I INTRODUCTION

1.1 Background of the study

A successful company usually has a robust risk management system. For a bank, it also plays very important role in banking sector. With the development of the banking industry, more and more bankers begin to explore more scientific risk management system for the bank. It can help the bank establish the warning mechanism and keep the bank running long-term.

In Indonesia, until May 2010, there are 122 commercial banks (Cited in the Indonesian banking statistics of Bank Indonesia, Vol.8, No.3, February 2010). Each bank faces different dominant risks due to different situations of the banks. However, there are a group of banks in Indonesia which are much more particular for the researcher to make a study on them. They are the Chinese total-owned banks.

In Indonesia there are 10 foreign owned banks (Cited in Vol.8 Indonesian banking statistics of Bank Indonesia (2010, Feb). Indonesia), which is an important integrant part of Indonesia banking industry. There into, there is a Chinese totally-owned bank, Bank of China Jakarta Branch, which ranks 8th in the group of foreign owed banks in 2007-2008(cited in the Rating 120 Banks Di Indonesia 2007-2008. (2009, May). Magazine “infobank”).

For the researcher, he is a limited stay resident of Chinese citizen in Indonesia. It is more interested for the researcher to make a study on this kind of bank. On one side, it must have certain risks for Chinese owned Bank when it steps out form the home country, and the researcher has not known clearly about the situation of the Chinese owned Bank in Indonesia. On the other side, as the last one which is a foreign totally-owned bank under the Bank Indonesia supervisory, it has certain goodness, but it will have a hard way to go.
One of the hard ways is how to manage its risks as a Chinese owned bank in Indonesia. Here, the researcher will make a research about the dominant risk(s) of Chinese bank in Indonesia. After making a research about Chinese owned Bank, he hopes he can find the problem and the solution for the Chinese owned bank and make contributions for the Indonesia banking industry and Chinese owned banks development in the world.

As we know, Bank is a special company as a financial intermediary. Its activities involve all kinds of companies. The bank loans money to other companies or other companies deposit in the bank, which are two basic activities, happened in the bank. Because different banks have different products, their activities subjects will be different. However, only from the basic activities of the bank, we can see some risks, such as credit risk, operational risk, and market risk.

Indonesia is a special country in financial supervisory since it had been attacked by the 1998 financial crisis. As banking industry plays an important role in financial world, since then all of the banks of Indonesia are strictly supervised by Bank Indonesia, Indonesia Labor Department and other national institutions. When a foreign owned bank steps into Indonesia market, it will take long time to negotiate with Indonesia government. Only from Bank Indonesia, it has made a lot of strict policies which each bank opening in Indonesia should be executed. It is much more difficult to manage well a foreign owned bank in Indonesia. Then, risks of the Chinese owned banks are arising. Generally, one bank often faces three main types of risks which mentioned above, credit risk, market risk and operational risk. However, for a Chinese owned bank, it is distinct because of the differences of two countries’ supervisory. Another main risk of 8 types of risks of Chinese owned bank in Indonesia is the compliance risk. Therefore, there are four big risks faced by a Chinese owned bank, credit risk, market risk, operational risk, and compliance risk.

Risk management is vital to the development of the banking sector. However, in
different banks, they have different situations, which make them face different main risks. Risks are viewed the life management nowadays, which become an important duty or job for banking sector. The experts often say like that who can manage well the risks of the bank, which will make a difference in banking sector. With the products of the Chinese owned bank expanding in Indonesia, the risks of the Chinese owned bank are increasing, too. Therefore, if Chinese owned bank wants to keep a healthy development in Indonesia market, they must find out what kinds of risks they are facing and what kind of risk affects the life of the Chinese owned bank in Indonesia market.

1.2 Company Profile

1.2.1 About Bank of China Limited

Established in 1912, Bank of China Limited (“Bank of China”) is the oldest bank in China. The Banker has ranked Bank of China one of the world’s top banks in terms of core capital. Bank of China has played an important role in promoting China’s economic and social progress through its active involvement in the country’s international trade and financial activities. Bank of China has been included in the Fortune 500 for 13 consecutive years.

Bank of China is the first Chinese bank that has presence in all major continents. At present the bank offers financial services through its global network of over 560 overseas offices in 26 countries and regions. In Hong Kong and Macau, Bank of China is one of the local note-issuing banks.

1.2.2 About Bank of China Limited Jakarta Branch

Bank of China Jakarta Branch was originally established in 1938. Based on the agreement of the governments of The People’s Republic of China and Republic of Indonesia and the memorandum between People’s Bank of China and Bank
Indonesia, Bank of China reactivated its Jakarta branch on 15 April 2003.

As part of the Bank of China Group’s global network, Bank of China Jakarta Branch offers a comprehensive range of banking services for both domestic and international business transactions. We have comprehensive advantages in providing trade and non-trade services to our esteemed customers.

Table 1.1 Products Comparison

<table>
<thead>
<tr>
<th>NO.</th>
<th>Products in Unit Office Location</th>
<th>Credit Card</th>
<th>Wealth Management</th>
<th>Cash Management</th>
<th>Private/Priority Banking</th>
<th>Consumer Banking</th>
<th>General Banking Services</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>CITIBANK</td>
<td>Jkt, Sby, Bdg, Medan, Semarang, Bali</td>
<td>✓  ✓  ✓  ✓  ✓  ✓  ✓  ✓</td>
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<td></td>
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<tr>
<td>2</td>
<td>STANDARD CH</td>
<td>Jkt, Sby, Bdg, Medan, Solo, Semarang, Bali</td>
<td>✓  ✓  ✓  ✓  ✓  ✓  ✓  ✓</td>
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</tr>
<tr>
<td>3</td>
<td>HSBC</td>
<td>Jkt, Sby, Bdg, Semarang, Medan, Bima</td>
<td>✓  ✓  ✓  ✓  ✓  ✓  ✓  ✓</td>
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<tr>
<td>4</td>
<td>ABN AMRO</td>
<td>Jkt, Sby, Bdg, Medan, Solo, Semarang, Bali, Manado, Kalimantan, Makassar</td>
<td>✓  ✓  ✓  ✓  ✓  ✓  ✓  ✓</td>
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<tr>
<td>5</td>
<td>THE BANK OF TOKYO -MITSUBISHI LTD</td>
<td>Jkt, Sby, Bdg</td>
<td>✓  ✓  ✓  ✓  ✓  ✓  ✓  ✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>JP MORGAN</td>
<td>Jkt</td>
<td>✓  ✓  ✓  ✓  ✓  ✓  ✓  ✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>BANGKOK BANK</td>
<td>Jkt</td>
<td>✓  ✓  ✓  ✓  ✓  ✓  ✓  ✓</td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>8</td>
<td>BANK OF CHINA</td>
<td>Jkt</td>
<td>✓  ✓  ✓  ✓  ✓  ✓  ✓  ✓</td>
<td></td>
<td></td>
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<tr>
<td>9</td>
<td>BANK OF AMERICA</td>
<td>Jkt</td>
<td>✓  ✓  ✓  ✓  ✓  ✓  ✓  ✓</td>
<td></td>
<td></td>
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<tr>
<td>10</td>
<td>AMERICAN EXPRESS</td>
<td>Jkt, Sby</td>
<td>✓  ✓  ✓  ✓  ✓  ✓  ✓  ✓</td>
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<tr>
<td>11</td>
<td>DEUTSCHI</td>
<td>Jkt, Sby</td>
<td>✓  ✓  ✓  ✓  ✓  ✓  ✓  ✓</td>
<td></td>
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</tbody>
</table>

Wealth Management : Mutual Funds or other with various innovative product
Cash Management : Corporate clients which have many branches or affiliates or subsidiary, banks helps to manage the funds
Private Banking : Clients with funds usually more than US$50,000.- will have priority services
Consumer banking : Instant money for clients consumptions
Jkt=Jakarta, Sby=Surabaya, Bdg=Bandung, Medan=Medan

1.3 Problem Identification

As a branching bank in overseas, Chinese banks face all kinds of risks during developing their products. According Basel II, there are three main risks in the bank which are credit risk, market risk and operational risk. However, due to the distinctness of Chinese banks in Indonesia market, they suffered much more strict supervisory from Indonesia. When the Chinese banks develop a new product which will suffer the supervisory from the Bank Indonesia, it will have another risk which is regulatory risk, i.e. compliance risk what we called in bank inside. Besides, as a format of overseas branch bank, most important decisions are made
by the head office of China, which caused some risks such as market risk, compliance risk etc. For example, one of the Chinese banks products is RMB product, the interest of RMB deposit is decided by the head office and it cannot have a flexible floating rate, which makes the overseas branch suffer interest risk which is belong to one type of market risk. As a particular bank, also a company, it must have operational risk when running the bank’s operation. For bank itself, its basic business is the deposit and loaning business which occupy big profitable part of the bank, which will make it suffer credit risk. Then, for the Chinese banks of Indonesia market, they will suffer four main risks which are credit risk, market risk, operational risk, and regulatory risk. Generally speaking, when a foreign owned bank steps into Indonesia, it often starts with few products. Chinese banks of Indonesia market are also like that. With the products of the Chinese banks increasing, the risks of the Chinese banks in Indonesia market are also becoming much more and higher. On one side, once a foreign bank enters into a new market, it must have time to know and be familiar with the environment and the customers there. On the other hand, different countries have different culture and the Chinese banks do not have honest customers there. Although there are many risks existed in the Chinese banks of Indonesia, it must have one or some main risk(s) when they develop their products in foreign market. Generally, one product of the bank has included more than one type of risk. Which type of risk is the main risk of Chinese banks in Indonesia?

