CHAPTER I
INTRODUCTION

1.1 Introduction

This Chapter gives information about background and current situation of the study, the research problem, research objectives, research questions, scope and limitations of the study, the definition of key terms, and structure ofthe proposal. These will assist the reader in understanding the topic of the research.

1.2 Background of Study

Indonesia's economy grows and develops through various types of institutions. Bank financial institutions are one of the financial institutions that have a significant impact on the Indonesian economy. Banks are financial institutions that play an important role in a country's economy. According to the Banking Law of the Republic of Indonesia No. 21 of 2008, a bank is an entity that collects funds from the population in the form of savings and distributes them to the population in the form of loans or other forms in order to improve the standard of living of the general public. The banking sector is closely related to the country's economic problems. Banking directly contributes to economic stability and development. Since the bank's founding period is indefinite, bank management strives to maintain continuity in banking operations. Maintaining and expanding a banking institution requires the right competitive edge.

Competition among banks can arise from competing for productive resources such as deposits, savings, and loans, which are the main sources of income for banks. Current competition will encourage banks to improve service quality and lower prices. Competition also affects bank stability. Banking markets are showing greater resilience as they are more concentrated and less competitive. This makes banking more stable (Bikker, 2009). The relationship between the level of competition in the banking sector and bank stability has become a classic debate. Have two views on the relationship between bank competition and bank stability. These two ideas are called “competition-fragility” and “competition-stability”.

competition-fragility states that increasingly intense competition will impact bank stability. This is because the eight-level competition reduces the ability of banks to generate profits and encourages them to take greater risks in order to generate greater profits. The first study of the relationship between competition and bank stability was done by Keeley (1990), who showed that increased competition in the 1980s reduced bank profits from monopoly rents and increased bank failures in the United States. As competition intensifies and margins shrink, banks tend to take more risk to increase profits. Credit quality has deteriorated, making banks even more vulnerable. This hypothesis is supported by a study by De Nicolo et al. Supported. (2003), Berger et al. (2008), Scheck et al. (2009), Uhde & Heimeshoff (2009), and Beck et al. (2012), Demsetz, Saidenberg and Strahan 1996, Carletti and Hartmann 2003).

On the other hand, competition-stability has the opposite meaning, with increased competition actually increasing bank stability and decreasing competition decreasing bank stability. This hypothesis is supported by studies by Allen & Douglas (2003), Boyd and De Nicolo (2005), and Beck et al. (2005). Supported. (2006), Chang et al. (2007), Yeyati & Micco (2007), Evrensel (2008), Schaeck et al. (2009), Boyd and Denicolo (2005). Banks with high market power (low competition) tend to set high lending rates. Stiglitz and Weiss (1981) argue that high interest rates pose a high risk to a bank's loan portfolio due to adverse selection when the quality of the bank-financed projects is poor. As a result, loan interest rates have risen, prompting potential customers to look for other financing options with significantly lower interest costs. In addition, customers who borrow at high interest rates are prone to default, leading to increased credit risk. Banks' non-performing loans are on the rise. This would endanger the stability of the banking system.

Therefore, against the above background, there are some disagreements among experts based on different research fields, and little research is still done on banking competition and Islamic banking stability. Therefore, the authors are interested in studying the competition and stability of Islamic banks in Indonesia, titled ”The Effect of Competition and Stability on The Effectiveness of Islamic Banks in Indonesia”.

1.2.1 Background of Bank Stability

Financial stability, as opposed to financial vulnerability or instability, theoperating state of institutions (banking stability) and the market make up the financial system. Financial stability is the core prerequisite for the functioning of an economic system. Financial stability is the basis for making sound decisions about the actual allocation of resources over time and thereby improving the saving and investment environment. Financial loopholes wouldcreate an uncertain and dangerous situation that would lead to misassignment and reluctance to enter intertemporal contracts. In an extreme in some cases, the disruption of the financial sector will have a disastrous effect on economic activity and even political stability. So, maintaining financial stability is themain objective of financial institutions (Crockett, 1997).

Market power has long been thought to be necessary to ensure stability in the banking sector. Banks with high profitability and good capital are the best banks to withstand shocks to their balance sheets. Thus, banks have market power, and

Earnings are considered more stable. The probability of a bank receiving a shockwill depend in part on their risky behavior. Literature classical financial structure argues that highly indebted firms have encouraged participation in risky behaviors. If the bet is successful, the shareholders advantage; If this does not work, the lender will have to bear the cost (Jensen and Meckling 1976).

1.2.2 Background of Bank Competition

The influence of competition on banking stability is still the subject of debate in banking literature (Berger et al., 2009). According to the traditional view ofcompetitive fragility, increased competition will erode market power, reduce profit margins, and result in a decrease in the value of the franchise, i.e., Continuing to operateor market value is higher than its book value. In this situation, banks will bear morerisk to increase their profits (Keely, 1990; Demsetz,1996). For example, Kelly (1990) found that increased competition and deregulation followed by the easing of barriersto branching in the United States in the 1980s had erode profitability and lead to bankfailure. Similarly, Helmannet al. (2000) stated that the removal of the interest rate ceiling deposits has eroded profitability and increased moral hazard behavior in banks. Some recent empirical studies point in this direction, namely increased competition is associated with increased portfolio risk, because as measured by the degree of financial problems in Spain (Jimenez et al., 2007).

