THE EFFECT OF ISLAMIC COMERCIAL BANKS' HEALTH AND THEIR COST OF FUND UPON ITS FINANCING IN INDONESIA OVER 2005-2009

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Abstract: Bank's health is a long-time discussed topic, for it is a measure of whether banks are running well or not. Cost of fund is also a measurement tool in regard to cost of interest charged to depositors. In this research, Bank's health—CAMELS analysis—and cost of fund are tested whether they have the effects on its funding, shariah-compliant bank. Bank's health and cost of fund are important, since they are the measurement of factors affecting bank's financial intermediations. This research discovers that simultaneously, shariah-compliant Bank's health and cost of fund affect Bank's funding significantly; while partially, asset, earning, and cost of fund are the only significant factors affecting bank's funding. Therefore, Shariah-Compliant Banks must maintain their health and cost of fund in order to increase their funding that ends up in state's economic development.

Keywords: Bank's Health, funding, economic development

INTRODUCTION

The first Islamic Bank in Indonesia is Muamalat Bank that was established in 1992 under UU. No.7, 1992. And ever since we see the emergence of many Islamic Banks that have been trying to enter this new prospective market niche. Yet, time wil always be the best method to test their ability and strength. Our past experience with crises such as monetary crisis In 1997 and financial crises—led by subprime mortgage crisis in USA—had become the best evidence of how Islamic Bank coped those issues pretty well. Their assets continuosly increase at a significant number, they even have a low NPF, and are consistent with their intermediary function.

* Dosen Manajemen Pada Universitas Muhammadiyah Maluku Utara dan Mahasiswa Program Doktor Ilmu Ekonomi Unhas tahun 2012

(Assets, Depositor Funds and Financing - Islamic Commercial Bank and Islamic Business Unit)
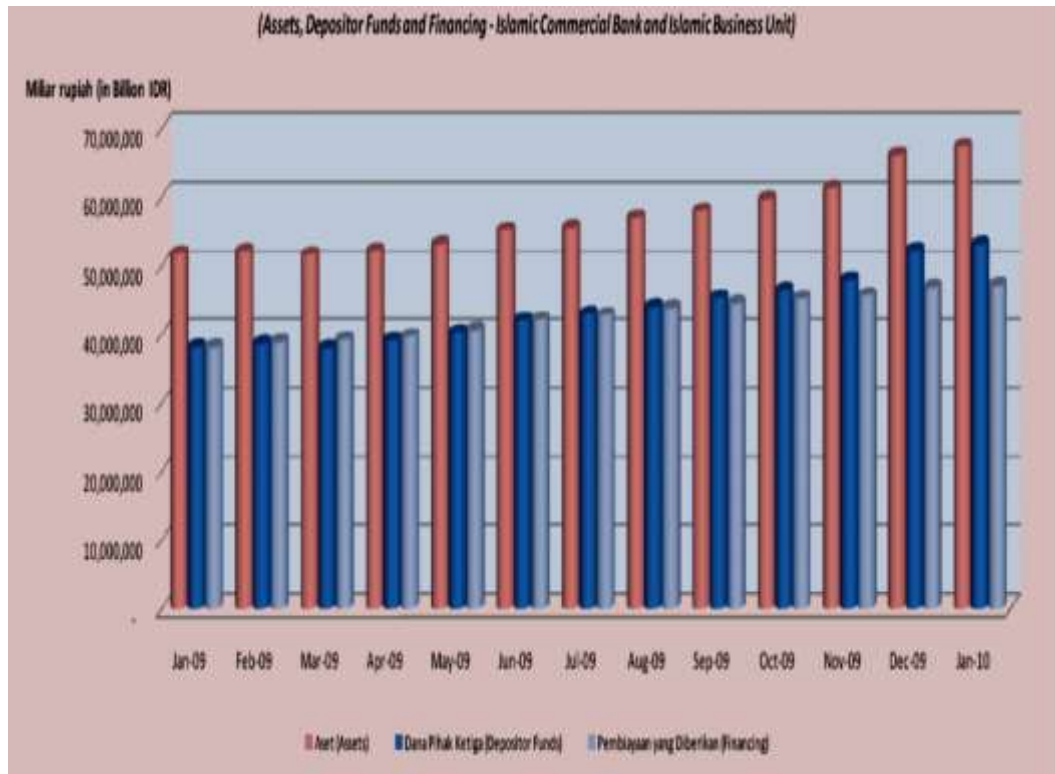
Source: Central Bank of Indonesia

In Indonesia our law allows a dual banking system. dual-window banking is a bank could thus have two windows under the same roof, one for conventional banking operations and the other for interest-free transactions based on *Shariah* (Warde, 2000). Generally, Islamic window banks are not independent financial institutions, but are specialized set-ups within conventional financial institutions that offer *Shariah* compliant products and services for their clients (Iqbal and Mirakhor, 2007). This system allowed the establishment of many new Islamic Banks and satisfied the Muslims whom tried to save and invest their wealth in Islamic manner and jurisprudence. Interestingly, It also attracted many non-muslims customers.

