MICROPRUDENTIAL ASPECT BASED ON RULE OF THUMB IN BANKING INDUSTRY

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ABSTRACT: *An Important element of the microprudential in banking industry is its measurement of financial performance. The measurement can be illustrated as financial ratios that is able to empower all resources possessed by bank to achieve the certain goals, target or missions which are intended to be accomplished by a bank, that is to prosper its people.*

The involvement of regulator in supporting the success of government heavily depends on the characteristic of its banking community. While good measurement become the main tool to manage banking in the more global world, reform in rule of thumb in the development of financial performance is a very crucial factor to achieve the ultimate goal of microprudential. The regulator movement as an administrative reform is better than policy enforcement act. It is also an act of culture change reflecting and challenging basic financial performance value.

Keywords : *Microprudential, rule of thumb, financial ratios.*

INTRODUCTION

Microprudential regulation is the approach to financial regulation that purpose to mitigate risk to the financial system as a whole (or "systematic risk"). Microprudential regulation or MicroprudentialSupervision is firm level oversight or financial regulation by regulators of financial institution (Financial Service Authority/OJK) , "enduring the balance sheets of individual institution are robust to shocks."

Defining the right performance dimensions is crucial because the goals which are set and the measurement that are made shape employees' views of what is important. In the terms often heard is business organizations "what you measure is what you get." (R.S. Kaplan & DP Norton, "The Balanced Scorecard – Measures that Drive Performance," Harvard Business Review, 70, no. 1 (January – February 1992), P.71.

What is worrisome is that employees work to improve the areas which are measured regardless of *whether or not the measurement dimensions are defined correctly.* If the measurement dimensions are not defined correctly; that is, if they are not congruent with the organization's objectives or agreed upon strategies, the result controls with actually encourage employees to do wrong things.

LITERATURE REVIEW AND HYPOTHESIS

Paul KibathiKagecha (2014) "Bank Performance: Does Bank Size Matter?

> "Fromthe results of the study, we have established that bank size, capital adequacy, liquidity, age and assetquality do not count in determining bank profitability in Kenya

Jacob A. Bikker and Jaap W.B. Bos (2008), Bank Performance;

"The appropriate definition of output in banking has been a frequent topicof discussion, the two mainstreams being the intermediation approach and theproduction approach. The former assumes that a bank attracts deposits and otherfunds and transforms them into loans and securities (investments), using inputssuch as labor, capital and materials. Interest payments are seen as part of the costsand the corresponding dual cost function includes not deposits but the interestrate paid on deposits as an input factor. Loans and investments are the outputcomponents. Examples of this view are found in Altunbas et al. (1994, 1995)and Barr et al. (1994). The latter approach assumes that a bank provides servicesrelated to loans and deposits. In this view, interest payments are not regarded asbanking costs. The output components comprise loans and deposits. Examples ofthis approach can be found in Swank (1996), Resti (1997) and Berger and DeYoung(1997), among others. Since operating costs appear to make up the bulk of banks'cost inefficiency (Berger and Humphrey, 1991), this analysis, in line with most ofthe literature, takes the production approach".

METHOD

This research is conducted through a qualitative approach with a phenomenological strategy. Phenomenological strategy - a study which is conducted at particular setting in a real live (natural setting) to investigate and understand phenomena; what had happened, why does it happen and how does it happen. It other word the research is based on the "going exploring" concept that involves in-depth and case oriented study on several cases or single case (Weber, 1960).

To support this study, data collected for this qualitative research were collected through primary data sources and secondary data source. Primary data is a source of data obtained directly by researchers who conduct research. Secondary data is an indirect source of data to data collectors. Also performed by gathering information of the respective parties that are competent to provide information.

Measuring Performance

Many different results measures can be linked to rewards. Many objective financial measures; such as net income, earnings per share, and return on assets, are in common use. So are some non-financial measures; such as market share growth (in units), and the timely accomplishment of certain tasks. Some measurements involve subjective judgements.

Evaluators may be asked to judge whether a manager is "being a team player" or "developing employees effectively" and to record their judgments on a measurement scale from 1 (poor) to 5 (excellent).

For most high-level line managers, most of the key results areas linked to rewards are defined in financial terms. The measures may be either market-based performance indicators or accounting profits or returns. Lower-level managers, on the other hand, are typically evaluated in terms of operational data which are more controllable at the local level. The key result areas for a production manager might be a combination of efficiency, inventory control, quality, delivery time, and product development time.

This discontinuity between financial and operational performance measures creates a critical pivotal point in the management hierarchy which one set of researches called a *hinge*. At some critical middle organizational level, often a lower-profit-center level, managers must translate financial goals into operational goals. These managers' goals are primarily defined in financial terms, so their communications with their superiors are primarily in financial terms. Because their subordinates' goals are primarily operational, their download communications are primarily in operational terms.

