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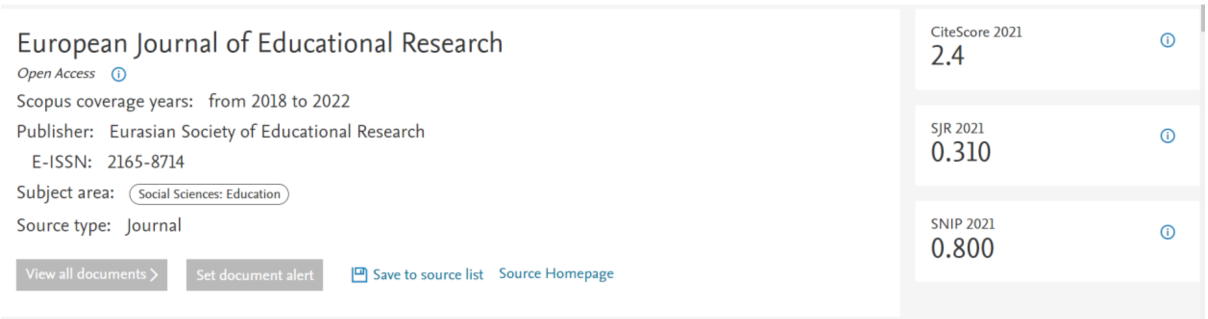

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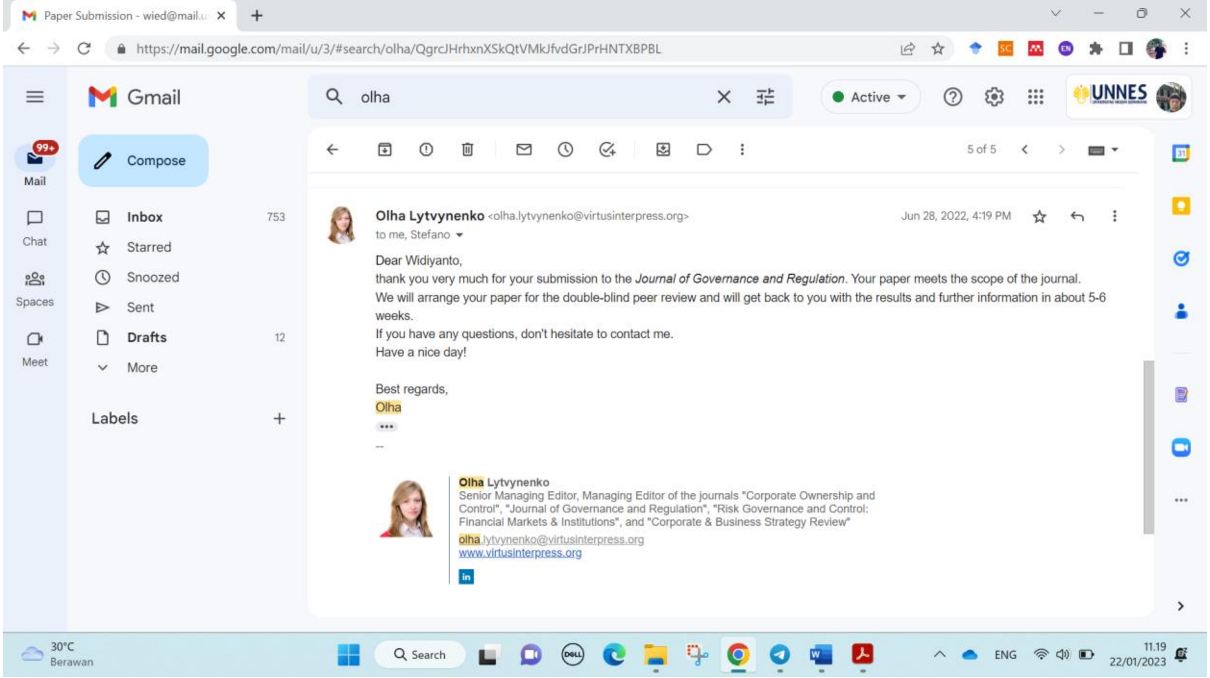

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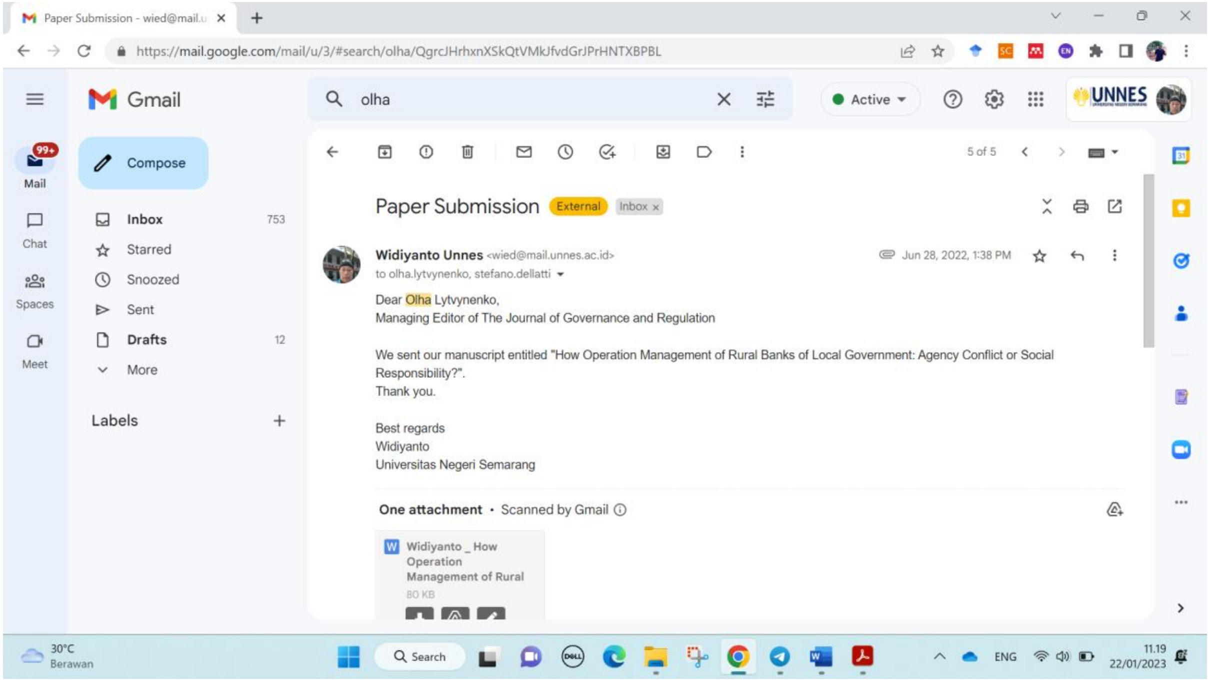

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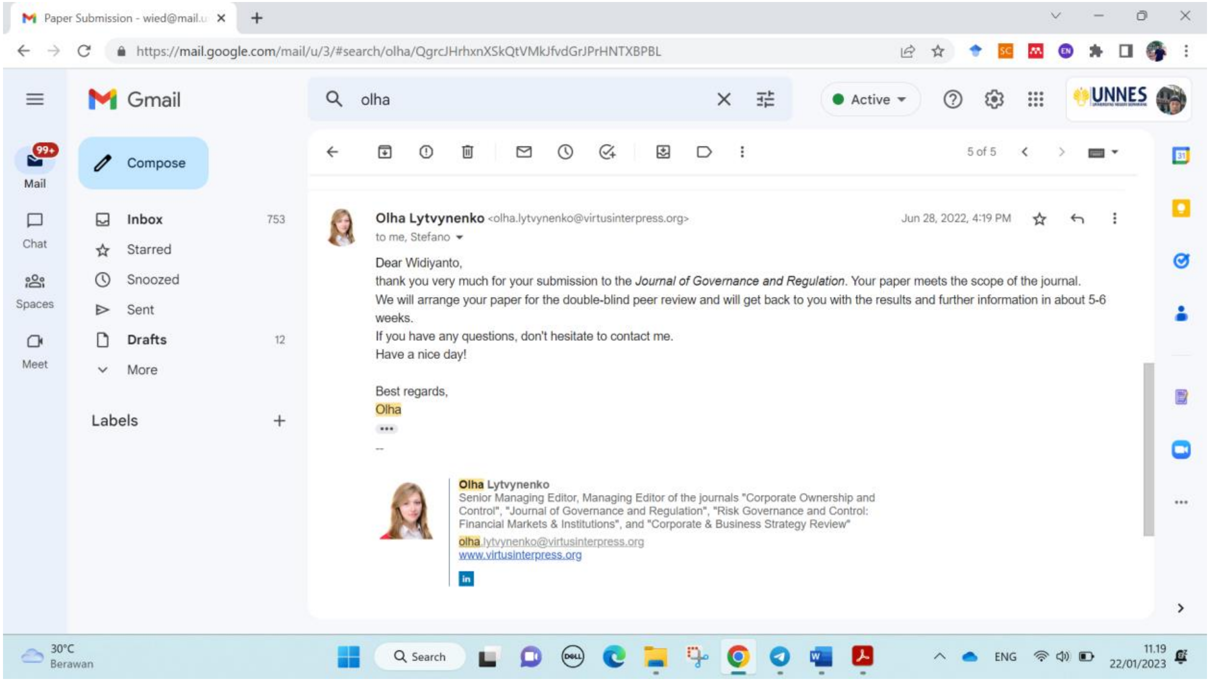

Artikel saat Submission

How Operation Management of Rural Banks of Local Government: Agency Conflict or Social Responsibility?

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Abstract

Rural banks with local government ownership as majority shareholders aimed to increase public welfare and earning profits. Post-merger and Acquisition (Post-M&A) due to COVID-19 increases rural bank risk in lending. The research objective is to determine the impact of increased risk on rural bank lending. Data were collected from 32 annual reports of rural banks in Indonesia. Documentation was used to collect the data. LDR is dependent variable, risk as independent variable, and CAR, NPM, and ROE as control variables. Technique of analysis data is analysis of covariance. The result show Banks with below-average risk have a greater difference (0.0393) than above-average risk (0.0347). Other result indicate that Loan Deposit of Ratio (LDR) is not determined by the bank's health or the business risk of the debtor. Government demands through financing in local government, and it ignores risks and produces risk-taking behavior of managers. The government, as the majority shareholder, has a more effective monitoring role.

Keywords: Agency conflict, Social Responsibility, Rural Bank, Local Government Ownership

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1. INTRODUCTION

Agency conflict, ex-ante, information asymmetry lead to a conflict of interest between managers and external shareholders who are not directly involved in firm management (Cariola et al., 2011; Jensen & Meckling, 1976). The conflict of interest worsens when state-owned enterprises make a larger appropriation than non-SOE (Rashid Khan et al., 2020). SOE is characterized by political interests and corporate expropriation, resulting in greater agency conflict between principals and agents than non-SOEs.

The presence of political connections provides benefits in increasing company performance because they have more access to financing, profitable projects (Wati, 2020). The resulting agency cost is greater because of the behavior of managers pursuing political connections with the government and ignoring the company's interests, which leads to lower productivity (Harris et al., 2016); lower quality of financial reports (Wati, 2020).

To sum up, the situation is similar in the banking sector. State-Owned Banks (also State-Owned Enterprises/SOEs) also have agency conflict, which may increase due to increased political content. Since banks were privatized and owned by the government (SOE), long-term performance was static or no different; the result was that the legacy of pre-privatized long-term loans increased post-privatization (Berger et al., 2005). The wider impact is due to the increase in government ownership in banking resulting in a slowdown in the development of the financial sector and economic growth (La Porta, 2001).

Our study was conducted in rural banks owned by a local government and experienced a decline in performance due to the COVID-19-19 pandemic. As a result, the Financial Services Authority (*Otoritas Jasa Keuangan*/ OJK) in February 2020 conducted a Merger and Acquisition (M&A) in the hope of increasing performance resulting in increased free cash flow and survival capabilities (Maama et al., 2017). In addition, if the government owns it, the ability of performance monitoring resources is better than others (Noerdin, 2016). M&A produces more resources so that managers with discretionary power make greater use of them for their interests and shareholders (Jensen, 1986). They prevent any mechanism that could reduce control (Nogueira & Kabbach de Castro, 2020), exacerbated by the presence of political connections.

Many types of research on the benefits and costs of companies with political connections have been carried out; therefore, we add the impact of political connections in terms of the lenders (banking sector), which is still limited (Amdanata & Mansor, 2018). Our paper describes the second part of the literature review, and the third describes the research method. Fourth, report the results and findings; lastly, we present a discussion.

2. LITERATURE REVIEW

Agency Conflict in Merger and Acquisition (M&A)

The agency conflict begins with a paper (Akerlof, 1970) on the used car market, with the analogy of plum (good quality car) and lemon (bad quality car). A transaction failure occurs when both parties have an information imbalance. When the seller has better information about the plum car than the buyer, the buyer only buys all the cars (plum or lemon) at the average price of the two; as a result, all the cars offered are lemon cars. Information asymmetry, ex-post, agency conflict, and incomplete contracts result in agency conflict, where the agent acts not in the interests of the principals. They choose projects with low risk to produce low yields; the results are not by the preferences of shareholders (La Rocca et al., 2007).

We define M&A, as (Maama et al., 2017) state, as a merger as a strategy of combining resources to achieve common goals, and each entity still owns part of the company. The acquisition is a long-term agreement when one company buys another company. The direct impact of M&A on shareholders or when a merger occurs, shareholders' shares experience dilution, and the acquisition results in shareholders not having discretionary power. Agency conflicts are exacerbated when managers use larger resources when M&A is carried out. When the company's size increases, managers try to increase their welfare by ignoring shareholders' welfare.

Hypothesis Development

There are many influences from M&A on bank performance. M&A will have an impact on increasing the quality of products and services provided by the bank (Alvarez-González & Otero-Neira, 2020). Mergers between banks will create value for bidders in the long run but will be faced with greater costs and risks. The results of the study show that the merger destroys the value of the company's shares for banks pursuing a market penetration strategy (Hassan & Giouvris, 2020). Banks that do M&A on a large scale can reduce systemic risk, deal with good profitability, and support geographic diversification stability (Hassan & Giouvris, 2021).

However, bank M&A policies do not always provide the best solution. Many banks in Greece have faced crashes after the M&A. Banks fail to create value despite government assistance (Tampakoudis et al., 2020). Other findings show that there is no positive relationship between M&A and AT (asset turnover). AT ratio even worse. Furthermore, the evidence shows that stand-alone banks outperform merger banks after M&A in Nigeria (Yusuf & Raimi, 2019). We find that overall, successful mergers improve the quality of the information environment, while unsuccessful deals decrease it (Howe & Morillon, 2020).