This research will investigate the relationship between Banks health and their cost of fund to their funding because it is one of the function of Bank as an intermediary. Siklos had said that Financial intermediary is an entity that connects surplus and deficit agents. The classic example of a financial intermediary is a bank that transforms bank deposits into bank loans (2001). Moreover, he emphasized that

Through the process of financial intermediation, certain assets or liabilities are transformed into different assets or liabilities(2001).

Skully and Brown had investigated this intermediary function of Islamic Banks in 11 countries and did not found a clear pattern between profitability, Islamic financing, and and their efficiency. It might be because of their different development in each country, the jurisprudence, and their compliance to Islamic law (2003). Thus, a question may arise whether the Islamic factor that had became the crucial factor of their strength against crises or just the non-interest basis. Ferro had suggested that instead of copying and replicating every shariah rules to their banks, Conventional banking trying to establish Islamic Banking must include the human touch in their activities (2005).

The Central Bank of Indonesia in The Blueprint of Islamic Banking Development in Indonesia has emphasized the vision of Shariah compliant Banks— the focus of this article— that "A sound sharia banking system that is competitive, efficient and compliant with prudential practices, and capable of supporting real economic sector through the implementation of share based financing and trades with real underlying transactions in the spirit of brotherhood and good deeds to promote well-being for all society" (2002). Underlining the word of financing will be the major theme of this paper.

To meet the existing standard, this research will follow the regulation of Central Bank of Indonesia to assess the performance or health of Islamic Banks under PBI No. 6/10/PBI/2004 and since that regulation was for conventional banking, The Central Bank of Indonesia issued the PBI No.9/1/PBI/2007, which specifically regulated the evaluation of Islamic banking in Indonesia. CAMELS is indeed the tool used in this research to monitor the performance of Islamic banks. Cost of Fund is also used in this research for it is one of the most important factors in determining their financing.

But we know that CAMELS is not the only method to assess the performance. Some scholars had used many different financial indicator like Harker and Stavros that used PER, firm's stock beta and alpha, and Tobin's q ratio (1998). Some only used profitability, efficiency, and Islamic banks' financing (Skully and

Brown, 2003). Rokhim herself used CAR as the indicator of strength and soundness of the banks (2005). ROE and ROA had been used by At-Tamimi to investigate the performance of UAE Islamic and Conventional banking (-). A more extreme result came from Okpara's study that revealed factors affecting banks' performance in Nigeria were intervention from board of commissioners, political crises, undercapitalization, and corruptive behavior from the officials (2009). The list of research method to assess banks' health will keep growing because they all have a fundamental and strong theory behind it.

Some scholars had also proven that CAMELS was a good analysis to assess financial performance of a bank. Almilia and Hardiningtyas had used it to predict bankruptcy and financial problem (2003). Maya and Indri had concluded that CAMELS was a valid method to evaluate financial performance. They also found that investment decision was not always based on CAMELS ratios in financial statement due to problem of accessing the data (2008).

The significant role of cost of fund had been investigated by Euis and Rini that found a significant relationship between cost of fund and financing (2009). The problem arises when one important factor in cost of fund which is BI rate that was consistently adjusted by Central Bank of Indonesia to meet the current condition of Indonesian economy had not been followed by banks. Such problem had been found by Hadad, Santoso, and Besar. They concluded in their paper that although cost of fund calculation had a positive relation with the decreasing of BI rate, interest charged to costumers was still overpriced (2003). Another interesting result of their research was that Foreign Currency statutory Reserve Requirements (GWM) had not been a dominant factor to set cost of fund and interest rate of a credit. While Riyadi had stated that one of the important factor affecting cost of fund is Foreign Currency statutory Reserve Requirements (2004).

Mc Guire and Tarashev had came to conclusion that there was a long-term relation between Banks' health and their financing (2008). This research had been consistent with Hosuno and Masuda that found a decrease in investment as a respond to a decrease in Banks' health (2005). The same result had also been found

by Ushijima (2007), Klein, Peek and Rosengren (2000), and Fukuda, Kasuya, and Nakajima (2005).

