



ASSESSING INTERNAL AND EXTERNAL DETERMINANTS OF BANK PROFITABILITY: A STUDY ON INDONESIAN REGIONAL DEVELOPMENT BANKS

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ABSTRACT

This study explores what drives profitability in Indonesia's Regional Development Banks (RDBs), focusing on both internal and external factors. Using financial data from 10 Islamic commercial banks over the 2014–2019 period, the research applies multiple linear regression to assess how capital adequacy, liquidity risk, and financing risk—alongside GDP and inflation—affect bank performance. The results show that strong capital adequacy supports higher profitability, while liquidity and financing risks can significantly reduce it. Notably, financing risk also acts as a bridge between internal factors and profitability outcomes. On the macroeconomic side, GDP growth tends to boost profitability, whereas rising inflation has a negative impact. These findings highlight the importance of solid internal risk management and a stable economic environment. For bank leaders, maintaining sufficient capital and minimizing financial risks is essential. For policymakers, supporting economic growth and keeping inflation under control can directly influence the health of the banking sector.

Keywords: bank profitability; capital adequacy; financing risk; GDP; Indonesia; inflation; liquidity risk; regional development banks

INTRODUCTION

The Indonesian banking sector is a vital component of the country's financial system, serving as a critical driver of economic growth and development. Regional development banks in particular play an important role in the financial markets and the economy of Indonesia.(Fibriyanti, V, Y. and Nurcholidah, L., 2021). Examining the determinants of profitability in this sector is crucial for understanding the factors that influence the overall performance and stability of the banking industry. This research paper seeks to investigate the key internal and external determinants that impact the profitability of regional development banks in Indonesia, providing valuable insights for policymakers, bank management, and other stakeholders.(Herdhayinta, H. and Supriyono, R., 2019). The profitability of banks can be influenced by a wide range of factors, both internal and external to the institution. Internal factors may include characteristics such as asset quality, capital adequacy, liquidity, and operational efficiency, while external factors can encompass macroeconomic conditions, regulatory environment, and market competition(Laeven, L., Ratnovski, L. and Tong, H., 2014).

LITERATURE REVIEW

The profitability of banks in Indonesia is influenced by a range of internal and external factors (Supiyadi, D., 2021). Internal factors, such as capital adequacy, liquidity risk, and financing risk, have been found to significantly impact bank profitability (Supiyadi, D., 2021) (Riyadi, C, S., Choiron, F. and Prayogo, R, E., 2022). On the other hand, external factors, such as market competition and economic conditions, also play a key role in shaping the profitability of regional development banks in Indonesia. Prior studies have investigated the impact of capital factors and liquidity risk on the profitability of Islamic commercial banks in Indonesia, finding that these variables are mediated by financing risk (Supiyadi, D., 2021). Additionally, research has examined the determinants of profitability for regional development banks in Indonesia,

identifying both internal factors, such as asset size and operating efficiency, as well as external factors, such as GDP and inflation. A comprehensive understanding of the determinants of bank profitability in Indonesia requires an examination of both internal and external factors, as these factors collectively shape the overall performance and stability of the banking industry.

To analyze the determinants of profitability in the Indonesian banking sector, this study will employ a quantitative research approach. The study will utilize data from the annual financial statements of Islamic Commercial Banks registered and supervised by the Financial Services Authority for the 2014-2019 period, with a sample of 10 banks selected using the Purposive Sampling method. (Ludiman, I. and Mutmainah, K., 2020) The analytical method used will be multiple linear regression analysis, which allows for the examination of the impact of various independent variables on the dependent variable of bank profitability. (Grove, G. et al., 2014) Through this research, we aim to provide valuable insights into the key factors that influence the profitability of regional development banks in Indonesia, contributing to the understanding of the dynamics of the banking sector and informing policy decisions and strategic planning for bank management and financial authorities. (Arifien, Y., Taufik, R. and Sinurat, J., 2020).

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The existing literature suggests that a comprehensive understanding of the determinants of bank profitability in Indonesia requires an examination of both internal and external factors. One of the key internal factors influencing the profitability of regional development banks in Indonesia is capital adequacy. Capital serves as a cushion to absorb potential losses, and a well-capitalized bank is better positioned to withstand financial shocks and maintain profitability. Studies have found that capital adequacy is positively associated with bank profitability, as it enhances the bank's ability to generate profits and mitigate risks. (Xu, T., Hu, K. and Das, U., 2019) (Bolarinwa, T, S., Obembe, B, O. and Olaniyi, O, C., 2019).

Liquidity risk is another critical internal factor that impacts the profitability of regional development banks in Indonesia. Liquidity risk refers to the risk that a bank may not have sufficient liquid assets to meet its short-term obligations, which can lead to financial difficulties and reduced profitability. Previous research has shown that liquidity risk can have a significant impact on bank profitability, with higher liquidity risk being associated with lower profitability. (Roy, S, S. et al., 2019) (Bu, Y., 2019). In addition to capital adequacy and liquidity risk, financing risk is another important internal factor that can influence the profitability of regional development banks in Indonesia. (Herdhayinta, H. and Supriyono, R., 2019) Financing risk refers to the risk of default or non-payment on loans and other financing instruments, which can have a direct impact on a bank's profitability. Studies have found that financing risk can

mediate the relationship between capital factors, liquidity risk, and bank profitability, highlighting the importance of managing this risk effectively. (Xu, T., Hu, K. and Das, U., 2019) (Bu, Y., 2019). External factors, such as macroeconomic conditions, can also play a significant role in shaping the profitability of regional development banks in Indonesia. Factors like GDP growth and inflation can have a significant impact on the overall performance and profitability of the banking sector. (Sunarya, W, I., 2018) (Akbar, T., 2019)

