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The Impact of Non-Performing Loans Towards Financial Performance of BPR in Central Java, the Role of Empathy Credit Risk

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ABSTRACT
The lending activities of commercial banks are exposed to the risk of non performing loan. Some individuals cannot repay fully while others are only able to repay a small portion of loans which ultimately results in NPL accumulation. This research proposed empathy credit risk approach as a derivation of spiritual leadership theory and agency theory used to reduce NPL. This study aims to examine the empathy credit risk model as an effort to overcome the problem of collectability in non-performing loans in improving the financial performance of BPR in Central Java. The population in this study was 260 leaders at the BPR in Central Java Province with a sampling method with a purposive sampling technique to obtain respondents as many as 150 BPR leaders. Data analysis using SEM AMOS shows the result that credit collectibility (business prospects, debtor performance, and ability to pay) have positive significant relationship with non-performing loans (NPLs). Non-performing loans have a negative significant effect on the financial performance of banks. empathy credit risk moderates the influence of business prospects, debtor performance, and ability to pay with non-performing loans (NPLs).

Keywords: *Financial Performance, Empathy Credit Risk, Non-Performing Loans (NPL), Credit Collectability.*

1. INTRODUCTION

The Covid-19 pandemic has increased uncertainty and made liquidity and cash extremely important. The choice of investment with low risk while paying attention to cash flow will be a matter of great concern to banking industry players as a result of which financial decision makers will act rationally in making decisions. The aspect of rationality in decision making when facing uncertainty is associated with economic and financial portfolios, human intelligence and reasoning. This aspect can lead to errors in the decision-making process and is known as bias and is a common thing in investor behavior [1]. Bank credit management is a concern because bank credit does not only affect the stability of the bank itself but also on economic stability The lending activities of commercial banks are faced with the risk of default by some individuals and companies who cannot meet their debt payment obligations on time. Some individuals are unable to fully repay while others are only able to pay a small portion of the loans that have resulted in accumulated NPL. This credit risk analysis is related to the lending policy of banking companies and is related to internal factors measured by the amount of third party funds (TPF), Capital Adequacy Ratio (CAR), Non Performing Loans (NPL), Return On assets (ROA), and Loan to Deposit Ratio (LDR) and external factors such as debtors who are unable to repay loans, the economic situation in Indonesia.

The main goal of financial companies such as banking is to increase company value. Agency conflicts that result in opportunistic management will result in lower earnings quality. The low quality of earnings will lead to mistakes in making decisions by users such as investors and creditors, so that the company's value will decrease. Agency theory has become a strong research base in finance and accounting disciplines. Agency theory arises when the agency relationship of one or more people (principal) employs another person (agent) to provide a service and then delegates authority to return decisions to the agent. The separation between ownership and management of the company has the potential to cause conflict [2]. It is impossible for a company to have zero agency cost in order to guarantee that managers will

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make optimal decisions from the views of shareholders because of the large differences in interests between them [4].

The concept of universal spiritual leadership that has been developed by Louis W. Fry since 2003 and can be adapted to various types of organizations. Religious ethical values act as mission-focused, vision-directed, philosophy driven and value-based institutions in advancing the organization [5]. Spiritual leadership is a type of leadership that combines the values, attitudes and behaviors needed to motivate themselves and others in such an intrinsic way, so that they have a sense of spiritual defense through a call of duty and membership as part of an organization [6].

Credit collectability was reflected in the level of provision for reported loan losses, this was the impact of an economic downturn that had an impact on bank income and capital [7]. Furthermore, The measurement of the loan provision level is a credit risk that reflects the economic condition of a country which will have an impact on non-performing loans [8]. The business cycle on contraction or expansion of bank loans will have an impact on gross domestic product (GDP) and this assumption then makes the banks believe that lowering the provision for loan losses will improve their financial performance [9].

Non-performing loans have an insignificant negative relationship to financial performance [10], contrary with this result a research state that t there is a significant negative effect of non-performing loans on financial performance (ROE from state owned commercial banks) or it can be said that the level of non-performing loans in the banking system is the failure of bank performance. Non-Performing Loans, even though they have a negative effect on financial performance, are not significant. This means that if the non-performing loan gets bigger, it will reduce financial performance, however, the effect is not significant because of the effort to control the non-performing loan condition of each bank in Indonesia in a short time so that there is a small possibility that the bank will experience a higher non-performing loan than regulated [11]. This result contradicts the results of research by [12] which states that non-performing loans have a negative and statistically significant impact on bank performance. Another consequence of the increase in non-performing loans is that the cost implications of the outsourcing unit assigned to track non-performing loans will increase bank operational costs so that financial performance decreases [12]. Other research which states that non-performing loans have a negative contribution to financial performance only when financial development related to the market is high [13]. Some further research can be carried out to see the impact of NPLs on bank profitability and performance by considering all relevant factors [14].

