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Environmental and Strategy Changing and the Implications on Performance in the Banking Sector

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Abstract

This paper investigates the causal relationship between environmental complexity, policy of Bank Indonesia, diversification strategy, and performance in the banking industry. Data banking industry in East Java, in 2007-2009, is used. Structural Equation Modelling (SEM) was used as an analytical tool. Diversification strategies are grouped into related-diversification strategy (bank's main income) in form interest-based income and unrelated-diversification strategy (fee-based income), income that is outside the interest income (other services). The study findings suggest the diversification strategy is able to mediate relationship between environmental complexity with performance, but related-diversification strategy can not improve performance. Similarly, today bank has been change the banking strategy of related-diversification into unrelated-diversification. The higher complexity of environment, the greater need for BI intervention (BI policy). These findings provide important implications for bank managers and regulators in Indonesia, particularly banks in East Java.

Key words: environment complexity, Bank Indonesia Policy, diversification strategy, and performance.

Introduction

Indonesia get crisis since mid-1997. Indeed, during the condition, Indonesia's financial condition is not too bad. In 1996 state budget, Indonesia enjoyed a surplus of 1.9% of GDP. Indonesia's foreign debt is 55.3 billion U.S. dollars, or approximately 24% of GDP, whereas domestic debt does not exist. Realization of Budget 1997 to first semester is also good. Budget surplus at first semester of this year reached 1.8% of GDP and government debt has not much changed (Boediono, 2009).

The process of bank recapitalization completed in 2000. Indonesia government debt reached Rp1.226, 1 trillion (equivalent to 60.8 billion U.S. dollars at the time) or about 96% of GDP. The number of domestic debt is Rp643 trillion. The amount is created by cost accumulation that arising from the three principal policy, namely: Policy of Bank Indonesia Liquidity Assistance (BLBI), Bank Guarantee Policy and Bank Recapitalization Policies to rescue crisis-stricken banking sector. All the three policies are implemented sequentially in line with developmental stage of the crisis (Boediono, 2009).

The world economy showed growth retardation since entering 2001 and has even been in a recession. Meanwhile, the socio-political and security conditions of Indonesia are still not stable and still faces some obstacles. Therefore various structural problems in the country still continues, characterized by high fixed risk and uncertainty of business. The large amount of debt makes Indonesia government also facing the problem market concerns, particularly domestic debt falling due from 2004 and onwards. Maturity recap bonds are concentrated in years 2004-2009. Government securities in Bank Indonesia also began fall 2004 with amount that continues to increase until 2018. In period 2004-2009, total amount of bonds recap fall due is around Rp379 trillion and debt of Bank Indonesia of about Rp137 trillion. This problem can be solved by issuing new bonds with time maturities not vulnerable.

Economic agents confidence to Indonesia gradually recovered in last two years. These conditions have given a very positive impact on macroeconomic stability. The rupiah strengthened and more stable, inflation and interest rates declined significantly, stock prices rose, and national production began to show improvement although still below the desired level. Interest rate of Indonesia Bank Certificates (IBC) decreased continuously but has not been followed by a decline in mortgage interest rates. Investment credit that is expected to support investment growth experienced a growth, but still slow level. The economy has not shown 7% growth per year because the investment has not been moving fast. Business climate has not been conducive and the credit risk remains high in real sector to be one indication of causes of banking sector was reluctant to make credit more extensively.

Indonesia's macroeconomic performance in line with the performance of banking sector. Until late 2007, the growth is reflected in increase of total assets, supported by growth in earning assets, increased Capital

Adequacy Ratio (CAR) and decreased profitability in 2007. This decline occurred until 2009, as shown by Table 1.

Table 1. Performance Indicators of Commercial Banks

Indikator	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total Asset (trillion Rp)	1.030,5	1.099,7	1.112,2	1.196,2	1.272,3	1.469,8	1.693,5	1.986,5	2.310,6	2.534,1
DPK (trillion Rp)	699,1	797,4	835,8	888,6	963,1	1.127,9	1.287,0	1.510,7	1.753,3	1.973,0
Credit (trillion Rp)	320,5	358,6	410,3	477,2	595,1	730,2	832,9	1.045,7	1.353,6	1.470,8
LDR (Credit/DPK, %)	45,8	45,0	49,1	53,7	61,8	64,7	64,7	69,2	77,2	74,5
NII (trillion Rp)	2,9	3,1	4,0	3,2	6,3	6,2	7,7	8,9	9,4	11,9
ROA (%)	0,9	1,4	1,9	2,5	3,5	2,6	2,6	2,8	2,3	2,6
NPLs Gross (%)	18,8	12,1	8,1	8,2	5,8	8,3	7,0	4,6	3,8	3,8
NPLs net (%)	5,8	3,6	2,1	3,0	1,7	4,8	3,6	1,9	1,5	0,9
CAR (%)	12,7	20,5	22,5	19,4	19,4	19,5	20,5	19,2	16,2	17,4

Source: Indonesia Bank (2009), Indonesia Economic Report, 2009

Performance indicators for commercial banks from 2000-2009 showed a better condition. Total assets, deposits, credit, capital and profit before tax tends to increase. Banks are still cautious in lending to avoid a credit crunch. This can be seen on loan to deposit ratio (LDR) that still relatively low and non-performing loans (NPLs), which decreased until 2004, but deteriorated again in 2005 until 2007. Profitability of commercial banks until 2004 still increased when look at return on assets (ROA) and net interest income (NII). The growth of banking assets reached USD 2534.1 billion in 2009, supported by loan growth of Rp 1470.8 trillion. However, credit growth is still not shown any increase in optimal functioning as intermediation banking. On the one hand, credit growth is low due to bank have high risk perception in real sector because of global financial crisis. On the other hand, low credit growth is also due to slow economic activity and high interest rates. LDR, one indicator of banking intermediation, in 2009 showed at slower rate after the three previous years showed an increase in relatively good. LDR is constantly increasing during 2005-2008, but in 2009 LDR decreased (74.5%) (Table 1). It indicates that intermediation function of banks has not gone as expected, as indicated by decrease in the value of LDR. That is, banks are still not perform optimally its main function as an intermediary bank.

The empirical research results in several countries show a positive relationship between the development of financial sector and real sector (Bencivenga and Smith, 1991; Levine and Zevros, 1998; Rousseau and Wachtel, 1998 in Rahayu, 2007). Conversely, the fact that occurred in Indonesia are conflicting conditions. On the one hand, banks in Indonesia have not shown risk intermediation in world point of view, the condition much better than when a crisis hit or when compared with other countries in the region. From year 2000-2007, banks in Indonesia have a good enough condition based on following financial performance: level of profitability, high CAR and low non-performing loans (NPL). Indonesia's economic situation looks normal under banking sector scene, despite Indonesia's economic growth is lower in comparison with other countries in same region (based on publication data of Bank Indonesia, Indonesian Financial Statistics December 2007), average economic growth from 2000 to 2006 for State ASEAN-5 shows Indonesia is at bottom (Malaysia 5.2%, Thailand 4.97%, Filipinos 4.9%, Singapore 4.7%, Indonesia 4.5%).

Market research company Bureau van Dijk (Singapore) in collaboration with Bureau of Research Infobank (2006) conducted a survey of financial performance. Of 20 largest banks in Southeast Asia, Indonesia banking performance is superior in financial ratios such as return on average assets (ROAA), return on average equity (ROAE) and net interest margin (NIM). However, ratio pretty good finance was not followed by smooth functioning of bank, primarily as an intermediary institution funds. Intermediation function of banking, lending in particularly, face constraints as seen from the decrease in demand and supply of credit. From demand side, high interest rate loans and weakening purchasing power are factors that cause decline in credit demand. Decline in credit demand is reflected in an increase the undisbursed loans. From supply side, there is increased of bank risk perception on real economy due to various unresolved structural problems that inherent in the sector. As a result, banks increasingly cautious in extending credit. New bank lending in 2006 grew lower when compared to loan growth in 2005.

The crisis that has hit Indonesia (since 1997 monetary crisis and global economic crisis in 2008) has resulted in very rapid environmental change, dynamic, and full of uncertainty. Environment becomes more complex. Changes continue to occur from time to time in line with changes of economy in the country. This condition will affect the banking industry performance. The government and central bank responds to these environmental changes by issuing a policy package. Apparently, policy packages that have been issued by government and BI can suppress the increased environment complexity. Indonesia can overcome adverse effects of turmoil current world economic crisis (2008 global crisis) better than at time 1997 crisis. This can be seen from general bank performance indicators improvement since year 2000-2009.

Thus, it can be said that there was a relationship between changes in external environment and government policy. Environmental change is followed by a trend of change strategies. Apparently, the changes in environment and strategy is also followed the changes in banking performance. The phenomenon is in line with phenomenon of ESP (Environment-Strategy-Performance). This paper aims to uncover these linkages by using ESP phenomena at banking industry in Indonesia.

The results of this study are expected contributing to theory to enrich strategic management literature related to development of phenomenon or paradigm of environment-strategy-performance (ESP), can be integrated with complexity of environment, government policy and BI, diversification strategies, and performance, especially in banking industry. It is expected, the results obtained may provide a more comprehensive understanding. This research is expected to make practical contribution in making decisions about the development of banking industry, especially against a critical factor in developing a performance as well as provide input in evaluating this strategy. At the end, it also expected to provide input in selecting strategy that could be applied to certain environmental conditions and particular purpose. Contribution to managerial practices is that diversification strategy can be used for strategic competitiveness and sustainable competitive advantage, involving resources and competencies of company. In addition, the results of this study may provide insight the extent of environment complexity, BI policies and diversification strategy diversification that contributes to banks performance. For regulators, results of this study can become input in policy making, especially in banking industry.