1.4 Statement of Problem

Since the main purpose of this research is to identify the dominant risk of the Chinese banks in Indonesia, the following problem statement has been used to guide this research work:

What is the dominant risk(s) of the Chinese banks during they evolve business activities in Indonesia?
1.5 Research objective

The research objective is tending
1. to find out the dominant risk of Chinese banks in Indonesia market,
2. to analyze how these risks happen to the business activities of Chinese banks in Indonesia market,
3. to contribute for the development of Chinese banks in Indonesia market,
4. to keep a healthy growth of banking industry in Indonesia;
Furthermore, the researcher will give some suggestions to Chinese banks on solutions of reducing and avoiding these risks.

1.6 Significance of the study

The research is intended to give some contributions to several parties as follows:

1.6.1 For President University Committee

This research is about the study of main risk(s) of Chinese banks in Indonesia which I choose as my thesis topic to fulfill the satisfaction President University required usually. The research can show how to implement the class knowledge into real research and get meaningful findings. It also can provide some references to the following students of President University and help them make their thesis better.

1.6.2 For Banking Industry

This research is about the main risks analysis of Chinese banks in Indonesia. The research could give some suggestions to the Chinese banks of Indonesia market on the study of finding main risk(s). It could contribute some solutions of avoiding and eliminating the risks.
1.6.3 For Bank Indonesia
This research indirectly help Bank Indonesia make a research about the study of the main risks in business activities of Chinese banks in Indonesia. Through this research, Bank Indonesia could know clearly about the Indonesian Chinese bank and make a better supervisory.

1.6.4 For Indonesia Government
This research deals with the main risks of Chinese banks in Indonesia. It could give some suggestions to the government to find out the solutions of avoiding and eliminating risks in financial sector. The government could be liable to create better business environment, adopt favorable policies for foreign companies and attract more potential customers for the Chinese banks in Indonesia, to accelerate the development of Indonesia economy.

1.6.5 For the researcher
This research can enrich the knowledge of the researcher and it will make the researcher understand more about the risk management knowledge, banking knowledge, detail situation of Chinese banks in Indonesia market.

1.6.6 For the Students
This research contains the knowledge of risk management of banking industry, which could help students, especially, who want to get to know more about the current situation of Chinese banks in Indonesia. It will provide some references during the study of students who want to find some materials about this kind of knowledge.
1.7 Theoretical Framework

For this research, researcher would like to use theory of risk management theory and Basel Capital Accord to make a survey in the dominant risk of Chinese banks in Indonesia. According to the definition and the scale of foreign bank, only Bank of China Jakarta branch can be viewed as a Chinese bank. The PT. ICBC Indonesia is just a joint-venture bank at most. Therefore, the researcher made the research in Bank of China Jakarta Branch. According to Basel there are three biggest risks in banking sector which are Credit Risk, Market Risk and Operational Risk Because the Chinese banks run as a type of foreign-owned bank, it must follow the local regulation from all of the supervisory institution and department, such as Bank Indonesia, Indonesia Labor Department, Indonesia Investment Coordinating Board (BKPM), etc. The most institution BOC JKT branch communicates with is Bank Indonesia. If one of the indicators of BOC JKT branch cannot fulfill the requirement of BI, it will be punished. Therefore, BOC JKT branch see importantly to the compliance risk, i.e., regulatory risk which we often read in the book.
1.8 Scope and Limitation of the study

The research included some factors affecting the research to develop a broad and deep survey on finding the dominant risk of the business activities of Chinese banks in Indonesia. There are limitations as follows:

a) The research is only based on all of Chinese banks which are running in Indonesia market. Since there are not too many Chinese banks in Indonesia market, it cannot cover the risk situations of other Chinese banks which plan to enter into Indonesia market.

b) This research only includes four main factors that affect the business activities of Chinese banks in Indonesia market, and because the bank the researcher surveyed did not calculate other risk value, which makes the researcher cannot obtain enough data to analyze. It does not cover other factors of risks.
c) The research only made the research according to the business of Corporate banking of the bank, because the most businesses of the bank is controlled by this field, and the bank just has general banking service (not have too many products), which makes the researcher have limitation of survey.

1.9 Assumptions and Hypothesis

In this study, there are four hypotheses for analyzing the roles of the dominant risk(s) in business activities of Chinese banks in Indonesia, as followed:

a) $H_0$: The credit risk is the dominant risk in business activities of Chinese banks in Indonesia. $H_1$: The credit risk is not the dominant risk in business activities of Chinese banks in Indonesia.

b) $H_0$: The market risk is the dominant risk in business activities of Chinese banks in Indonesia. $H_1$: The market risk is not the dominant risk in business activities of Chinese banks in Indonesia.

c) $H_0$: The operational risk is the dominant risk in business activities of Chinese banks in Indonesia. $H_1$: The operational risk is not the dominant risk in business activities of Chinese banks in Indonesia.

d) $H_0$: The compliance risk is the dominant risk in business activities of Chinese banks in Indonesia. $H_1$: The compliance risk is not the dominant risk in business activities of Chinese banks in Indonesia.
1.10 Definition of the terms

1.10.1 Foreign Branch Bank

As a unit of financial firm grows larger in size it usually decides at some point to establish a branching organization, particularly if it serves a rapidly growing region and finds itself under pressure either to follow its business and household customers as they move into new locations or lose them to more conveniently located financial-service competitors. Branching organizations offer the full range of services from several locations, including a head office and one or more full-service branch offices. Such an organization is also likely to offer limited services through a supporting network of drive-in windows, ATMs, computers networked with the bank’s computers, point of sale terminals in stores and shopping centers, the Internet, and other advanced communications systems.

Senior management of a branching organization usually located at home office, though each full-service branch has its own management team with limited authority to make decisions on customer loan applications and other facets of daily operations. For example, a branch manager maybe authorized to approve a customer loan of up to $100,000. Larger loan requests, however, must be referred to home office for a final decision. Thus, some services and functions in a branching organization are highly centralized, whereas others are decentralized at the individual service facility level.

Foreign Branch Bank is a type of foreign owned bank that is obligated to follow the regulations of both the home and host countries. Because the foreign branch banks loan limits are based on the parent bank's capital, foreign banks can provide more loans than subsidiary banks. Banks often open a foreign branch in order to provide more services to their multinational corporation customers. However,

operating a foreign branch bank may be considerably complicated because of the
dual banking regulations that the foreign branch needs to follow. For example, suppose the Bank of America opens a foreign branch bank in Canada. The branch would be legally obligated to follow both Canadian and American banking regulations.

The Basle Committee of Supervisors has made a clear distinction between (1) branches, which have no separate legal status and are therefore integral parts of the parent bank, (2) subsidiaries, which are legally independent institutions owned by an entity incorporated abroad, and (3) joint ventures, which are legally independent institutions incorporated locally.

1.10.2 Joint Venture

A bank that is concerned about risk exposure in entering a foreign market, lacks the necessary expertise and customer contacts abroad, or wishes to offer services prohibited to banks alone may choose to enter into a joint venture with a foreign financial firm, sharing both profits and expenses.

A JV on a continuing basis is the normal business undertaking. It is similar to a business partnership with two differences: the first, a partnership generally involves an ongoing, long-term business relationship, whereas an equity-based JV comprises a single business activity. Second, all the partners have to agree to dissolve the partnership whereas a finite time has to lapse before it comes to an end (or is closed by the Court due to a dispute).

The term JV refers to the purpose of the entity and not to a type of entity. Therefore, a joint venture may be a corporation, a limited liability enterprise, a partnership or other legal structure, depending on a number of considerations such

as tax and tort liability.

JVs are normally formed both inside one's own country and between firms belonging to different countries. Within one, JVs usually combine different strengths in a field or are formed because of legal restrictions within a country; for example an insurance company cannot market its policies through a banking company. Some JVs are also formed because the law of a country allows dispute settlement, should it occur, in a third country. They are also formed to minimize business, tax and political risks. The JV is an alternative to the parent-subsidiary business partnership in emerging countries, discouraged, on account of (a) ignoring national objectives (b) slow-growth (c) parental control of funds and (d) disallowing competition.

JVs can be in the manufacture of goods, services, travel space, banking, insurance, web-hosting business, etc.