Consolidation through mergers and acquisitions represents one of the main outcomes of the financial transformation process and contemporary trends in the Indian banking sector. The literature shows that the pre-merger bank finances are very important in determining the post-merger performance of the merged entity (Kuriakose & Paul, 2016). The study found that banks differ in most of the key areas, and this may have an adverse impact on post-merger performance.

Post-M&A, rural banks experienced an increase in total assets along with an increase in agency conflict. In Indonesia, there are two operational guidelines for rural banks owned by the local government. The first guideline is under the central bank in Regulation No. 8/26/PBI/2006. Regulations regulate issues such as corporate governance as ownership, board of directors, and Supervisory Board. Second, the Minister of Home Affairs, local government regulations, and state-owned banks must be harmonized with government regulations (Amdanata & Mansor, 2018; Noerdin, 2016).

Managers who act in the interests of the government post-M&A produce greater free cash flow, thereby harming other parties who are not directly involved in the management. Tighter banking regulations are more likely to produce risk-taking manager behavior; conversely, when regulations are loose, risk-taking is reduced (Lee, 2009). Managers try to maximize value for local government as majority shareholders by risk-taking on the industry.

SOE banking has a greater risk because it provides greater credit to politically connected companies (Rashid Khan et al., 2020; Wati, 2020). Under the pretext of being in the interests of the majority shareholders, managers take risk-taking actions to benefit from an increase in compensation (Dewanta & Arifin, 2020). Due to public demand for bank SOE to support the real sector and OJK supervision, risk exposure is lower (Ariefianto & Soepomo, 2013). Greater agency conflict encourages managers to finance risky projects of politically connected firms (Lee, 2009). We use the LDR proxy to measure the impact of increased risk due to local government ownership of rural banks.

Empirical findings show that deposit size, credit risk, portfolio investment, average loan interest rates, real gross domestic product (GDP) and inflation rate have a significant and optimistic effect on private commercial bank loans (Birhanu et al., 2021). Other findings show that the technical efficiency of BPRs has a significant positive impact on their lending to MSMEs in West Java Indonesia. These results underscore the importance of BPRs in maintaining and improving the efficiency of banks to increase their capacity to provide loans to MSMEs (Anwar et al., 2020).

Hypothesis: The agency conflict leads the rural banks' risk-taking to exceed the average; it increases the loan to deposit ratio (LDR).

3. RESEARCH METHODOLOGY

Data for 2020 were collected from 32 Rural Banks (*Bank Perkreditan Rakyat*/BPR) annual reports after the COVID-19 pandemic in Indonesia. We use a risk proxy with ROA deviation to measure systematic risk in the banking sector (Li & Malone, 2016). When the risk deviation value is below the average, we classify it as low risk, and if it is above the average, it is high risk. The dependent variable is LDR, and our control variable uses the CAR, NPM, and ROE proxies as the result of the manager's decision (Anita et al., 2014). Finally, we use Ancova:

$$LDR_i = \alpha_i + \beta_1 X_{1i} + \beta_2 D_{2i} + \sum_{i=1}^{3} \gamma_i + \mu_i$$

4. RESULTS

Table 1 panel A reports the difference between positive and negative CARs with a negative distribution. The presence of a political connection stimulates this local government rural bank to provide more credit than existing customer funds so that most rural banks have a larger LDR than the median (Amdanata & Mansor, 2018), which is likely to be given due to a politically connected company application.

Positive CAR Skewness is the availability of funds to deal with risks, most of which are lower than the median. It is not different from LDR; NPM is the ability of banks to generate profits from company operations. The bigger, the better. Net income/operating income or how big is the portion of net income from operating income. ROE as banking performance reported most of the data is greater than the median.

Table 1. Descriptive Statistics

Panel A: Descriptive Statistics						
	Min	Q1	Median	Q3	Max	Mean
LDR	54.600	67.503	72.705	80.490	92.210	67.821
Risk	-3.106	-0.745	-0.100	1.000	2.995	0.000
CAR	0.213	0.307	0.390	0.631	0.951	0.488
NPM	0.021	0.107	0.127	0.184	0.234	0.142
ROE	0.036	0.094	0.141	0.198	0.238	0.141

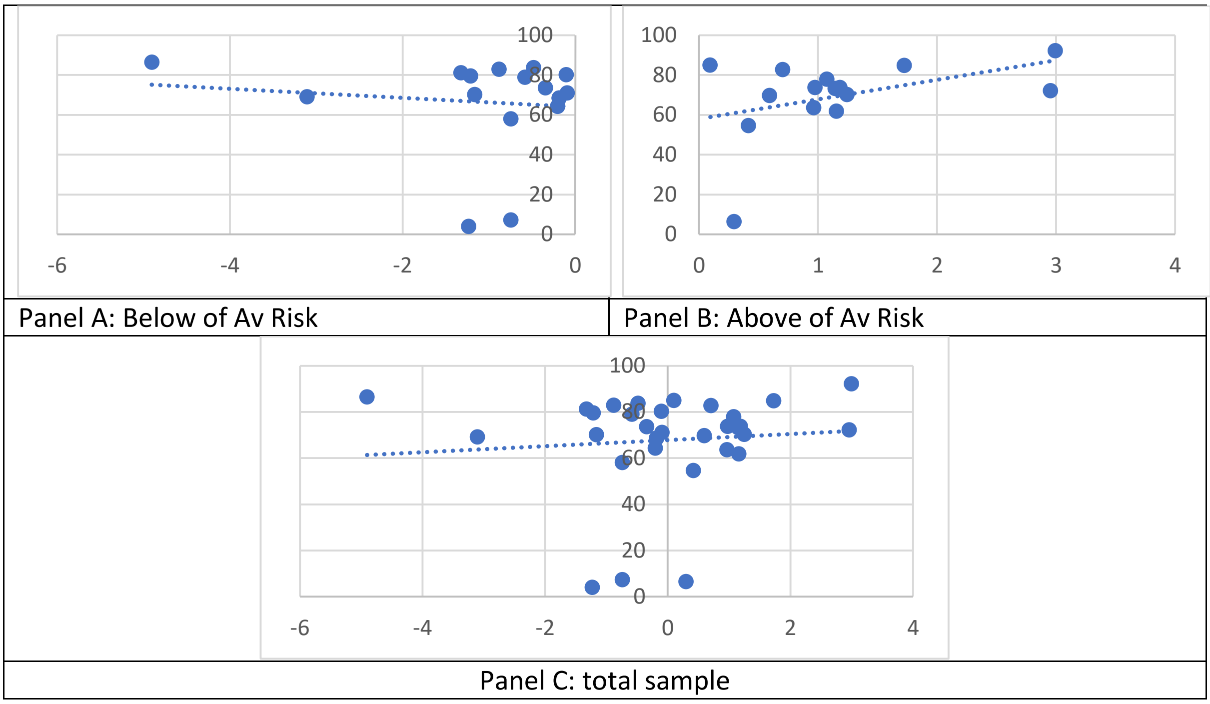
Panel B: Difference NPM			
	Below of Above Risk	Above to All Risk	Below to All Risk
Mean Difference	0.074078	0.034724	0.039354
t-test	1.59E-06	0.007451	0.003758
Sig	Yes	Yes	Yes

Panel B reports NPM as the proportion of net income from operating profit at various risk levels. Banks with below-average risk have a greater difference (0.0393) than above-average risk (0.0347). The above-average risk is greater, having a greater NPM of 0.074 than the below-average risk. When risk increases above average, producing company efficiencies, they reduce the rural bank's operating costs.

Table 2. Regression Analysis

	All		Above of Av Risk	Below of Av Risk
Intercept	53.55687	*	94.03775	31.65501
CAR	15.78906		0.781942	27.68302
NPM	-34.2657		-159.465	81.96898
ROE	81.05045		21.95035	97.06267
Multiple R	0.117915		0.251162	0.281081
R Square	0.013904		0.063082	0.079006
Adjusted R Square	-0.09175		-0.19244	-0.13353
Standard Error	22.93663		21.81056	25.63406
Observations	32		15	17
* sig. 5%				

Table 2 show that risk cannot determine the lending of rural banks in Indonesia. There is no significant influence of risk on LDR. Other variables also have significant value more than 0.05. So, there are no significant impact of CAR, NPM, and ROE on LDR.



Panel A: Below of Av Risk

Panel B: Above of Av Risk

Panel C: total sample

Figure 1. Below and Above Average Risk of rural banks

5. DISCUSSION

It is interesting to know that LDR is more than a third-party fund since smaller or lower risks do not determine it. When the risk is below average, the LDR of rural banks is not determined by banking value; they provide credit not based on CAR, ROE, or NPM. It is possibly due to public demands to support government policies (Ariefianto & Soepomo, 2013) and the thickness of the agency conflict (Noerdin, 2016).

The risk-taking behavior of rural bank managers is explained by the risk-shifting problem shifting (Jensen & Meckling, 1976); from the demand side, managers prefer risk-taking projects that exceed the average because the manager will benefit if the project is successful. Due to the limited liability of managers and shareholders, if the project fails, debtholders will bear the risk. On the supply side, rural banks are more oriented towards public demands to support public financing, for example, in SMEs rather than agency conflict (Central Bank of Indonesia, n.d.; Eggertsson & Borgne, 2010).

There are two facts in the results: public demands to rural banks and agency conflict. When local government is not only profit-oriented, the demands for improving people's welfare become a priority. Rural banks are in line with the central bank, providing soft loans or other loans with greater risk tolerance than private banks. As a result, managers will be risk-taking with indications of an increase in LDR due to policy and credit stimulus from the government and local government.

M&A with SOE resulted in a larger free cash flow than without M&A. The result is that managers increase compensation from an increase in lending greater than savings funds; the result is increased welfare. They do empire building (Jensen & Meckling, 1976), although the risk is high, credit is still given. In other words, the increase in LDR is not determined by banking value but based on the interests of managers. (Cariola et al., 2011) describes the non-banking sector as an overinvestment problem due to the behavior of managers. They allocate company resources to high-risk projects because if the project fails, it becomes the responsibility of the debtholders.

The agency conflict in emerging markets is crucial, starting with the paper (La Porta, 2001). He reports that, on average, 42% of the top 10 banks are owned by governments and are common in poor and property-poor countries. The increased risk of LDR results in a greater probability of bankruptcy. With labor oversupply conditions, rural bank managers may lose their jobs and find it difficult to find other jobs (Agarwal & O'Hara, 2007). They will find it difficult to find another job in extreme conditions if the rural bank goes bankrupt because it loses its reputation (Hernández-Lagos et al., 2017).

The M&A strategy for rural banks has had an impact on bank policy in general. The government's role as the dominant ownership will also affect the post-M&A banking strategy. Therefore, the study of bank performance after the M&A and the COVID-19 pandemic will be more interesting. Financial and non-financial indicators as well as internal and external factors will be able to investigate these impacts more comprehensively. The quality of service will be better or will it experience a significant decline. Product and service innovation will be an interesting theme to be studied more deeply.

6. CONCLUSION

Post-M&A, due to the COVID-19 pandemic, most rural banks of SOE have higher LDR than average. Local government as majority shareholders does not only act for business interests but demands to increase public welfare. This study aims to analysis the impact of risk on LDR post-M&A of rural banks in Indonesia. The result is that the LDR is not determined by the risk characteristics of the debtor, either above or below the average risk. In addition, the control variable shows that it does not determine the LDR, which can be explained through the agency conflict. Managers who act in the interests of shareholders override the interests of customers. It is proven that rural bank health ratios such as CAR, NPM, and ROE do not determine LDR significantly. The compensation of rural bank managers is determined by the quantity of credit granted, not by the credit quality. The presence of information asymmetry results in managers and majority shareholders having superior information than customers, then they provide greater credit than customer deposits.

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3. Reviewer's report_Journal of Governance and Regulation, 7 SEPTEMBER 2022

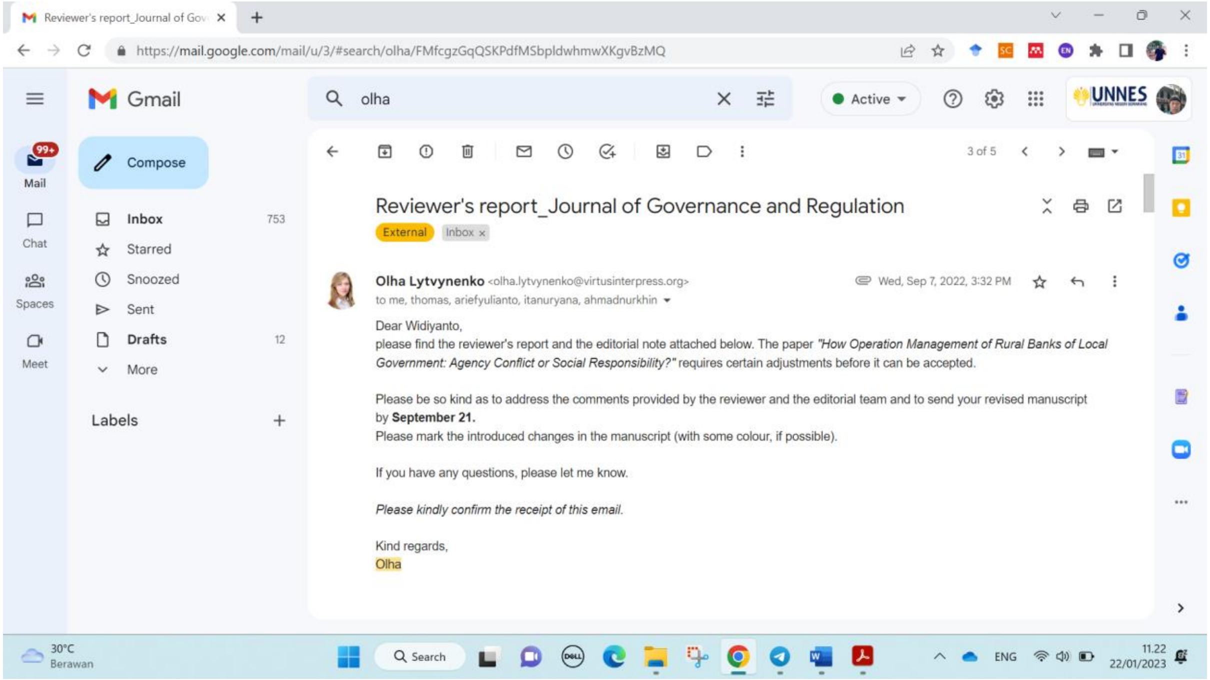
Dear Widiyanto,
please find the reviewer's report and the editorial note attached below. The paper *"How Operation Management of Rural Banks of Local Government: Agency Conflict or Social Responsibility?"* requires certain adjustments before it can be accepted.

Please be so kind as to address the comments provided by the reviewer and the editorial team and to send your revised manuscript by **September 21.**
Please mark the introduced changes in the manuscript (with some colour, if possible).

If you have any questions, please let me know.

Please kindly confirm the receipt of this email.

Kind regards,
Olha



Catatan Revisi

Editorial Note

1) The approximate length of the paper should amount to 5000-10,000 words or 25-40 typed pages.