Literature Review and Hypotheses

Empirically, ESP paradigm used by several researchers in field of management strategies to examine strategies and performance on various types of industries, including banking. Man and Wafa (2007), Bou and Beltran (2005), Edelman et al (2005), Smith and Cooper (1988), Bettis (1981), Jemison (1987), Hopskin (1997), Gani and Jermias (2009) have assess the impact of competitive environment, business strategy, and structure of corporate governance to company performance. Colpan (2008) conducted research on companies listed in Japan's textile industry. Corbett (2008) conducted a study on manufacturing firms in New Zealand. Grewal et al (2008) conducted research on MNC companies. Dahlan et al (2007), Nermin, et al (2007), Paul E. Bierly, III

and Paula S. Daly (2007), WS. Low & S.M. Cheng (2006) compare the perceptions of managers about the environment, ability, strategy and business performance in Taiwan and China. Colpan and Hikino (2005) examined changes in economic environment, strategy and financial performance in largest textile company in Japan. The research results of Lau, Thomas, and Chaw (2004) demonstrated the organizational capability and business environment have direct positive impact on performance. The business environment is an intervening variable that strengthens the relationship between organizational capabilities and performance.

Company's internal organizational structure plays an important role in influencing the behavior of companies in order to get better performance (Martin, 1994:285-286). Meanwhile, another study describes the relationship between market structure, behavior, and firm performance (structure-conduct-performance/SCP), using SCP hypothesis and efficiency hypothesis. SCP paradigm emphasizes the hypothesis of collusive behavior among firms in concentrated markets industry, ie the lower level of competition, the higher rate of profit. This hypothesis is supported if the impact of market concentration on performance is positive, despite the company's efficiency. SCP relationship can be unidirectional or simultaneous (Delorme, et al 2002).

On the other hand, efficiency hypothesis emphasizes the importance of corporate efficiency. If company has a higher efficiency level, then fee structure will come down. Companies can apply two strategies, maximize profits by keeping the price and quantity level or lower price and increase quantity. If company implemented a second strategy, more efficient firms will gain market share (Smirlock, 1985).

Relation between Environmental complexity relationship with Diversification Strategy, Policy and Performance

Environmental complexity reflects the degree of heterogeneity or diversity factors, activity or situation faced by firms (Benito et al. 2010). Environmental complexity arises because individual's inability to predict anything accurately. Environmental complexity often have higher uncertainty and turbulence characteristics (Sia, et al. 2004), as the crisis that hit Indonesia since 1997. Griffin (2004) explains that uncertainty is a driving force caused by the change and complexity. Rate of change or upheaval environment shows the extent to which the environment can be relatively simple or relatively complex or dynamic. Environmental turbulence is an unexpected change, sometimes without any warning at all. The most common form of turbulence is a crisis-type.

Environmental uncertainty and turbulence triggered by business needs, consumer tastes, increased competition, technological change, economic and social issues (Braglia and Petroni 2000). Meanwhile, Luke (2001) connects the complexity of competitive environment, technology, regulation, and international development. Miller (1993 cited Elbanna 2009) said that indicators of environmental uncertainty are as follows: product, economic, competition, and government policies. Rapid technological change, deregulation, and globalization has increased competition and turbulence and complexity. These conditions force managers to adopt new ways and use other organization form that is more responsive (D'Aveni 1994, Hamel and Prahalad, 1994, Brown and Eisenhardt 1998).

The environment complexity, as an external environmental factor that can not be controlled by company, has been demonstrated by previous investigators. Bird (1991) argued that complexity and the changing industrial environment can affect the intensity of strategic planning. That is, the increase industries that use strategic planning system show that complex environment and rapid changes can spur more intensive strategic planning.

The results of some previous studies found a significant relationship between environment and strategy (Hoskisson 2003, Benito and Rocha 2010). The opinion was supported by other researchers. Naranjo (2003) demonstrated environmental influence on the organization's decision process in choosing a strategy. Li (1991)

showed interaction between environment and strategy of product innovation has a positive effect on performance

Lukas (2001) examine the strategic fit paradigm in context of transitional economies in People's Republic of China. Environmental uncertainty is measured by using three dimensions: complexity, dynamism, and hostility. The findings of this study indicate: (1) in a transitional economy in China proved have suitability between environment with strategy. More prospective strategic orientation is used when the company experienced level of environmental dynamism and hostility is low, a condition that can predict the market (eg low uncertainty). According with predictions, strategic orientation is more protective when companies faced with high levels of environmental dynamism and hostility, a condition that become characteristic of environmental uncertainty, (2) compatibility between environment and have implications for strategy's performance in China's transitional economy.

Hashim, et al. (2001) examined relationship between environmental complexity, strategy and performance. This study uses a contingency approach. Environment is used as a moderator the relationship between business strategy and performance of 100 SMEs in manufacturing sector in Malaysia. Environmental variables were measured using 2 dimension namely environment of uncertainty and intensity of competition. The findings of this study indicate that relationship between business strategy and performance of SME's moderated by environment.

Luo (1999) investigated the relationship between environment, strategy and performance of small businesses in urban and rural China. The results showed: (1) Characteristics of business environment (complexity, Dynamism and hostility) has a significant influence on strategy orientation (innovativeness, proactiveness and risk-taking). (2) The strategy orientation has a positive effect on performance (profitability and market position).

In contrast to results of study above (Bird 1991, Luke 2001, Hashim, et al. 2001, and Luo 1999), Hopkins (1997) study and develop an integrative model of relationship between managerial, environmental, organizational factors, intensity of strategic planning, and financial performance data from 112 banks. The findings of this study indicate that intensity of bank's involvement in strategic planning has a positive direct effect on financial banks performance, and mediate the influence of managerial and organizational factors on bank performance. However, environmental factors (complexity and change) does not affect strategy.

Differences of opinion among researchers related the influence of environment on organizational decision lies at the emphasis in determining organization priority decision in reaching different purposes (Hitt 2001: 228-250). Organizational decisions in determining the choice of strategy will be different based on available resources characteristics. Situational factors become control variables in relationship between environment and strategy, as explained by contingency theory (Luthans and Stewart, 1997, 2001; Pandya and Rao 1998; Koufteros, Vonderembse and Jayaram 2005). They also explained that interaction between environment and resources is situational variables in a sub-system organization. Fisher (2004) also showed that competitive strategy of Porter (1980) is a contingency variable that has implications in choosing related- and unrelated-diversification, and orientation strategy by Miles and Snow (1978) classified as defender, prospectors, and analyzer.

The crisis that occurred since 1997 have produced environment changes. The environment become increasingly fast-changing, more dynamic, more uncertain and more turbulent. These changes have increased the environment complexity. At that time, Indonesia government issued a series of deregulation policies (government policy) in real sector and monetary policy to cope unfavorable circumstances. At this early stage, rapid deregulation have more impact on the monetary sector through a series of changes in banking sphere. A series of policy has resulted many changes in banking in Indonesia. Therefore it can be said that there was a

significant relationship between environment complexity and government policies (deregulation) and eventually could improve and enhance bank performance.

The theory of industrial organization explained that industrial market structure will be established by regulation. The structure of this market will further affect market behavior, such as product strategy, and ultimately will affect the performance (Scherer, 1981). Pearce and Robinson (2007) and Wheelen and Hunger (2004) explains that political environment (government policy) impact on company performance. Barth, et al (2000) does not find relationship between government regulation with commercial banks performance in developed countries.

The findings of Pearce and Robinson (2007); Wheelen and Hunger (2004), Barth (2000), Scherer (1981) is different from findings of several other researchers. Chen et al (2005) found the higher the government's intervention against Direct Government-Controlled Company (DGCC), the lower the company's performance. Tian (2001) found that firm value is decrease when government intervenes the ownership of small holdings. Conversely, when government ownership take place at large company, value of company increase. Sun and Tong (2003) found that government intervention through ownership of shares China companies influence the company performance. The research of Alamsyah, et al (2005) indicates that banking disintermediation reduces the effectiveness of monetary policy during crisis and post-crisis. Azis (2004) does not find relationship between monetary policy and real sector in Indonesia. Policies should be able to increase effectiveness through standardization of routine decisions and employee and manager discretion in implementing strategy (Pearce and Robinson 2007). Thus, policies could increase effectiveness through standardization of routine decisions and employee and manager discretion in implementing the strategy (Pearce and Robinson 2007).

Adu (1999:467) found that environment directly affects business performance. Hidayat (2004) also found that macro environment and internal industry can directly affect business performance. Hansen and Wernelfelt (1989) examined the economic model of firm performance and organizational model of firm performance. The research findings show that both models can explain the company performance two times greater than economic factors.

Porter (1980, 1985), Griffin (1987), Robbins (1992, 1996), describes the environment as an institution or a force that come from outside organization, such as: suppliers, customers, competitors, government regulation, public pressure, where organization has little control (less control) and the strength can affect organizational performance (Solomon, et al 2001).