Today, the term 'JV' applies to more occasions than the choice of JV partners; for example, an individual normally cannot legally carry out business without finding a national partner to form a JV as in many Arab countries where it is mentioned that there are over 500 JVs in Saudi Arabia with Indians alone. Also, the JV may be an easier first-step to franchising, as McDonald's and other fast foods, found out in China in the early difficult stage of development.

1.10.3 Basel Accords

The Basel Accords refer to the banking supervision Accords (recommendations on banking laws and regulations), Basel I and II issued (and Basel III under development) by the Basel Committee on Banking Supervision (BCBS). They are called the Basel Accords as the BCBS maintains its secretariat at the Bank of

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International Settlements in Basel, Switzerland and the committee normally meets there.

1.10.4 Compliance Risk

Compliance Risk reaches beyond violations of the legal system and includes violations of rules and regulations. Compliance risk arises from an institution’s failure to enact appropriate policies, procedures, or controls to ensure it conforms to laws, regulations, contractual agreements, and other legally binding agreements and requirements. In particular, legal risks can result if a financial institution does not provide adequate attention to the operating circulars, procedures and rules of the payment and settlement systems in which it participates. Similarly, an institution’s contractual relationships with customers, counterparties, and vendors must be sound and appropriate to the relevant legal framework(s) such as payment and bankruptcy frameworks. Contracts, among financial institutions, their customers, and counterparties are also important to allocate risk-sharing responsibilities applicable to payments. Finally, an institution must ensure it is in compliance with all the regulations from supervisory institutions in host country.

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II LITERATURE REVIEW

2.1 Banks

2.1.1 Definition of Banks

In conducting Business, Banks collect funds from the society and transfer them back in a form of various alternative investments. Related with the function to collect funds, banks are often called trusted institutions. There are 3 types of banks, as the following:

a. Banks

Banks are commercial unit that collect funds from the society in a form of saving and transfer the funds back to the society in a form of credits and/or other forms in order to improve society living standards (Bulter, B., D Bulter, 1997, p10).

b. Public Banks

Public Banks are commercial units that conduct business conventionally and/or according to sharia principles in their activities to provide payment traffic services (Bulter, B., D Bulter, 1997, p12).

2.1.2 Classification of Bank

Bank had divided into 2 grouping bank forms (Fitch, Thomas, 1997, p20), as the following:

2.1.2.1 Based on functions:

a. Central bank

Central Bank is a bank with main function as banks’ supervisor and as monetary stabilization (Fitch, Thomas, 1997, p22).
b. Common bank
Common bank is a type of bank that operates in fund gathering, especially in accepted saving in form demand savings and deposits, also on giving a credit in short term or long term (Fitch, Thomas, 1997, p24).

c. Saving Bank
Saving Bank is a type of bank with main activity to accept the saving from the customers and makes loans (Fitch, Thomas, 1997, p26).

2.1.2.2 Based on ownership

1. Government bank/ state bank
Government bank/ state bank is a type of bank in which the ownership belongs to the government in forms of shares (Fitch, Thomas, 1997, p35). For examples: BNI, BRI, BTN and Bank Mandiri.

2. National Private Bank
National Private Bank is a type of a bank in which the ownership belongs to private institution and organization (Fitch, Thomas, 1997, p40). The national private bank is grouping into two forms, as the following:

a) Foreign exchange bank
Foreign Exchange Bank is a type of bank which is able to complete financial transactions in conducting international business, such as financial transactions export and import such as letter of credit (Fitch, Thomas, 1997, p45). For examples: Bank Bukopin, Bank BCA, Bank Danamon, Bank Niaga, Bank International Indonesia, etc.

b) Non foreign exchange bank
Non foreign exchange bank is a type of bank which is only engaging in domestic
financial transactions (Fitch, Thomas, 1997, p47). For examples: Bank Himpunan Saudara, Bank Harfa, Bank Index Selindo, Bank Eksekutif, etc.

3. Foreign Bank

Foreign bank is a type of bank which is owned by the multinational groups (Fitch, Thomas, 1997, p50). For example: Citibank, Bank ABN Amro, Deutsche Bank, Bank of Tokyo, etc.

2.1.3 Bank Goals

There are two bank goals, as the following:

1. Short term(Garcia,F.L, 1962, p34)
   a) Accomplish Bank’s minimum obligation of liquidity needs that had reported weekly on Bank Indonesia.
   b) Giving maximal services to investor(capitalist)
   c) Satisfying customers by extending excellent services
   
   Investing fund in securities

2. Long term(Garcia,F.L, 1962, p35)
   a) Achieve maximal profits
   b) Maximize company value

2.1.4 Common Bank Function and Activities

Common Bank as financial intermediate institution provides financial services, for both surplus unit and deficit unit (Woelfel,Charles J, 1994, p15). There are four common bank fundamental functions such as:

   a) Provide mechanism and payment tool more effectively on economy activity.
   b) Making money
   c) Assemble and distribute funds to society.
d) Offering the other financial services.

There are 15 forms (Woelfel, Charles J, 1994, p17), as the following:

1) Collecting fund from citizen
2) Giving a credit
3) Buying, selling, or for both guarantee self risk and interest, and investor order (capitalist order).
4) Move over money, for both owned interest and investor interest (capitalist interest)
5) Put loan, or lending fund to/from/for the other bank; both using a letter, telecommunication facility and notes receivable, cheque, or other facilities.
6) Receive a payment from marketable securities billings, and evaluating by or evaluation among third sides.
7) Provide a place to safe goods and marketable securities.
8) Carry out entrusted activity for other sides according to contract.
9) Placing fund in form of marketable securities that have not stated in stock exchange
10) Buy through a guarantee auction, both entirely or half of it on debtor who had not fulfilled their obligation in bank, with guarantee decision that bought is obliged to liquefy immediately.
11) Doing factoring activities, credit card and trusteeship delegated activities.
12) Provide expenses with profit divided capital.
13) Doing other activities, such as foreign currency; doing capital
14) Participation on bank or to other companies in financial field; such as leasing, venture capital, stock company, and assurance and doing temporary capital participation to overcome credit failure cause.
15) Other activities as usual carried out by the bank as long as it is not against the law.
2.1.5 Bank Fund Management

2.1.5.1 The definition of Bank Funds Management

Bank funds management is a process of the managed society funds union allocation in bank, and usually it is for bank and society interest, also a maximized fostering through entire resources movements that provided to accomplish a sufficient rent ability level adjusted with a valid law decision boundary (Edwards, Burt, editor. Credit Management Handbook. Aldershot, UK; Gower, 1997, p55).

From the definition above, there are four core activities related to bank fund management which are:

a) Entire bank activities in society funds union
b) Bank activities to maintain citizen trustworthy with cash provided for preserve and society interest saving.
c) Funds’ placing on credit is useful as society money needs services labor in other forms, both long term and short term for rent ability interest.
d) Bank capital is managed as usual function as its role as activity movement.

2.1.5.2 Bank Funds Sources

Funds play important role to accomplish bank’s goal. Without fund or lack of fund the bank cannot do anything or less importance for economics. In some cases, lack of funds that faced by bank will create problem for national condition such as monetary crisis in 1998.

The cash that both are owned by the bank does not come from the bank itself, but it may from someone else. That money will be withdrawn back in certain time either in full amount or partial amount. (Edwards, Burt, editor. Credit Management Handbook. Aldershot, UK; Gower, 1997, p65)

There are three fund sources for a bank (Edwards, Burt, editor. Credit Management Handbook. Aldershot, UK; Gower, 1997, p70), as the followings:
1. Funds from self capital (Funds from the first side)

The funds come from bank stockholders, such as bank owners. The funds are divided into 3 parts, as the following:

a) Paid in capital

The paid in capital means the total amount of money injected into the company by its stockholders at the time that bank is established.

b) Reserves

Reserves mean that half of the bank profits had been detached into a capital stock and other stocks that had been used to cover the existing risk in the future.

c) Retained Earnings

Retained earnings may be put into working capital instead of dividend payouts.

2. Loan fund from outside

The bank may borrow from other parties.

a) Loans from other banks (call money)

Usually this loan from the other bank (call money) had been asked if there are urging needs. The time period of this call money is usually not a long time, just about one month and even a few months only. Sometimes there is someone who holds this calls money just one night; therefore it is called as overnight call money.

b) Loans from bank or the other financial institution in foreign country

Usually this loan formed as middle term loans or even long term loans. This realization of this loan must meet the requirements of Bank Indonesia in order to keep the solvability of the bank.

c) Loans from non-bank financial institution (Loans from LKBB)
Sometimes this loan is not really formed as loans or credits, but it seems to be like marketable securities that can be bought and sold before maturity date.

d) Loans from central bank (Loan from Bank Indonesia)
The common bank can borrow from central bank (Bank Indonesia) if there is lack of liquidity in order to survive.