2) Please revise the title of the paper to make it more *clear* in order to increase the readability of your paper and the citation rate.

3) In order to enhance the readability of the manuscript, please provide in the section «Abstract» more detailed description of the research problem, purpose of the research, methodology used, main findings of the paper, conclusion, relevance of the paper. The appropriate length would be 150-200 words.

4) It is preferable that the „Abstract" contains 1-2 in-text citations of the sources mentioned in the list of references that the research is based on or that the research contributes to.

5) Each subsection should be numerated as well. Please, adjust your titles of the sections.

6) In the "Introduction" section please add one more paragraph describing in detail the general structure of the paper.
(e.g. The structure of this paper is as follows. Section 2 reviews the relevant literature. Section 3 analyses the methodology that has been used to conduct empirical research on...)

7) As for the section "Literature Review", it is important to add a few more references of the recent years (2018-2022) in order to make the paper more citable. Please extend this section as currently it is quite short.

8) "Research Methodology" section should also contain description of alternative methods that would be suitable for conducting the research. In general, please, provide more detailed description of methodology, because currently it's quite short.

9) We recommend specifying more deeply why this paper is important for future research (section "Conclusion") and whether there are some limitations of the research. In general, please, provide more detailed conclusions and implications of the results, because currently they are quite short.

10) The editorial team of the journal highly recommends adding the following source to your list of references as it will enhance the relevance of your work:

- Abdel-Baki, M., Kostyuk, A., & Govorun, D. (2011). Will the proposed regulatory reforms by the Basel committee improve economic performance in emergingeconomies? An empirical application to Egypt and Ukraine [Special issue]. *CorporateOwnership & Control, 8*(2-1), 14-29. https://doi.org/10.22495/cocv8si1p2

You may cite it in Literature Review as follows:
Tighter banking regulations are more likely to produce risk-taking manager behavior; conversely, when regulations are loose, risk-taking is reduced (Abdel-Baki, Kostyuk, & Govorun, 2011; Lee, 2009).

11) Please make sure that all the references cited in the paper are included in the reference list and all the sources in the reference list are properly cited in the paper.

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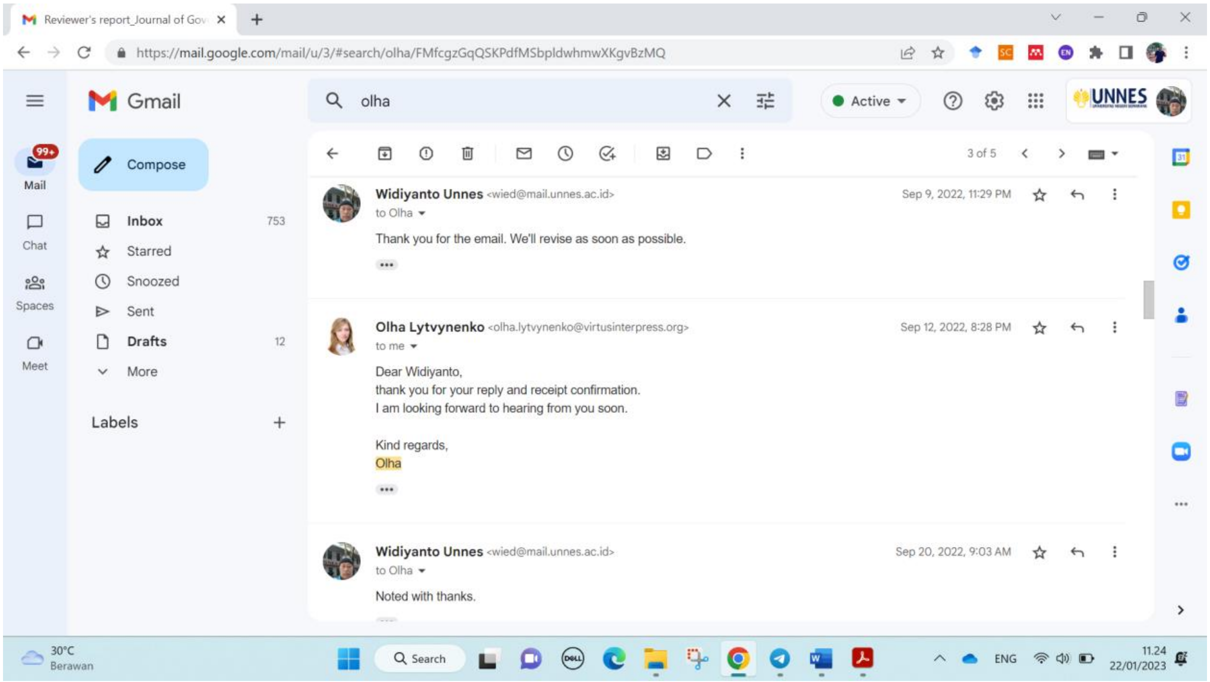
Reviewer's Report

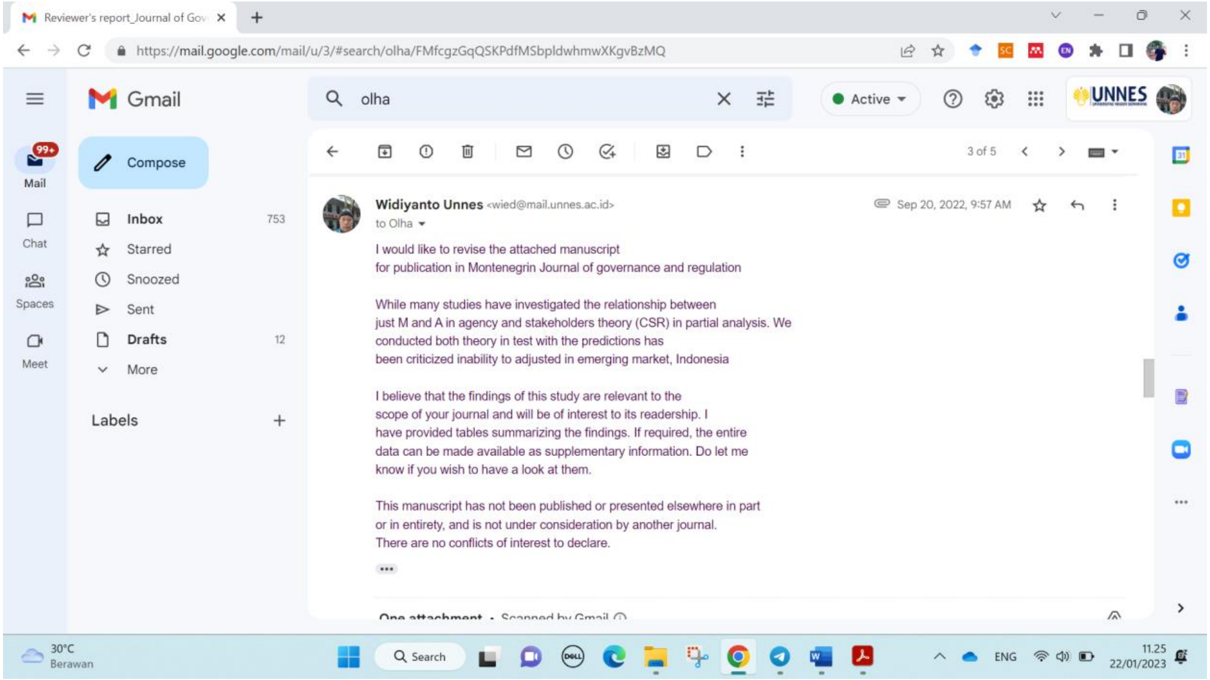
Journal:	Journal of Governance and Regulation		
Title of the paper:	**How Operation Management of Rural Banks of Local Government: Agency Conflict or Social Responsibility?**		
Date of the Review completion:	07 September 2022		
Please choose options that can characterize the paper:			
Originality and importance of the paper to the field of research:	Medium		
The **structure** of the paper:	Is easy to follow and understand		
Please tick relevant for the **abstract**	The abstract provides an accurate summary of the manuscript (including aim, methods, key results and relevance of the study)	☐yes	X no
	The abstract contains unnecessary information (please explain)	☐yes	☐X no Needs focused based discussions and result in brief and also recommendation .
	Is the abstract of appropriate size? (150-200 words)	☐Xyes	☐ no
Please tick relevant for the **introduction**	Does the introduction identify the purpose of the paper or hypothesis and set the paper within the broader research perspective?	☐yes	☐X no
	The introduction puts the rest of the paper into perspective (explains paper's structure)	☐Xyes	☐ no
Methods used in the paper:	Suit the aim of the research		
	Does the methodology part allow replicating or reproducing results (to check them or to perform a similar study)?	☐yes	X☐ no
	If empirical study: is the sample size large enough and was selected in an appropriate way (leave blank if not acceptable)?	☐Xyes	☐ no
Results and discussion:	Are the interpretations provided by the author(s) supported by the findings obtained in the study?	☐yes	X☐ no
Are there any **figures or tables** that have to be corrected / deleted?	Yes, some corrections need to be done (please explain)		
	Are the figures and/or tables clear and you can understand their essence?	X☐yes	☐ no
Conclusions:	Do not reveal main findings of the paper		
	Conclusions are supported by the findings, analysis and interpretations of the author(s)	☐Xyes	☐ no
	Does the conclusion section repeat the abstract of the paper?	☐yes	☐X no
References	Are all references in the list used in the paper?	☐Xyes	☐ no
	Are the number, relevance and "age" of the citations appropriate?	☐yes	☐ no
Language of the paper:	Is low, majour revisions needed		
Length of the paper:	Is appropriate		
What is your main verdict?	Accept paper with majour revisions		

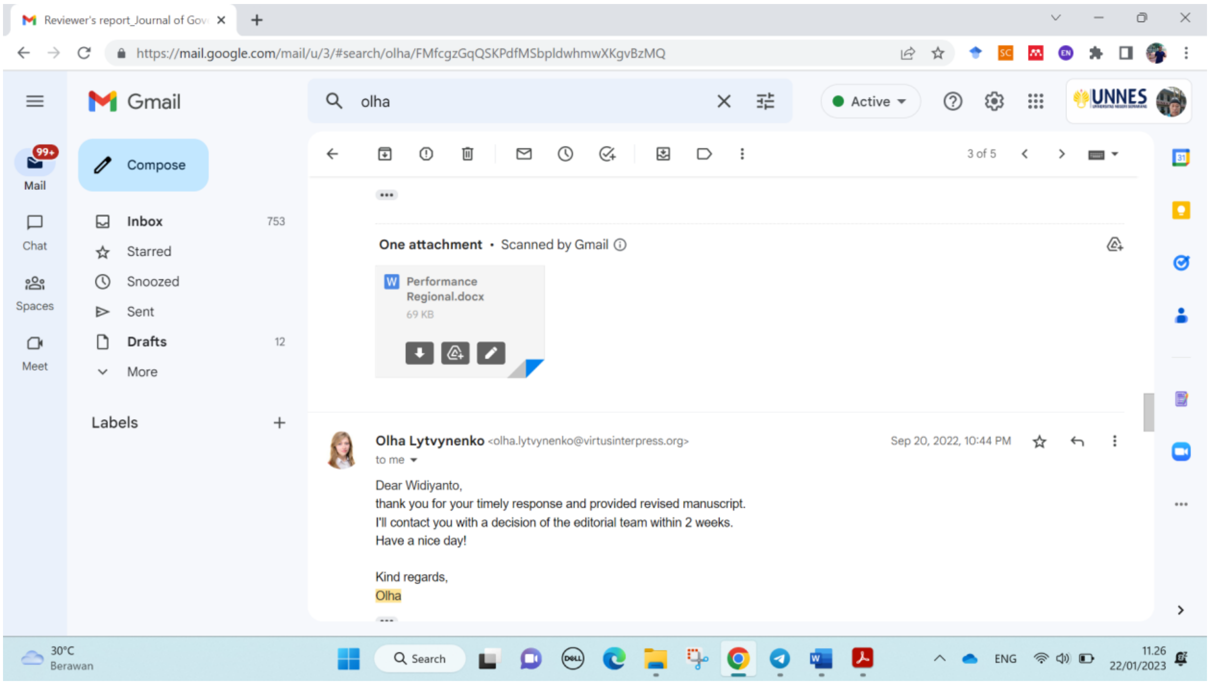
Field for the comments of the reviewer:
Following changes are needed to improve the quality of the article: 1)Title: Operation Management of Rural Banks of Local Government in Indonesia: An assessment of Agency Conflict or Social Responsibility 2) Abstract needs to include research question. 3) Citation in introduction is not followed properly as per APA style. 4) Research question must be added in the Introduction. 5) At least 5/7 literature review from 2018 to till 2022 may be included. A paragraph on research gap must be added in the Literature review. Hypothesis testing need to be given with mentioning alternative hypothesis and null hypothesis. 6) RESEARCH METHODOLOGY is incomplete .Time period of the study and data set must be properly addressed. All the variables both dependent and independent variables must be written stands for such as: ROA. Need to be tested multicollinearity problem and autocorrelation problem must be mentioned in research methodology. 7) Table:2 reports regression analysis. But it seems that only intercept is positive. As such some other variables may be taken such as increase the ratio of money supply to GDP .Based on multicollinearity problem and autocorrelation problem, corrective measures need to be taken. Best thing to do an autoregressive distributed lag (ARDL) model is an ordinary least square based model. 8) Each table and figure needs adding sources. 9) In the conclusion, implications of the study in a paragraph and also in another a paragraph on Future research work must be added. 10) Reference must be given properly as per APA style without any typing error.

4. Email-balasan menanggapi permintaan revisi- 9-September - 2022



5. Email-pengiriman file paper yang telah diperbaiki 20-September - 2022





Paper yang telah diperbaiki

Rural Banks of Local Government: Agency Conflict or Social Responsibility

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Abstract

Rural banks with local government ownership as majority shareholders aimed to increase public welfare and earning profits. Post-M&A due to COVID-19 increases rural bank risk in lending. The research objective is to determine the impact of increased risk on rural bank lending from perspective agency conflict or CSR oriented.

Data were collected from 32 annual reports of rural banks in Indonesia that showed different results. The government, as the majority shareholder, has a more effective monitoring role. Multiple regression has been used to analysis data of LDR (long-term debt ratio) as dependent variable, and our independent variable uses the CAR (Capital Adequacy Ratio), NPM (net profit margin), and ROE(return on equity).

The result is that the determination of Loan Deposit of Ratio (LDR) is not determined by the bank's health or the business risk of the debtor. Government demands through financing in local government, and it ignores risks and produces risk-taking behavior of managers. Corporate social responsibility oriented to society demand has been produced from rural banks owned by government. More severe, the presence of asymmetric information resulted in the financial services authority (OJK) and central bank not being able to observe optimally. As a result, financing to society is more allocated to CSR, and manajer as agent, and uniquely, the decision of the manager does not result in agency conflict.