In contrast to the results of above study, Simons (cited Fauzi 2010) states that intensity and uncertainty affect environmental performance. The more dynamic corporate environment (indicated by level of environmental uncertainty is high) then the more likely has negative effects on performance, and vice versa. Furthermore, Simon explained that business environment become factors that influence the strategic uncertainty that will lower company's ability to achieve stated-goals. Faurer and Chaharbaghi (1996) found that level of the competitive environment dynamics had no effect on business performance.

The environment complexity can affect the strategy of diversification directly or indirectly in influencing diversification decisions (Keats and Hitts 1988). They define complexity as the heterogeneity and concentration of environmental elements. Dess and Beard (1984), Keats and Hitt (1988), Hitt and Hokisson (1990) characterize the environment complexity with level of competition. That is, the environment complexity can be seen from the structure of an industrial market. Hitt and Hokisson (1990) states that in relatively perfect market conditions (high-level competition), diversification strategy may moderate the relationship between environmental performance. Conversely, with assumption the market is not perfect, the environment moderates relationship between strategy and performance. Thus, the higher environment complexity, the greater probability companies select unrelated-diversification strategy than related-diversification strategy.

The researchers believe that environmental differences may cause differences in performance. Geiger and Hoffman (1998), Luo (2002), Houston and Naranjo (2003) states that difference in diversification performance in developed and developing countries, as well as differences in regulatory environment, will result diversification performance differences. Mayer and Whittington (2003) supports the opinion of Naranjo, et al (2003) by comparing the performance difference in some developed countries and developing countries at two different time periods to demonstrate the performance difference due to different environments.

Relation between diversification Strategy on Performance.

Strategy is one important aspect to address the rapid changes and unpredictable. This is a pattern of actions to Achieve objectives (Thompson and Strickland, 1995) or as a unified, comprehensive, and integrated plan that relating the strategic advantages of firm to Challenges of environment (Jauch and Glueck, 1988 in Idrus, 1997). Strategy could determine clearly where an organization will be taken and how scarce resources are allocated as efficiently as possible, and how continues improvement can be maintained and or enhanced. It is structured to respond to external changes that are relevant to an organization such as the industry changes, technology, economics, public policy, political, competitive environment, consumer tastes, and suppliers behavior change (suppliers of funds, human resources, and material). Incapacity or indifference to external environmental changes will create 'shock' to an organization (Idrus, 1997).

Company's internal environment also has a major role to improve performance or even to create competitiveness for company (Crain, 2009). Organizational performance improvement could not be achieved only by manager. The organization requires perseverance and support from various parties at all levels organization (Hopskin, 1997). Therefore, leadership , business model, namely all internal structures, mental frameworks, and operating procedures, processes, and practices are needed to determine how to do the work and how people (people) involved in each activity within an organization (Jagersma; 2009, Crain; 2009). Thus, the strategy used to maintain, sustain, and improve organizational performance and competitive advantage (Kudla, 1980; Robinson and Pearce, 1983 in Idrus 1997

Principally, diversification strategy may help banks to more survive in face of crisis (Elsas et al 2010). Conceptually, diversification should have a positive effect on corporate performance as it helps companies achieve economies of scale, greater scope and leverage the experience to other markets (Rumelt, 1984). However, empirical studies on the role of diversification on performance of company gives different results. Montgomery and Wernerfelt (1988) pointed out that diversification has a negative impact on performance. Diversification often increases the cost of operation, causing conflict in form of greater managerial and organizational complexity (Chakrabarti et al.. 2007). Berger and Ofek (1995) have examined the effects of diversification of products or services and (Ghoshal 1987) examines the international diversification on corporate performance.

The results of other empirical studies shown that diversification strategy has an impact on banking performance (Berger, et al 2010). Nath, et al (2010) and Li and Rwegasira (2008) supports the findings Berger (2010). Li and Rwegasira (2008) found that association between diversification strategy and corporate performance is positive and significant. Lu and Yao (2006) found an association between diversification and firm performance. Elsas, et al (2010) gives a new poin of view the direct and indirect effects of diversification strategies on firm value, by distinguishing the aggregate effects of diversification and growth through interaction, and vertical integration. Nath, et al (2010), gives a new perspective on the model of functional capabilities and corporate diversification strategies affect performance in China's transitional economy.

Over the last decade, many banks around the world have implemented a diversification strategy (Elsas et al. 2010). The reasons of bank diversification strategy are: (1) high levered banks (Berger, et al 2010), (2) diversification strategy can also accelerate organization to get their credibility which acts as a filter or loans monitor (Diamond 1984), (3) diversification strategy can increase the value of bank (Hitt, Hokisson, Ireland

2001), because banks are faced with rapid environmental changes that triggered by high levels of competition, technological advances, and deregulation. Bank expand its business scope mainly as a strategic response to business uncertainty. Effectively, diversification can give value-added through two mechanisms: (a) develop a scope of economical (economies scope) between business units within company so that it can produce synergistic benefits, and (b) develop market power to increase income. Bank implement diversification strategy in order to enhance strategic competitiveness of its business scope. When diversification strategy increases strategic competitiveness, total firm value will increase. Therefore, diversification strategy between sectors can reduce chance of bankruptcy / financial pressures that expensive, and can better survive in a state of crisis (Elsas 2010).

Study of Jensen (1986) provide evidence that financial institutions should focus on a single business line so that greatest benefit from the expertise and reduce the problems of agency, allowing investors to diversify their own. However, recent studies have shown that costs may be greater than the benefits obtained when bank chose diversified (elses 2010). DeYoung and Roland (2001) found that U.S. banks change their lending activities with traditional fee-based activities associated with a higher revenue volatility. The researchers that supporting diversification showing that banks are diversifying to benefit from leveraging skills and managerial capabilities, products and geographical areas (Datta and McLaughlin, 2007), as well as economic obtain coverage through deployment of fixed costs of product and regional / geographic (Drucker and Puri, 2009).

Companies make diversify in order to expand the scope of industrial companies. Diversification is considered more efficient because of resource transfer between segments. Therefore, the company's resources can be used more optimally. This happens if companies make related-diversification. When companies perform unrelated-diversification, inter-segment transfer of resources is hard to do. Rumelt (1982) stated the company that diversifying in related-business provides good results on ROI and ROE compared with companies that diversifying in unrelated-business. From some of these findings we can conclude that there is no consistency of the results because relationship between diversification and performance (diversification-performance linkage) depending on industry characteristics (Santalo and Becerra 2008).

Based on above description, researchers will use a diversification strategy. The consideration is that credit growth is still not shown any increase in order banking intermediation functions optimally. In addition, other financial performance indicators show a better condition. Empirically, diversification strategy considered to be able to improve performance, particularly in crisis and post-crisis period (Berger et al. 2010; elses 2010). Diversification strategy is a strategy of diversity efforts made by bank as a form of strategic response to changing external environment and evaluation to get feedback in formulating future strategies. Diversification strategy is divided into two groups, namely: related-diversification and unrelated-diversification strategy. Related-diversification strategy is business-related activities of bank, as a collector of funds from public (in the form of demand deposits, savings deposits, and savings deposits) and channeled back to community (in form of working capital loans, investment loans, and consumer credit). Bank revenues from main activity is interest (interest-based income) that included in opinion of bank's operations. Meanwhile, unrelated-diversification strategies are activities outside bank's main functions, such as providing other services (Kasmir 2010) in the form of cash transfers, clearing, bank guarantees, buying and selling securities, accepting deposits (tax, telephone), and wage payments (salary, retired). Income from that banking activities is called fee-based income. These are grouped into banks non-operasional revenue. Therefore, diversification can be measured using Specialization Rate (SR). Specialization rate (SR) is a comparison between the opinions of interest (income of the bank) by your total income. If SR is greater than 70% percent then grouped into categories of related-diversification strategy, whereas if the SR is smaller than 70% percent then grouped into categories of unrelated-diversification strategy (Rumelt 1974, 1977, 1982).

The results of empirical studies find that diversification strategy has an impact on bank performance (Berger, et al 2010). Nath, et al (2010) and Li and Rwegasira (2008) supports the findings Berger (2010). Li and Rwegasira (2008) proposed the hypothesis that there is a negative relationship between diversification strategy

and corporate performance. In contrast, the evidence shows the relationship between diversification strategy and corporate performance is positive and significant. Lu and Yao (2006) found an association between diversification and corporate performance in China by using variables moderated the impact of state ownership and mechanisms for control group. They found that diversification strategy can increase performance of company when the company adopted a higher level of diversification. Researchers found the study's findings that appear contradict to Boot (2003) and found that diversification strategies indirectly affect the market value of control variables (profitability). Elsas, et al (2010) gives a new view of direct and indirect effects of diversification strategies on firm value, by distinguishing the effects of diversification through interaction of aggregate growth, and vertical integration. These results contradict with the findings of Leven and Levine (2007), which shows the diversification strategy has direct and negative effect on bank value.

Diversification of research approaches can be analyzed with the industrial economics and management disciplines. Rumelt (1974), Hitt and Hokisson (1990) conducted a study with a diversified industrial economy approach to explain the relationship between structural changes and diversification of economic performance. Other researchers also conducted a study diversification by using a managerial approach to explain how companies can exploit the potential synergies of diversification in order become a source of sustainable competitive advantage (Barney, 2002; Matsusaka, 2001). Initially, some researchers claim that diversification is a strategic choice in any business organization, because it has the potential to create value. Anshoff (1965:128) states, diversification is an evolution of company growth. In contrast, some other researchers found that diversification reduces the value of a firm (Lang and Stulz, 1994; Berger and Offek 1996; Salvaes 1996; Leven and Levine 2007). These different findings contradict with theory of economies scope. The theory explains that economies scope of multibusiness company can benefit economically through the use of shared assets, allocation of funds to reduce business risk, or internal transaction costs are cheaper in between business units (Nayyar, 1993; Elsas, et al 2010).