3. Funds from citizens/TPF (Third Party Fund)
The funds from citizens are known as the main source of funds that can be collected. That is why all the banks compete to influence citizens to save their money in a bank. The fund can be divided into 3 types as follows:

a) Demand deposit
Demand deposit is the kind of deposit that can be withdrawn anytime by the depositor.

b) Time deposit
Time deposit is the kind of deposit that can only be withdrawn when the time period is expired.

c) Saving
Savings account is daily transaction of an individual to put in and withdraw money as and when he likes, interest not being the main criterion (cited in http://in.answers.yahoo.com).

2.2 Basel Accords

2.2.1 Basel I
Basel I is the round of deliberations by central bankers from around the world, and in 1988, the Basel Committee (BCBS) in Basel, Switzerland, published a set
of minimal capital requirements for banks. This is also known as the 1988 Basel Accord, and was enforced by law in the G10 countries in 1992. Basel I is now widely viewed as outmoded. Indeed, the world has changed as financial conglomerates, financial innovation and risk management have developed. Therefore, a more comprehensive set of guidelines, known as Basel II are in the process of implementation by several countries (cited in http://en.wikipedia.org/wiki/Basel_I).

2.2.1.1 Main framework

The original Basel capital standards are known today as Basel I. Under the terms of Basel I, the various sources of capital were divided into two tiers:

Tier1 (Core) Capital includes common stock and surplus, undivided profits (retained earnings), qualifying noncumulative perpetual preferred stock, minority interest in the equity accounts of consolidated subsidiaries, and selected identifiable intangible assets less goodwill and other intangible assets.

Tier2 (Supplemental) Capital includes the allowance (reserves) for loan and lease losses, subordinated debt capital instruments, mandatory convertible debt, intermediate-term preferred stock, cumulative perpetual preferred stock with unpaid dividends, and equity notes and other long-term capital instruments that combine both debt and equity features.

To determine each bank’s total regulatory capital, regulators must deduct from the sum of Tier1 and Tier2 capital several additional items, including investments in unconsolidated subsidiaries, capital securities held by the bank that were issued by other depository institutions and are held under a reciprocity agreement, activities pursued by savings and loan associations that may have been acquired by a banking organization but are not permissible for national banks, and any other deductions that regulatory supervisors may demand.
Basel I stipulated that for a bank to qualify as adequately capitalized it must have:

1. A ratio of core capital (Tier1) to total risk-weighted assets of at least 4 percent.
2. A ratio of total capital (the sum of Tier1 and Tier2 capital) to total risk-weighted assets of at least 8 percent, with the amount of Tier 2 capital limited to 100 percent of Tier 1 capital (Peter S. Rose & Sylvia C. Hudgins (2010). Bank Management & Financial Services, 8th Edition. New York: McGraw-Hill Education, P488).

2.2.2 Basel II

Basel II is the second of the Basel Accords, which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. The purpose of Basel II, which was initially published in June 2004, is to create an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks banks face. Advocates of Basel II believe that such an international standard can help protect the international financial system from the types of problems that might arise should a major bank or a series of banks collapse. In practice, Basel II attempts to accomplish this by setting up rigorous risk and capital management requirements designed to ensure that a bank holds capital reserves appropriate to the risk the bank exposes itself to through its lending and investment practices. Generally speaking, these rules mean that the greater risk to which the bank is exposed, the greater the amount of capital the bank needs to hold to safeguard its solvency and overall economic stability (Peter S. Rose & Sylvia C. Hudgins (2010). Bank Management & Financial Services, 8th Edition. New York: McGraw-Hill Education, P496).
2.2.2.1 Objective

1. Ensuring that capital allocation is more risk sensitive;
2. Separating operational risk from credit risk, and quantifying both;
3. Attempting to align economic and regulatory capital more closely to reduce the scope for regulatory arbitrage.

2.2.2.2 Pillars of Basel II

The three “pillars” of Basel II are:

(1) Minimum capital requirements for each bank are based on its own estimated risk exposure from credit, market, and operational risks.

(2) Supervisory review of each bank’s risk-assessment procedures and the adequacy of its capital will be done to ensure they are “reasonable.”


Measurement Approach of related Risks involved in BASEL

The first pillar deals with maintenance of regulatory capital calculated for three major components of risk that a bank faces: credit risk, operational risk, and market risk. Other risks are not considered fully quantifiable at this stage.

The credit risk component can be calculated in three different ways of varying degree of sophistication, namely standardized approach, Foundation IRB and Advanced IRB. IRB stands for "Internal Rating-Based Approach".

For operational risk, there are three different approaches - basic indicator approach or BIA, standardized approach or TSA, and the internal measurement
approach (an advanced form of which is the advanced measurement approach).

For market risk the preferred approach is VaR (value at risk).

As the Basel 2 recommendations are phased in by the banking industry it will move from standardized requirements to more refined and specific requirements that have been developed for each risk category by each individual bank. The upside for banks that do develop their own bespoke risk measurement systems is that they will be rewarded with potentially lower risk capital requirements. In future there will be closer links between the concepts of economic profit and regulatory capital.

Credit Risk can be calculated by using one of three approaches:

1. Standardized Approach

2. Foundation IRB (Internal Ratings Based) Approach

3. Advanced IRB Approach


Compliance Risk can be calculated by the standard of local supervisory institution. For example, In BOC JKT branch, if the supervisory report required by Bank Indonesia is not submitted on time, it will be imposed penalty. Thus, the bank will calculate based on previous experience, it will pull some potential economic capital out as the special compliance risk capital to cover the potential loss (cited in Circular Letter of Bank Indonesia No: 9/ 30 /DPNP Dated December 2007).
2.3 Risk Management

2.3.1 Risk
Risk to the manager of financial institution or to a regulator supervising financial institutions means the perceived uncertainty associated with a particular event. For example, will the customer renew his or her loan? Will deposits and other sources of funds grow next month? Will the financial firm’s stock price rise and its earnings increase? Are interest rates going to rise or fall next week, and will a financial institution lose income or value if they do?

Bankers, for example, are usually interested in achieving high stock values and high profitability, but none can fail to pay attention to the risks they are accepting to achieve these goals. Earnings may decline unexpectedly due to factors inside or outside the financial firm, such as changes in economic conditions, competition, or laws and regulations. For example, recent increases in completion have tended to narrow the spread between earnings on assets and the cost of raising funds. Thus, stockholders always face the possibility of a decline in their earnings per share of stock, which could cause the bank’s stock price to fall, eroding its resources for future growth (Peter S. Rose & Sylvia C. Hudgins (2010). Bank Management & Financial Services, 8th Edition. New York: McGraw-Hill Education, P181).

2.3.2 Types of Risk
Risk can be broken down into a number of components and even referenced using different terms as illustrated by the different risk matrices used currently by U.S. federal regulatory agencies and summarized in the table below (Peter S. Rose & Sylvia C. Hudgins (2010). Bank Management & Financial Services, 8th Edition. New York: McGraw-Hill Education, P182).
Table 2.1 Risk Matrices Used by Selected U.S. Regulatory Agencies

<table>
<thead>
<tr>
<th>Federal Reserve System</th>
<th>Comptroller of the Currency</th>
<th>National Credit Union Administration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit</td>
<td>Credit</td>
<td>Credit</td>
</tr>
<tr>
<td>Liquidity</td>
<td>Liquidity</td>
<td>Liquidity</td>
</tr>
<tr>
<td>Market</td>
<td>Interest Rate</td>
<td>Interest Rate</td>
</tr>
<tr>
<td>Operational</td>
<td>Transactional</td>
<td>Transactional</td>
</tr>
<tr>
<td>Legal</td>
<td>Compliance</td>
<td>Compliance</td>
</tr>
<tr>
<td>Reputation</td>
<td>Reputation</td>
<td>Reputation</td>
</tr>
<tr>
<td></td>
<td>Strategic</td>
<td>Strategic</td>
</tr>
</tbody>
</table>

However, in Bank of China Jakarta Branch, the Risk Management Committee accepted to use Credit, Market, Operational, Liquidity, Legal, Strategic, Reputation and Compliance risk as the daily risk which they should avoid, reduce, and share with other parties together.

Each of these forms of risk can threaten a financial firm’s day-to-day performance and its long-run survival. Let’s examine several of the most important types of risk encountered daily by financial institutions.

1. Credit Risk

Credit Risk is the probability that some of a financial institution’s assets, especially its loans, will decline in value and perhaps become worthless is known as credit risk. Because financial firms tend to hold little owners’ capital relative to the aggregate value of their assets, only a small percentage of total loans need to turn bad to push them to the brink of failure (Peter S. Rose & Sylvia C. Hudgins
2. Market Risk

In market-oriented economies, where most of the world’s leading financial institution offer their services today, the market values of assets, liabilities, and net worth of financial service providers are constantly in a state of flux due to uncertainties concerning market rates or prices. Market risk is composed of both price risk and interest rate risk.


Interest Rate Risk: Movements in market interest rate can also have potent effects on the margin of revenues over costs for both banks and their competitors. For example, rising interest rate can lower the margin of profit if the structure of a financial institution’s assets and liabilities is such that interest expenses on borrowed money increase more rapidly than interest revenues on loans and security investments.