Keywords: Agency conflict, Social Responsibility, Rural Bank, Local Government Ownership

Introduction

Agency conflict, ex-ante, information asymmetry lead to a conflict of interest between managers and external shareholders who are not directly involved in firm management (Cariola et al., 2011; Jensen & Meckling, 1976). The conflict of interest worsens when state-owned enterprises make a larger appropriation than non-SOE (Rashid Khan et al., 2020). SOE is characterized by political interests and corporate expropriation, resulting in greater agency conflict between principals and agents than non-SOEs.

The presence of political connections provides benefits in increasing company performance because they have more access to financing, profitable projects (Wati, 2020). The resulting agency cost is greater because of the behavior of managers pursuing political connections with the government and ignoring the company's interests, which leads to lower productivity (Harris et al., 2016); lower quality of financial reports (Wati, 2020).

To sum up, the situation is similar in the banking sector. State-Owned Banks (also State-Owned Enterprises/SOEs) also have agency conflict, which may increase due to increased political content. Since banks were privatized and owned by the government (SOE), long-term performance was static or no different; the result was that the legacy of pre-privatized long-term loans increased post-privatization (Berger et al., 2005). The wider impact is due to the increase in government ownership in banking resulting in a slowdown in the development of the financial sector and economic growth (La Porta, 2001).

Our study was conducted in rural banks owned by a local government and experienced a decline in performance due to the COVID-19-19 pandemic. As a result, the Financial Services Authority (*Otoritas Jasa Keuangan*/ OJK) in February 2020 conducted a Merger and Acquisition (M&A) in the hope of increasing performance resulting in increased free cash flow and survival capabilities (Maama et al., 2017). In addition, if the government owns it, the ability of performance monitoring resources is better than others (Noerdin, 2016). M&A produces more resources so that managers with discretionary power make greater use of them for their interests and shareholders (Jensen, 1986). They prevent any mechanism that could reduce control (Nogueira & Kabbach de Castro, 2020), exacerbated by the presence of political connections.

Many types of research on the benefits and costs of companies with political connections have been carried out; therefore, we add the impact of political connections in terms of the lenders (banking sector), which is still limited (Amdanata & Mansor, 2018). Our paper describes the second part of the literature review, and the third describes the research method. Fourth, report the results and findings; lastly, we present a discussion.

Literature Review

M&A in Bank

We define M&A, as (Maama et al., 2017) state, as a merger as a strategy of combining resources to achieve common goals, and each entity still owns part of the company. The acquisition is a long-term agreement when one company buys another company. The direct impact of M&A on shareholders or when a merger occurs, shareholders' shares experience dilution, and the acquisition results in shareholders not having discretionary power. Agency conflicts are exacerbated when managers use larger resources when M&A is carried out. When the company's size increases, managers try to increase their welfare by ignoring shareholders' welfare.

M&A often allows companies to develop a competitive advantage by increasing flexibility, growth, and shareholder value. Common M&A motives include strategic growth, talent growth, preparation for an IPO or exit, and entering a new geographic or demographic market. Originally M&A was a description to reframe a company. Over the years the traditional subject of Mergers & Acquisitions has been broadened to cover takeovers and issues related to corporate restructuring, corporate control, and changes in corporate ownership structure.

Agency Conflict in M&A

The agency conflict begins with a paper (Akerlof, 1970) on the used car market, with the analogy of plum (good quality car) and lemon (bad quality car). A transaction failure occurs when both parties have an information imbalance. When the seller has better information about the plum car than the buyer, the buyer only buys all the cars (plum or lemon) at the average price of the two; as a result, all the cars offered are lemon cars. The presence of asymmetric information has produced an adverse selection problem between rural banks and debtors. SOE banking is more politically connected and is faced with trade-offs between solving agency problems and SCR oriented

Information asymmetry, ex-post, agency conflict, and incomplete contracts result in agency conflict, where the agent acts not in the interests of the principals. They choose projects with low risk to produce low yields; the results are not by the preferences of shareholders (La Rocca et al., 2007).

PAT (principles-agent theory) does not only occur in M&A transactions, it has been broadly defined, there is a principal-agency relationship whenever one individual is based on the actions of another. Both seek to achieve their optimal goals. Subject goals interact and conflict with each other. One of the subjects performs an action to achieve the goal. This action has an impact on the interests of other subjects. Agents can act opportunistically, he pursues their goals without regard to other subjects. One party (principal) a certain party (agent) to perform tasks for him. This phenomenon of conflicting interests and information asymmetry is quite often the reason for the failure of M&A transactions.

In an M&A transaction, company A cannot be sure to have all the information about the quality of company B before the contract is made. sometimes the acquirer experiences a nasty surprise after the transaction is executed. To offer this offer, the principal offers an average purchase price. So the loss is not too big if the quality of the agent is poor. As a result, agents with poor skills will accept the average offer because they feel they are being paid well and high-quality agents will not accept the offer because they expect a better offer. In the worst case, that effect can destroy the entire market.

Post-M&A, rural banks experienced an increase in total assets along with an increase in agency conflict. In Indonesia, there are two operational guidelines for rural banks owned by the local government. The first guideline is under the central bank in Regulation No.8/26/PBI/2006. Regulations regulate issues such as corporate governance as ownership, board of directors, and Supervisory Board. Second, the Minister of Home Affairs, local government regulations, and state-owned banks must be harmonized with government regulations (Amdanata & Mansor, 2018; Noerdin, 2016).

Managers who act in the interests of the government post-M&A produce greater free cash flow, thereby harming other parties who are not directly involved in the management. Tighter banking regulations are more likely to produce risk-taking manager behavior; conversely, when regulations are loose, risk-taking is reduced (Lee, 2009). Managers try to maximize value for local government as majority shareholders by risk-taking on the industry.

SOE banking has a greater risk because it provides greater credit to politically connected companies (Rashid Khan et al., 2020; Wati, 2020). Under the pretext of being in the interests of the majority shareholders, managers take risk-taking actions to benefit from an increase in compensation (Dewanta & Arifin, 2020). Due to public demand for bank SOE to support the real sector and OJK supervision, risk exposure is lower (Ariefianto & Soepomo, 2013). Greater agency conflict encourages managers to finance risky projects of politically connected firms (Lee, 2009). We use the LDR proxy to measure the impact of increased risk due to local government ownership of rural banks.

In terms of the impact of CSR on cross-border M&A, using stakeholder theory, (H. Li et al., 2022)reports that the successful completion of cross-border M&A largely depends on stakeholder evaluations of the merged and acquired firms. In his study, emerging market multinationals (EMMs) that tend to have bad news with respect to their domestic CSR engagements are less likely to complete cross-border deals and are more likely to take longer than their counterparts. They showed that firms that share similar CSR profiles are more likely to manage mergers, conclude their deals more quickly, enjoy greater merger synergies, improve their long-term performance, and experience fewer changes in CSR policies after deals are finalized.

The CSR perspective explains, has provided evidence of stakeholders and CSR issues are more important in the acquisition process. The CSR program is a means to gain public legitimacy in state-owned banking. As companies develop and nationalize, they are faced with diverse institutional contexts with and competing expectations. CSR provides a comprehensive instrument for dealing with conflicts of interest tailored to local resources by state-owned banks

Based on these considerations, mergers and acquisitions can be more than the reach of the domain analysis with the stakeholders of the stakeholders. Stakeholder theory provides a reasoned perspective on how companies should manage their relationships with stakeholders to develop competitive resources, and achieve sustainable success, goals that are broader than financial performance. The stakeholder perspective also helps explain how a company's own stakeholder network can be a sustainable competitive advantage. An important consequence of decision making for stakeholders is recognizing that dealing with social responsibility issues. Stakeholder-based reasoning provides practical motivation for companies to act responsibly with regard to stakeholder interests and addressing community concerns.

Hypothesis

The agency conflict leads the rural banks' risk-taking to exceed the average; it increases the loan to deposit ratio (LDR).

Research Method

Data for 2020 were collected from 32 Rural Banks (*Bank Perkreditan Rakyat*/ BPR)) annual reports after the COVID-19 pandemic. We use a risk proxy with ROA deviation to measure systematic risk in the banking sector (X. Li & Malone, 2016). When the risk deviation value is below the average, we classify it as low risk, and if it is above the average, it is high risk. The dependent variable is LDR, and our independent variable uses the CAR, NPM, and ROE proxies as the result of the manager's decision (Anita et al., 2011). Finally ,we use Ancova

$$LDR_i = \alpha_i + \beta_1 X_{1i} + \beta_2 D_{2i} + \sum_{i=1}^{3} \gamma_i + \mu_i$$

Results and Findings

Table 1 panel A reports the difference between positive and negative CARs with a negative distribution. The presence of a political connection stimulates this local government rural bank to provide more credit than existing customer funds so that most rural banks have a larger LDR than the median (Amdanata & Mansor, 2018), which is likely to be given due to a politically connected company application.

Positive CAR Skewness is the availability of funds to deal with risks, most of which are lower than the median. It is not different from LDR; NPM is the ability of banks to generate profits from company operations. The bigger, the better. Net income/operating income or how big is the portion of net income from operating income. ROE as banking performance reported most of the data is greater than the median.

Table 1

Panel A: Descriptive Statistics

	Min	Q1	Median	Q3	Max	Mean
LDR	54.600	67.503	72.705	80.490	92.210	67.821
Risk	-3.106	-0.745	-0.100	1.000	2.995	0.000
CAR	0.213	0.307	0.390	0.631	0.951	0.488
NPM	0.021	0.107	0.127	0.184	0.234	0.142
ROE	0.036	0.094	0.141	0.198	0.238	0.141

Panel B: Difference NPM

	Below of Above Risk	Above to All Risk	Below to All Risk
Mean Difference	0.074078	0.034724	0.039354
t-test	1.59E-06	0.007451	0.003758
Sig	Yes	Yes	Yes

Panel B reports NPM as the proportion of net income from operating profit at various risk levels. Banks with below-average risk have a greater difference (0.0393) than above-average risk (0.0347). The above-average risk is greater, having a greater NPM of 0.074 than the below-average risk. When risk increases above average, producing company efficiencies, they reduce the rural bank's operating costs.

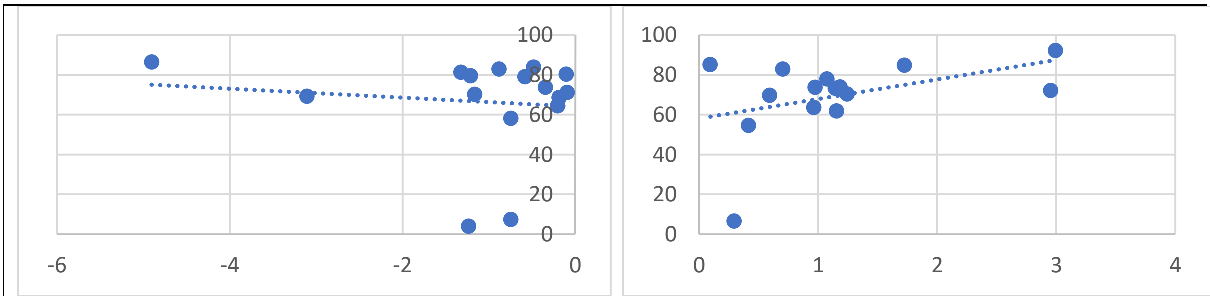
Table 2: Regression Analysis

	All		Above of Av Risk	Below of Av Risk
Intercept	53.55687	*	94.03775	31.65501
CAR	15.78906		0.781942	27.68302
NPM	-34.2657		-159.465	81.96898
ROE	81.05045		21.95035	97.06267
Multiple R	0.117915		0.251162	0.281081
R Square	0.013904		0.063082	0.079006
Adjusted R Square	-0.09175		-0.19244	-0.13353
Standard Error	22.93663		21.81056	25.63406
Observations	32		15	17

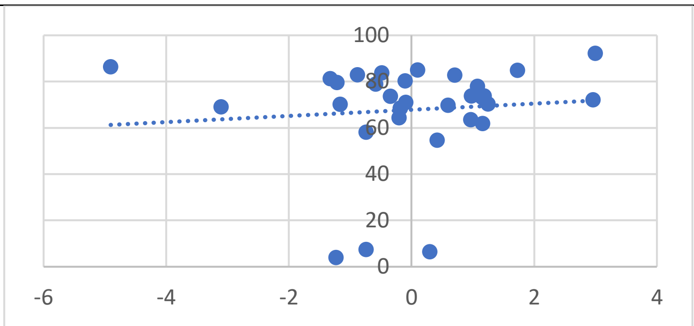
* sig 5%

It is interesting to know that LDR is more than a third-party fund since smaller or lower risks do not determine it. When the risk is below average, the LDR of rural banks is not determined by banking value; they provide credit not based on CAR, ROE, or NPM. It is possibly due to public demands to support government policies (Ariefianto & Soepomo, 2013) and the thickness of the agency conflict (Noerdin, 2016).

The risk-taking behavior of rural bank managers is explained by the risk-shifting problem shifting (Jensen & Meckling, 1976); from the demand side, managers prefer risk-taking projects that exceed the average because the manager will benefit if the project is successful. Due to the limited liability of managers and shareholders, if the project fails, debtholders will bear the risk. On the supply side, rural banks are more oriented towards public demands to support public financing, for example, in SMEs rather than agency conflict (Central Bank of Indonesia, n.d.; Eggertsson & Borgne, 2010).



Panel A: Risk dibawah rata-rata	Panel B: Risk diatas rata-rata



Panel C: total sample

There are two facts in the results; public demands to rural banks and agency conflict. When local government is not only profit-oriented, the demands for improving people's welfare become a priority. Rural banks are in line with the central bank, providing soft loans or other loans with greater risk tolerance than private banks. As a result, managers will be risk-taking with indications of an increase in LDR due to policy and credit stimulus from the government and local government.

M&A with SOE resulted in a larger free cash flow than without M&A. The result is that managers increase compensation from an increase in lending greater than savings funds; the result is increased welfare. They do empire building (Jensen & Meckling, 1976), although the risk is high, credit is still given. In other words, the increase in LDR is not determined by banking value but based on the interests of managers. (Cariola et al., 2011) describes the non-banking sector as an overinvestment problem due to the behavior of managers. They allocate company resources to high-risk projects because if the project fails, it becomes the responsibility of the debtholders.

The agency conflict in emerging markets is crucial, starting with the paper (La Porta, 2001). He reports that, on average, 42% of the top 10 banks are owned by governments and are common in poor and property-poor countries. The increased risk of LDR results in a greater probability of bankruptcy. With labor oversupply conditions, rural bank managers may lose their jobs and find it difficult to find other jobs (Agarwal & O'Hara, 2007). They will find it difficult to find another job in extreme conditions if the rural bank goes bankrupt because it loses its reputation (Hernández-Lagos et al., 2017).