If managers identify more than one result measure for a given employee, they must attach relative importance weightings to each measure so that the judgments about performance in each result area can be aggregated into an overall evaluation. The weightings can be addictive; for example, 60 percent of the overall evaluation is based on return on assets and 40 percent is based on sales growth. The weightings can also be multiplicative; for example, Browning Ferris Industries multiplies a score on achievement of profit and revenue goals by a score assessed based on environmental responsibility. If the environmental responsibility score is less than 70 percent, the multiplier, and hence, the resulting bonus, is zero.

Sometimes, such as in the examples presented above, the organization makes the weightings of performance measures explicit to the individuals being evaluated. Often, however, particularly where performance evaluations are done somewhat subjectively, the weightings are partially or totally implicit. Leaving the weighting implicit blurs the communication from superiors to subordinates about what results are important. Employees are left to try and infer what results will most affect their overall evaluations.

What is bank performance?

Performance is the end result of an activity. Managers are concerned with bank performance – the accumulated results of all the bank's work activities. It's a multifaceted concept, but managers need to understand the factors that contribute to bank performance. After all, it's unlikely that they want (or intend) to manage their way to mediocre performance. They want their bank, work units, or work groups to achieve high levels of performance.

All managers must know which measures will give them the information they need about bank performance. Productivity is the amount of goods and services produced divided by the inputs needed to generate that output. Bank and individual work units want to be productive. They want to produce the most services using the least amount of inputs. Output is measured by the revenue a bank receives. Input is measured by the costs of acquiring and transforming resources into outputs.

It's management's job to increase this ratio. Of course, the easiest way to do this is to raise prices of the outputs. But, in today's competitive environment, that may not be an option. The only other option, then, is to decrease the inputs side by being more efficient in performing work and thus decreasing the bank's expenses.

Bank effectiveness is a measure of how appropriate bank goals are and how well those goals are met. That's the bottom line for managers, and it's what guides managerial decisions in designing strategies and work activities and in coordinating the work of employees.

The Essence Of Ratio Analysis

Ratio analysis is a powerful tool of financial analysis. A ratio defined as "the indicated quotient of two mathematical expressions" and as "the relationship between two or more things." In financial analysis, a ratio is used as an index or yardstick for evaluating the financial position and performance of a firm. The absolute accounting figures reported in the financial statements do not provide a meaningful understanding of the performance and financial position of a firm. An accounting figure conveys meaning when it is related to some other relevant information. The relationship between two accounting figures, expressed mathematically, is known as a financial ratio (or simply as a ratio). Ratios help to summarise the large quantities of financial data and to make qualitative judgement about the firm's financial performance. For example, consider current ratio, it is calculated by dividing current assets by current liabilities; the ratio indicates a relationship- a quantified relationship between current assets and current liabilities. This relationship is an index or yardstick which permits a qualitative judgement to be formed about the firm's ability to meet its current obligations. It measures the firm's liquidity. The greater the ratio, the greater the firm's liquidity and *vice versa*. The point to note is that a ratio indicates a quantitative relationship, which can be, in turn, used to make a qualitative judgement. Such in the nature of all financial ratios.

Financial Controls

Every bank wants to earn a profit. To achieve this goal, managers of banks need financial controls. For example, they might analyze quarterly income statement for excessive expenses. They might also compute financial ratios to ensure that sufficient cash is available to pay on going expenses, that funding levels haven't become too high, or that assets are used productively.

Bank managers use conventional financial measures such as ratio analysis and budget analysis. As below, summarizes some of the most popular financial ratios.

Objectives	Ratio	Healthy regulator criteria	Calculation	Meaning
Liquidity	LDR	110%	Loan : Deposits	Tests the banks ability to meet short obligations
Capital Adequacy	CAR	Min. 8 %	Net Worth : ATMR	Equity Capacity to Buffer Risks
Efficiency	BOPO	93.52 %	Operational Expense : Revenue	Tests the banks ability to operate efficiently
Credit Problem	NPL	<5%	Bad Debt : Lending (Credit)	Tests the banks ability to know potential loss of credit exposure
Profitability	ROA	5%	Earnings before tax : Assets	Measures the efficiency of assets to generate profits

Sources: Financial Service Authority (PeraturanOtoritasJasaKeuangan), 2018

Although these ratios can be used apple to apple, but there are some constraints as shown below:
Bank size (BUKU 1, BUKU 2, BUKU 3, BUKU 4)
There are 4 BOOKS in the national banking industry in Indonesia;

- Book 1 (core capital below Rp 1 trillion),
- Book 2 (core capital Rp 1 trillion - Rp 10 trillion),
- Book 3 (core capital Rp 10 trillion - Rp 50 trillion), and
- Book 4 (core capital above Rp 50 trillion)

1. Bank status (Foreign Exchange Bank vs Non Foreign Exchange Bank)
2. Listed Company or Private Company

Therefore, using these ratios based on the same parameters is not proper.