3. Operational Risk

Operational risk refers to uncertainty regarding a financial firm’s earnings due to failures in computer systems, errors, misconduct by employees, floods, lightning
strikes, and similar events. The board group of actions included in this risk definition often decrease earnings due to unexpected operating expenses. Some analysts say that operational risk is the risk of loss due to anything other than credit or market risk. Others say it includes legal and compliance risk, but not reputation or strategic risk. The consolidation and convergence of financial firms and the complexity of today’s financial-services technology has made operational risk a broad risk category that needs to be addressed by both managers of financial firms and government regulators (Peter S. Rose & Sylvia C. Hudgins (2010). Bank Management & Financial Services, 8th Edition. New York: McGraw-Hill Education, P185).

4. Compliance Risk


2.3.3 Risk Management

Risk management is the process by which manages satisfy needs by identify key risks, obtaining consistent, understandable, operational risk measures, choosing which risks to reduce and which to increase any by what means, and establishing procedures to monitor the resulting risk position (David H. Pyle 1997, Bank Risk Management: Theory, P.4).

The risks contained in the bank's principal activities, i.e., those involving its own balance sheet and its basic business of lending and borrowing, are not all borne by the bank itself. In many instances the institution will eliminate or mitigate the financial risk associated with a transaction by proper business practices; in others,
it will shift the risk to other parties through a combination of pricing and product design. The banking industry recognizes that an institution need not engage in business in a manner that unnecessarily imposes risk upon it; nor should it absorb risk that can be efficiently transferred to other participants. Rather, it should only manage risks at the firm level that are more efficiently managed there than by the market itself or by their owners in their own portfolios. In short, it should accept only those risks that are uniquely a part of the bank's array of services. Elsewhere, Oldfield and Santomero (1995), it has been argued that risks facing all financial institutions can be segmented into three separable types, from a management perspective. These are:

(i) risks that can be eliminated or avoided by simple business practices,

(ii) risks that can be transferred to other participants, and

(iii) risks that must be actively managed at the firm level.

In the first of these cases, the practice of risk avoidance involves actions to reduce the chances of idiosyncratic losses from standard banking activity by eliminating risks that are superfluous to the institution's business purpose. Common risk avoidance practices here include at least three types of actions. The standardization of process, contracts and procedures to prevent inefficient or incorrect financial decisions is the first of these. The construction of portfolios that benefit from diversification across borrowers and that reduce the effects of any one loss experience is another. Finally, the implementation of incentive-compatible contracts with the institution's management to require that employees be held accountable is the third. In each case the goal is to rid the firm of risks that are not essential to the financial service provided, or to absorb only an optimal quantity of a particular kind of risk.

There are also some risks that can be eliminated, or at least substantially reduced
through the technique of risk transfer. Markets exist for many of the risks borne by the banking firm. Interest rate risk can be transferred by interest rate products such as swaps or other derivatives. Borrowing terms can be altered to effect a change in their duration. Finally, the bank can buy or sell financial claims to diversify or concentrate the risks that result in from servicing its client base. To the extent that the financial risks of the assets created by the firm are understood by the market, these assets can be sold at their fair value. Unless the institution has a comparative advantage in managing the attendant risk and/or a desire for the embedded risk they contain, there is no reason for the bank to absorb such risks, rather than transfer them. However, there are two classes of assets or activities where the risk inherent in the activity must and should be absorbed at the bank level. In these cases, good reasons exist for using firm resources to manage bank level risk. The first of these includes financial assets or activities where the nature of the embedded risk may be complex and difficult to communicate to third parties. This is the case when the bank holds complex and proprietary assets that have thin, if not non-existent, secondary markets. Communication in such cases may be more difficult or expensive than hedging the underlying risk. Moreover, revealing information about the customer may give competitors an undue advantage. The second case included proprietary positions that are accepted because of their risks, and their expected return. Credit risk inherent in the lending activity is a clear case in point, as is market risk for the trading desk of banks active in certain markets. In all such circumstances, risk is absorbed and needs to be monitored and managed efficiently by the institution. Only then will the firm systematically achieve its financial performance goal (David H. Pyle 1997, Bank Risk Management: Theory, P.8).
2.4 Economic Capital Theory

2.4.1 Definition of Economic Capital Theory

Economic Capital also called Risk Capital. In finance, mainly for financial services firms, economic capital is the amount of risk capital, assessed on a realistic basis, which a firm requires to cover the risks that it is running or collecting as a going concern, such as market risk, credit risk, and operational risk, etc. It is the amount of money which is needed to secure survival in a worst case scenario. Firms and financial services regulators should then aim to hold risk capital of an amount equal to economic capital (Basel Accords & http://en.wikipedia.org/wiki/Economic_capital).

2.4.2 Measurement of Economic Capital

Typically, economic capital is calculated by determining the amount of capital that the firm needs to ensure that its realistic balance sheet stays solvent over a certain time period with a pre-specified probability. Simply saying, it equals the accumulated amount of unexpected loss of all kinds of risk capital. Therefore, economic capital is often calculated as value at risk. The balance sheet, in this case, would be prepared showing market value (rather than book value) of assets and liabilities (http://en.wikipedia.org/wiki/Economic_capital).

The first accounts of economic capital date back to the ancient Phoenicians, who took rudimentary tallies of frequency and severity of illnesses among rural farmers to gain an intuition of expected losses in productivity. These calculations were advanced by correlations to predictions of climate change, political outbreak, and birth rate change (http://en.wikipedia.org/wiki/Economic_capital).

The concept of economic capital differs from regulatory capital in the sense that regulatory capital is the mandatory capital the regulators require to be maintained while economic capital is the best estimate of required capital that financial institutions use internally to manage their own risk and to allocate the cost of
maintaining regulatory capital among different units within the organization (http://en.wikipedia.org/wiki/Economic_capital).
III  RESEARCH METHODOLOGY

3.1 Research Method

This study is using quantitative research. Quantitative research is the systematic scientific investigation of properties and phenomena and their relationships. The objective of quantitative research is to develop and employ mathematical models, theories and/or hypotheses pertaining to natural phenomena. The process of measurement is central to quantitative research because it provides the fundamental connection between empirical observation and mathematical expression of quantitative relationships (Creswell, 1994). Quantitative research is generally approached using scientific methods.

Moreover, quantitative research is a formal, objective, systematic process in which numerical data are utilized to obtain information about the world (Burns and Grove cited by Cormack, 1991, p140).

Simply speaking, quantitative research uses data to find the factors that affecting the problem defined by the researcher and how each factor affects the problem. It is a very controlled, exact approach to research. In this study, the researcher collected the numerical data by interviewing related department employees of the company surveyed in. From the data, the research processed, made a statistic and got results. The results would be used to analyze what is the dominant risk(s) in the business activities of BOC JKT branch in Indonesia.

Most of statistical information in internal database of Bank of China Jakarta Branch consists of data that are summarized and presented in a form, which is easy to understand. In order to describe deeply and in detail, the research is using descriptive analysis. The result of the statistic will be explained in Chapter IV.
3.2 Research Framework

The research is focusing on the level of significance to each risk in business activities. The researcher studied the contribution of each risk to the unexpected loss of the bank every month in latest 3 years. Based on Basel Accord, there are three main risks (Credit Risk, Market risk, Operational Risk) in a commercial bank; because the research subject is a foreign branch bank, a form of foreign-owned bank, Bank of China Jakarta Branch, it had to consider the Compliance Risk more into daily business activities.

Therefore, the research framework as below:

![Image of research framework]

**Figure 3.1 Research Framework**

- **Independent Variable**
  Each Unexpected Loss of:
  - Credit Risk (x1)
  - Market Risk (x2)
  - Operational Risk (x3)
  - Compliance Risk (x4)

- **Dependent Variable**
  Total Unexpected Loss caused by risk(y)
3.3 Research Time and Place

The research is conducted in Bank of China Jakarta Branch, with time range of monthly data from January 2007 to December 2009. In total, the employed monthly data used are 36 items.

3.4 Research Instruments

3.4.1 Data Collection

Secondary data is a type of data that had been collected for a certain objective. It means the data or information from the existing sources. There are two types of secondary data: qualitative and quantitative data. The data could be in form of raw data material which will need a certain processing to be clear enough to be summarized, or complied data that have been received some form of selection of summarizing (Saunders et al. 2003). In this context, the data used are secondary raw data, as the data has been obtained from result of studies done by others, but it still need further processing in order to fit this research. For example, the employee of related department calculated the (Economic Capital) risk capital value based on each business activity of the entire bank, but not the sum of risk value. It is imperative and coverable to put each raw data sum together to see the whole risk value of the entire bank.

3.4.2 Data processing

The data processing tools used to test the hypothesis are Microsoft Excel and SPSS version 16 application software. The software are very important since both are relatively easy to operate, especially SPSS, which will process more complicated data directly into result, such as regression model, correlation, and coefficient, etc..
3.5 Testing the Hypothesis and Data analysis

3.5.1 Classic Assumption Tests

3.5.1.1 Normality test

Normality test is used to examine whether the data is distributed normally. Normality test can be measured from several ways such as plot spread data and also statistical test such as: Chi-square, Kolmogorov-Smirnov, Lifefors and Shapiro Wilk. This test needed to make sure that the data used distributed normally, means also it is free from classic test.