Conclusion

Post-M&A, due to the COVID-19 pandemic, most rural banks of SOE have higher LDR than average. Local government as majority shareholders does not only act for business interests but demands to increase public welfare. The result is that the LDR is not determined by the risk characteristics of the debtor, either above or below the average risk. In addition, the control variable shows that it does not determine the LDR, which can be explained through the agency conflict. Managers who act in the interests of shareholders override the interests of customers. It is proven that rural bank health ratios such as CAR, NPM, and ROE do not determine LDR.

The compensation of rural bank managers is determined by the quantity of credit granted, not by the credit quality. The presence of information asymmetry results in managers and majority shareholders having superior information than customers, then they provide greater credit than customer deposits.

Author Contributions: AY and WY are generating an idea for this research. He proposes and contributing to the literature review, research method, discussion. PT and Ita data collection.

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Acknowledgments: Gratitude goes to Universitas Negeri Semarang to support the research

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6. Revision required, 4 OKTOBER 2022

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1) The approximate length of the paper should amount to 5000-10,000 words or 25-40 typed pages.

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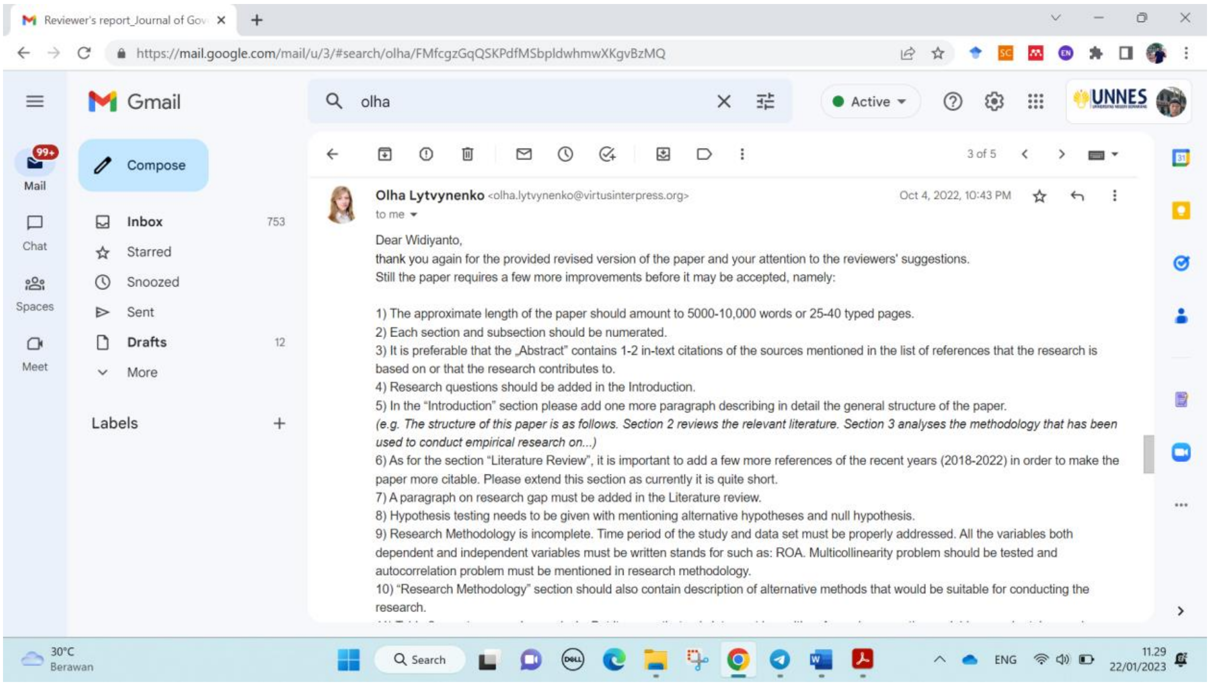
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Widiyanto Unnes <wied@mail.unnes.ac.id> Oct 8, 2022, 9:16 AM
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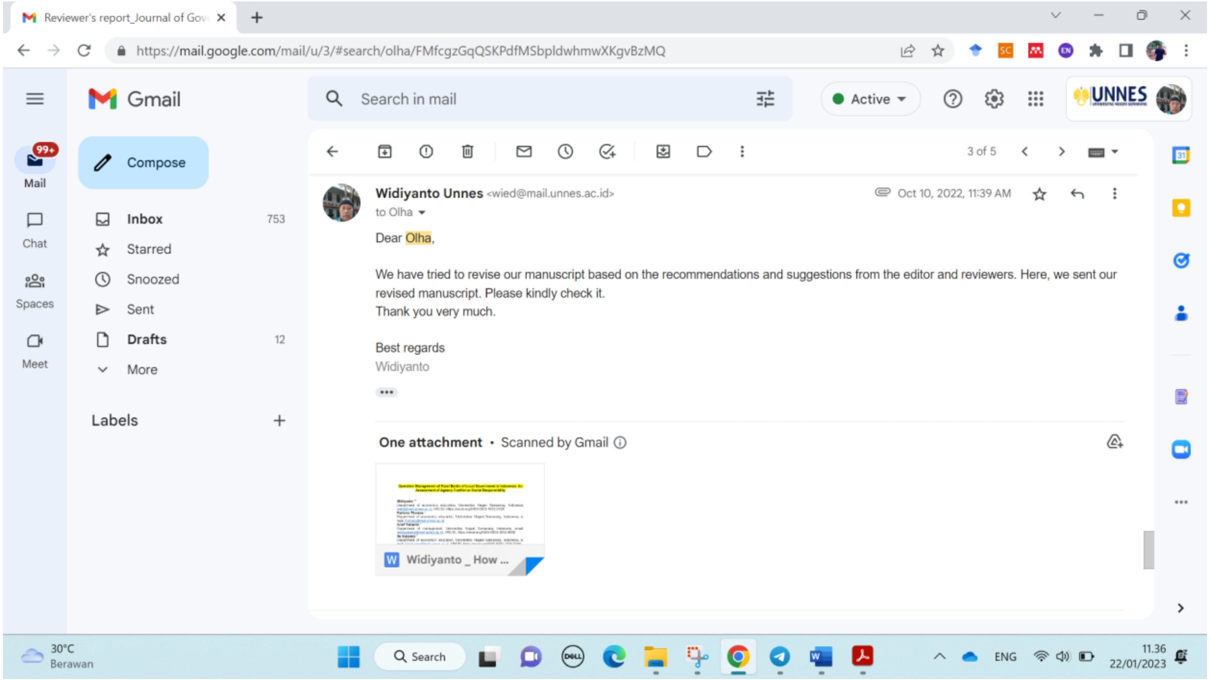

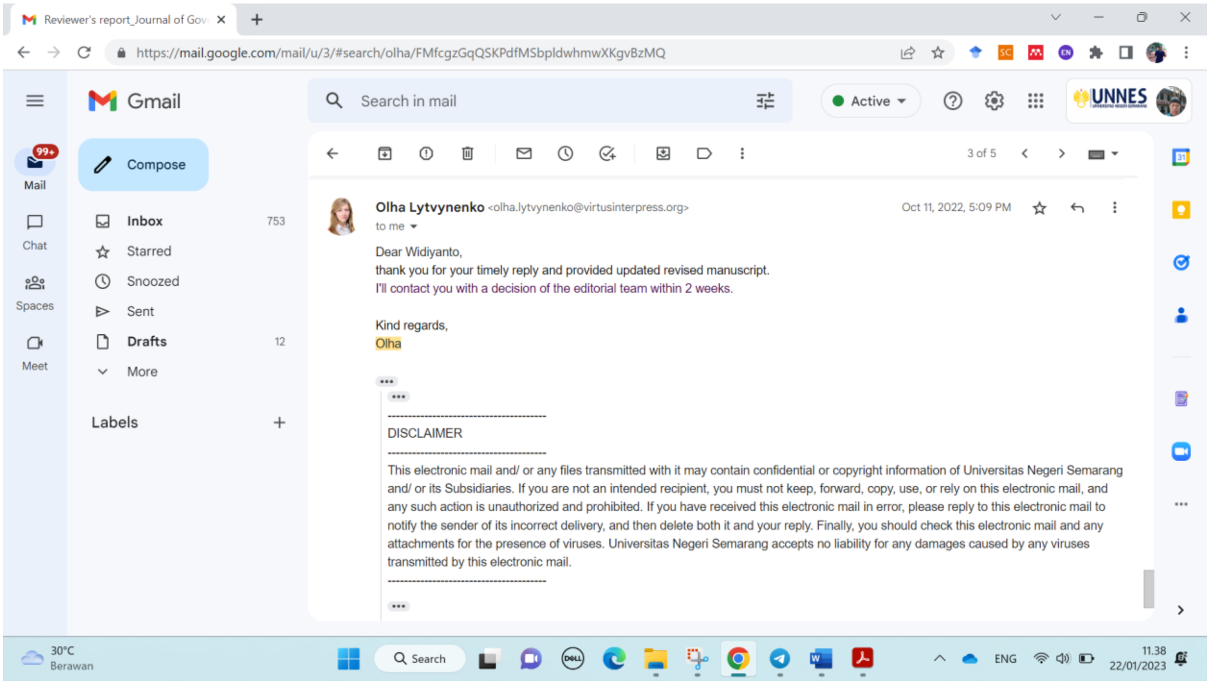

Paper yang telah diperbaiki

Operation Management of Rural Banks of Local Government in Indonesia: An Assessment of Agency Conflict or Social Responsibility

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Abstract

Rural banks with local government ownership as majority shareholders aimed to increase public welfare and earning profits. State-Owned Banks (also State-Owned Enterprises/SOEs) also have agency conflict, which may increase due to increased political content. The resulting agency cost is greater because of the behavior of managers pursuing political connections with the government and ignoring the company's interests, which leads to lower productivity (Harris et al., 2016); lower quality of financial reports (Wati, 2020a). Post-merger and Acquisition (Post-M&A) due to COVID-19 increases rural bank risk in lending. The research objective is to determine the impact of increased risk on rural bank lending. Data were collected from 32 annual reports of rural banks in Indonesia. Documentation was used to collect the data. LDR (Loan Deposit of Ratio) is dependent variable, risk as independent variable, and CAR (Capital Adequacy Ratio), NPM (Net Profit Margin), and ROE (Return on Equity) as control variables. Technique of analysis data is analysis of covariance. The result show Banks with below-average risk have a greater difference (0.0393) than above-average risk (0.0347). Other result indicates that LDR is not determined by the bank's health or the business risk of the debtor. Government demands through financing in local government, and it ignores risks and produces risk-taking behavior of managers. The government, as the majority shareholder, has a more effective monitoring role. Corporate social responsibility oriented to society demand has been produced from rural banks owned by government. More severe, the presence of asymmetric information resulted in the financial services authority (OJK) and central bank not being able to observe optimally. As a result, financing to society is more allocated to CSR, and manager as agent, and uniquely, the decision of the manager does not result in agency conflict.

Keywords: Agency conflict, Social Responsibility, Rural Bank, Local Government Ownership

JEL Classification: G20, G21, G28, G34, G38

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Author Contributions:

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Methodology: Widiyanto, Arief Yulianto

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Validation: Widiyanto, Partono Thomas

Formal Analysis: Widiyanto, Ita Nuryana

Investigation: Widiyanto, Arief Yulianto

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Data Curation: Ita Nuryana, Ahmad Nurkhin

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Visualization: Arief Yulianto, Ahmad Nurkhin

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Declaration of Conflicting Interests:

The Authors declare that there is no conflict of interest.

1. INTRODUCTION

Agency conflict, ex-ante, information asymmetry led to a conflict of interest between managers and external shareholders who are not directly involved in firm management (Cariola et al., 2011a; Jensen & Meckling, 1976a). The conflict of interest worsens when state-owned enterprises (SOE) make a larger appropriation than non-SOE (Rashid Khan et al., 2020a). SOE is characterized by political interests and corporate expropriation, resulting in greater agency conflict between principals and agents than non-SOEs.

The presence of political connections provides benefits in increasing company performance because they have more access to financing, profitable projects (Wati, 2020a). The resulting agency cost is greater because of the behavior of managers pursuing political connections with the government and ignoring the company's interests, which leads to lower productivity (Harris et al., 2016); lower quality of financial reports (Wati, 2020b).

To sum up, the situation is similar in the banking sector. State-Owned Banks (also State-Owned Enterprises/SOEs) also have agency conflict, which may increase due to increased political content. Since banks were privatized and owned by the government (SOE), long-term performance was static or no different; the result was that the legacy of pre-privatized long-term loans increased post-privatization (Berger et al., 2005). The wider impact is due to the increase in government ownership in banking resulting in a slowdown in the development of the financial sector and economic growth (La Porta, 2001a).

Our study was conducted in rural banks owned by a local government and experienced a decline in performance due to the COVID-19-19 pandemic. Hidajat (2020) states rural banks are banks that accept deposits and provide short-term credit to rural communities. Rural banks are financial institutions that are close to the community. As a result, the Financial Services Authority (*Otoritas Jasa Keuangan*/ OJK) in February 2020 conducted a Merger and Acquisition (M&A) in the hope of increasing performance resulting in increased free cash flow and survival capabilities (Maama et al., 2017a). In addition, if the government owns it, the ability of performance monitoring resources is better than others (Noerdin, 2016a). M&A produces more resources so that managers with discretionary power make greater use of them for their interests and shareholders (Jensen, 1986). They prevent any mechanism that could reduce control (Nogueira & Kabbach de Castro, 2020), exacerbated by the presence of political connections.

Many types of research on the benefits and costs of companies with political connections have been carried out; therefore, we add the impact of political connections in terms of the lenders (banking sector), which is still limited (Amdanata & Mansor, 2018a). The research question of this paper is what the impact of increased risk on rural bank lending? So, we investigate the effect of risk on the loan deposit ration of the rural banks.

The structure of this paper is as follows. Section 1 describes the background of this study. Section 2 reviews the relevant literature and explain the hypotheses development. Section 3 analyses the methodology that has been used to conduct empirical research. Section 4 show the results. Section 5 we present the discussion. And the last section, we describe the conclusion of this paper, including the recommendations and the limitations.

2. LITERATURE REVIEW

a. Merger and Acquisition (M&A) in Bank

We define M&A, as (Maama et al., 2017b) state, as a merger as a strategy of combining resources to achieve common goals, and each entity still owns part of the company. The acquisition is a long-term agreement when one company buys another company. The direct impact of M&A on shareholders or when a merger occurs, shareholders' shares experience dilution, and the acquisition results in shareholders not having discretionary power. Agency conflicts are exacerbated when managers use larger resources when M&A is carried out. When the company's size increases, managers try to increase their welfare by ignoring shareholders' welfare.

