# CHAPTER I

# INTRODUCTION

## 1.1. Background of the Study

The recent financial crisis has led to a large increase in the number of bank failure, making the banking industry more complicated than any other industries despite the financial details of banks file in their annual reports (Ng & Rusticus, 2012). The issue of bank survival in this millennium has attracted a high interest to scholars of financial services and regulators, as the diversity of significance for bank survival does not only apply to strategic decisions made by banks, but also to decisions made by regulators that are concerned on bank stability (Berger & Bouwman, 2013). Regulatory and technology advancement factors was said to have contribution to this threat, that includes the removal of regulatory ceilings on bank deposit rates, introduction of interest bearing checking accounts, relaxation of branching laws, the increasing competition with the emergence of mega banks through mergers and acquisitions, and also the lack of personal interaction between bankers, borrowers and depositors (Ndu & Wetmore, 2005). Hence, in periods of crisis, many financial institutions are bound to face hardship for business survival (Pramuka, 2011).

Efficiency of commercial banks is one of the core issues for the economists all over the world due to its strong association with economic growth of the country (Zaidi, 2005). Economic growth would be achieved by utilizing the existing resources of the banks in an appropriate and efficient way (Saeed, 2005). Efficiency of commercial banks has an importance for evaluation of its performance. Banking efficiency provides signal for the economic development of a country (Sathye, 2005). Efficiency of commercial banks is actually the relationship of different combinations of outputs and inputs of the banks to achieve the optimum level. The optimum level can be achieved under the objective of inputs minimization, while producing the same level of outputs and outputs maximization with the same level of inputs.

Bank is an institution that has permission to exert derived from community funds in savings and fullfill to the public of loans. Thus bank serves as an intermediary between depositors and users, households and companies. Society in general requires the mechanisms that can be used as an intermediary distribution of depositors savings of investors, based on an agreement of payment and company. Lack of communication as well as various variety of experience with regard to the liquidity, the risk, time and so forth, has made a direct relationship between depositors with investors which is inefficient and, has limited space. There are two types of banks Indonesia, Conventional Bank and Sharia Bank. Conventional bank is a bank that do its business based on profit principle. Sharia bank is a bank that do its business based on Islamic principle. Conventional bank and Sharia bank nowdays always compete to be the people's choice. The result of high competition between Conventional bank and Sharia bank make them need a lot of fund, product and number of branding so that they can reach more people who need banking services.

The banking business is like any business because of the specific risks it poses to the community: loss of depositors saving crisis, systematic failure of one or more credit institutions of the entire banking system. In addition, the system is regularly confronted with a difficulty although this sector is one of the most regulated economy. The most recent example is the subprime crisis. This crisis leads to bank failures with adverse consequences on the real economy across the world. It is therefore imperative to protect the depositors against these bank failures in an environment characterized by the existence of market imperfections (Dewatripont and Tirole, 1994). These failures can lead to a systemic crisis (Bhattachary and Thakor, 1993) where social cost are higher than the private ones. Therefore, risk is at the heart of the banking business. Moreover, the high volatility in interest rate in recent years along with the significant level of financial leverage for most companies has also contributed to the growing relevance of interest rate exposure.

The influence of interest rate and exchange rate changes on bank stock returns has been the major interest of bank managers, regulatory authorities, academic communities and investors, since the failure of numerous banks have been especially attributed to the adverse influence of fluctuations in interest rates and exchange rates.

The issue of interest rate risk is one of the major interest on the banking regulatory and academic communities. The Interest rate risk (IRR) is acknowledged as one of the major financial risk born by companies. This is due to the fact that changes in interest rates influence both a firm expected cash flows and the discount rates used to value them. As a mater of fact, the only two studies that have employed a nonparametric approach in the context of corporate exposure to risk have focused on the exchange rate exposure (Guo and Wu, 1998; Aysun and Guldi, 2009).