Another interesting study is by Bai and Elyasiani (2013). His results Research shows that an increase in the sensitivity of CEO compensation to risk(also called Vega) will also cause instability for the bank. Vega as a competitor'srepresentative will increase the bank's vulnerability. A view that differs from the weakly competitive view is called the competitive-stable. Molyneux et al. (2014) showed that the higher degree of concentration of the banking market will lead to less financial fragility and pricing power, which will increase the risk level of banks. Another reason from the point of view of stability of competition is a highly concentrated banking sector the market will make bankstake more risk if banks believe in the vision too big to fail and the banks feel that they are explicitly and implicitly protected by government safety net.

1.3 Problem Statement

Based on the background of the problems stated above, problems can be identified, namely:

1. The banking intermediation function in Indonesia has not been optimal from the aspect of banking effectiveness in managing its operational activities.
2. There are still many bank stability and bank competitions that have not been effective from year to year, seen from the net income to total assets.
3. There are differences in the results of research by previous researchers, so further research is needed to discuss the factors that influence the effect of competition and stability on the effectiveness of Islamic banks in Indonesia.

1.4 Research Questions

The research conducted in this paper aims to solve the following research questions:

RQ1 : What is the effect of bank competition on bank effectiveness?

RQ2 : What is the effect of bank stability on bank effectiveness?

1.5 Research Objectives

The research objective is what the researcher expects to achieve in the research of study. A research objective is usually expressed in lay terms, which arewords or statements that someone outside of a specific field can understand. Thispart may be linked with the hypothesis.

1.5.1 General Objective

The objective of this research is to specifically investigate the effect of competition and stability on the effectiveness of Islamic banks in Indonesia and conduct empirical research utilizing bank Islamic data.

1.5.2 Specific Objective

The following are the research objectives presented in this research:

1. To examine the effect of competition on bank effectiveness.
2. To examine the effect of stability on bank effectiveness.

1.6 Significance of Study

The results of this study are expected to provide the following benefits:

1. Theoretical Benefits
    a) Its theoretical usefulness is to serve as a reference for next research or for the reader. It is hoped that this research will be carried out Complementing and adding to existing research before.
    b) The results of this study are expected to provide a more in-depth description and understanding of the effect of competition and stability on the effectiveness of Islamic banks in Indonesia.
2. Practical Benefits
    a) Its practical utility is that it can be used as a reference by governments and financial authorities in deciding or evaluating policies related to competition and stability in the banking sector.
    b) For academics, the results of this research are expected to be useful as information material for further research in relevant fields.
    c) For the general public, the results of this study are expected to be useful as

education and information to find out matters related to banking competition and stability.

d) For the banking world, the results of this research are expected to be useful and provide input for banks to improve banking performance to make it more effective.

1.7 Scope of Study

Based on the background and identification of the problems that have been described to avoid widening the problems in this study, the authors will not discuss them too far. The problem that the researchers will discuss in this study only focuses on the effect of competition and stability on the effectiveness of Islamic banks in Indonesia with explanatory factors, namely explained variables which consist of bank competition and bank stability while the core explanatory variables consist of bank effectiveness.

1.8 Limitation of The Study

In accordance with the research background that has been mentioned, many things need to be resolved related to the problems that arise when determiningbank competition affects stability. Researchers in this case analyze the factorsthat affect bank stability such as bank competition. Therefore, it is necessary tolimit the problem so that the discussion does not deviate from the research title.

1.9 Definition of Key Terms

1.9.1 Definition of Bank Stability

Financial stability describes the condition where the financialintermediation process functions smoothly and there is confidence in the operation of key financial institutions and markets within the economy.

Financial stability can be defined as “a condition in which the financial systemis not unstable". It can also mean a condition in which the three components ofthe financial system -- financial institutions, financial markets and financial infrastructure -- are stable.

‘Stability of financial institutions’ refers to a condition in which individual financial institutions are sound enough to carry out their financial intermediation function adequately, without assistance from external institutions including the government.

‘Stability of financial markets’ means a condition in which there is no major disruption of market transactions, with no significant deviation of financial asset prices from economic fundamentals, thereby enabling economicagents to raise and operate funds with confidence.

‘Stability of financial infrastructure’ refers to a condition in which the financial system is well structured to ensure smooth operation of market discipline, and both the financial safety net and the payment and settlement arerunning effectively.

1.9.2 Definition of Bank Competition

Define banking competition as the struggle for consumers of banking services to create such conditions that allow other participants to exert decisive influence on the market. This improves the typology of competition among banks, and he then defines four types of competition : Competition between banks, competition between state-owned banks and non-state-owned banks, competition between banks and non-bank credit institutions, and competition between banks and non-financial institutions.

Basically, he has two approaches to measuring competition: structural and non-structural (Astuti & Saputra, 2019). Bikker and Haaf (2002) found that the structural approach uses concentration to measure competition, whereas the unstructured approach does not use concentration to measure competition. The easiest way to measure competition is to measure concentration (where multiple banks control a large portion of the existing market) using concentration ratios (Wibowo, 2017). Concentration ratio (CR) is a measure of competition that can be calculated from the share or percentage of revenues, profits, or third-party funds in a banking sector dominated by multiple large banks.

1.10 Summary

The introduction provides information on the research topic, Importance of research. Research background provides an overview an overview of the research theme and an introduction to the ideas used in the research. Research question, research goal, research question and its meaning Research, research limitations, definitions of key terms, research structure application. This will allow the reader to better understand Reason for this study. This research proposal consists of his three elements. Here are the details for each chapter:

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CHAPTER 2 LITERATURE REVIEW

This chapter comprises a study of relevant experts' theoretical underpinnings for the topic's research, an empirical literature review, a research framework, and research hypotheses.

CHAPTER 3 RESEARCH METHODOLOGY

This chapter describes the research technique, covering the demographic and research sample, data gathering methods, data analysis methods, and researchvariable.