Cautions In Using Ratio Analysis

The ratio analysis is a widely used technique to evaluate the financial position and performance of a business. But there are certain problems in using ratios. The analyst should be aware of these problems. The following are some of the limitations of the ratio analysis.

1. It is difficult to decide on the proper *basis of comparation*
2. The comparison is rendered difficult because of *differences in situations* of two companies or of one company over years.
3. The *price level changes* make the interpretations of ratios invalid.
4. The *differences in the definitions* of items in the balance sheet and the profit and loss statement make the interpretation of ratios difficult.
5. The ratios calculated at a point of time are less informative and defective as they suffer from *short-term changes*.

6. The ratios are generally calculated from past financial statements and, thus are *no indicators of future.*

Standards for comparison. Ratios of a company have meaning only when they are compared with some standards. It is difficult to find out a proper basis of comparison. Usually, it is recommended that ratios should be compared with industry averages. But the industry averages are not easily available. In India, industry data on financial ratios are available from: (i) company finance studies conducted by the Reserve Bank of India and published in RBI Bulletin; (ii) studies, entitled *Financial Performance of Companies,* published annually by ICICI since 1972, and (iii) industry ratios, published by IDBI in *Operational Statistics.*

Company differences. Situations of two companies are never same. Similarly, the factors influencing the performance of a company in one year may change in another year. Thus, the comparison of the ratios of two companies becomes difficult and meaningless when they are operating in different situations.

Price level. The interpretation and comparison of ratios are also rendered invalid by the changing value of money. The accounting figures, presented in the financial statements, are expressed in the monetary unit which is assumed to remain constant. In fact, prices change over years which affects accounting earnings. At least three effects of inflation can be identified. *First*, the nominal value of inventory increases on account of rising prices. This results into "inventory profit." A firm will lose in real terms if the general price level increases faster than appreciation in the value of inventory. *Second*, assets are stated at original cost (less depreciation) in the balance sheet. Because of inflation, their current value or replacement cost will be much higher than book value. Thus depreciation calculated on book value will be very low. *Third*, inflation affects accounting profits of the firms which borrow. If the interest rate is fixed, shareholders gain at the cost of lenders. The real value of the lenders' obligation is reduced by inflation. The accounting profit does not recognize the gain from borrowing arising due to inflation. Since firms will differ in terms of the nature of their inventory, age and type of assets and debt policy, inflation will affect them differently.

Different definition. In practice, differences exist as to the meaning of certain terms. Diversity of views exist as to what should be included in net worth or shareholders' equity, current assets or current liabilities. Whether preference share capital and current liabilities should be included in debt in calculating the debt-equity ratio? Should intangible assets be excluded to calculate the rate of return on investment? If intangible assets have to be included, how will they be valued? Similarly, profit means different things to different people.

Changing situations. The ratios do not have much use if they are not analysed over years. The ratios at a moment of time may suffer from temporary changes. This problem can be resolved by analyzing trends of ratios over year. Although trend analysis is more useful but still the analysis is static to an extent. The balance sheets, prepared at different points of time are static in nature. They do not reveal the changes which have taken place between dates of two balance sheets. The statements of changes in financial position reveal this information.

Past data. The basis to calculate ratios are historical financial statements. The financial analyst is more interested in what happens in future, while the ratios indicate what happened in the past. Management of the company has information about the company's future plans and policies and, therefore, is able to predict future happening to a certain extent. But the outside analyst has to rely on the past ratios, which may not necessarily reflect the firm's financial position and performance in future.

Rule Of Thumb As Best Practice

The rule of thumb should identify various benchmarks, the standards of excellence against which to measure and compare. As a tool for monitoring and measuring bank performance, the rule of thumb can be used to identify specific performance gaps and potential areas of improvement. But best practices aren't just found externally.

Sometimes those best practices can be found inside the bank and just need to be shared. Research shows that best practices frequently already exist within a bank but usually go unidentified and unnoticed. In today's environment, banks seeking high performance levels can't afford to ignore such potentially valuable information.

CONCLUSION

These parameters cannot be used as best practice. The flexibility of bank management becomes low, which makes bank management difficult, because one of them is related to the debtor behavior and deposan behavior. Beside that interest rate in addition, interest rates are greatly influenced by government intervention with the establishment of LembagaPenjaminSimpanan (LPS).

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