Based on the background of the problem, namely gap research and business phenomena that exist in Rural Banks (BPR), the problem formulation of this study is "What is the empathy credit risk model as an effort to overcome non-performing loans in improving the financial performance of Rural Banks (BPR) in Central Java".

2. LITERATURE RESEARCH AND PREPOSITION DEVELOPMENT

Integration of Spiritual Leadership Theory and Agency Theory: Emphatic credit Risk approach

Spiritual Leadership Theory is a leadership model that uses an intrinsic motivation model by combining the existence of a vision, hope / faith, and altruistic love as well as workplace spirituality, and spiritual well-being. spiritual survival [15]. A term often used synonymously with charity, altruistic love, and the values contained therein are manifested through selfless care, care, and benevolence, both for oneself and for others. For spiritual leadership theory, altruistic love is defined as a sense of wholeness, harmony, and well-being generated through care, care, and respect for oneself and others. Underlying this definition are the values of patience, kindness, lack of envy, forgiveness, humility, selflessness, self-control, trust, loyalty, and honesty [5], [16].

The study of [5] regarding the causal model of spiritual leadership theory shows that there is a positive relationship between the quality of spiritual leadership, spiritual survival and organizational outcomes, which consist of commitment and productivity. Spiritual leadership values developed by [5]are: vision, hope / faith, altruistic love (trust, forgiveness, integrity, honesty, courage, humility, kindness, empathy, patience).

The agency theory approach describes shareholders as principals and management as agents. Management is a party contracted by shareholders to work for the interests of shareholders, for this reason management is given some power to make decisions in the best interests of shareholders so that management is obliged to account for all its efforts to shareholders. According to agency theory, conflicts between principal and agent can be reduced by aligning interests between principal and agent. The presence of share ownership by managerial (insider ownership) can be used to reduce the agency cost that has the potential to arise, because by owning company shares it is expected that managers will feel the benefits directly from every decision they make. This process is called the bonding mechanism, which is a process to equalize management interests through a binding program for management in the company's capital [17]. According to bank theory, there are six (6) main types of risk associated with bank credit policies, namely; credit risk (risk of repayment), interest risk, portfolio risk, operating risk, credit deficiency risk and trade union risk [18]. The credit risk management system includes risk identification, measurement, assessment, monitoring and control [18].

The integration of the dimensions of the spiritual leadership theory and risk management can formulate propositions to build organizational performance. The proposition is empathy credit risk (ECR), which is the behavior of a leader who is able to lead by understanding and understanding the situation of others, able to feel the distress of others, able to understand economic conditions to protect the company from business failure. Emphatic credit risk will reduce non-performing loans and potentially affect the company's financial performance. The spiritual dimension of leadership with an empathetic approach, namely being able to understand and read other people's feelings, feel the difficulties of others, understand and want to do something is integrated with indicators from agency theory with a credit risk approach, namely risk identification, measurement, assessment, monitoring and control. Produce an Emphatic credit risk indicator, namely: Emphaty solution, Monitoring and evaluating, Interpersonal approach and Risk identification. Empathy Credit Risk (ECR) is a new method approach integration of some theory of [5], [19]–[21] that is placed between NPL and performance is expected to reduce non -performing loan (NPL). This approach uses forms of empathy in resolving bad credit problems with customers, so that with a more humanistic approach, it is hoped that bad credit customers will be able to think rationally, and foster a sense of optimism about their bad credit problems.

Non-Performing Loan

One of the risks faced by banks is the risk of not repaying the credit that has been given to the debtor or known as credit risk [11]. Credit risk includes non-performing loans [22]. Non-performing loans (NPLs) are non-performing loans in which the debtor is unable to meet loan arrears and interest payments within the agreed period in the agreement [23]. Non Performing Loans or often referred to as non-performing loans are loans that experience repayment difficulties due to gaps and / or external factors beyond the control of the debtor, such as bad economic conditions or liaison with parties who have excess funds and need funds [13].