3.5.1.2 Multicollinearity Test

Multicollinearity is the correlation among the independent variables. In some cases, multiple regression results may seem paradoxical. Even though the overall P value is very low, all of the individual P values are high. This means that the model fits the data well, even though none of the X variables has a statistically significant impact on predicting Y. This is possible when two X variables are high correlated; they both convey essentially the same information. In this case, neither may contribute significantly to the model after the other one is included. However, together they contribute a lot. If multicollinearity is present in a multiple regression model, the model is still good for prediction, but interpretation of individual coefficient is not valid.

In order to discover if there is relationship among independent variable, the test is using tolerance (T) and variance inflation factor (VIF) value. For Multicollinearity, VIF should be greater than 0.1 and less than 10. If the test meets these criteria meaning that your data is not facing multicollinearity.

3.5.2 Testing the Hypothesis

To determine if there is a linear relationship between X and Y, a statistical test (F-Test and T-test) is performed. The null hypothesis is that there is no linear
relationship between the two variables (i.e., $\beta=0$), and the alternative hypothesis is that there is a linear relationship (i.e., $\beta \neq 0$). If the null hypothesis can be rejected, then we have proven that a linear relationship does exist.

### 3.5.2.1 F-test

F test is used to see whether the variables are independent collectively can affect dependent variable. It determines the significant correlation between variables.

To accept or refuse the hypothesis it depends on the value of the significance. If the significant F less than alpha ($\alpha$), which has been decided that is 0.05 thus the $H_0$ is accepted. It means simultaneously all the independent variables influence significantly towards the dependent variable. In contrary, if the significant F > $\alpha$ (a=0.05), thus $H_1$ is accepted, means that simultaneously all independents variables has no significant influence towards the dependent variable.

### 3.5.2.2 T-test

The researcher uses t test to see the influence of each independent variable in regression model towards the dependent variable, in comparing value of significant t each independent variable with significant standard $\alpha=0.05$.

Hypothesis: If significance t < 0.05, accept $H_0$; If significance t > 0.05, reject $H_0$.

### 3.6 Limitations

The limitations in conducting the research are primary due to the time constraints and accessibility to the books as the groundwork for the theoretical analysis. The time given to finish the investigation was considered insufficient. This condition probably made the expected quality of research could not be achieved, as it should be. The difficulties in finding books and other references in researcher’s campus library had also been an important matter. It was costly since the researcher had to go to other campus libraries and research centers which provide more literatures needed to support the research.
IV ANALYSIS AND INTERPRETATION OF DATA

This part is an extensive report of the results of the research. Researcher presents here a full analysis of the data gathered. To analyze the data gathered from respondents, the researcher has used the methods such as descriptive statistics, multiple regressions to find out the dominant risk(s) that affect the business activities of Chinese banks in Indonesia market.

4.1 Classic Assumption Test Results

Classic test is a test that should be performed before hypothesis test executed. This test performed in importance to make sure that the regression model tested was free from classic assumptions. In another world, if the regression model tested wasn’t free from classic assumptions, so the model used fails to meet the purpose of prediction. In this research, the writer used three kinds of classic test to make sure that the model used properly to perform hypothesis test.

There are normality test, autocorrelation test and multicollinearity test which will test the data and make sense the research. The regression model will show how the relationship between each independent variable and dependent variables.
4.1.1 Normality Test

Figure 4.1 Histogram Picture SPSS Result

Normality test can be measured from several ways such as plot spread data and statistical test such as: Chi-square, Kolmogorov-Smirnov, Liliefors and Shapiro Wilk. For this research, the writer used normal plot spread data can be measured from figure 4.1 above.

According to figure 4.1, histogram output shows that the existing data spread has spread to all normal curve area. It can be concluded that this data has normal distribution. Besides, the second way is looking at P-P Plot normal output picture.
Based on P-P Plot normal output of figure 4.2, it can be discovered that the data spread has spreading to entire area and around the line and not on the line. It means that the data is normally distributed.

From the Plot, there are several points which are around the line, based on the theory of the statistician, this indicates that the data is normality distributed and if the disperse points are not around the line, for example, the points form a linear line, it will indicate that the data is normally distributed.
The normality test is the pre-requisite of the quantitative analysis and precondition of making the analysis of the data.

### 4.1.2 Multicollinearity Test

<table>
<thead>
<tr>
<th>Model</th>
<th>Collinearity Statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Tolerance</td>
</tr>
<tr>
<td>Creditx1</td>
<td>.517</td>
</tr>
<tr>
<td>Marketx2</td>
<td>.664</td>
</tr>
<tr>
<td>Operationalx3</td>
<td>.409</td>
</tr>
<tr>
<td>Compliancex4</td>
<td>.319</td>
</tr>
</tbody>
</table>

To discover if there is relationship among independent variable. The test is using tolerance and variance inflation factor (VIF) value. For Multicollinearity, VIF should be greater than 0.1 and less than 10. If the test meets these criteria meaning that your data is not facing multicollinearity.

From the table above (Table 4.1), all the independent variables show that the VIF values are greater than 0.1 but less than 10. So the researcher can conclude that the data is not facing multicollinearity.

### 4.2 Hypothesis Testing Analysis

#### 4.2.1 F-test

By using F test, researcher wants to find out whether independent variable is independent collectively that can influence dependent variables. In order to find result, researcher used SPSS 16.0, and get result as Table 4.2:
### Table 4.2 ANOVA

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Regression</td>
<td>725554222932.327</td>
<td>4</td>
<td>18138555733.082</td>
<td>23.261</td>
<td>.000(a)</td>
</tr>
<tr>
<td>Residual</td>
<td>241737402861.229</td>
<td>31</td>
<td>7797980737.459</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>967291625793.556</td>
<td>35</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

From the table above (Table 4.2), it shows that the F Test (Simultaneous Significance Test) of the regression model is 23.261 (F calculation) and the significance is 0.000. As a rule of thumb, because this significance F (0.000) is lower than 0.01, it can be concluded that all the independent variables collectively have highly significant influence towards the dependent variable simultaneously. The regression model is suitable for the data and can be used to draw conclusion about the research problems identified in Chapter 1.

#### 4.2.2 T-test

By using T test, the researcher wants to find out how each independent variable influence the dependent variable. In order to find out the result, researcher used SPSS 16.0, and get result as Table 4.3:

### Table 4.3 Coefficients of Significance

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
</tr>
<tr>
<td>1 (Constant)</td>
<td>-1055838.739</td>
<td>299291.647</td>
<td></td>
<td>-3.528</td>
</tr>
<tr>
<td>Creditx1</td>
<td>2.243</td>
<td>1.677</td>
<td>.167</td>
<td>1.338</td>
</tr>
<tr>
<td>Marketx2</td>
<td>1.731</td>
<td>1.614</td>
<td>.118</td>
<td>1.073</td>
</tr>
<tr>
<td>Operationalx3</td>
<td>4.133</td>
<td>1.577</td>
<td>.368</td>
<td>2.620</td>
</tr>
<tr>
<td>Compliancex4</td>
<td>4.305</td>
<td>1.850</td>
<td>.370</td>
<td>2.327</td>
</tr>
</tbody>
</table>

From the table above (Table 4.3), it shows that Credit Risk (x1) is not statistically significant toward the dominant risk of business activities of Chinese banks in Indonesia market, because the value of significant t test (0.191) is higher than 0.05. Therefore, the first hypothesis (H0) should be rejected.
Market Risk (x2) is not statistically significant toward the dominant risk of business activities of Chinese banks in Indonesia market, because the value of significant t test (0.292) is higher than 0.05. So the second hypothesis (H0) should be rejected.

Operational Risk (x3) is statistically significant toward the dominant risk of business activities of Chinese banks in Indonesia market; because the value of significant t test (0.013) is lower than 0.05. So the third hypothesis (H0) should be accepted.

Compliance Risk (x4) is statistically significant toward the dominant risk of business activities of Chinese banks in Indonesia market; because the value of significant t test (0.027) is lower than 0.05. So the forth hypothesis (H0) should be accepted.

### 4.2.3 Regression Model Result

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
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<td></td>
<td></td>
</tr>
<tr>
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<td>1.677</td>
<td>.167</td>
<td></td>
</tr>
<tr>
<td>Marketx2</td>
<td>1.731</td>
<td>1.614</td>
<td>.118</td>
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</tr>
<tr>
<td>Operationalx3</td>
<td>4.133</td>
<td>1.577</td>
<td>.368</td>
<td></td>
</tr>
<tr>
<td>Compliancex4</td>
<td>4.305</td>
<td>1.850</td>
<td>.370</td>
<td></td>
</tr>
</tbody>
</table>

According to data analysis method, the equation is as follows:

\[ Y = -1055838.739 + 2.243 \times x1 \text{ (Credit Risk)} + 1.731 \times x2 \text{ (Market Risk)} + 4.133 \times x3 \text{ (Operational Risk)} + 4.305 \times x4 \text{ (Compliance Risk)} \]

The regression direction coefficient of x1 variable (Credit Risk) is b1 (2.243), which means that the direction between Credit Risk and the Unexpected Loss is
positive, when Credit Risk increases, the Unexpected Loss of Chinese bank will become higher.

