

CHAPTER 2

LITERATURE REVIEW

2.1 Introduction

Researchers have widely comprehended the correlation between stability and competition from two distinct viewpoints - competition- fragility and competition- stability. Several research projects that have been carried out to examine the relationship between bank stability and competition have yielded inconsistent outcomes, possibly due to variations in regions and specific sample durations. The objective of this study is to specifically scrutinize the influence of bank competition and stability on bank effectiveness and conduct empirical research utilizing Islamic bank data.

2.2 Review of Related Literature

Previous research has pointed to a strong link between bank competition and stability. The current literature presents her three main perspectives: The first perspective, known as the 'competitive vulnerability' perspective, suggests that competition among banks leads to less stability. Beck et al. (2013) found that increased competition reduces bank stability, especially in countries with stricter regulation, lower systemic risk and more developed equity and foreign exchange markets.

His second view, named "Competitive Stability," postulates that increased competition among banks will improve stability. Soedalmono et al. (2013) analyzed the Asian banking system from 1994 to 2009 and found that capitalization increased as market competition decreased. However, this increase was insufficient to counteract the impact of higher risk-taking, which led to decreased stability.

A third perspective states that there is a non-linear relationship between bank competition and stability. This view suggests that as competition among banks increases, stability first increases and then decreases. Martinez-Miera and Repullo (2010) used the model of Boyd and De Nicolo (2005) and considered both risk transfer and marginal benefit effects. They found an inverted U-shaped relationship between bank competition and credit risk in credit markets. Jimenez et al. (2013) confirmed this view using data from Spanish banks, and using a centralized index measuring bank competition, found a linear relationship between both the loan and deposit markets. Similarly, Liu et al. (2013) created a competition index using data from 10 European countries from 2000 to 2008 to test the stability. This also confirms the inverted U-shaped relationship between bank competition and stability.

However, some researchers argue that when banks become more competitive, stability first decreases and then increases. Tobacco et al. (2012) used data from 10 Latin American countries from 2003 to 2008 and used the Boone index to measure banking competition. They find that the impact of banking competition on risk behavior is non-linear, with both low and high levels of competition helping to improve financial stability, while medium levels of competition have the opposite effect, suggesting that As a result, researcher found that inter-bank competition has a positive U-shaped relationship between an competition and stability.

2.2.1 Bank Islamic

Bank comes from the word baroque (French) and the word banco (Italian), meaning chest/cabinet or bank. This definition describes the basic functions of a commercial bank, namely: First, as a secure deposit function, providing a safe place to deposit money, and second, as a transaction function, providing a means of payment for the purchase of goods and services (Antonio, 2006: 02).

In Indonesia, Islamic banking regulations are included in Law No. 2. The 21st of 2008 states that Shariah Bank is a bank operating under Shariah principles and according to its type consists of Shariah Commercial Bank (BUS), Shariah Business Entity (UUS) and Shariah Finance Bank (BPRS).

- a. Islamic Commercial Bank (BUS) is an Islamic bank Its activity provides payment transaction services. Bus It can operate as a foreign exchange bank or a non-foreign exchange bank. A forex bank is a bank that can carry out all transactions abroad or related to foreign currencies. Overseas remittance, overseas debt collection, opening letter of credit, etc.
- b. A Shariah entity (hereinafter referred to as a UUS) is a traditional commercial bank head office operating unit that serves as the headquarters of an office or entity that conducts business on the basis of Shariah principles. The UUS is below the relevant traditional commercial bank directors. UUS can operate as a foreign exchange bank or a non-foreign exchange bank.
- c. The Islamic People's Financial Bank is a bank deeply rooted in Shariah. Your activity does not provide payment transaction services. Legal form of a limited liability company BPRS.

According to Ismail (2011: 28) An Islamic commercial bank is an autonomous Islamic bank according to its charter and is not part of a conventional bank. On the other hand, according to Sadie (2015: 36) Islamic banking itself is an entity that collects funds from the public in the form of savings and distributes them on credit and/or otherwise in order to improve the standard of living of the people on the basis of Shariah principles.