Some literature has shown some of reasons why diversification strategy has a positive influence and negative impact on company performance. Typically, the potential benefits of diversification increase due to the broader scope of business when companies operate in several different businesses (Teece, 1982 in Santalo and Becerra, 2008). Meanwhile, the potential cost of diversification related to larger internal governance in the management activities of inter-segment firms (Rajan et al., 2000). Benefit and costs incurred by diversification can not be considered equal in all industries. Of course, the benefits and costs is highly dependent on characteristics of industry. Santalo and Becerra (2008) argues that absolute optimum degree for all industrial diversification may not exist, because hindered by heterogeneity of industry. The optimal diversification strategy and the diversification-performance linkage depends on industry characteristics.

Li and Wong (2003) examined the association of diversification with performance of major companies in China. The results showed that diversification strategy is not only seen from financial aspect alone but need to consider environmental contingency factors such as institutional factors (political, legal, societal) that affect the company's strategy. Selection of appropriate strategies will be able to improve company performance. They found that related-diversification strategy to be less than optimal due to the uncertainty of institutional behavior. Only using unrelated-diversification will lower the value of company. Balance or a combination between the application of unrelated-diversification and related-diversification strategy is expected to be the optimal strategy to improve company performance.

Many researchers have different opinions about the performance differences between firms. This distinction is an important issue in strategic management (Hawawini, Subramanian and Verdin, 2003). Capron (1997) suggests that diversification performance differences are caused by: (1) differences in managerial motivation, (2) different environments, (3) measurement problem (Whited, 2001), (4) problems of data (Villalonga, 2004), (5) sample selection bias (Graham et al., 2002), and (6) failure to take into account the endogeneity of diversification decision (Campa and Kedia, 2002). Empirically, the difference findings from some researchers about the relationship of diversification strategy on performance can be explained by using the

strategic management literature. Here, broadly explain why a company to diversify, diversify how much it costs, when diversification can improve the performance of company and when it could hurt company (Chakrabarti et al., 2007; Montgomery, 1994). The main reason is benefits perception of diversification associated with a larger target market, the usage of unused productive capacity, reduction of risk in terms of diverse business portfolio and capability build-up. Conceptually, diversification should have a positive effect on corporate performance as it helps companies achieve economies of scale, greater reach and leverage the experience to other markets (Rumelt, 1984). However, empirical studies on the role of diversification on performance of the company gives different results. Montgomery and Wernerfelt (1988) pointed out that diversification has a negative impact on performance. Diversification often increase operating costs, leading to conflicts in the form of greater managerial and organizational complexity (Chakrabarti et al., 2007). The effect of diversification of products or services have been studied by Berger and Ofek (1995). Meanwhile, Ghoshal (1987) examined the effect of international diversification on corporate performance. Based on arguments above, diversification impact on long-term business performance.

Theoretical study and results of previous studies that have revealed shows still there are gaps that need to be researched and is a virtue of this study, namely the relationship environment complexity with BI policy. Research on environment relationship-strategy-performance for the banking industry is still rarely done. During this time, in the knowledge of researchers, previous studies rarely connect directly with the environmental complexity of both government and BI policies. Most of previous research examining Environment Complexity and policy variables used as indicators of external environment (such as Amoako, 2003; Thompson 1967 cited in Griffin 2004; Badri, et al. 2000; Ward, et al, 1995; Hopkins, 1997, Luke 2001, Benito, et al. 2010, Sharfanan and Dean, 1991 cited in Badri, et al. 2000, Benito, et al. 2010). In this study, environment complexity variables and serve as a direct influence on policy. The policy referred to in this study are issued by BI (read: BI policy). One task of BI is set and implement monetary policy by Act No.3, 2004. In addition, researchers also address BI policy towards diversification strategy, as suggested by Li and Wong (2003).

The above phenomena explain the relationship environment complexity with BI policy. One of external environment changes that much effect on banking sector is a range of policies issued by BI. As a highly regulated industry, banks continue to deal with changes in government regulations. The banking sector must "comply" with applicable regulations for the sake of sustainability-managed business. Regulatory/policy can be supportive or impede banks performance. Relations and environmental complexity of BI policy is based upon facts or events of crisis that hit Indonesia since 1997 until 2008 global economic crisis. Development of an improved national banking and economic condition of Indonesia with strong fundamentals is based on the facts on the various policy packages issued by BIAYA. Indonesia is expected to overcome the adverse impact of the turmoil of the world economic crisis today betterly than at the time of the 1997 crisis. BI responding to these environmental changes by issuing a policy package. Evidently, Indonesia can overcome the adverse effects of the turmoil of the world economic crisis at this time (the global crisis of 2008) are better than at the time of the 1997 crisis. Therefore, the authors assume that linkage of the BI policy environment is very important to investigate. Act No. 23, 1999 on Bank which is then converted into Act No. 3, 2004 states, one of the BI task is to formulate and implement monetary policy. Government policy that researched in this study are the rules and policies issued by Bank Indonesia as, API policy, banking policy Packages (Pack 2006, Pack 2008), Statutory Reserves (GWM), and Bank Indonesia interest rate. This study does not define performance same as previous studies, but refer to the criteria stipulated by Bank Indonesia, which is using the concept of Capital, Asset Quality, Management, Earning, Liquidity (CAMEL). Based on the description of conceptual framework, then in figure 1, the hypothesis is derived within the framework of the hypothesis:

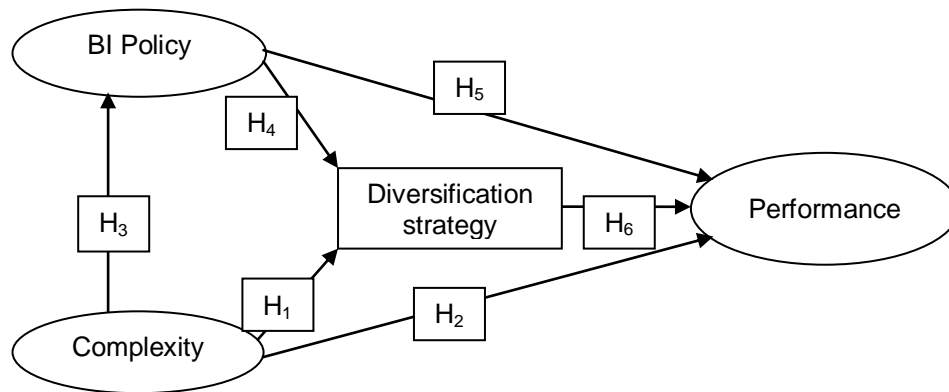


Figure 1. Research Hypothesis Framework

Figure Gambar 1. Research Hypothesis Framework

Source : Benito dan Rocha, 2010, Tan dan Tan 2005; Hoskisson 2003, Naranjo 2003, Lukas 2001; Hasyim et al. 2000, Luo 1999, Bird 1991, Adu 1999, Keats dan Hitts 1988, Pearce dan Robinson 2007; Show et al. 2005; Wheelen dan Hunger 2004, Barth, et al 2000 Chen et al. 2005; Alamsyah et al 2005, Azis 2004, Tian 2001, Sherer 1981, Nath, et al 2010; Li dan Rwegasira 2008; Lukas 2001, Lu dan Yao 2006, Li dan Wong 2003.

Research Methods

Population and Study Sample

1. Population

This study uses the entire population of the National Commercial Bank (NCB) in East Java, at the time of the research is done (2010). Until today, the number of commercial banks in East Java area 386 branch offices (based Commercial Bank Report / LBU December 2010, BI). Banks are scattered throughout the District / City, included into four (4) Work Area Indonesia Bank Offices (IBO), namely: (1) IBO Surabaya, (2) IBO Malang, (3) IBO Kediri, and IBO Jember (Circular Letter of Bank , March 2009).

2. Samples

Samples was determined using the purposive sampling technique. Purposive sampling is a method of sample selection that determined based on certain criteria (Sekaran, 2003). Bank criteria used in this study is the National Commercial Bank that included in the top ten rankings, based on the magazine's ownership group Rating "Infobank", edition No.. 375 in June 2010. The number of samples is 253 bank branch offices. The unit of analysis is the company (bank). Respondents in the study is the Branch Head.

Variable Measurement Techniques

This study used four variables: the environment complexity, diversification strategy, the policy of Bank Indonesia, and performance.

The Environment Complexity Variables

The environment complexity is the level of diversity and heterogeneity of each of the elements of external environment will affect the bank's strategic decisions. Environment Complexity indicators developed from Benito (2010), Braglia and Petroni (2000) Luke (2001), DESS and Miller (1993), and the concept of competitive forces Porter (1996). Indicators of environmental complexity include: Changes in consumer tastes (4 items statements); The level of competition (7 items questions); Changes in behavior of suppliers (3 item questions); The development of technology, (4 item question). These questions are kind of closed questions,

was measured using a 5-point Likert scale.