The regression direction coefficient of $x_2$ variable (Market Risk) is $b_2$ (1.731), which means that the direction between Market Risk and the Unexpected Loss is positive, when Market Risk increases, the Unexpected Loss of Chinese bank will become higher.

The regression direction coefficient of $x_3$ variable (Operational Risk) is $b_1$ (4.133), which means that the direction between Operational Risk and the Unexpected Loss is positive, when Operational risk increases, the Unexpected Loss of Chinese bank will become higher.

The regression direction coefficient of $x_4$ variable (Credit Risk) is $b_1$ (4.305), which means that the direction between Compliance Risk and the Unexpected Loss is positive, when credit risk increases, the Unexpected Loss of Chinese bank will become higher.

4.3 Implication of the result

The implication from this study as the following:

According to partial test (T test) result, Operational Risk variable affects the unexpected loss of Chinese bank significantly and it is the dominant risk in business activities of Chinese banks in Indonesia market. The relationship between both is positive. In the other words, if the Operational Risk increases, the unexpected loss of Chinese banks will become bigger. Operational Risk often relates with other risks, such as variables listed, Credit Risk, Market Risk, and Compliance Risk. Besides, other risks like Liquidity, Strategic, Reputation and
Transaction, etc. All of these risks could be related with the dominant risk of this research. It might cause big loss for the bank, where something people cannot predict or presume.

From the T test, we can see that Credit Risk variable is not significant to the unexpected loss, however, the coefficient of Credit Risk is positive with Y (unexpected loss) and it is logistically. Meanwhile, according to Basel Accords, it is one of the most important risks, which are credit risk, market risk and operational risk. Therefore, the banks, especially for the commercial banks having more credit businesses must care about this type of risk.

For the market risk, the result is also practical, match for the status of the bank. From the overview of Indonesia business environment, and the stability of the banking sector, there is no fluctuation whatever in interest rate, foreign exchange rate and stock price, etc. Although it is not significant to unexpected loss of Bank of China Jakarta Branch, the bank cannot ignore it as well.

For the compliance risk, it presents the data of independent variable is significant to dependent variable, which means the bank the researcher studied is still risky on obeying the rules published by Bank Indonesia. Bank of China Jakarta Branch is a foreign branch of Bank of China, ltd., it must comply and abide with the regulations adopted by both sides, which are from home country and host country. Therefore, this type of risk is much more important for a foreign bank to master and operate it better.
V CONCLUSIONS AND RECOMMENDATIONS

5.1 Conclusions

This research is done to investigate the significant influence of four factors that affect the dominant risk of Chinese bank’s business activities in Indonesia market. There are four independent variables which are Credit Risk, Market Risk, Operational Risk and Compliance Risk. The dependent variable is Unexpected Loss which is used to measure the Economic Capital (Risk Capital) in the point view of banks.

There are several conclusions that can be taken from this research:

Operational Risk (x3) is the dominant risk that affects the business activities of Chinese banks in Indonesia market in this research. When conducting the business to other parties, the Chinese banks always face most operational risk comparing to other risk categories; when employees or systems operate internally in the bank, it also faces operational risk, which often happen irregularly. Nowadays, more and more banks, not only Chinese banks of Indonesia market, but also Chinese banks of Chinese market, attached great importance to this type of risk. In addition, some specialists said Operational Risk had become the main risk in commercial banks. The hypothesis (H1) that “The operational risk is not the dominant risk in business activities of Chinese banks in Indonesia” is rejected from the regression model; the beta coefficient is the highest with positive relationship.

Credit Risk (x1) is also one of the main risks among the business activities of Chinese banks in Indonesia market in this research but the effect is not as high as Operational risk. Credit risk often occurs when the third party has the debt obligation with the banks. Because crediting products are the basic and general affairs of the banks, it often comes up with the businesses increasing. Although it
is not the dominant factor variable in this research, it cannot prove that it does not affect the increase of the whole risks; meanwhile, the beta coefficient of credit risk is also positive toward the unexpected loss from the data and the bank cannot ignore it as well.

Market Risk (x2) is also one of the main risks among the business activities of Chinese banks in Indonesia market in this research. As we all know, market risk is everywhere. None can predict accurately about the market information and what will happen next. It must have impact on Chinese bank more or less in Indonesia market. Especially for a foreign owned bank. For example, none knows what will happen to the Indonesia economic environment and whether the IDR go to appreciate or depreciate. Moreover, the regression model got the result that the beta coefficient of market risk is positive toward the unexpected loss from the data and the bank cannot ignore it as well.

Compliance Risk (x4) is also one of the main risks among the business activities of Chinese banks in Indonesia market in this research. Compliance Risk which is similar with regulatory risk and legal risk occurs under the supervisory from the supervisory institution of host country. The supervisory is often useful and helpful to the banks usually for running legally and complying with their regulations. However, it often meets the conflict when issuing products, because of the differences between the regulations of two countries (home country and host country). Therefore, sometimes it might cause loss to the bank especially for the foreign owned banks. Moreover, the result from regression model shows that the coefficient of compliance risk is positive toward the unexpected loss from the data and the bank cannot ignore it as well.
5.2 Recommendations

For students, it is very important to know that risk is everywhere, although you might not meet the risks banks faced, you must learn how to recognize them which are around yourself and manage them well. Therefore, students must learn more knowledge about the risk and something related, in order to help them know how to avoid, reduce, and transfer risks to the third parties better.

For banking institution, when there are more businesses come to you, it means the risks of bank itself are increasing. Then, if the risks present out, the banks maybe cause losses. Therefore, the banks must have sound mechanism for risk management, and set up risk management committee to supervise the risk period.

In case of other risks from the external, the banks must build up better relationship with local supervisory institutions and obey the rules strictly. Thus, the banks have sound system no matter from internal or from external; the risks will be hard to attack to the banks.

For supervisory institutions, you must supervise each bank which runs under your control and treat them equally. For example, once a bank issue and publish a new product in the market, you must give a fair and equal evaluation and assessment to every bank. The supervisory institution must do some inspection work on each bank and boost them improve the mechanism and regulation system.

The research can be improved and enriched by including other factors, not only the four factors, credit risk, market risk, operational risk and compliance risk. If the future researcher can add other factors, such as strategic risk, liquidity risk, reputation risk and legal risk it will become more complete.

The future researcher can find another Chinese bank case to study and make a survey till some other Chinese banks enter into Indonesia market, not just limited in Bank of China Jakarta Branch.
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Creswell John W, Qualitative & Quantitative approaches, 1994

B. Internet

http://www.boc.cn
http://www.bocid.com
http://www.imf.org
http://www.answers.com/topic/foreign-branch-bank
http://www.web.worldbank.org
C. Articles

Booklet: Wholesale Payment Systems Section: Wholesale Payment Systems Risk Management Subsection: Legal (Compliance) Risk

D. Electronic Publication

Appendices

SPSS Result:

Table Appendix 1 Descriptive Statistics

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Table Appendix 2 Correlations

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a All requested variables entered.
b Dependent Variable: ULy

### Table Appendix 4 Model Summary (b)

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a Predictors: (Constant), Compliancex4, Marketx2, Creditx1, Operationalx3
b Dependent Variable: ULy

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a Predictors: (Constant), Compliancex4, Marketx2, Creditx1, Operationalx3
b Dependent Variable: ULy

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a Dependent Variable: ULy
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a Dependent Variable: ULy
Table Appendix 10 Histogram of Regression Standardized Residual

Histogram

Dependent Variable: ULy

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Std. Dev. = 0.941
N = 36

Table Appendix 11 Plot of Regression Standardized Residual

Normal P-P Plot of Regression Standardized Residual

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The panel of Examiners declare that the thesis entitled “The Study of the Dominant Risk of Chinese Banks in Indonesia (a case study of Bank of China Jakarta Branch)” that was submitted by Zhao Jiangtao majoring in Economics Major in Management from the Faculty of Economics was assessed and approved to have passed the Oral Examinations on September 17\textsuperscript{th}, 2010.

Ir. Erny Hutabarat, MBA
Chair-Panel of Examiners

Ir. B.M.A.S. Anaconda Bangkara, MT
Examiner

Jozef Raco, M. Sc, M.A.
Examiner
DECLARATION OF ORIGINALITY

I declared that this thesis, entitled “The Study of the Dominant Risk of Chinese Banks in Indonesia (a case study of Bank of China Jakarta Branch)” is, to the best of my knowledge and belief, an original piece of work that has not been submitted, either in whole or in part, to another university to obtain a degree.

