performance. Ikatan Bankir Indonesia (2016) states risk management helps the bank to protect and increase the value of the company in three ways, that are, help to create competitive advantage, optimize risk management costs, and help bank's leaders improve performance.

One of the activities in risk management is risk detection. The bank's ability to detect risks is very important for their operations. Risk detection can help management to realize potential losses in operating activities and encourage management to be more careful on activities with potential risk.

Many studies of bank risk on the performance that has been done. However, the study showed inconsistent results. This encourages that the future study is needed. Simultaneously Attar (2014) Adeusi, et al.(2013), and Harelimana (2016) state that bank risk have negative effect to bank performance. While partially, relationship of bank risk on bank performance has a different result.

Alkhatib, at al. (2012) , Ansori & Buana (2018), and Mansyur (2017) state that their research on credit risk has a negative effect on bank performance. However, Herry (2015) argues that credit risk has a positive significant effect on

bank performance. Wijewardana & Wimalasiri (2017) and Attar (2014) also supports operational risk has negative influence on bank performance.

Agustini (2015) argues that market risk has a significant negative relationship on bank performance. Nevertheless, Mansyur (2017) reveals that market risk has a insignificant negative effect on bank performance. Arif & Nauman (2012) and Mahfuzah & Malikussaleh (2018) state that liquidity risk has a significant negative effect on bankf performance. However, Badawi (2017) states that liquidity risk has no effect on bank performance.

The influence of bank risk on performance is also supported by agency theory. Pratiwi (2016) state that agency theory explain that there was a conflicts of interest between the owner (principals) and manager (agent) due to inconsistent interest between to parties. Conflicts of interest that occur between two parties will cause agency cost. In this study, banking risk assessment can reduce agency problem, so that the objectives between managers and shareholder will be achieved. Achievement of these objectives can be seen through bank performance.

Bank performance is the bank's achievement to produce income from operational activities. Globally, bank performance is an achievement from finance, marketing, raising and distribution of funds, technology, and human resources are well managed. Bank performance can also be interpreted as the bank success in achieving the planned goals. Jumingan (in Sarwoko, 2009) states bank performance is an image of the bank financial condition in a period of both the aspects of fundraising and distribution of funds which is usually measured by indicators of

capital adequacy, liquidity, and profitability. In addition, Olteanu (in Apatachioae, 2015) argue that bank performance reflects the overall results showing by the level of profitability that correlates with the risk taken by the bank.

Good performance must be achieved by each company in order to measure its ability to manage resources. Many indicators can be used to measure company performance. These indicators include financial ratios such as Return On Assets (ROA), Return On Equity (ROE), Return On Investment (ROI), and Tobin Q calculations.

The indicator used by previous research to see bank performance is Return On Assets (ROA). ROA is the ratio of comparison between earnings before tax and total assets. The greater of ROA means the better of bank's performance.

Performance measurement with ROA has a simple formula. Meanwhile, ROA has a weakness. Arnova (2011) states measurement of ROA is considered risky because it only focuses on large growth without regard to the high rate of return from capital costs, which will destroy the value of the company. In addition, Ikatan Bankir Indonesia (2016) states that the problem of the ratio method is to use financial accounting data, so to produce results that are sensitive to the selection of accounting methods and difficult contrast to other companies if no adjustments before. ROA also use the total assets purchased from time to time and many events that can affect the value of assets so that the calculation of ROA is irrelevant. ROA records something that has already happened, meaning it does not see the potential for the future. Furthermore, ROA also does not take into account risk factors.

This study has a difference with previous research. If previous research on bank performance is measured by ROA, this study uses Economic Value Added (EVA) as a performance measurement. EVA is operating profit after tax reduced by the cost of capital to produce profits. Fitriyah (2002) states EVA is popularized by the Stern Steward through a management service company that is a consulting company from the United States. EVA has been adopted by several companies in western countries such as the United States, Britain, and Germany. Santoso (2008) (in Arnova, 2011) states since the usage of EVA in 1991 more than 300 companies in the world adopted EVA to measure their performance.