Variable diversification strategy

Diversification strategy of using indicator of categories specialization rate (SR) refers to the Rumelt (1974, 1977, 1982). SR is the ratio between the loan interest income on total revenue. The indicator is measured using a ratio scale. The questions used were open questions. Question items used are interest income and total income credit with a range of the last 3 years (2007-2009).

Policy Variables Bank Indonesia

Policy is a set of policies or regulations that can support or hinder the banks performance. Policies in this study are issued by Bank Indonesia. BI policy indicators are as follows: Policy Indonesian Banking Architecture (API), policy packages: Pakto Pakjan 2006 and 2008), Statutory Reserves (GWM), and the interest rate of Bank Indonesia. The indicators are translated into a seven-item-item questions. These questions are closed questions, was measured using a five-point Likert scale (5).

Performance

Performance is the level of performance or achievements of the company within a certain time period or outcomes (achievement) as a measure to evaluate the success or failure, or the appropriateness of strategies used. Performance measurement in this study on the analysis refer to CAMEL (Kasmir, 2008; 2010).

Data Collection

The data in this study were collected in two ways. (1) mail survey, sending questionnaires to the Executive Branch of Bank sampled. (2) Interview, conducted to obtain information in depth and insightful of object study, identify problems, and confirm the results of analysis or discussion.

Data Analysis Methods

Relations model causality requires analysis tools that are able to explain the relationship. Therefore, this study uses Structural Equation Modelling (SEM) method.

Discussion of Research Findings

Evaluation of Models

The results of overall goodness of fit model shows that all measurements are at an acceptable level. It can therefore be expressed goodness of fit model is acceptable. That is, this test produces a fairly good confirmation of the indicators and the causal relationships among variables. This test is able to prove that model of the relationship between the environment complexity-BI policy - diversification strategy - banks performance is suitable with the observed data.

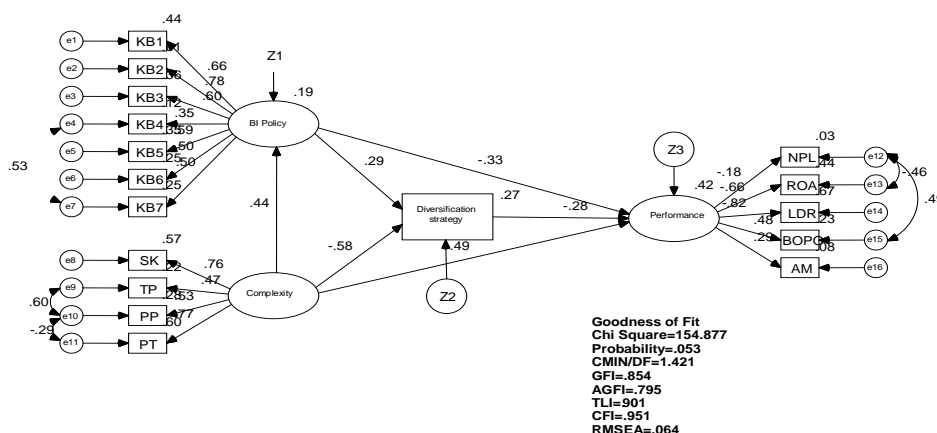


Figure 2. Structural Model

Figure 2. Structural Model

Model Test Results

The results of hypothesis testing showed that all the hypothesis is accepted at significant level of $p < 0.05$ (Table 2). This model is appropriate to describe the complexity of the causal relationship model of the environment, BI policy, diversification strategy, and banks performance in the banking industry. To test this model researchers propose six hypotheses. The results of testing of the hypothesis suggests that all the hypotheses accepted or supported. That is, the model is appropriate to describe the complexity of the causal relationship model of the environment, BI policy, diversification strategy, and performance for the banking industry. Thus, the results of this study indicate conformity with the phenomenon or paradigm Environment-Strategy-Performance (ESP). This finding is also interesting, there are three hypotheses that have a negative influence. Discussion of the results of the analysis is based on these hypotheses.

Table 2. Critical Value Ratio, Coefficient Line (Standardize Regression) between variables

No.	Path	Path Coefficient	Critical Ratio	Probability	Note
1	EC → DS	-0.579	-4.282	0.000	Significant
2	EC → Banking Performance	0.493	2.568	0.010	Significant
3	EC → BIP	0.437	2.923	0.003	Significant
4	BIP → DS	0.294	2.240	0.025	Significant
5	BIP → Banking Performance	-0.325	-2.027	0.043	Significant
6	DS → Banking Performance	-0.280	-2.119	0.034	Significant

Sources: Processed Primary data, 2011

Effect of Environmental Complexity of Diversification Strategy

Hypothesis 1 which states there is the environment complexity impact of diversification strategy, accepted or endorsed (Table 2). These findings suggest that environment complexity significantly influence the rate of decline Specialization, diversification means increasing. These results indicate the higher levels of environmental complexity, the more diversified strategy used (meaning that bank's strategy led to the business activities of non-credit / fee-based income). In other words, the environment complexity has a direct influence in encouraging banks to diversify the business activities to non-credit (fee-based income). Thus, at this time has been a change in banking strategy. This condition is in accordance with the situation researched, environment faced by banks in East Java. As a result of banking has difficulties raise cheap funds. Therefore, banks are required to conduct a strategy that leads to the business activities of non-credit (fee-based income), to increase the fee from non-operational. Steps taken are (1) improve customer activity, such as fees for transactions at Automatic Teller Machine (ATM), internet, mobile, and SMS banking, (2) increase the yield margin wide and inelastic to interest rates decrease, such as sector consumption and micro business sector, small and medium enterprises (SMEs), and (3) Remittances (remittance). This product is a transfer or remittances from abroad into the country (inward remittance) and vice versa from the domestic to abroad (outward remittance). Large fees obtained from inward remittances, mainly from Indonesian Workers (IW) in Middle Eastern countries (Saudi Arabia, Jordan, UAE, Bahrain, Kuwait, and Qatar), Malaysia, Singapore, Tokyo, Hong Kong, Taiwan, and South Korea. These findings indicate that banking environment facing increasingly complex in East Java. The higher the environment complexity faced by banks, the faster the changes in consumer tastes, the level of competition tighter, changes in the behavior of suppliers, and technological developments are increasingly high.

Changes in consumer tastes are shifting consumer tastes as a result of rapid changes in the external environment. The characteristics consumer tastes changes makes the customer demands of a growing number of bank credit products, increase bargaining power of customers in the transaction (eg in a credit transaction), customers are increasingly sensitive to interest rate changes both credit and savings, and customer demands for

the development of innovation new products is increasing. Changes in consumer tastes is faster, it has encouraged banks to diversify the business activities of non-credit (fee-based income).

The level of competition is the level of competition among banks or the level of competition in the bank environment (market). Based on the results of interviews with the head of the bank branch, it is known banks in East Java faces high competition level. Competition occurs not only between banks counterpart, but also with non-bank financial institutions. Competition is very high cause: liquidity becomes tight, making it difficult to find low-cost funds (in the form of deposits or deposits and savings), there was the struggle to get deposits by offering high interest rates; high customer turnover; banks increase the credit quality (more prudent); consideration in choosing a bank is the interest rate; and on-line systems, such as ATM networks.

The impact is customer becoming dominant, both individuals and institutional clients, be sensitive to the interest, information is increasingly open, as well as customers compare the inter-bank facilities. In addition, there is competition with non-bank financial institutions (as a replacement product), such as: financial institution / cooperative savings and loans, loan sharks; transactions via teller (manpower) vs. ATM (machine); Investments, mutual funds, Bonds of Indonesia Republic (BIR) ; and foreign financial institutions.

The more stringent level of competition has encouraged banks to diversify the business activities of non-credit (fee-based income). Level of competition is reflected by very strict competition: the intensity of competition in setting the lending rates between banks and non-bank institutions are rising, the strategy made competitors increasingly diverse, the intensity of the establishment of bank branches higher, the intensity of competition is doing promotion higher, and products substitution more and more.

Suppliers is the source of acquisition or investment funds and a third party. Changes in the behavior of suppliers also encourage banks to make a diversification strategy that leads to activity-fee-based to create business income. The changes in behavior is reflected by the supplier: bargaining power of suppliers in financial transactions (investment fund) is higher, the role of suppliers in determining the level of mortgage interest rates is higher, and the role of suppliers in the supervision of the credit is higher.

The increasingly rapid technological developments level have been encouraging banks to strengthen their diversified strategy. Bank's strategy increasingly leads to business activities of non-credit. Rapid technological development level is the result of dynamic changes in the external environment and turbulent. Level of technological development is shown by the increase intensity of the development of new product innovation bank, the higher intensity of development of information technology in support of the bank's operations (such as banks can provide services to customers faster, more accessible, and more accurately via ATM), a faster rate of intensity procedures loan / credit bank, and the level of information provided to customers more accurate.

In general, these findings theoretically consistent with formulation strategies statement to achieve the desired performance that should notice or adapt to changing industry environment (Glueck, 1980 in Idrus 1997; DESS, 1994; Ansoff, 1982; Aaker, 1988; Sapp and Smith, 1984). This finding also is consistent with the findings Hoskisson (2003), Benito and Rocha (2010), that environmental influence the strategy. The opinion was supported by Naranjo (2003), which indicates the environmental influence on the organization's decision process in choosing a strategy. The researchers did not specifically mention the direction of the influence of environment on strategy is positive or negative. Only Li (1991) which states unequivocally that interaction between environment and strategy of product innovation has a positive effect on performance. While Hidayat (2004) and Muafi (2008) found the influence of environment on strategy is negative. Hidayat and Muafi observe the cement industry environment which includes the intensity of competition, the Indonesian Cement Association, politics and security, government regulations and shareholders. Apparently, the results of this study support the findings of Hidayat (2004) and Muafi (2008).