Actually banks provide links from surplus unit to deficit unit of the economy. In the last fifty years, financial sectors, especially, banking sector has been expanding a lot in both developed and underdeveloped countries (Hassan, 2004). Efficiency of the banks and different controversial issues, like competition and economies of scales are linked together. Competition between different banks and banking systems forces these banks to operate efficiently. The lack of different banking systems and relatively small number of banks, in economy, might encourage monopoly by restricting their output among different banks. Efficiency of the banks normally depends on different banking systems and number of banks in the market, along with their ability to achieve economies of scales (Qayyum and Khan, 2006). Different banking systems force banks to operate efficiently. Efficiency of banks might result in high profits, good customer service or use for risk diversion (Berger et al., 1993a, b). Efficiency of banks might be influenceed by different factors like size, interest expense, total profits etc. (Hassan et al., 2009).

The major result of this research to compare the efficiency of sharia banks and conventional banks are under loan based approach and income based approach. In addition, it aims to investigate the economies of scales for both banking streams. The result revealed the influence of banks specific factors on efficiency, like investment, loans, zakat, bills payable, fixed assets and deposits and borrowing from other financial institutions.

## 1.2. Problem Identification

Bank is the one of financial institution that has big influence on the economy of a country. Bank have two types, which is conventional bank and sharia bank. These types have different basic. Conventional bank is the bank that do its business based on profit principle. Sharia bank is the bank that do its business based on Islamic principle.

Efficiency is a fundamental concept in Neo-classical theory. At a more aggregate level, efficiency is related to the problem of optimal allocation of resources. In a competitive environment, the existence of inefficiency at the firm level (in the long run) is difficult to justify. Inefficient firms are expected to be driven out of the market by more efficient ones and, in the long run, only the efficient ones will remain. For the economy as a whole, the optimal allocation of resources is an important factor for the determination of growth. If scarce resources are not used for their most productive ends, it is clear that an economy will grow at a rate less than its potential capacity.

Efficiency of commercial banks is one of the core issues for the economists all over the world due to its strong association with the economic growth of the country. Economic growth could be achieved by utilizing the existing resources of the banks in an appropriate and efficient way. Efficiency of commercial bank is important to evaluate of its performance. Banking efficiency provides signal for the economic development of a country.

## 1.3. Problem Formulation

a. How is the performance of sharia bank based on investment, loans, zakat, bills payable, fixed assets, and deposits and borrowing from other financial institution?

b. How is the performance of conventional bank based on investment, loans, CSR, bills payable, fixed assets, and deposits and borrowing from other financial institution?

c. How is the efficiency of sharia bank?

d. How is the efficiency of conventional bank?

e. Which one has the most efficiency, the conventional bank or the sharia bank?

f. How does macroeconomic factors (inflation, interest rate, and exchange rate) influence the efficiency of bank?

## 1.4. Research Objectives

The objective of this research is to know the efficiency of sharia bank and conventional bank based on input and output, the difference of efficiency between conventional bank and sharia bank, and also the influence of macroeconomic factors toward bank efficiency.

## 1.5. Research Contributions

a. For Investor

The result of this research can be used for more information to assess the efficiency of bank. Thus, investor can be more selective when doing investment in banking sector.

b. For Bank

The result of this research can give more information for bank to increase the efficiency of the bank

c. For Next Researcher

The result of this research can give more information about the efficiency of the bank as well as the comparison, development and refinement of previous studies.

## 1.6. Systematics of Writing

This research contains five chapters with the following details:

**Chapter I: Introduction**

This chapter describes and explains about the background of study, problem statement, research objectives, significance of this study, and research benefits.

**Chapter II: Literature Review**

This chapter describes the theories and concepts related to the problem of this research. It also provides a review of previous researches in similar topic and problem, then explains the hypothesis formulation based on this literature.

**Chapter III: Research Method**

This chapter contains population and sample, data collection method, data types, variable definition and measurement, research model, research equation, operational hypothesis, data analysis technique, and systematic writing.

**Chapter IV: Research Findings and Discussion**

This chapter provides research data and findings and also discusses about the result of the research.

**Chapter V: Conclusion and Recommendation**

This chapter describe conclusion of this research and recommendation for the future research.