The reason for choosing EVA to see the performance is because EVA considers capital costs, so the interests of shareholder are fulfilled. Through EVA, companies will get a more realistic performance than other measurements. Arnova (2011) argues that EVA as performance is increasingly relevant because it reflects the company's ability to create added value and eliminate financial engineering.

Endri & Wakil (2008) argue that EVA helps managers ensure that the company can add shareholder value, while investors can use EVA to find out which shares will be able to increase its value. Fitriyah (2002) states that EVA is a single measure to assess company performance, so it requires a trend analysist of each ratio of previous years. Tunggal (2001) (in Purnamawati, 2012) argues the results of the EVA calculation encourage the allocation of company funds for investments with low capital costs.

However, EVA also has several disadvantages. Tunggal (2001) (in Purnamawati, 2012) states EVA only describes the value of the company in a one period and EVA cannot be applied easily because the EVA calculation is complex. In addition, Mirza (in Fitriyah, 2002) reveals that accurate EVA calculations depend on the company's internal transparency in financial statements.

Based on the previous explanation, further research is needed. This research adopts EVA to see bank performance. In addition, this research proposes a time period in this study is for three years, its since 2015 to 2017, so the titles in this research is “Bank’s Risk Behavior and Economic Value Added: Empirical Evidence on Indonesian Banking Industry”.

1.2 Problem Statement

Bank Indonesia has been issued Peraturan Bank Indonesia No. 11/25/PBI/ 2009 about Application of Risk Management in Commercial Banks. The regulation was made because the external and internal conditions of the banking sector were growing rapidly. The development of the banking industry will be followed by increasingly complex risks for bank business activities. Risks in banking operations need to be managed properly, so as not to disturb the business continuity and performance of the bank.

The performance of a bank is an important indicator for stakeholders to assessing the current condition of the bank. However, good performance does not necessarily reflect the bank in a healthy state. Bank performance becomes more valuable when the company manages various risks that may arise in their

operations. This show that study about risk management on bank performance is needed. Remember the performance measurement is very broad, this study proposes EVA to see the bank performance.

This research has been conducting to answer the question:

1. Does Operational Risk affect the EVA?
2. Does Market Risk affect the EVA?
3. Does Credit Risk affect the EVA?
4. Does Liquidity Risk affect the EVA?
5. Does Compliance Risk affect the EVA?
6. Does Legal Risk affect the EVA?
7. Does Strategic Risk affect the EVA?
8. Does Reputation Risk affect the EVA?

1.3 Research Objective

In step with the problem statement, the objectives of this study were:

1. To analyze whether Operational Risk affects the EVA
2. To analyze whether Market Risk affects the EVA
3. To analyze whether Credit Risk affects the EVA
4. To analyze whether Liquidity Risk affects the EVA
5. To analyze whether Compliance Risk affects the EVA
6. To analyze whether Legal Risk affects the EVA
7. To analyze whether Strategic Risk affects the EVA
8. To analyze whether Reputation Risk affects the EVA

1.4 Benefits Of Study

1.4.1 Theoretical benefits

The results of this research are expected to be a source of reference for research and increasing the reader's insight into the risk management implementation on bank performance.

1.4.2 Practical benefits

This research is also expected to be used by banking service users such as creditors, debtors, and investor to analyzing the performance of the bank concerned. In addition to bank companies, it can be used as a basis to make decision.

1.5 Structure Of The Study

CHAPTER I : INTRODUCTION

Explain the background that contains the basis for selecting themes for research, the formulation of the research problem, the purpose, benefits, and the systematic writing.

CHAPTER II : LITERATURE REVIEW

Explain the concept and theoretical foundation with regard to the relationship between variables, previous studies as a basis of understanding and reasons, a hypothesis to be study and theoretical description.

CHAPTER II : RESEARCH METHODOLOGY

Explain the research approach, variables, determine the sample population, types and sources of data, and data collection methods.

CHAPTER IV : RESULT AND DISCUSSION

Explain the description of the object of research, data analysist, and discussion of research results.

CHAPTER V : CONCLUSION AND SUGGESTION

Explain the results that can be concluded from the research that has done, the limitations of the research and suggestions for the results of the research.