SUMMARY

SRI MURTIYANTI. The Impact of Credit Risk and Profitability on Capital Adequacy of the Banking Industry in Indonesia. Supervised by NOER AZAM ACHSANI and DEDI BUDIMAN HAKIM.

Credit risk is one of the most significant risks that banks face, considering that lending activity is one of the main sources of income in commercial banks. Banks are required to apply risk management in an effective manner. Application of risk management shall encompass at least adequacy of processes of identification, measurement, monitoring, and control of risk to ensure that business activities conducted by banks do not incur losses exceeding the capacity of the bank or that may disrupt the sustainability of bank operations. In an attempt to increase a bank's ability to absorb risks, the improvement of a bank's capital quality and quantity to be in accordance with international standards is deemed necessary. In order to increase a bank's capital quality, it is also considered necessary for the bank to have additional capital which will have the function as a buffer in the event of a financial and economic crisis which may negatively affect financial system stability.

The main purpose of the research is to analyze the relationship between credit risk and profitability on the capital adequacy ratio (CAR) of commercial banks in Indonesia. The research uses monthly time series data ranges from January 2010 to December 2014 which is obtained from Indonesian Banking Statistic, Bank Indonesia. As of December 2014, the banking industry in Indonesia consists of 119 conventional commercial banks with 19,948 office networks. Bank Indonesia classifies conventional commercial banks into 6 groups, namely State Owned Banks - Bank Persero (4 banks), Foreign Exchange Commercial Banks - Bank Umum Swasta Nasional Devisa (38 banks), Non-Foreign Exchange Commercial Banks - Bank Umum Swasta Nasional Non Devisa (29 banks), Regional Development Banks - Bank Pembangunan Daerah (26 banks), Joint Venture Banks - Bank Campuran (12 banks) and Foreign Owned - Kantor Cabang Bank Asing (10 banks).

This research uses ratio of Loan to Total Assets (KTA), Loan to Deposit Ratio (LDR), Non Performing Loan (NPL), ratio of Loan Losses Provision to Loan (CKPN) as the indicators of credit risk, and Operations Expenses to Operating Income (BOPO) and Return on Assets (ROA) as the indicators of profitability. The test result by using ECM Model shows that both credit risk and profitability performance have a significant impact to capital adequacy ratio (CAR) which is partially affected by the characteristic and the complexity of bank group. This study also suggests that the pace towards the long term balance is, in general, less than one year.

Keywords: credit risk, profitability, non performing loan and capital adequacy ratio