2.2.2 Bank Competition

A race is an attempt by two individuals or groups to compete over the same object.

The purpose of competition is to increase market share and generate higher profits (Bicker and Hanif, 2002; Kocabay, 2009). Competition among banks arises from competing for productive resources such as deposits, savings, and loans that generate income. Non-price competition between banks can take the form of prices and promotions to attract as many customers as possible. Competition can also take the form of new products and services backed by technological developments that can reduce production and distribution costs.

There are two different views on the impact of competition on bank stability. First, the traditional view is that intense competition among banks increases the supply of credit to companies that need it (Windyastuti and Armanto, 2013). Highly competitive pressures in the financial sector are likely to drive improvements in production efficiency, financial product quality and innovation. It is also expected that increased competition will reduce the cost of intermediation services and significantly reduce the time required to process loans, making intermediation services more efficient, ultimately leading to higher revenues for banks. A highly competitive banking market will use its power to weed out weaker banks while promoting the survival of healthy banks. Contrary to the first view above, the second view says that competition is actually hurting new business and the future of the banking sector, as borrowers face an increased supply of credit due to increased banking competition. This model is based on the assumption that competition increases moral hazard and negative choice problems for borrowers. As competition among banks increases, businesses are forced to choose between banks and lenders, and as the number of banks increases, the efforts of banks to select potential borrowers diminish.

In general, there are two approaches to competition theory: structural and unstructured. The Structural Approach differs from the traditional Industrial Organization (IO) theory, the calculation of competition based on concentration, or the so-called Structural Behavioral Performance (SCP) approach. According to the SCP approach, high

levels of concentration lead to complicit and non-competitive behavior. The higher the concentration, the higher the market power. Therefore, there is a negative correlation between concentration and competitiveness. Unstructured approaches, on the other hand, place more emphasis on information on competitive behavior and are concentration independent, such as competitive calculations based on the elasticity of returns to input prices (Bikker and Haaf, 2002: 53-98). In the banking sector it is important to calculate the level of competition. Due to the different characteristics of banks in general from non-banking organizations, and the important role of banks in the economy, there has been a great deal of research on the level of competition taking place on banking data using both structural and non-structural approaches. In addition, the relatively rapid development of the banking sector is driving the change in the level of competition among banks.

In general, there are four factors that influence the level of competition in the banking sector. They are regulation, rapid growth in demand for banking services, technological development, and innovation in global financial markets (Maudos et al., 2002). Regulations that affect changes in the market and banking structures (reflected in changes in the number of banks) affect the level of competition. Mulyaningsih and Daly (2011), in their study on the degree of competition in Indonesian banks from 2001 to 2009, argued that Indonesian banking is concentrated in large banks. These banks operate in a less competitive market than smaller banks and have monopoly power that allows them to behave like a monopoly or oligopoly. This finding is supported by research showing that market concentration contributes to a less competitive environment. According to Weil, competition often involves competitive situations between multiple parties fighting over something. Competition in banking involves multiple agents. Bank competition can be measured by measuring bank concentration, market power and market share, or interaction patterns among banks in the banking sector (Athoammar, 2015: 20).

According to Demirguc-Kunt and Peria (2010), the Lerner index can indicate the market power of banks that set prices above their marginal cost. The Lerner Index values reflect the level of competition in the banking industry in three broad categories.

- a. In a perfectly competitive market with high demand elasticity, the value of the Lerner index approaches zero.
- b. In a monopoly market characterized by a zero or near-zero market elasticity value, the value of the Lerner exponent converges to infinity.
- c. A monopolistically competitive market when market conditions are between the above two market structures.

2.2.3 Bank Stability

Conducting research on financial stability, particularly in the banking industry, is a challenging task. The definition of financial stability itself is intricate, particularly regarding how to gauge it. According to Gadanez and Jayaram (2009), financial stability refers to a state where the financial system, consisting of financial institutions, financial markets, and financial infrastructure, can withstand shocks and adjust to current circumstances to decrease the likelihood of disruptions in the financial intermediation process, which can significantly alter the distribution of savings into lucrative investment prospects (Kočišová, 2015).