M&A often allows companies to develop a competitive advantage by increasing flexibility, growth, and shareholder value. Common M&A motives include strategic growth, talent growth, preparation for an IPO or exit, and entering a new geographic or demographic market. Originally M&A was a description to reframe a company. Over the years the traditional subject of Mergers & Acquisitions has been broadened to cover takeovers and issues related to corporate restructuring, corporate control and changes in corporate ownership structure.

b. Agency Conflict in Merger and Acquisition (M&A)

The agency conflict begins with a paper (Akerlof, 1970) on the used car market, with the analogy of plum (good quality car) and lemon (bad quality car). A transaction failure occurs when both parties have an information imbalance. When the seller has better information about the plum car than the buyer, the buyer only buys all the cars (plum or lemon) at the average price of the two; as a result, all the cars offered are lemon cars. The presence of asymmetric information has produced an adverse selection problem between rural banks and debtors. SOE banking is more politically connected and is faced with trade-offs between solving agency problems and SCR oriented.

Information asymmetry, ex-post, agency conflict, and incomplete contracts result in agency conflict, where the agent acts not in the interests of the principals. They choose projects with low risk to produce low yields; the results are not by the preferences of shareholders (La Rocca et al., 2007).

PAT (principles-agent theory) does not only occur in M&A transactions, but it has also been broadly defined, there is a principal-agency relationship whenever one individual is based on the actions of another. Both seek to achieve their optimal goals. Subject goals interact and conflict with each other. One of the subjects performs an action to achieve the goal. This action has an impact on the interests of other subjects. Agents can act opportunistically; he pursues their goals without regard to other subjects. One party (principal) a certain party (agent) to perform tasks for him. This phenomenon of conflicting interests and information asymmetry is quite often the reason for the failure of M&A transactions.

In an M&A transaction, company A cannot be sure to have all the information about the quality of company B before the contract is made. sometimes the acquirer experiences a nasty surprise after the transaction is executed. To offer this offer, the principal offers an average purchase price. So, the loss is not too big if the quality of the agent is poor. As a result, agents with poor skills will accept the average offer because they feel they are being paid well and high-quality agents will not accept the offer because they expect a better offer. In the worst case, that effect can destroy the entire market.

c. Hypothesis Development

There are many influences from M&A on bank performance. M&A will have an impact on increasing the quality of products and services provided by the bank (Alvarez-González & Otero-Neira, 2020). Mergers between banks will create value for bidders in the long run but will be faced with greater costs and risks. The results of the study show that the merger destroys the value of the company's shares for banks pursuing a market penetration strategy (Hassan & Giouvris, 2020). Banks that do M&A on a large scale can reduce systemic risk, deal with good profitability, and support geographic diversification stability (Hassan & Giouvris, 2021).

However, bank M&A policies do not always provide the best solution. Many banks in Greece have faced crashes after the M&A. Banks fail to create value despite government assistance (Tampakoudis et al., 2020). Other findings show that there is no positive relationship between M&A and AT (asset turnover). AT ratio even worse. Furthermore, the evidence shows that stand-alone banks outperform merger banks after M&A in Nigeria (Yusuf & Raimi, 2019). We find that overall, successful mergers improve the quality of the information environment, while unsuccessful deals decrease it (Howe & Morillon, 2020).

Consolidation through mergers and acquisitions represents one of the main outcomes of the financial transformation process and contemporary trends in the Indian banking sector. The literature shows that the pre-merger bank finances are very important in determining the post-merger performance of the merged entity (Kuriakose & Paul, 2016). The study found that banks differ in most of the key areas, and this may have an adverse impact on post-merger performance.

Post-M&A, rural banks experienced an increase in total assets along with an increase in agency conflict. In Indonesia, there are two operational guidelines for rural banks owned by the local government. The first guideline is under the central bank in Regulation No. 8/26/PBI/2006. Regulations regulate issues such as corporate governance as ownership, board of directors, and Supervisory Board. Second, the Minister of Home Affairs, local government regulations, and state-owned banks must be harmonized with government regulations (Amdanata & Mansor, 2018b; Noerdin, 2016b).

Managers who act in the interests of the government post-M&A produce greater free cash flow, thereby harming other parties who are not directly involved in the management. Tighter banking regulations are more likely to produce risk-taking manager behavior; conversely, when regulations are loose, risk-taking is reduced (Abdel-Baki et al., 2011; Lee, 2009a). Managers try to maximize value for local government as majority shareholders by risk-taking on the industry.

SOE banking has a greater risk because it provides greater credit to politically connected companies (Rashid Khan et al., 2020b; Wati, 2020b). Under the pretext of being in the interests of the majority shareholders, managers take risk-taking actions to benefit from an increase in compensation (Dewanta & Arifin, 2020). Due to public demand for bank SOE to support the real sector and OJK supervision, risk exposure is lower (Ariefianto & Soepomo, 2013a). Greater agency conflict encourages managers to finance risky projects of politically connected firms (Lee, 2009b). We use the LDR proxy to measure the impact of increased risk due to local government ownership of rural banks.

Empirical findings show that deposit size, credit risk, portfolio investment, average loan interest rates, real gross domestic product (GDP) and inflation rate have a significant and optimistic effect on private commercial bank loans (Birhanu et al., 2021). Other findings show that the technical efficiency of BPRs has a significant positive impact on their lending to MSMEs in West Java Indonesia. These results underscore the importance of BPRs in maintaining and improving the efficiency of banks to increase their capacity to provide loans to MSMEs (Anwar et al., 2020).

In terms of the impact of CSR on cross-border M&A, using stakeholder theory, (H. Li et al., 2022) reports that the successful completion of cross-border M&A largely depends on stakeholder evaluations of the merged and acquired firms. In his study, emerging market multinationals (EMMs) that tend to have bad news with respect to their domestic CSR engagements are less likely to complete cross-border deals and are more likely to take longer than their counterparts. They showed that firms that share similar CSR profiles are more likely to manage mergers, conclude their deals more quickly, enjoy greater merger synergies, improve their long-term performance, and experience fewer changes in CSR policies after deals are finalized.

The CSR perspective explains, has provided evidence of stakeholders and CSR issues are more important in the acquisition process. The CSR program is a means to gain public legitimacy in state-owned banking. As companies develop and nationalize, they are faced with diverse institutional contexts with and competing expectations. CSR provides a comprehensive instrument for dealing with conflicts of interest tailored to local resources by state-owned banks

Based on these considerations, mergers and acquisitions can be more than the reach of the domain analysis with the stakeholders. Stakeholder theory provides a reasoned perspective on how companies should manage their relationships with stakeholders to develop competitive resources, and achieve sustainable success, goals that are broader than financial performance. The stakeholder perspective also helps explain how a company's own stakeholder network can be a sustainable competitive advantage. An important consequence of decision making for stakeholders is recognizing that dealing with social responsibility issues. Stakeholder-based reasoning provides practical motivation for companies to act responsibly about stakeholder interests and addressing community concerns.

Rural banks are growing in large numbers and becoming popular financial institutions in Indonesia (Hidajat, 2020). But, there are few studies examining the relationship between risk and LDR. Based on the above explanations, there are research gap in the relationship of the risk and lending policy of the banks. There is significant impact of the credit risk on bank loans (Birhanu et al., 2021). Other findings show that the technical efficiency of BPRs has a significant positive impact on their lending to MSMEs in West Java Indonesia (Anwar et al., 2020).

Other researchers even prove the opposite relationship, risk is influenced by financing policies (Umar et al., 2021). Banks usually increase the loan/advance disbursement to increase profitability, which dries out liquidity and enhances liquidity risk (Ahamed, 2021). Previous research has proven the significant effect of LDR on bank profitability (Karamoy & Tulung, 2019). And other study found the impact of risk onfinancial performance of the bank (Wood & McConney, 2018).

And the hypothesis of this study as follows.

H1 The agency conflict leads the rural banks' risk-taking to exceed the average; it increases the loan to deposit ratio (LDR).

3. RESEARCH METHODOLOGY

This study is a quantitative study with the aim of determining the impact of increased risk on rural bank lending. Documentation was used to collect the data. Data for 2020 were collected from 32 Rural Banks (*Bank Perkreditan Rakyat*/BPR) annual reports after the COVID-19 pandemic in Indonesia. Ancova analysis was used to analyze the data. Normality and multicollinearity were tested.

We use a risk proxy with ROA (return on assets) deviation to measure systematic risk in the banking sector (X. Li & Malone, 2016). When the risk deviation value is below the average, we classify it as low risk, and if it is above the average, it is high risk. The dependent variable is LDR, and the independent variable uses the CAR, NPM, and ROE proxies as the result of the manager's decision (Anita et al., 2014).

CAR is a ratio that shows how much the total assets of a bank that contain risks (credits, investments, securities, claims on other banks) are also financed from their own capital in addition to obtaining funds from sources outside the bank. NPM is the company's ability to generate profits at a certain level of sales. NPM can be interpreted as the level of company efficiency, namely the extent to which the company's ability to reduce costs in the company. LDR is a ratio that measures the ratio of the amount of credit extended by the bank to the funds received by the bank, which describes the bank's ability to repay the withdrawal of funds by depositors by relying on the credit provided as a source of liquidity.

Finally, we use Ancova to analyze the data as follow.

$$LDR_i = \alpha_i + \beta_1 X_{1i} + \beta_2 D_{2i} + \sum_{i=1}^{3} \gamma_i + \mu_i$$

4. RESULTS

Table 1 panel A reports the difference between positive and negative CARs with a negative distribution. The presence of a political connection stimulates this local government rural bank to provide more credit than existing customer funds so that most rural banks have a larger LDR than the median (Amdanata & Mansor, 2018b), which is likely to be given due to a politically connected company application.

Positive CAR Skewness is the availability of funds to deal with risks, most of which are lower than the median. It is not different from LDR; NPM is the ability of banks to generate profits from company operations. The bigger, the better. Net income/operating income or how big is the portion of net income from operating income. ROE as banking performance reported most of the data is greater than the median.

Table 1. Descriptive Statistics

Panel A: Descriptive Statistics						
	Min	Q1	Median	Q3	Max	Mean
LDR	54.600	67.503	72.705	80.490	92.210	67.821
Risk	-3.106	-0.745	-0.100	1.000	2.995	0.000
CAR	0.213	0.307	0.390	0.631	0.951	0.488
NPM	0.021	0.107	0.127	0.184	0.234	0.142
ROE	0.036	0.094	0.141	0.198	0.238	0.141
Panel B: Difference NPM						
	Below of Above Risk		Above to All Risk		Below to All Risk	
Mean Difference	0.074078		0.034724		0.039354	
t-test	1.59E-06		0.007451		0.003758	
Sig	Yes		Yes		Yes	

Source: author’s data analysis

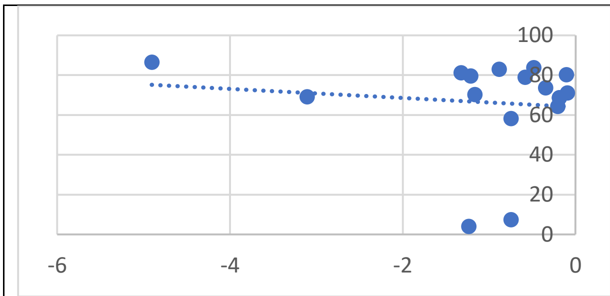
Panel B reports NPM as the proportion of net income from operating profit at various risk levels. Banks with below-average risk have a greater difference (0.0393) than above-average risk (0.0347). The above-average risk is greater, having a greater NPM of 0.074 than the below-average risk. When risk increases above average, producing company efficiencies, they reduce the rural bank's operating costs.

Table 2. Regression Analysis

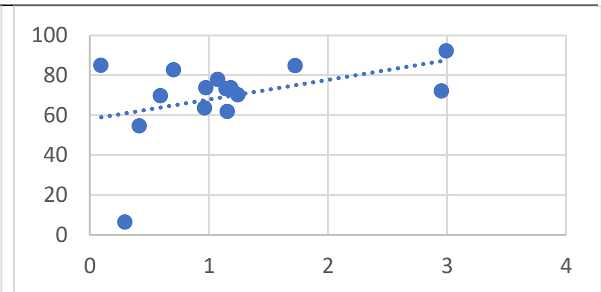
	All		Above of Av Risk	Below of Av Risk
Intercept	53.55687	*	94.03775	31.65501
CAR	15.78906		0.781942	27.68302
NPM	-34.2657		-159.465	81.96898
ROE	81.05045		21.95035	97.06267
Multiple R	0.117915		0.251162	0.281081
R Square	0.013904		0.063082	0.079006
Adjusted R Square	-0.09175		-0.19244	-0.13353
Standard Error	22.93663		21.81056	25.63406
Observations	32		15	17
* sig. 5%				

Source: author’s data analysis

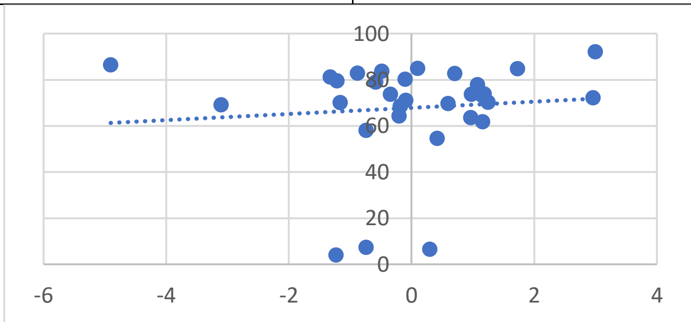
Table 2 show that risk cannot determine the lending of rural banks in Indonesia. There is no significant influence of risk on LDR. Other variables also have significant value more than 0.05. So, there are no significant impact of CAR, NPM, and ROE on LDR.



Panel A: Below of Av Risk



Panel B: Above of Av Risk



Panel C: total sample

Figure 1. Below and Above Average Risk of rural banks
(Source: author’s data analysis)

5. DISCUSSION

It is interesting to know that LDR is more than a third-party fund since smaller or lower risks do not determine it. When the risk is below average, the LDR of rural banks is not determined by banking value; they provide credit not based on CAR, ROE, or NPM. It is possibly due to public demands to support government policies (Ariefianto & Soepomo, 2013b) and the thickness of the agency conflict (Noerdin, 2016b).

The risk-taking behavior of rural bank managers is explained by the risk-shifting problem shifting (Jensen & Meckling, 1976b); from the demand side, managers prefer risk-taking projects that exceed the average because the manager will benefit if the project is successful. Due to the limited liability of managers and shareholders, if the project fails, debtholders will bear the risk. On the supply side, rural banks are more oriented towards public demands to support public financing, for example, in SMEs rather than agency conflict (Central Bank of Indonesia, n.d.; Eggertsson & Borgne, 2010). The previous study found that the presence of a standalone risk committee, training in risk management and/or related courses, and the appointment of the chief risk officer (CRO) to the board increases instead of decreasing bank risk (Mashamba & Gani, 2022).

There are two facts in the results: public demands to rural banks and agency conflict. When local government is not only profit-oriented, the demands for improving people's welfare become a priority. Rural banks are in line with the central bank, providing soft loans or other loans with greater risk tolerance than private banks. As a result, managers will be risk-taking with indications of an increase in LDR due to policy and credit stimulus from the government and local government.