Using all those variables, the researcher aims to get a correlation between banks' health and their cost of fund related to their financing. But the problems present when we tried to access the CAMELS data, specifically management and sensitivity, for acquiring such information requires a qualitative approach that would be very difficult to leak out from the banks so it was decided to use some financial ratios as proxy to those indicators. So availability of the data will be crucial in this research.

RESEARCH METHOD

The object of this research is three Islamic Comercial Banks that have established their operation since 2005-2009, which are Bank Syariah Muamalat Indonesia, Bank Syariah Mandiri, and Bank Syariah Mega Indonesia. Secondary data is taken from quarterly financial statements of Banks and will be regressed to discover the relationship of all variables. This research also used the classical test assumptions of the multiple regressions and found the normality of the data.

The CAMELS itself in this study are measured by

a. Capital, measured by Capital Adequacy Ratio

b. Assets, measured by Productive Assets' Quality Ratio

c. Management, measured by Asset turnover Ratio (Rani; 2009)

d. Earnings, measured by Net Operating Margin

e. Liquidity, measured by Short-Term Mismatch Ratio

f. Sensitivity, measured by Gap Ratio (Hays)

RESULTS

After employing the regression analysis the summary of the result are found as follow:

Relation of variables	Beta	t-test	F-test	Result	R-Square	Coefficient of other variables
X1 to Y1	.021	.207		Ho accepted		
X2 to Y1	-.276	-2650		Ho rejected		
X3 to Y1	.096	1.172		Ho accepted	0.687	0.313
X4 to Y1	.315	3.161	16.296	Ho rejected	or	or
X5 to Y1	.013	.155		Ho accepted	68.7%	31.3%
X6 to Y1	.042	.399		Ho accepted		
X7 to Y1	-.685	-7.772		Ho rejected		

The result of this research had emphasized and strengthened the previous research that Banks' health and cost of fund significantly affect financing. But the cost of fund variable, which had the highest partial relation showed us that in deciding their financing banks will always pay their biggest attention to its cost of fund. This is simply because cost of fund is the amount spent by banks to acquire deposits, which then was channel to the needy costumers. Riyadi had emphasized this in his suggestion that banks must pay a close attention to the movement of their fund raised. This is to create balance between banks' obligation and their aspiring profit. He the concluded that factors affecting cost of fund will be primary in deciding their pricing of the funds lent (2006). The negative relation definitely meant that any increase in cost of fund will directly decrease the desire to borrow from banks. For customers will rather choose to save their money instead of investing it.

Cost of fund and CAMELS had a relation of 68.7% to financing would be meaning that they had a quite strong effect on the amount of sum lent by Islamic Banks. some part of those variables will still be in the control of management to decide the most appropriate policy. But there are factors such as economy and BI rate that are beyond the management control. Even The Central Bank of Indonesia does not have a strong position to influence the banks because of their independency. This could be seen by the level of current BI rate at the time of measurement which was 6.5%; yet, Banks does not directly follow this policy by decreasing their rate of borrowing.

Each bank has its own mechanism, for it has a different target and goal to reach. Different marketing strategy will also hold a trump card like BRI, which focuses on micro scale credit, certainly is different with BCA, which targeted middle-upper classes. It is supported by Hafer who said that "*each loan and prospective borrower have their own characteristics that may necessitate different lending rates. For example, the loan rate charged to a specific customer reflects that customer's credit worthiness, previous relationship with the bank, the maturity of the loan, the nonfee services provided by the bank in maintaining the loan, the use of fixed or flexible maturities and rates, and other factors*". Differentiation between each bank when projecting their financing was another factor that likely shared its portion affecting Islamic banks financing in this research; although banks' health and their cost of fund are still the dominant and significant factor affecting the size of their financing.

CONCLUSION

That Banks health and cost of fund affecting their financing had underlined an implication that in order to maintain their intermediary function by increasing and focusing on their outstanding performance along with the low level of cost of fund. Though, many factors outside the variables tested in this research had shared a significant portion on the level of financing such as monetary factor and social-politics of a country. Every slowdown in economy will certainly lead to a decrease in financing. Islamic Banking as an institution has a very big role and responsibility to take part in successing the economy development of a nation for the main principle behind Islamic Economy is to regulate the society behavior toward the right path as dictated by Allah SWT.

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