Non-performing loans are indicated by substandard credit, credit under special mention, doubtful credit, and bad credit (Regulation of the Financial Services Authority of the Republic of Indonesia Number 33 / POJK.03 / 2018). Bank Indonesia (BI) divides non-performing loans in Indonesia into three groups, namely substandard credit, doubtful credit and bad credit. The division of non-performing loans into three groups is based on the degree of collectability, namely the accuracy of credit repayments or credit installments [24]. So it can be concluded that Non-Performing Loans are non-performing loans which are one of the keys to assessing the quality of bank performance. The indicators are Bad credit, Total Credit and Accuracy of payment [25].

Finance Performance

Financial performance is measured using a mixture of financial analysis such as, (ROA, ROE, and Tobin-Q) or by comparisons of performance counters according to budget or sometimes a combination of all available proxies [26]. Financial performance is an analysis carried out to see the extent to which a company has implemented proper and correct financial implementation rules [27]. Company performance is a description of the financial condition of a company which is analyzed by means of financial analysis, so that it can be seen about the good and bad financial condition of a company that reflects work performance in a certain period. This is very important so that resources are used optimally in the face of environmental changes [28]. The company's financial performance is closely related to performance measurement and appraisal. Performance measurement is the qualification and efficiency and effectiveness of the company in business operations during the accounting [24]. Financial performance is measured using a mixture of financial analysis such as, (ROA, ROE, and Tobin-Q) or by comparisons of performance counters according to budget or sometimes a combination of all available proxies [24]. The assessment of the performance of commercial banks is measured using total assets, net income and total capital [29].

Preposition Development

The Effect of Credit collectability on Non Performing Loans

The classification of credit collectibility is based on the Decree of the Board of Directors of Bank Indonesia No. 30/267 / KEP / DIR, dated 27 February 1998 concerning productive quality and reserve formation, 5 (five) credit collectibility categories were determined, namely credit quality was determined to be 5 (five) collectibility, namely Current; In Special Mention, Substandard; Doubtful and Loss. In determining credit quality, OJK refers to three assessment factors, namely: business prospects, debtor performance, and ability to pay.

Business prospects are the entire business, with measurement of financial and non-financial aspects as parameters. The indicators are business growth, market conditions, affiliation support, management quality [31] Financial Services Authority Regulation No. 33 / POJK.03 / 2018). Debtor performance is an assessment criterion from the bank before the debtor gets a loan. The measurement of debtor performance is to use indicators: Profit acquisition, capital structure, cash flow and market risk sensitivity [32]. Financial Services Authority Regulation No. 33 / POJK.03 / 2018).

The ability to pay debtors is the debtor's ability (repayment power) to pay principal debt and interest from income and / or profit (profit). The indicators are the accuracy of payments, debtor financial information, completeness of credit documents and suitability of the use of funds (Financial Services Authority Regulation No. 33 / POJK.03 / 2018). Good and continuous loan monitoring is the main key in the credit process. There is a strong relationship between credit risk monitoring, collection policies and loan arrears [33]. The prospective debtor's business conditions compared to other similar businesses in the area and environmental locations, the marketing conditions of the prospective debtor's business results and government policies that affect the prospects for the industry in which the company loan applicant is in.

Scholars recommend that there is a need for supervision, standardization and policies in the credit process, because they greatly affect bank profitability[12], [13], [33]–[35]. the quality of the borrower's credit collectability can help CCB to identify borrowers based on the probability of credit payments so that it will help CCB to reduce bad credit which can affect bank income from credit.

H1 Credit collectability has the potential to reduce non-performing loans

The moderating effect of empathy credit risk on the relationship between Credit collectability and Non Performing Loans

Credit risk is the risk of loss because the debtor does not pay for assets or other lines of credit (either principal or interest (coupons) or both). Events of default include late payments, debt repayment restructuring, and bankruptcy. Interest rates affect credit risk because borrowers may not be interested in paying financing / credit costs or may find such assets expensive in the future.

The efficiency of banking companies can affect bad credit in the banking industry. Bank management may not thoroughly evaluate their customers' credit applications because of their poor evaluation skills. In addition, the problem of asymmetric information between lenders and borrowers further complicates this problem. In addition, management may not be efficient in managing the loan portfolio. As a result, this results in a lower credit rating for approved loans and a high probability of default resulting in higher bad debts. Therefore, bank inefficiency can lead to higher bad credit.