Strategy as one important aspect to address the rapid and unpredictable changes, is required. The findings indicate that banking industry in East Java increasingly use diversified strategy. Principally, highly diversified strategy done in order to help banks better able to survive in the face of an increasingly complex environment and can better survive in a state of crisis. This statement is supported by Berger (2010) who explains that bank should make a strategy of diversification. Bank with high-levered and diversified between sectors can reduce the chance of bankruptcy or high financial pressures, and can better survive in a state of crisis (Elsas 2010). Demsetz and Strahan (1997) explained that application of portfolio theory in the banking industry supports the notion that strategy of diversification can reduce risk, especially in crisis condition. Diversification strategy can accelerate banks to get their credibility which acts as a filter or monitor loans (Diamond 1984).

Effect of Environmental Complexity on Performance

The environment complexity has wide influential and positive impact on banking performance. That is, the higher the level of environment complexity the higher the level of banking performance. In other words, the more complex an environment likely to be followed by an increase in bank performance.

These findings support some previous research results. Adu (1999) found that environment directly affects business performance. Luke (2001) found that environment has an influence on performance. Hashim, et al. (2001) also found that environment complexity have an influence on the performance of SME's. Luo (1999) examined the relationship between environmental performance of existing small businesses in the urban and rural areas China. Luo results indicate that business environmental characteristics (complexity, Dynamism and hostility) has a significant impact on performance (profitability and market position). The findings of Tan and Tan (2005) shows the environment has a significant positive interaction with the strategy and performance. Tan and Lischert (1994) does not find suitability between the environment (complexity, dynamism and hostility) and the strategy and have significant implications and positive impact on business performance.

In contrast to the results of research that has been explained above, Fauzi (2010) states that intensity and uncertainty affect environmental performance. The more dynamic corporate environment (indicated by the level of environmental uncertainty is high) then the more negative effect on performance, and vice versa. Furthermore, Simon explained that business environment is one of the factors that influence strategic uncertainty, will lower the company's ability to achieve the goals set. Faurer and Chaharbaghi (1996) found that level of the dynamics of the competitive environment does not have an influence on business performance. Porter (1980, 1985), Griffin (1987), Robbins (1992, 1996) describes the environment as an institution or a force at outside the organization, such as: suppliers, customers, competitors, government regulation, public pressure. Organizations have less control and power can influence organizational performance (Solomon, et al 2001).

Indirect effects of complexity mediated by the environment on the performance of diversification strategies, with amounting to -0016. The direct effect of complexity on the performance is 0493 and the total effect is 0477. These findings illustrate that a direct influence complexity on performance is greater than the indirect effect environment complexity on performance that mediated by a strategy of diversification. That is, the environment complexity have a significant and negative effect on performance, mediated by a strategy of diversification. Diversification strategy used to minimize the total effect due to the effects of diversification strategies is negative. From these findings can be stated that diversification strategy less able to improve bank performance in East Java when the environmental conditions have higher complexity. Banking performance can be improved if the bank uses unrelated-diversification strategy or strategies that lead to non-credit business activities (fee-based income). These findings are relevant to the empirical study of DeYoung and Roland (2001) which states that banks in the United States to replace the activities of traditional services with fee-based activities to get higher revenue. These findings are also relevant to the phenomena that occur in Indonesia. BI data shown 2009 is a largest profit of Indonesia Bank in the history of Indonesian banks, namely 45, 2 trillion

rupiah. Compared to earnings in 2008 of 30.6 trillion rupiah, there is an increase of 47%. Meanwhile, credit grew only 9% with the trend of declining interest rates.

Effect of Environmental Complexity of BI Policy

Hypothesis 3 which states there is the Environment Complexity influences on the policy of Bank Indonesia, supported or accepted. These results reflect the higher levels of environmental complexity, the higher the bank's dependence on the BI policy. In other words, the banking industry, while facing the environmental conditions of higher complexity, requiring a more stringent policy of BI. Policies or regulations issued by the government and Bank Indonesia is one of the external environment changes that much effect on the banking sector. As a regulated industry, the banking industry faced with changes in government regulation continuously. The banking sector must comply with applicable regulations for the sake of sustainability-managed business. The policy can be supportive or impede the banks performance. Relations and environmental complexity of the BI policy is based upon facts or events of the crisis that hit Indonesia since 1997 until the 2008 global economic crisis. Indonesia can overcome the adverse effects of the turmoil the current world economic crisis better than at the time of the crisis in 1997, is based on the development of an improved national banking and economic condition of Indonesia's strong fundamentals based policy packages issued by should cost.

The theory of industrial organization explained that industrial market structure is formed, among others, by regulation. The structure of this market will further affect market behavior, such as product strategy and will ultimately affect the performance (Scherer, 1981). BI has a strategic position in creating a conducive climate for economic development activities and create a healthy banking system, strong and efficient through its policies. To that end, the existence of a healthy bank, both individually and as a whole as a system, is a prerequisite for a healthy economy. To create a sound banking among other adjustment is necessary and effective bank supervision. Banking policy, formulated and implemented by the Bank, are part of an effort to create, maintain, and maintain a sound banking system. Whatever the model to be used in performing duties BI to regulate and to supervise banks, the aim is to achieve a high level of trust from the community to the bank. Thus, the higher the environment complexity, BI policy increasingly required by the banking industry. Evidently, Indonesia can overcome the adverse effects of the turmoil of the world economic crisis at this time (the global crisis of 2008) is better than at the time of the 1997 crisis. The findings of this study also proves that environment complexity have direct and positive impact on the BI policy.

Effect of Bank Indonesia policy towards Diversification Strategy

Hypothesis 4 which states there is influence the BI policy towards diversification strategy, accepted or endorsed (Table 2). Effect of BI policy to diversification strategy is a direct, significant and positive. The positive direction indicates that policy of Bank Indonesia has a direct influence in encouraging banks to strategic activities concentrated on the core business (lower the level of diversification).

The results of this study support the findings of Pearce and Robinson (2007) and Wheelen and Hunger (2004) which states that success of the banking industry is influenced by government policies. Furthermore, Wheelen and Hunger explained that main elements of the external environment is government policy. The change of government policy will impact on the strategy and business performance. DESS (1994), Glueck (1981), and (Hashim, Wafa and Solomon 2001) explains that in order to achieve optimal performance, the strategy should be formulated with due regard to the environment, such as legislation or government policy. Scherer (1981) explained that industrial market structure will be established by regulation. Furthermore, this market structure will affect market behavior, such as product strategy.

Research the relationship between these policies to diversification strategy is a respond to Li and Wong (2003) suggestions. Apparently, these findings can be answered according to the suggestion, namely, BI policies affect directly, significant and positive on diversification strategy. This means that the higher the BI

policy (the greater the interference BI) then the banks increasingly forced to make a strategy that leads to the business of credit (interest-based income).

Real conditions in 2007-2009 period showed credit growth is still not result in increased bank intermediation function optimally (BI, East Java Regional Economic Studies 2009). On the one hand, low growth in bank loans due to the high risk perception of the real sector due the global financial crisis. On the other hand, it is also due to slowing economic activity and high interest rates. LDR is one indicator of banking intermediation. The year 2009 showed the LDR slower, after the previous year 2007-2008 showed an increase in relatively good. LDR is constantly increasing during 2007-2008. But in 2009 LDR decreased from 67.53% in 2008 to 66.43% in 2009. In terms of deposits, the growth of public funds during 2009 also showed a little increase of when compared to the previous year. Non-performing loans (NPLs) declined until 2008, but increased in 2009.

The results of this study indicate there is compliance with the real conditions. BI policies can encourage banks pursuing a strategy of diversification and therefore contributes to the banks performance. Adaptation strategies and configuration evolution between environment strategy is positively related to firm performance. The study's findings are consistent with existing conditions, but differ with the expected. Nevertheless, the banks performance in East Java in 2010 better than 2009. Improved performance achievements are inseparable from the support of the policy issued by BI (such as: API, package banking policy (Pack 2006, Pack 2008), statutory reserves, and interest rates Indonesia), which is more flexible in responding to the dynamics of economic development; including, encourage banks to channel credit to productive real sector, as SMEs. Consequently, the organizational environment is considered to determine the context of strategy formulation. These results indicate the environment has a significant positive interaction with the strategy and performance.

Policy Influence on Performance of Bank Indonesia

Hypothesis 5 which states there is an influence on the performance of the banking BI policy, endorsed or accepted (Table 2). BI policy relationship with banks healthy is negative and direct. That is, the more policies issued by BI the lower banks performance. In other words, the BI policy resulted in a decline of banking performance.

.... These findings indicate that policy had been issued regulators can not improve the banks performance in East Java, as shown by the negative sign on the path coefficients. As a regulated industry, banks continue to deal with changes in government regulations. The banking sector must "comply" with applicable regulations for the sake of sustainability-managed business. Therefore, banks are often claimed to be the kind of high-regulated industry, so often seems to be over-regulated.