M&A with SOE resulted in a larger free cash flow than without M&A. The result is that managers increase compensation from an increase in lending greater than savings funds; the result is increased welfare. They do empire building (Jensen & Meckling, 1976b), although the risk is high, credit is still given. In other words, the increase in LDR is not determined by banking value but based on the interests of managers. (Cariola et al., 2011b) describes the non-banking sector as an overinvestment problem due to the behavior of managers. They allocate company resources to high-risk projects because if the project fails, it becomes the responsibility of the debtholders.

The agency conflict in emerging markets is crucial, starting with the paper (La Porta, 2001b). He reports that, on average, 42% of the top 10 banks are owned by governments and are common in poor and property-poor countries. The increased risk of LDR results in a greater probability of bankruptcy. With labor oversupply conditions, rural bank managers may lose their jobs and find it difficult to find other jobs (Agarwal & O’Hara, 2007). They will find it difficult to find another job in extreme conditions if the rural bank goes bankrupt because it loses its reputation (Hernández-Lagos et al., 2017).

The M&A strategy for rural banks has had an impact on bank policy in general. The government's role as the dominant ownership will also affect the post-M&A banking strategy. Therefore, the study of bank performance after the M&A and the COVID-19 pandemic will be more interesting. Financial and non-financial indicators as well as internal and external factors will be able to investigate these impacts more comprehensively. The quality of service will be better or will it experience a significant decline. Product and service innovation will be an interesting theme to be studied more deeply.

6. CONCLUSION

Post-M&A, due to the COVID-19 pandemic, most rural banks of SOE have higher LDR than average. Local government as majority shareholders does not only act for business interests but demands to increase public welfare. This study aims to analysis the impact of risk on LDR post-M&A of rural banks in Indonesia. The result is that the LDR is not determined by the risk characteristics of the debtor, either above or below the average risk. In addition, the control variable shows that it does not determine the LDR, which can be explained through the agency conflict. Managers who act in the interests of shareholders override the interests of customers. It is proven that rural bank health ratios such as CAR, NPM, and ROE do not determine LDR significantly. The compensation of rural bank managers is determined by the quantity of credit granted, not by the credit quality. The presence of information asymmetry results in managers and majority shareholders having superior information than customers, then they provide greater credit than customer deposits.

The implication of this research is how BPR management can manage loans after M&A properly, paying attention to the interests of customers and of course the interests of shareholders. Although risk does not prove to have a significant effect, loan management is very important to maintain the possibility of increasing profitability in the future. The characteristics of customers can be studied more carefully by management so that the distribution of financing becomes safer and more prudent.

The scope of data observations is one the limitation of this study. The data obtained are very limited. Although the results of the analysis can be used as a reference for policy makers, especially the relationship between risk and rural bank financing policies. Future research can increase the range of data analyzed and add other important variables related to the loan deposit ratio. The impact of the COVID-19 pandemic is very interesting to study more deeply. Research on the determinants of bank risk is also interesting, as has been done in previous studies with various variable sizes and research object settings (Mashamba & Gani, 2022).

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8. Your paper may be accepted_Virtus Interpress, 26 OKTOBER 2022

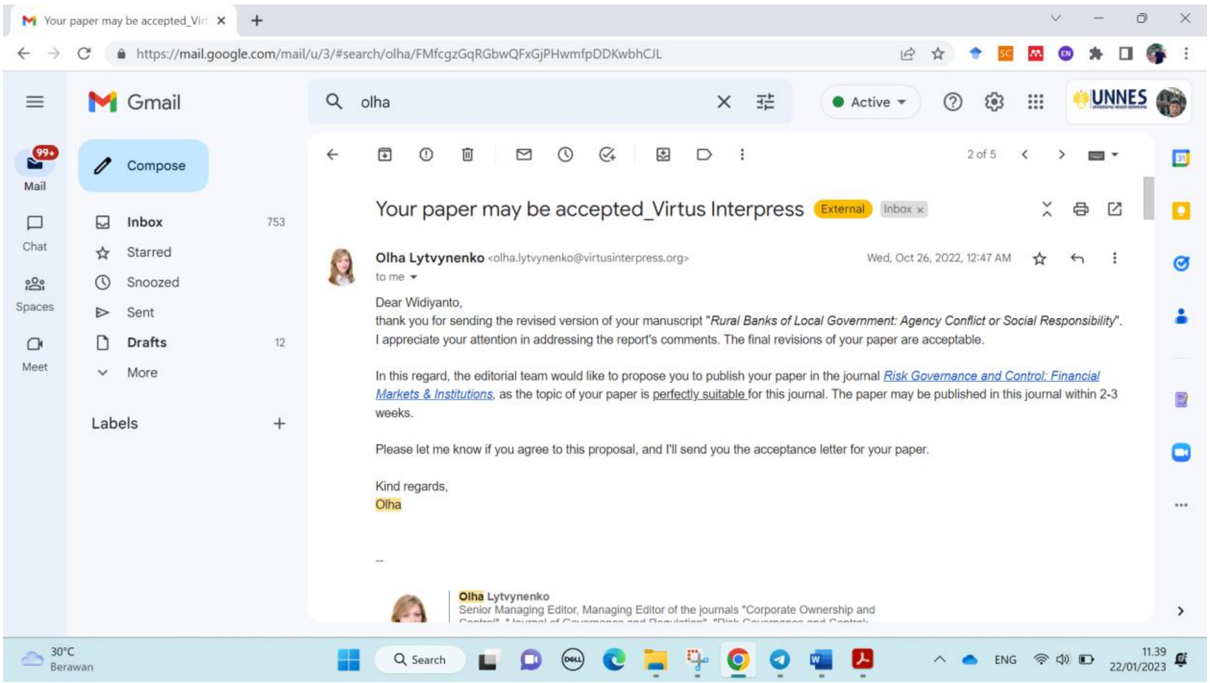
Dear Widiyanto,

thank you for sending the revised version of your manuscript "*Rural Banks of Local Government: Agency Conflict or Social Responsibility*". I appreciate your attention in addressing the report's comments. The final revisions of your paper are acceptable.

In this regard, the editorial team would like to propose you to publish your paper in the journal *Risk Governance and Control: Financial Markets & Institutions*, as the topic of your paper is perfectly suitable for this journal. The paper may be published in this journal within 2-3 weeks.

Please let me know if you agree to this proposal, and I'll send you the acceptance letter for your paper.

Kind regards,
Olha



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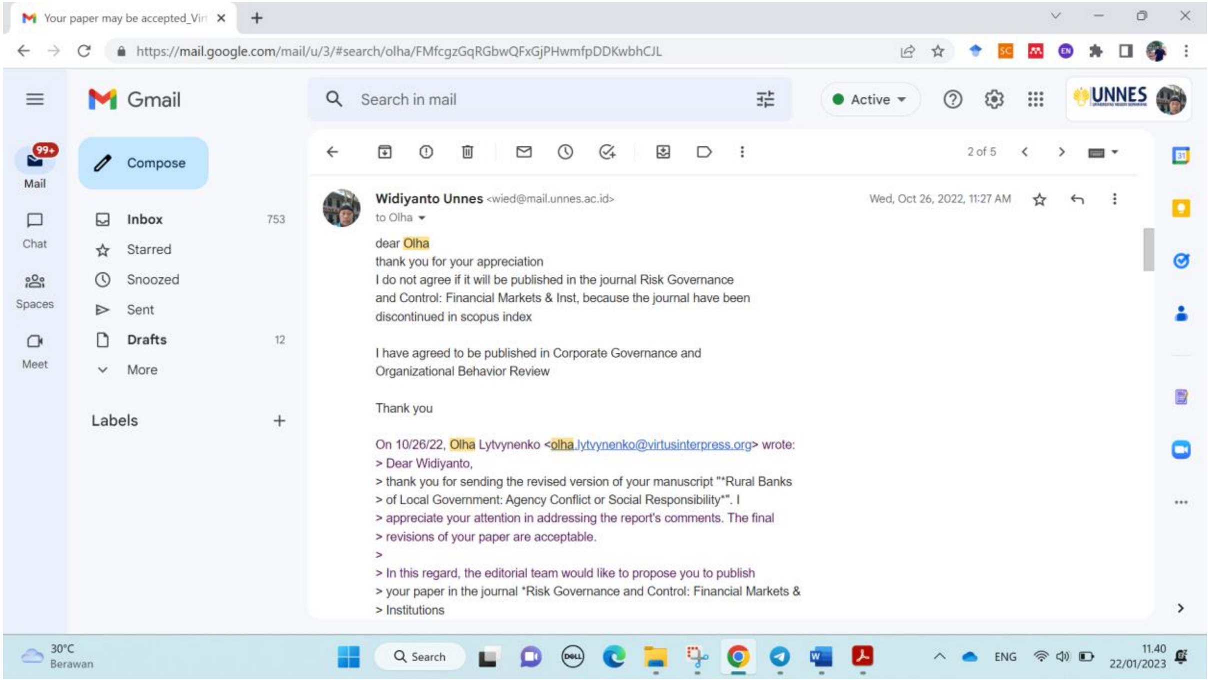

Widiyanto Unnes <wied@mail.unnes.ac.id>
to Olha
Wed, Oct 26, 2022, 11:27 AM

dear Olha
thank you for your appreciation
I do not agree if it will be published in the journal Risk Governance and Control: Financial Markets & Inst, because the journal have been discontinued in scopus index

I have agreed to be published in Corporate Governance and Organizational Behavior Review

Thank you

On 10/26/22, Olha Lytvynenko <olha.lytvynenko@virtusinterpress.org> wrote:
> Dear Widiyanto,
> thank you for sending the revised version of your manuscript "*Rural Banks
> of Local Government: Agency Conflict or Social Responsibility*". I
> appreciate your attention in addressing the report's comments. The final
> revisions of your paper are acceptable.
>
> In this regard, the editorial team would like to propose you to publish
> your paper in the journal *Risk Governance and Control: Financial Markets &
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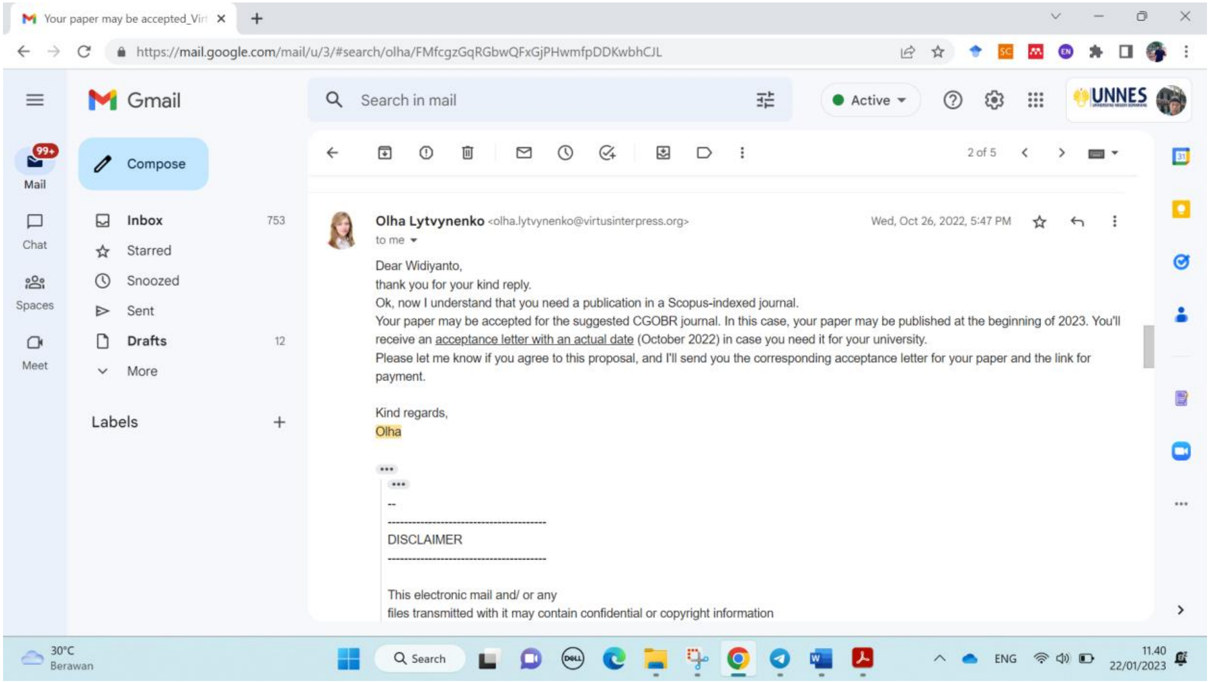

Olha Lytvynenko <olha.lytvynenko@virtusinterpress.org>
to me
Wed, Oct 26, 2022, 5:47 PM

Dear Widiyanto,
thank you for your kind reply.
Ok, now I understand that you need a publication in a Scopus-indexed journal.
Your paper may be accepted for the suggested CGOBR journal. In this case, your paper may be published at the beginning of 2023. You'll receive an acceptance letter with an actual date (October 2022) in case you need it for your university.
Please let me know if you agree to this proposal, and I'll send you the corresponding acceptance letter for your paper and the link for payment.

Kind regards,
Olha

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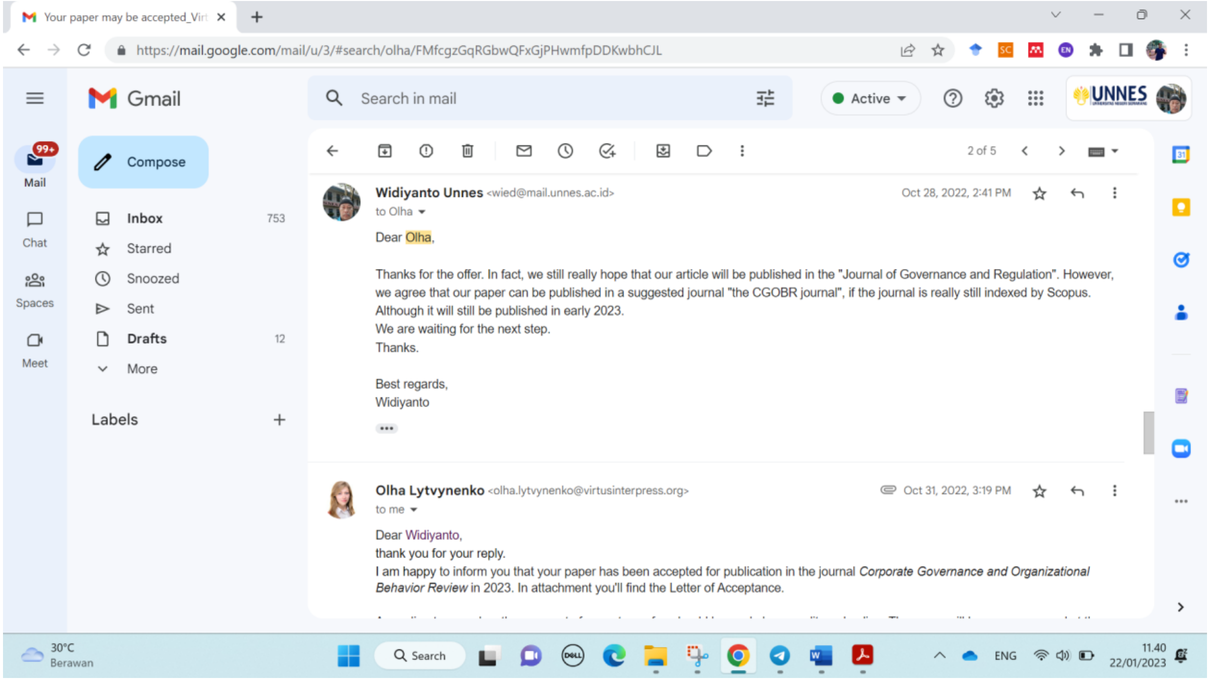

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https://mail.google.com/mail/u/3/#search/olha/FMfcgzGqRGbwQFxGjPHwmfpDDKwbhCJL

Widiyanto Unnes <wied@mail.unnes.ac.id> Oct 28, 2022, 2:41 PM
to Olha

Dear Olha,

Thanks for the offer. In fact, we still really hope that our article will be published in the "Journal of Governance and Regulation". However, we agree that our paper can be published in a suggested journal "the CGOBR journal", if the journal is really still indexed by Scopus. Although it will still be published in early 2023.
We are waiting for the next step.
Thanks.