The process of monitoring and mitigating credit risk has a positive relationship with financial performance [36]–[38]. [18], [36] states that creit risk has a significant relationship to financial performance. In this case, the following hypothesis can be proposed:

H2 Emphatic credit risk moderates the relationship between credit collectability and non-performing loans

The Effect of Non-Performing Loans on Financial Performance

Several studies have shown that banking concentration can also influence banking system stability, and there are two conflicting views on the stability-concentration argument. The first argument is that banks in a more concentrated market will reduce risky lending due to lower competition in the market because they have fewer competitors [24] NPL has a negative effect on economic growth, accumulated NPL makes it difficult for Banks to finance new and economic businesses, Commercial Banks are required to set aside funds to cover possible losses that are expected from bad loans [39]. Another consequence of the increase in NPL is that the cost implication of the outsourcing unit assigned to track non-performing loans will increase bank operational costs [22].

Research by [22] states that in order to minimize NPL and improve the performance of the commercial banking sector in Uganda, a number of reforms have been carried out including restructuring, namely the takeover of bankrupt banks which are then sold and combined with other banks (mergers), bureaus. credit reference (CRB) to reduce information gaps between lenders and borrowers with; provide timely and accurate information about the borrower's debt profile, and payment history.

This study departs from the differences in the results of the study by [10] which state that non-performing loans have an insignificant negative relationship to financial performance, this result is different from [14] which states that there is a significant negative effect of non-performing loans on financial performance (ROE from state owned commercial banks) or it can be said that the level of non-performing loans in the banking system is the failure of bank performance. [12] which states that non-performing loans have a negative and statistically significant impact on bank performance.

H3 When non-performing loans decrease, financial performance will increase

3. METHODOLOGY

This type of research is "explanatory research", meaning that it emphasizes the relationship between research variables (causality) by testing the hypothesis, the description contains descriptions but the focus lies on the relationship between variables. Data collection was carried out by distributing questionnaires which were submitted directly to the leadership of the Rural Bank (BPR). The population in this study is the leadership of the People's Credit Bank (BPR) in Central Java Province, amounting to 260, which are distributed in 35 districts / cities in Central Java. Then the sampling method was purposive sampling technique, so the sample of this study was 150 respondents. To analyze the data in this study, The Structural Equation Modeling (SEM) was used from the AMOS 20.0 package.

4. ANALYSYS RESULT AND DISCUSSION

Analysis Result

Tabel 1. Composite Reliability

Reliability and AVE			
Construct	**Composite Reliability**	**AVE**	**Cronbach Alpha**
CC	0.668129	0.502449	0.009843
NPL	0.718013	0.565124	0.240336
FP	1.000000	1.000000	0.000000
ECR	1.000000	1.000000	0.000000
ECR	1.000000	1.000000	0.000000

Table 1 shows the results of the composite reliability of each good construct, namely ≥0.7. According to [24] an indicator is said to have good reliability if the value is above 0.70 and can be maintained and accepted at a value of 0.50 to 0.60. It can be seen here that the value for composite reliability, Credit Collectability, is 0.67, NPL is 0.72, emphatic credit risk is 1.00, and Financial Performance is 1.00, these values refer to Chin's opinion, so the results of the composite reliability of each construct are good. can be used in the analysis process to show whether there is a relationship in each construct, because the results obtained have a value of ≥ 0.70, from the results above all variables have a composite reliability value of 0.7 means that they have a good reliability value and can be used for further research process. What is meant by reliable here is that the indicators used in real research are in accordance with the real conditions of the research object.

Tabel 2 Hypothesis Result

Structural Model—BootStrap				
	Entire Sample estimate	**Mean**	**Std. eror**	**T-Statistic**
NPL->FP	0.3720	0.4224	0.1347	2.762
CC->FP	-0.0880	-0.1796	0.1338	2.658
ECR->FP	0.3430	0.3357	0.1590	2.157
moder1-ECR>CC--komit	0.1210	0.1592	0.1229	2.984

The results of the data processing above show that the first hypothesis is accepted. Credit collectability is proven to reduce NPL. Second hypothesis which reads emphatic credit risk moderates the relationship between Credit collectability and NPL accepted. The third hypothesis is also proven.

Tabel 3 R-SQUARE (R^2)

	R-square
NPL	0,138
Financial Performance	0.130

Based on the R square value, it shows that the variation in Non Performing loans can be explained by the collectability of 13.8%, the remaining 86.2% is explained by variations in other variables that are not included in the model. Variations in financial performance can be explained by credit collectability and non-performing loans by 13%, the remaining 87% is explained by variations in other variables that are not included in the model.