Cikarang, Indonesia, August 31st, 2010

_____________________
Zhao Jiangtao
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Thanks to all my schoolmates for being supportive and nice to me along with my university life.

Thanks to my family, it is you give me strongest support for my growth and progress.
ABSTRACT

This research is aimed to identify the dominant risk(s) that affect the business activities of Chinese banks in Indonesia market. Since there are only few banks which are Chinese total-owned banks, such as Bank of China Jakarta Branch. The researcher tries to find out what are the dominant risk(s) that affect the business activities of Chinese banks. The research is conducted in Jakarta in Indonesia. This research is a case study of Bank of China Jakarta Branch which is supported by Basel Accords and Economic Capital theory about risk management in banking sector.

This study is a quantitative research. The researcher directly finds the secondary data and analyzed the data with multiple regression model based on the statistics. The researcher uses F test and to identify the level of significance between the independent variable and dependent variable. The researcher also uses T test to identify which risk factor has highest significance with the dependent variable, which is unexpected loss.

The research has found that operational risk is the dominant risk that affects the business activities of Chinese total-owned banks in Indonesia market. The researcher found that all of the independent variables (credit risk, market risk, operational risk and compliance risk) have correlation with dependent variable (unexpected loss). In addition, the research found that the operational risk has a positive relationship with the unexpected loss of the bank with the highest significance 0.013.

The researcher recommends that the Chinese total-owned banks should pay more attention to operational risk when conducting its business with customers in Indonesia market. Meanwhile, they cannot ignore other risks, too.
Table of Content

PANEL OF EXAMINERS APPROVAL SHEET ........................................... i
DECLARATION OF ORIGINALITY .......................................................... ii
ACKNOWLEDGEMENT ........................................................................ iii
ABSTRACT ............................................................................................. iv
Table of Content .................................................................................. v
List of Tables ......................................................................................... viii
List of Figures ........................................................................................ ix
I INTRODUCTION ................................................................................ 1
  1.1 Background of the study ................................................................. 1
  1.2 Company Profile ........................................................................... 3
    1.2.1 About Bank of China Limited ............................................... 3
    1.2.2 About Bank of China Limited Jakarta Branch ..................... 3
  1.3 Problem Identification ................................................................. 4
  1.4 Statement of Problem ................................................................. 5
  1.5 Research objective ....................................................................... 6
  1.6 Significance of the study .............................................................. 6
    1.6.1 For President University Committee .................................... 6
    1.6.2 For Banking Industry ............................................................. 6
    1.6.3 For Bank Indonesia ................................................................. 7
    1.6.4 For Indonesia Government ................................................... 7
    1.6.5 For the researcher ................................................................. 7
    1.6.6 For the Students ................................................................. 7
  1.7 Theoretical Framework ............................................................... 8
  1.8 Scope and Limitation of the study ................................................. 9
  1.9 Assumptions and Hypothesis ...................................................... 10
  1.10 Definition of the terms .............................................................. 11
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.10.1 Foreign Branch Bank</td>
<td>11</td>
</tr>
<tr>
<td>1.10.2 Joint Venture</td>
<td>12</td>
</tr>
<tr>
<td>1.10.3 Basel Accords</td>
<td>13</td>
</tr>
<tr>
<td>1.10.4 Compliance Risk</td>
<td>14</td>
</tr>
<tr>
<td>II LITERATURE REVIEW</td>
<td>15</td>
</tr>
<tr>
<td>2.1 Banks</td>
<td>15</td>
</tr>
<tr>
<td>2.1.1 Definition of Banks</td>
<td>15</td>
</tr>
<tr>
<td>2.1.2 Classification of Bank</td>
<td>15</td>
</tr>
<tr>
<td>2.1.3 Bank Goals</td>
<td>17</td>
</tr>
<tr>
<td>2.1.4 Common Bank Function and Activities</td>
<td>17</td>
</tr>
<tr>
<td>2.1.5 Bank Fund Management</td>
<td>19</td>
</tr>
<tr>
<td>2.2 Basel Accords</td>
<td>21</td>
</tr>
<tr>
<td>2.2.1 Basel I</td>
<td>21</td>
</tr>
<tr>
<td>2.2.2 Basel II</td>
<td>23</td>
</tr>
<tr>
<td>2.3 Risk Management</td>
<td>26</td>
</tr>
<tr>
<td>2.3.1 Risk</td>
<td>26</td>
</tr>
<tr>
<td>2.3.2 Types of Risk</td>
<td>26</td>
</tr>
<tr>
<td>2.3.3 Risk Management</td>
<td>29</td>
</tr>
<tr>
<td>2.4 Economic Capital Theory</td>
<td>32</td>
</tr>
<tr>
<td>2.4.1 Definition of Economic Capital Theory</td>
<td>32</td>
</tr>
<tr>
<td>2.4.2 Measurement of Economic Capital</td>
<td>32</td>
</tr>
<tr>
<td>III RESEARCH METHODOLOGY</td>
<td>34</td>
</tr>
<tr>
<td>3.1 Research Method</td>
<td>34</td>
</tr>
<tr>
<td>3.2 Research Framework</td>
<td>35</td>
</tr>
<tr>
<td>3.3 Research Time and Place</td>
<td>36</td>
</tr>
<tr>
<td>3.4 Research Instruments</td>
<td>36</td>
</tr>
<tr>
<td>3.4.1 Data Collection</td>
<td>36</td>
</tr>
<tr>
<td>3.4.2 Data processing</td>
<td>36</td>
</tr>
</tbody>
</table>
3.5 Testing the Hypothesis and Data analysis ............................................ 37
  3.5.1 Classic Assumption Tests ................................................................. 37
  3.5.2 Testing the Hypothesis ................................................................. 37
3.6 Limitations ....................................................................................... 38
IV ANALYSIS AND INTERPRETATION OF DATA ......................................... 39
  4.1 Classic Assumption Test Results ......................................................... 39
    4.1.1 Normality Test ........................................................................ 40
    4.1.2 Multicollinearity Test ................................................................ 42
  4.2 Hypothesis Testing Analysis ............................................................... 42
    4.2.1 F-test ....................................................................................... 42
    4.2.2 T-test ....................................................................................... 43
    4.2.3 Regression Model Result ............................................................ 44
  4.3 Implication of the result ...................................................................... 45
V CONCLUSIONS AND RECOMMENDATIONS ......................................... 47
  5.1 Conclusions ...................................................................................... 47
  5.2 Recommendations ............................................................................ 49
List of References ..................................................................................... 50
Appendices ............................................................................................... 53
## List of Tables

<table>
<thead>
<tr>
<th>Table</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Table 1.1</td>
<td>Products Comparison</td>
<td>4</td>
</tr>
<tr>
<td>Table 2.1</td>
<td>Risk Matrices Used by Selected U.S. Regulatory Agencies</td>
<td>27</td>
</tr>
<tr>
<td>Table 4.1</td>
<td>Multicollinearity Test</td>
<td>42</td>
</tr>
<tr>
<td>Table 4.2</td>
<td>ANOVA</td>
<td>43</td>
</tr>
<tr>
<td>Table 4.3</td>
<td>Coefficients of Significance</td>
<td>43</td>
</tr>
<tr>
<td>Table 4.4</td>
<td>Regression Model Result</td>
<td>44</td>
</tr>
<tr>
<td>Table Appendix 1</td>
<td>Descriptive Statistics</td>
<td>53</td>
</tr>
<tr>
<td>Table Appendix 2</td>
<td>Correlations</td>
<td>53</td>
</tr>
<tr>
<td>Table Appendix 3</td>
<td>Variables Entered/Removed (b)</td>
<td>54</td>
</tr>
<tr>
<td>Table Appendix 4</td>
<td>Model Summary (b)</td>
<td>54</td>
</tr>
<tr>
<td>Table Appendix 5</td>
<td>ANOVA (b)</td>
<td>54</td>
</tr>
<tr>
<td>Table Appendix 6</td>
<td>Coefficients (a)</td>
<td>54</td>
</tr>
<tr>
<td>Table Appendix 7</td>
<td>Coefficient Correlations (a)</td>
<td>55</td>
</tr>
<tr>
<td>Table Appendix 8</td>
<td>Collinearity Diagnostics (a)</td>
<td>55</td>
</tr>
<tr>
<td>Table Appendix 9</td>
<td>Residuals Statistics (a)</td>
<td>55</td>
</tr>
<tr>
<td>Table Appendix 10</td>
<td>Histogram of Regression Standardized Residual</td>
<td>56</td>
</tr>
<tr>
<td>Table Appendix 11</td>
<td>Plot of Regression Standardized Residual</td>
<td>56</td>
</tr>
</tbody>
</table>
List of Figures

Figure 1.1 Theoretical Frameworks ............................................................... 9
Figure 3.1 Research Framework................................................................. 35
Figure 4.1 Histogram Picture SPSS Result................................................. 40
Figure 4.2 P-P Plot Normal Output Picture SPSS Result.............................. 41