The findings of this study support the results of the study Chen et al (2005) and Sun and Tong (2003). Policy / regulation can support or hinder the banking performance, such as in the case of Government-Controlled Direct Company (DGCC) in China. Chen et al (2005) found that the higher the government's intervention against a company, the lower the performance of the company. Sun and Tong (2003) also found that effect of government regulation on performance is negative, the company located in Bursa China. Furthermore, they explained that this condition is caused by the economic transition that occurred at that time in China.

In contrast to the results of the above study, Barth, et al (2000) did not find any strong relationship between regulation by the performance of commercial banks and trading companies in developed countries. Tian (2001) found that firm value decreases when the government intervened small holdings. Conversely, when the greater government ownership, the higher the value of the company. With regard to influence government policy, DESS (1994), Glueck (1981), and Hashim, Wafa and Sulayman

(2001) explains that in order to achieve optimal performance, the strategy should be formulated with due regard to the environment. The theory of industrial organization explained that industrial market structure will be established by regulation. The structure of this market will further affect market behavior, such as product strategy. This in turn will affect the performance (Scherer, 1981). Thus, these findings reinforce the findings of Chen et al (2005) and Sun and Tong (2003).

These findings are less consistent with the real condition. Banking performance in East Java in the period 2007-2009 study showed a better condition. Total assets, deposits, and credit showing an upward trend. In 2009 the growth of banking assets reached Rp 223,738,664, driven by loan growth of Rp 129,004,070. Only, credit growth is still not showing increased bank intermediation function optimally. LDR is one indicator of banking intermediation. LDR 2009 showed a slower rate after the previous year 2007-2008 showed an increase in relatively good. LDR is constantly increasing during 2007-2008. However, in 2009 LDR has decreased, from 67.53% in 2008 to 66.43% in 2009. In terms of deposits, the growth of public funds during 2009 also showed an increase of less high when compared to the previous year. Non-performing loans (NPLs) declined until 2008, but increased in 2009.

The discrepancy with the findings of this study due to the fact that occurrence of banking disintermediation may reduce the effectiveness of monetary policy during the crisis and post-crisis (Alam, et al 2005). Policy should be able to increase effectiveness through standardization of routine decisions and restrictions on managers and employees in implementing the strategy discretion (Azis 2004). Banking disintermediation can be seen from the decrease in the amount of bank lending is very significant. After the crisis passed, the macroeconomic indicators is relatively better, but the development of real sector has not improved. This is due to growth in outstanding loans to the real sector is still slow. Therefore, development of real sector became slow. Loans disbursed to the real sector has not been enough to become a tool of economic growth driver, as in the pre-crisis levels. This will greatly affect the process of economic recovery in Indonesia. Thus, the slowdown in bank credit growth in Indonesia after the 1997 crisis can be considered as one cause of slow economic recovery of Indonesia.

BI policies negatively affect performance. Apparently, commission-based revenue (fee-based income) can improve performance. The more stringent policies BI, the declining health of banks. In other words, the greater the intervention of BI, the declining health of banks. Other findings showed that BI policy has a direct effect on the performance of -0325. Indirect effects on the performance of the BI policy that is mediated by a strategy of diversification of -0082, and -0408 for the total effect. That is, the more diversified banks, the better performance, with the indirect influence of 0082. By implication, the lower the performance of the more diversified banks. That is, banks increasingly lead to activity-fee-based income, then the better the performance.

When viewed from the direct effects, indirect effects, and the total effect, the direct effect of the BI policy towards diversification strategy is 0294 and the total effect is 0294. Direct effect on the performance of the BI policy is -0325, indirect effects on the performance of the BI policy that is mediated by a strategy of diversification is -0082, and the total effect is -0408. Thus, it can be seen that direct and negative impact on the performance of the BI policy is greater than the indirect effect of BI's policy on performance were mediated by a diversification strategy.

Effect of Diversification Strategy on the Banking performance

Hypothesis 6 states there is the influence of diversification strategy on the banks performance. Relationship banking strategy of diversification to performance is a direct and negative. That is, the higher the rate Specialization, meaning the lower the level of diversification, the lower the performance. Conversely, the lower the rate Specialization, meaning the higher the level of diversification, the higher the performance. These findings suggest the strategy is more directed to activities that are concentrated on its core business (the lower the level of diversification), the greater the performance degradation and vice versa.

The findings of this study support the findings of Berger, et al (2010). Berger et al the group diversified into four dimensions: loans, deposits, assets, and geographical. They found that strategy of diversification has a negative effect on the performance of the banking industry in China. In addition, they also found that less successful intermediation in China during the study period (1996-2006). Less successful intermediation in China is caused by: (1) mismanagement of the bank (internal factors), with respect to policies and strategies adopted by the bank, both management and the quality of human resources, (2) external factors, related to the economic recession. Leven and Levine (2007) also found a diversification strategy of direct and negative effect on the value of the bank. Wan and Hoskisson (2003) found that environment is more abundant, there is a statistically significant negative relationship between product diversification to performance. There is a negative relationship between corporate performance with the interaction between product diversification with outbound international diversification. On the environment is less abundant, there is a negative relationship between outbound international diversification with company performance. They classified 16 Western European countries into the country environment with abundant resources and is not abundant. The results obtained showed abundant countries are Denmark, France, Germany, Netherlands, Norway, Sweden, Switzerland and United Kingdom. Less abundant countries are Austria, Belgium, Finland, Ireland, Italy, Portugal, Spain and Turkey.

The findings of the researchers on the study seems to contradict the findings of Nath et al (2010). Nath (2010) found a positive effect diversification strategy on financial performance. Researchers integrate resource-triad-performance capabilities. This study highlights that company controlled by the market is likely to have better business performance than companies that focus on operational capabilities. Also, companies are more capable when focused on a portfolio of products or services and concentrated on a variety of geographic markets. Research and Rwegasira Li (2008) also found that strategy of diversification has a positive influence on corporate performance. WAN and Hoskisson (2003) find a diversification strategy (product) is positively related to firm performance in an environment less abundant (Austria, Belgium, Finland, Ireland, Italy, Portugal, Spain and Turkey). Lu and Yao (2006) found that diversification strategy can improve the performance of state-owned enterprises as affiliated companies adopting a higher diversification. Boot (2003) found that diversification strategy does not directly affect the market value, but influential through the control variables (profitability). Elsas, et al (2010) found that diversification strategies have direct and indirect influence on the value of the firm, by differentiating effect through the interaction of growth of aggregate diversification and vertical integration.

The difference results from several researchers on the relationship of diversification strategy on performance, empirically can be explained by using the strategic management literature. It can be explained why a company to diversify, diversify how much it costs, when diversification can improve the performance of the company and when it could hurt the company (Chakrabarti et al.. 2007; Montgomery, 1994). The main reason is the perception of the benefits of diversification related to a larger target market, the use of idle capacity, reducing the risk of diverse business portfolio and capability build-up.

Conceptually, diversification should have a positive effect on corporate performance, because it helps companies achieve economies of scale, greater scope and leverage the experience to other markets (Rumelt, 1984). However, empirical studies on the role of diversification on the performance of the company pointed different results. Montgomery and Wernerfelt (1988) pointed out that diversification has a negative impact on performance. Diversification often increase operating costs, leading to conflicts in the form of greater managerial and organizational complexity (Chakrabarti et al.. 2007). The effect of diversification of products or services have been studied by Berger and Ofek (1995). Meanwhile, Ghoshal (1987) examined the effect of international diversification on corporate performance. Based on the arguments above, the diversification impact on long-term business performance.

In this study, a strategy of diversification is measured using the indicators of degree of specialization (Specialization rate). Degree of specialization is the ratio between income from interest (business core / core

business) of total revenue. From the findings of this study sample banks in the East Java leads to activities that are concentrated in non-credit business. If the observed changes in diversification rates from year to year, indicated by the average annual rate Specialization, Specialization rate decline occurred from 2008 (84.51%) to 2009 (80.73%), as indicated by Table 5.8. The decline was due to growth in bank lending slowed in 2009 compared to 2008. Some Bank Branch Chairman explained that decline in credit due to bank competition in the credit markets and the banking crisis is still under pressure due 2008 that have an impact on performance in 2009. They also confirmed that when seen from the magnitude of total revenues, total discretionary income not derived from mortgage interest but from other income, such as from fee-based income. Based on Bureau of Infobank's research (2010) Indonesia in 2009 banks recorded the largest profits in the banking history of Indonesia. According to BI data, banking has gained a profit of 45.2 trillion rupiah, up 47% compared with 2008 which amounted to 30.6 trillion rupiah. While credit grew only 9% with a declining trend in interest rates. From the above description it can be concluded that condition of banks in East Java is not much different from the other banking Indonesia (the results of research Infobank Bureau, 2010).

Research Implication

Theoretical Implications

The study intended to reveal the phenomenon or paradigm of environment-Strategy-performance (ESP) on the banking industry in East Java. As indicated by the previous chapter, this study theoretically expected to find a causal relationship between environmental complexity, BI policy, diversification strategy, and performance of the banking industry in East Java.

As already noted in the results and discussion, follows can be put forward some theoretical findings about the causal relationship between environmental complexity, BI policy, diversification strategy, and performance of the banking industry in East Java.