Discussion

The Effect of Credit collectability on Non Performing Loans

In assessing credit, banks must assess economic, political, social, economic and cultural conditions, government regulations and others. In conducting a financing analysis, debtors must look at general economic conditions and conditions in the investor's business sector, because creditors must consider the economic situation that will affect the debtor's business development. The assessment of the prospects for the business sector that is financed must have really good prospects so that the possibility of bad credit is relatively small. Conversely, if you have bad prospects, it will increase the risk of bad credit more and more.

The assessment (credit proposal) of prospective borrowers is a factor affecting loan performance, given the loss of financial institutions due to defaults [9], [30], [37], [38]. Good loan portfolio management and the quality of human resources (credit team) in fostering debtors affect loan performance. So it can be concluded that the Bank's ability to control the loan process properly and in terms of credit management, including high levels of monitoring after credit has been distributed greatly affects the level of credit irregularities or indications of default.

The Moderating Effect of Empathy Credit Risk on The Relationship Between Credit Collectability and Non Performing Loans

From a management accounting point of view, the quality of bank assets and operating performance are positively related. If the quality of the bank's assets is inadequate (eg loan amount becomes the amount to be collected), the bank will have to increase its bad debt losses as well as spend more resources on collecting non-performing loans. An increase in bad credit in the banking industry can be caused by external events, such as a bad situation in economic activity [41], [42]. When the bank experiences bad credit, the bank will spend more for billing, collecting and supervising the collection process. In avoiding bad credit, the Bank must constantly track the financial status of the debtor, be careful with the value of collateral, discuss amortization plans, pay fees for contract negotiations, calculate costs for holding, hold and dispose of collateral when the loan becomes outstanding. Banks that implement a humanist leadership pattern will be able to find solutions with a more empatic approach and benefit both parties.

Emphatic credit risk leadership emphasizes how leaders can extrinsically and / or intrinsically motivate followers to simultaneously use forms of empathy in solving bad credit problems with customers. With a more humanistic approach, bad credit customers are able to think rationally, and foster a sense of optimism regarding their bad credit problems. The implementation of empathy credit risk (ECR) has been proven to reduce non-performing loans by providing empathetic solutions, always monitoring and evaluating consumers, taking a personal approach and identifying risks. The attitude of a leader who is able to understand and understand the situation of others, able to feel the distress of others, able to understand economic conditions to keep the company from failing its business in risk identification, measurement, assessment, monitoring and control can reduce the risk of bad credit to customers.

Non Performing Loan and Finance Performance

NPL has a negative effect on economic growth, accumulated NPL makes it difficult for Banks to finance new and economic businesses, Commercial Banks are required to set aside funds to cover possible losses that are expected from bad loans [43], [44]. Another consequence of the increase in NPL is that the cost implication of the outsourcing unit assigned to track non-performing loans will increase bank operational costs [45]. Research by [22] states that in order to minimize NPL and improve the performance of the commercial banking sector in Uganda, a number of reforms have been carried out including restructuring, namely the takeover of bankrupt banks which are then sold and combined with other banks (mergers), bureaus. credit reference (CRB) to reduce information gaps between lenders and borrowers with; provide timely and accurate information about the borrower's debt profile, and payment history.

The decline in NPLs due to the leadership of this emphatic credit risk had an impact on financial performance. With a decrease in NPL, the Bank can reduce costs incurred for billing financing, bill collection and supervision including winning the trust of management and the public, keeping banks from being considered bad as a result of external affairs, reducing savings due to loss of credibility, and additional costs for monitoring quality loan. This reduction in costs will in turn reduce bank efficiency.

5. LIMITATION AND FUTURE RESEARCH

Limitation and Future Research

This study has a low R square value in measuring the effect of credit collectability on NPL, so it is necessary to include other elements to reduce NPL. External and internal factors that affect NPL can be used as new antecedents in efforts to reduce NPLs. Cultural factors and characteristics of the Bank are very interesting if they are used as control variables in the influence of NPLs on financial performance.

6. CONCLUSION

The ability of the Bank to control the loan process properly and in terms of credit management will greatly affect the reduction of NPL. Emphatic credit risk is able to strengthen the effect of credit collectability in reducing the risk of bad credit on customers. The decline in NPLs was due to Bankd Alam's ability to control credit collectability which was strengthened by this emphatic credit risk leadership which had an impact on financial performance. By decreasing the NPL, the Bank can improve bank efficiency so that financial performance will increase.

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