Tsomocos (2003) explains financial instability as a state where a group of bank customers default, and a few banks experience liquidity problems without going bankrupt, leading to a significant reduction in the profitability of the banking sector. Dumicić (2016) conducted a study to identify financial stability indicators using the principal component analysis method, which is summarized in the Systemic Risk Accumulation Index (SRMI). Friesland Ma (2014) measured stability based on the risks faced by banks, which are categorized into four risks, namely asset/portfolio risk,

insolvency risk, illiquidity risk, and systemic risk. These risks are assessed using various indicators such as Non- Performing Loans (NPL), z-score, distance to default, and other accounting data.

2.2.4 Bank Effectiveness

Effectiveness in this study measure as return of asset according to Richard M. Steers in Tangkilisan (2005), effectiveness is the extent of effort of a program as a system, with given resources and means to achieve its goals and objectives without crippling methods and resources and without placing undue pressure on program implementation. The leaders also gave 5 (criteria) to measure effectiveness, which are productivity, job adaptability, job satisfaction, profitability, ability to find resources (Rifa) 'i 2013:132).

2.3 Underpinning Theories

2.3.1 Prisoners' Dilemma Theory

The principle that explains the vulnerability of banks on the liability side is the theory of Prisoners' Dilemma. It is common knowledge that if public confidence in banks is lost, there will be a sudden and simultaneous withdrawal of funds, also known as a rush or run. Diamond and Dybvig (1983) examined the behavioral process that causes this phenomenon. The banks' vulnerability arises from the interplay between liquid liabilities, which are usually short-term, and illiquid assets, which are generally long-term.

2.4 Research Framework

In this study, researchers will study what factors affect bank effectiveness. This research will begin by exploring theories related to the variables used. These theories are obtained from previous research, books, and other sources. So based on the theories that have been obtained by researchers, it can be concluded that bank effectiveness can be

directly influenced by bank competition and stability. So that the relationship between the variables of this study can be described as follows:

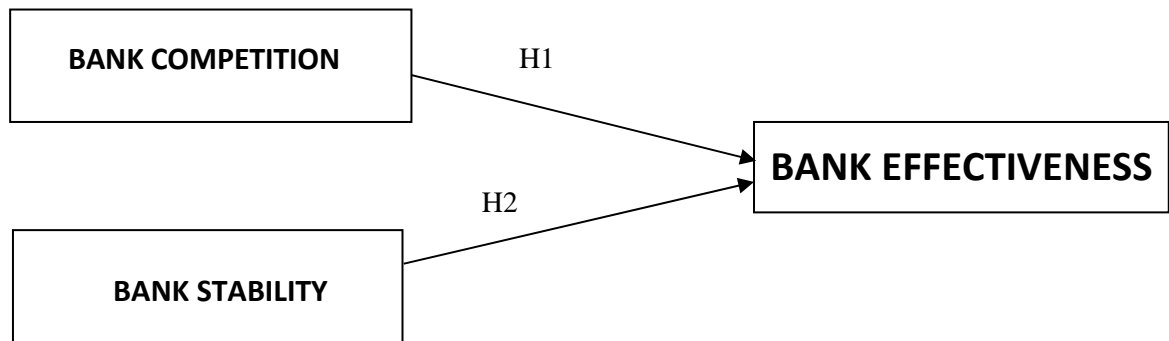


Figure 2.1 Research Framework

2.5 Research Hypothesis

A hypothesis is a temporary response/conclusion made to solve a research topic that has yet to be empirically tested. The hypothesis in dispute an accusation that may or mayn't be true.

H1: Bank Competition has significant relationship on Bank Effectiveness.

H2: Bank Stability has significant relationship with Bank Effectiveness.

2.6 Summary

In light of all the information, Chapter 2 has encompassed the examination of literature on the effect of competition and stability on the effectiveness of Islamic banks in Indonesia, investigation and previous studies. The connection between the independent and dependent variables in this study, along with the definitions that pertain to each variable. It is imperative for acquiring the theoretical framework relevant to this research.