Theoretical implications of these findings are:

1. Under conditions of the higher environment complexity, banking more appropriate to use a diversified strategy, or strategies that lead to non-credit business activities (fee-based income).
2. Under conditions of higher environmental complexity the required intervention of BI (BI policy) is the greater.
3. Diversification strategy is able to mediate the relationship between environmental complexity with performance.
4. The more stringent policy of BI, the lower the banks performance. That is, the more stringent policy of BI, the lower the banks performance. In other words, the greater the interference BI the lower the banking performance.
5. Bank Indonesia policy increasingly stringent, the more it will encourage banks to make loans to businesses diversification strategy (interest-based income), or the more stringent policy of encouraging banks BI pursuing a strategy that leads to activities that are concentrated on its core business (the lower the level of diversification).
6. The more diversified, the higher the banks performance in East Java in conducting business activities-fee-based income. That is, the more banks carry out business activities-fee-based income, the higher the performance of the bank. Thus, the bank's performance can be improved by using more diversified strategy.
7. In formulation of strategy, one thing to note is the suitability of strategies and policies with environmental factors. In this study the environment in question is the complexity of the BI environment and policy. Therefore, banks should be able to make intelligent market accurately and quickly. Intelligent market functions to direct the bank in order able to design appropriate services and quality, which is expected to improve performance.
8. The findings of this study further strengthens the phenomenon or paradigm Environment-Strategy-Performance (ESP), in implementation of the banking industry in Indonesia, especially in East Java.

Practical Implications

For The Banking

1. Banks should pay more attention to environmental conditions. In conditions of increasing environmental complexity, then banks are more suitable to use highly diversified strategy or strategies that lead to non-credit business activities (fee-based income), because the impact on banking performance improvement.
2. In strategies formulation, one thing to note is the suitability of banking strategy and policy on environmental factors. In this study the environment in question is the complexity of the BI environment and policy. To that end, banks are required to be able to make intelligent market accurately and quickly. Intelligent market function is to direct the bank to be able to design appropriate services and quality that will improve performance.

For Regulators

1. BI, through its policies, has a strategic position in creating a conducive climate and create a healthy, strong and efficient banking system. To create the required sound banking regulation and effective bank supervision. In carrying out the task to regulate and supervise banks, BI attempt to achieve a high level of public trust to the bank.
2. BI strict policy has been encouraging banks in pursuing a strategy that concentrated on its core business (the lower level of diversification). However, strict policies have an impact on performance degradation.
3. There are indications too wide gap between the ruler and rulee. Market Intelligence needed to bring the perpetrators of the banking regulator. Business actors need a "freedom". Excessive attention eventually create more regulation, but not oriented to real market needs in the field. Therefore, policies must be made selectively but in accordance with market needs, thereby increasing the efficiency and effectiveness of the optimal policy.

Limitations of Research

1. This study uses a mail survey data collection methods and not cross-matched all questionnaires, perception and data provided are not able to be controlled completely, either about the sincerity, honesty, and objectivity of the answers. Of course, this situation will affect the data collection, research bias, so the results are also biased.
2. Limitations of the data. Performance measurement in this study refer on CAMEL analysis. This study did not include elements of the CAR due the branch office does not have such data.

Conclusion

1. Relationship between environment complexity strategy and diversification is negative. That is, the environment complexity significantly influence the specialization decline, thereby increasing diversification. Negative direction of the diversification strategy has implications that banks increasingly diversified. Diversification is measured using a specialization level (Specialization rate), ie, the ratio between the opinions on the total income. The higher level of environment complexity, the more diversified its strategy. That is, the bank's strategy increasingly leads to non-credit business activities (fee-based income). Also, at this time, there have been changes in the banking strategy. This condition is in accordance with the real condition, the environment facing banks in East Java, increasingly complex environment makes banking difficulties raise cheap funds. To that end, banks pursuing a strategy that leads to the non-credit business activities (fee-based income), which increasing the fee from nonoperasional.
2. Effect of environmental complexity on the banks performance is positive. The higher level of environment complexity the higher the level of banking performance. In other words, the more complex environment, the higher a bank's performance. In addition to direct effects, the environment complexity also have an indirect effect on performance, mediated by a strategy of diversification. From these findings can be stated that diversification strategy less able to improve the banks performance in East Java, in conditions of higher environmental complexity. Banking performance can be improved when using more diversified strategy

- (unrelated) or strategies that lead to non-credit business activities (fee-based income). In this study, the environment complexity created by changes in consumer tastes, the level of competition, changes in the behavior of suppliers, and technological developments. These indicators provide a major contribution to the banks performance.
3. Effect of Environmental Complexity (EC) to BI policy is positive. These results reflect that the higher levels of complexity, the more stringent environmental policies BI. That is, when facing conditions of the higher environment complexity, the banking industry needs a more supportive of BI policy. As a high-regulated industry, the banking industry faced with changes in government regulations are constantly changing. The banking sector must comply with applicable regulations for the sake of business continuity management. The policy can be supportive or impede the banks performance. From the findings of this study, BI policy is supportive.
 4. Positive sign on the coefficient indicates that BI Policy (BIP) coherence with a diversification strategy (DS) is positive. The positive direction indicates that policy of Bank Indonesia has a direct influence in encouraging banks to do credit business diversification strategy (interest-based income). In other words, policies or regulations further encourage banks to BI strategy that leads to activities that are concentrated on its core business (the lower the level of diversification). The study's findings are consistent with existing conditions, only not as expected. Credit growth is still not showing improvement of banking intermediation function optimally (BI, East Java Regional Economic Studies 2009). On the one hand, low growth due to the perception of bank credit to high risk due to exposure to the real sector affected by global financial crisis. On the other hand, low credit growth is also due to slowing economic activity and high interest rates. Nevertheless, the banks performance in East Java in 2010 better than 2009. An increase in performance is closely linked to achievement of policy support BI.
 5. BI policy influence on banks performance is negative. That is, the more stringent policy of BI, the lower the performance. These findings indicate that BI policy can not improve banks performance in East Java. Other findings show that, BI policies have an indirect effect on performance, mediated by a strategy of diversification. This indirect effect suggests that performance can be improved as long as banks use increasingly diversified strategy (unrelated) or strategies that lead to non-credit business activities (fee-based income).
 6. Effect of diversification strategy on performance is negative. The lower level of diversification, the lower banks performance. That is, the higher rate Specialization, which means the lower level of diversification, the lower performance. These findings suggest that strategy is more directed to core business activities are concentrated (the lower level of diversification) are increasingly pushing performance degradation and vice versa.

Suggestion

For Banks

1. These research findings indicate that there have been changes in banking strategy from interest-based income (low diversification) to fee-based income (high diversification). Therefore, banks need to continually make improvements to infrastructure so that customers can use services that generate fee-based income is higher, which is expected to improve performance of bank.
2. Banks should not only pursue profits. Currently, the behavior of banks that tend to maximize profit from expectations of lead results, obtained from the assets or income from other (fee-based income), making the bank became increasingly risk averse. However, it must be remembered that, its main function is financial intermediation institutions, raise funds and disbursed in form of credit. Therefore, Bank should maintain the trust because bank is seller of securities (DPK stored) in form of demand deposits, savings and time deposits. In addition, banks should also encourage the revival of the real sector by way of lending, as well as to disseminate to community banking presence, as a business partner and introduce and improve their understanding of banking, and simplify lending procedures with caution principal.
3. In line with Li and Wong (2003) and Santalo and Becerra (2008), researchers have also suggested same thing, that bank needs to maintain the balance in implementation strategy of diversification, merger-related

diversification (strategy that leads to business activities of credit) with unrelated-diversification strategy, or strategies that lead to non-credit business activities (fee-based income). If only using related-diversification strategy, bank becomes less than optimal, due to uncertainty of institutional behavior. In contrast, using only if unrelated-diversification, it will lower the value of company (Li and Wong 2003). The balance between application of unrelated-diversification strategy with related-diversification is expected to be optimal strategy for improving banks performance (Santalo and Becerra 2008).

For Regulators

1. In making policy, Bank Indonesia needs to consider condition of banking environment so that effectiveness optimal policy could be reached.
2. BI should be able to create a policy that always leads to stable conditions, and creating a community trust to invest their funds. BI also needs to encourage banks to carry out functions for creating an investment intermediary, in order to promote quality economic growth by increasing number of jobs.
3. The government should be able to create spirit in real sector, so that banks can support more productive activities, such as, improving road infrastructure, electricity, ports, and airfields.
4. Government and / or BI should conduct an evaluation of policies that have been issued, such as:
 - a) Evaluation of implementation of BI policy in improving intermediation function, among other bonuses Removal Allowance for Earning Assets Formed Payer (PPAPWD) on a bank which provides facilities to SMEs.
 - b) Evaluation of policy implementation MOU with Minister, the Governor of Bank of companion of micro, small and medium enterprises (MSME) / (KKMB) connecting banks and SMEs.
 - c) Evaluation of implementation of government policy on improving SME credit through People Business Credit (POC).

Further Research For Development

1. Further research can be done by researching BI policies that support and less supportive banks perception. Furthermore, partially, testing can be done to the relationship between BI policies on other variables, so it will get a clearer role of these policies.
2. Further research can be done by adding managerial factors, such as human resource factors, into model. The success of banking also can not be separated from human factor. Business banking is a service business that is based on principle belief that human factor becomes very important factor in determining the success of business (as in Hopkins study 1997). Example, service quality will increase the success of operations performed by company, and the success of company's operations is determined by many factors, among others: the human factor (employees), technology, and customer involvement. The human factor has a major role on performance, even creating sustainable competitiveness for company (Crain 2009). ■

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