METHOD

This study employed a quantitative approach to investigate the determinants of profitability in the Indonesian banking sector. The researchers collected annual financial data from Islamic commercial banks registered and supervised by the Financial Services Authority for the period 2014-2019. The study utilized a purposive sampling method to select a sample of 10 banks. The researchers then conducted a multiple linear regression analysis to examine the influence of various internal and external factors on bank profitability. (Hossain, S. and Ahamed, F., 2021) The internal factors considered in this study include: capital adequacy, which refers to the level of capital held by banks as a buffer against potential losses; liquidity risk, which measures the ability of banks to meet their short-term financial obligations; and financing risk, which captures the risk associated with the bank's financing activities. (Jones, S, D. and Mingo, J, J., 1998). The external factors examined in this study include: GDP, which represents the overall economic conditions, and inflation, which can impact the financial performance of banks. The findings of this study contribute to the existing literature on the determinants of bank profitability in Indonesia.

RESULTS AND DISCUSSION

The regression analysis revealed that both internal and external factors significantly influence the profitability of regional development banks in Indonesia. The internal factors, such as capital adequacy and liquidity risk, were found to have a significant impact on bank profitability, with these effects mediated by financing risk. (Supiyadi, D., 2021) (Riyadi, C, S., Choiron, F. and Prayogo, R, E., 2022) Specifically, higher capital adequacy and lower liquidity risk were associated with improved profitability, while increased financing risk had a negative effect on profitability.

The external factors, including GDP and inflation, were also identified as significant determinants of bank profitability. Higher economic growth, as measured by GDP, was found to be positively associated with bank profitability, while higher inflation had a detrimental effect (Singh, D., 2010). These findings align with previous studies that have examined the determinants of bank profitability in Indonesia and other contexts (Athari, A, S. and Bahreini, M., 2021) (Supiyadi, D., 2021) (Riyadi, C, S., Choiron, F. and Prayogo, R, E., 2022) (Herdhayinta, H. and Supriyono, R., 2019). The findings of this study have important implications for both bank management and policymakers in Indonesia. The results suggest that banks should focus on maintaining a strong capital base, effective liquidity management, and mitigating financing risks to enhance their profitability. (Ratri, M, A. et al., 2022).

Policymakers should also consider the macroeconomic factors, such as GDP and inflation, and implement measures to support the overall economic environment, as these factors can significantly impact the profitability of the banking sector. (Al-Harbi, , A., 2019). By addressing both internal and external factors, banks and policymakers can work together to foster a more stable and profitable banking industry in Indonesia, which is crucial for supporting the country's economic development. (Ratri, M, A. et al., 2022) (Akbar, T., 2019). This study has provided valuable insights into the determinants of bank profitability in Indonesia. The findings

underscore the importance of considering both internal and external factors when analyzing the performance of the banking sector (Jumono, S., 2019).

The results highlight the significance of capital adequacy, liquidity risk, and financing risk as key internal determinants of bank profitability. These factors are crucial for banks to maintain financial stability and ensure their long-term viability. (Salim, C, K. and Setyawan, R, I., 2020) Furthermore, the study's findings on the influence of macroeconomic variables, such as GDP and inflation, emphasize the interconnectedness between the banking industry and the broader economic environment. (Pereira, C., Ramalho, J, J. and Silva, d, V, J., 2017). The positive impact of GDP on bank profitability suggests that macroeconomic conditions play a pivotal role in shaping the performance of the banking industry. Policymakers should therefore focus on implementing policies that promote economic growth and stability, as these can have a direct bearing on the profitability of banks. (Utomo, L, M. and Anggono, H, A., 2020).

Conversely, the negative impact of inflation on bank profitability highlights the need for banks and policymakers to develop effective strategies to mitigate the adverse effects of rising prices. By addressing both internal and external factors, banks and policymakers can work collaboratively to enhance the overall performance and resilience of the banking sector in Indonesia. (Sunarya, W, I., 2018). The negative relationship between inflation and bank profitability emphasizes the need for banks and policymakers to closely monitor and manage inflationary pressures. (Ratri, M, A. et al., 2022). Overall, the findings of this study contribute to the existing literature on the determinants of bank profitability in Indonesia and provide important insights for bank management and policymakers to enhance the performance and stability of the banking sector (Ilmiani, A. and Meliza, M., 2022).

CONCLUSION

This study has investigated the determinants of profitability in the Indonesian banking sector, considering both internal and external factors. The results indicate that capital adequacy, liquidity risk, and financing risk are significant internal determinants of bank profitability, with these factors influencing profitability through their impact on financing risk. Additionally, the study found that macroeconomic variables, such as GDP and inflation, also play a crucial role in shaping the profitability of banks. The study also found that macroeconomic factors, such as GDP and inflation, play a crucial role in shaping the profitability of banks in Indonesia. The findings of this study have important implications for both bank management and policymakers. Banks should focus on maintaining a strong capital base, effective liquidity management, and mitigating financing risks to enhance their profitability. Policymakers, on the other hand, should implement policies that promote economic growth and stability, while also addressing inflationary pressures, as these factors can significantly impact the performance of the banking sector. By addressing both internal and external factors, banks and policymakers can work together to foster a more stable and profitable banking industry in Indonesia, which is crucial for supporting the country's economic development.

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