Best regards,
Widiyanto

Olha Lytvynenko <olha.lytvynenko@virtusinterpress.org> Oct 31, 2022, 3:19 PM
to me

Dear Widiyanto,
thank you for your reply.
I am happy to inform you that your paper has been accepted for publication in the journal *Corporate Governance and Organizational Behavior Review* in 2023. In attachment you'll find the Letter of Acceptance.

10. Acceptance Letter ke jurnal Corporate Governance and Organizational Behavior Review, 31 OKTOBER 2022

Dear Widiyanto,

thank you for your reply.

I am happy to inform you that your paper has been accepted for publication in the journal *Corporate Governance and Organizational Behavior Review* in 2023. In attachment you'll find the Letter of Acceptance.

According to our rules, the payment of acceptance fee should be made by a credit card online. The paper will be open accessed at the website of the Publisher immediately after its publication. In this way you, as the author, will take part in our Virtus open-access network program. Moreover, under this immediate open access option, you will have a right to upload your paper (a PDF file of your published paper) as full-text elsewhere (ssrn.com, Researchgate, academia.edu, EconStor, RePEc, your university repositories, personal webpages, etc.) for open public access and disseminate the paper among your colleagues that will speed up your paper citation. Also, we will immediately, after publishing your paper at our website, start promoting your paper among our international network of scholars in corporate governance, accounting and finance (more than 5400 scholars worldwide) through direct linking, social networking, etc.

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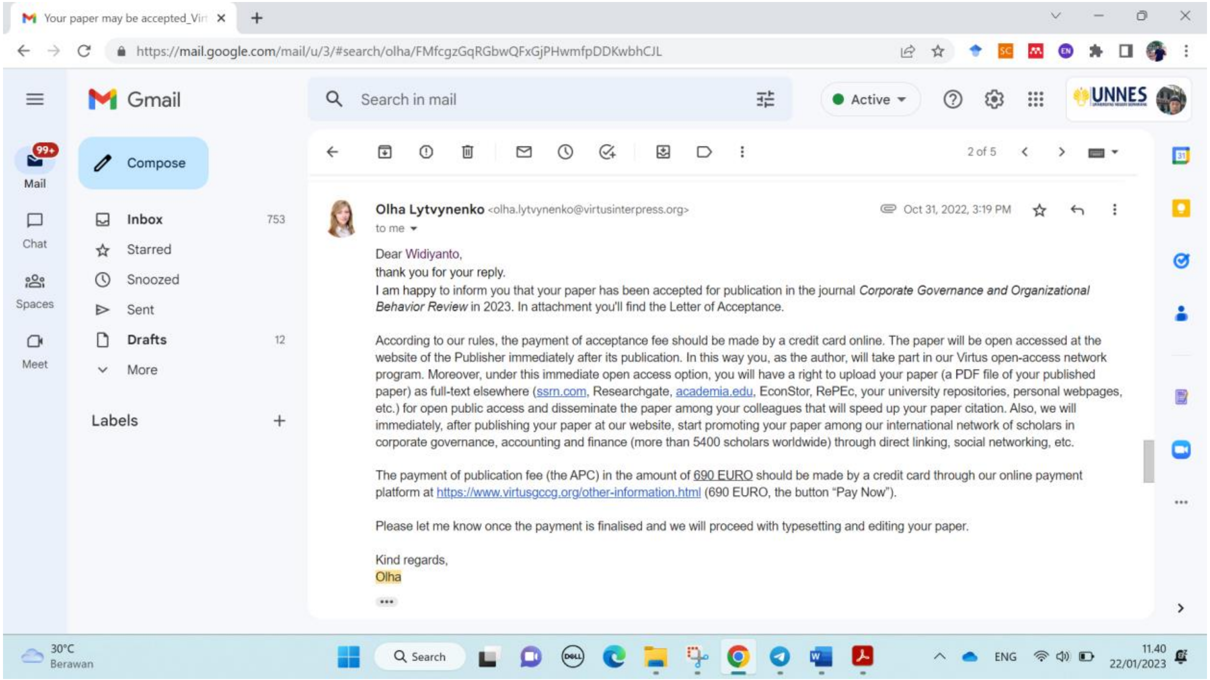
Please let me know once the payment is finalised and we will proceed with typesetting and editing your paper.

Kind regards,
Olha



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LETTER OF PAPER ACCEPTANCE

FROM: Publishing House "Virtus Interpress", Sumy, Ukraine DATE: October 31, 2022

TO/ATTN: Widiyanto
Department of Economics Education
Universitas Negeri Semarang
INDONESIA

Dear Widiyanto,

herewith it is certified that the paper titled *"Rural banks of local government: Agency conflict or social responsibility"* co-authored by Widiyanto, Partono Thomas, Arief Yulianto, Ita Nuryana, and Ahmad Nurkhinhas been blind reviewed and accepted for publishing in the issue of the journal *Corporate Governance and Organizational Behavior Review* (ISSN – 2521-1870 (printed version), ISSN – 2521-1889 (online version)) in 2023.

Director, Virtus Interpress,
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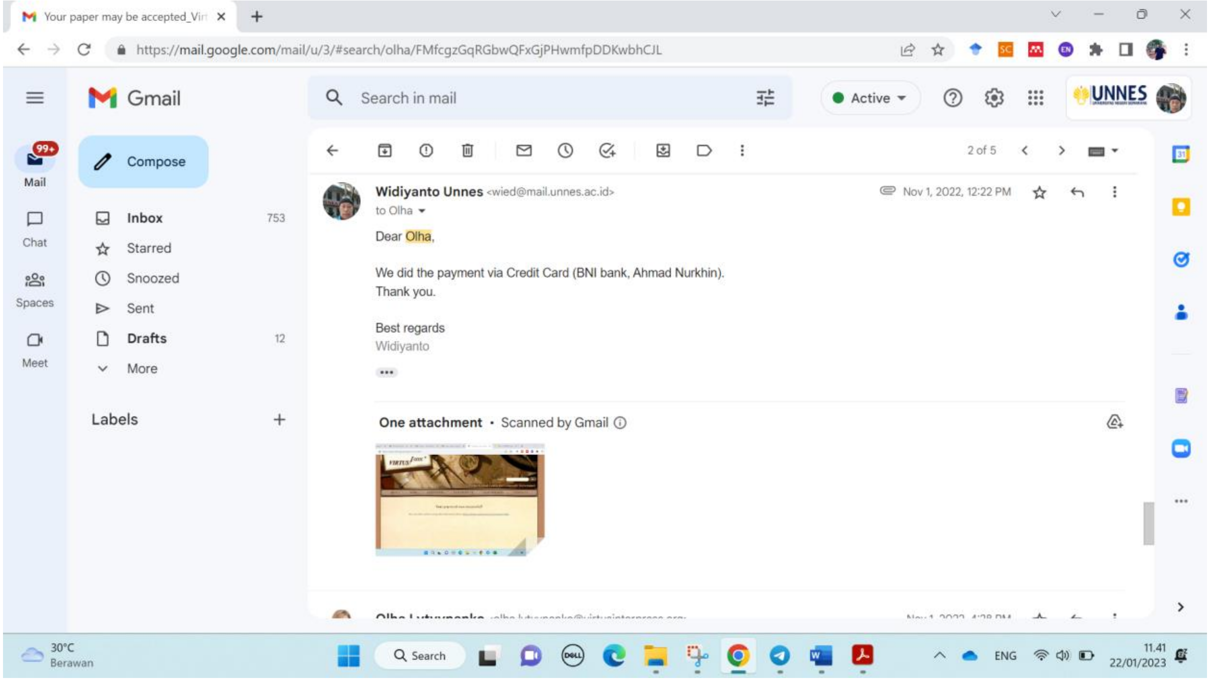
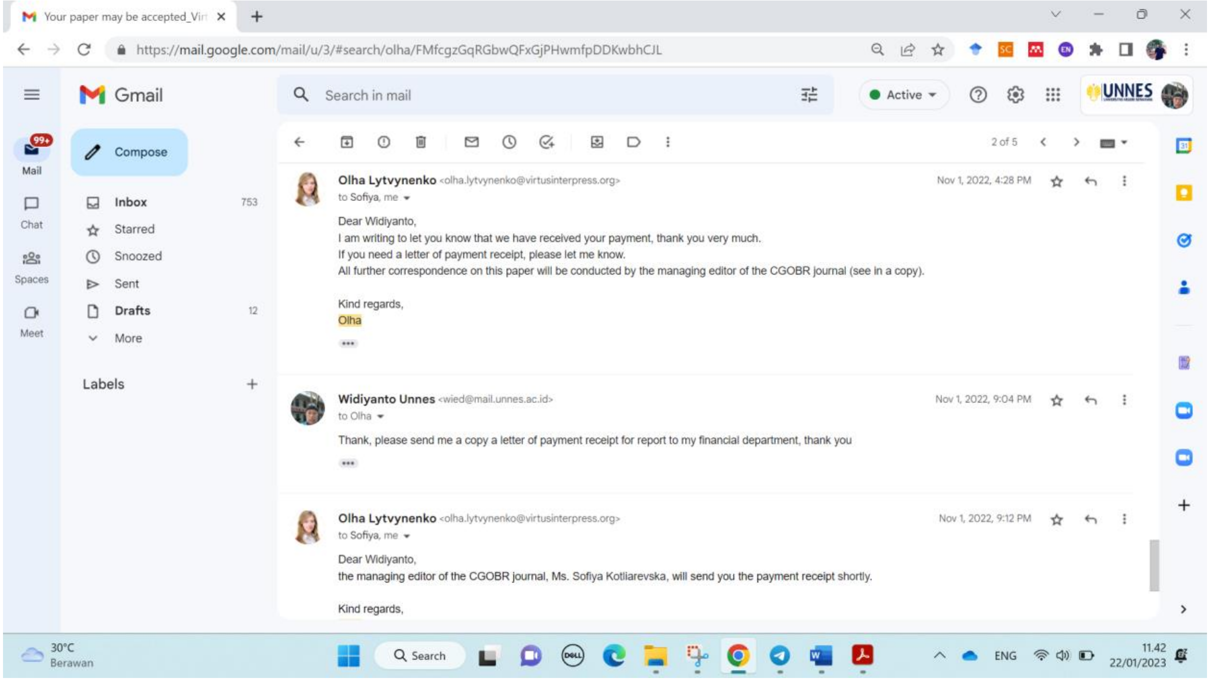




12. Proofreading_Corporate Governance and Organizational Behavior Review journal, 9 DESEMBER 2022

Dear Widiyanto,

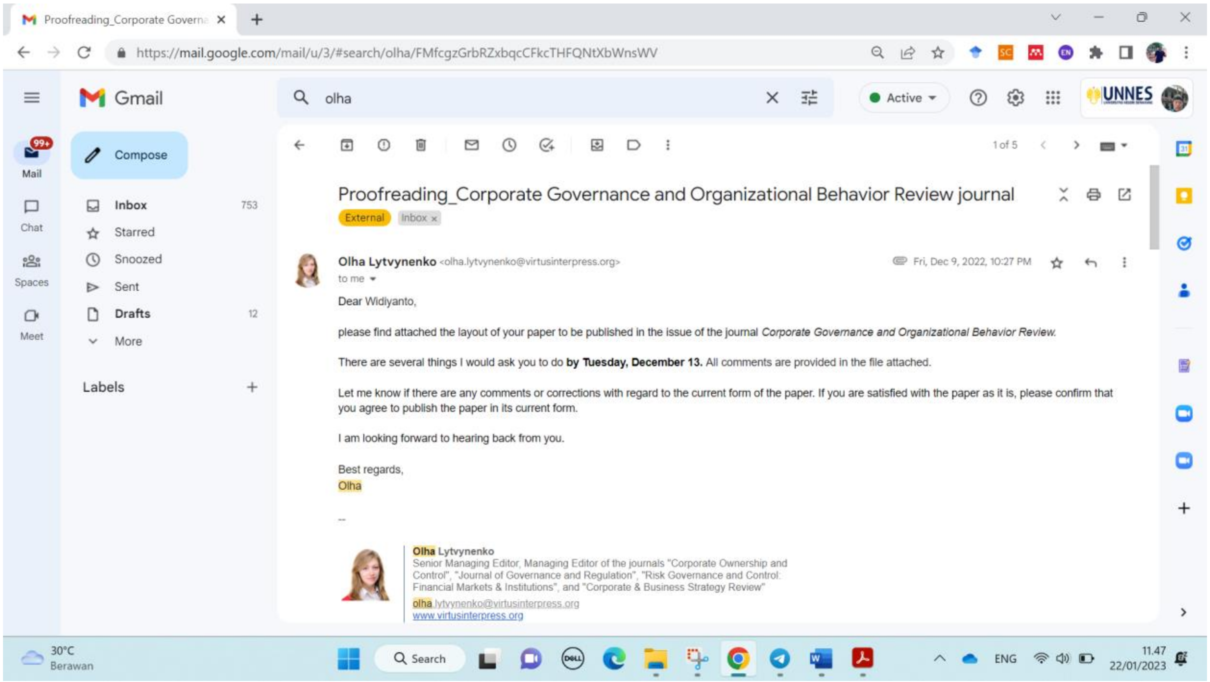
please find attached the layout of your paper to be published in the issue of the journal *Corporate Governance and Organizational Behavior Review.*

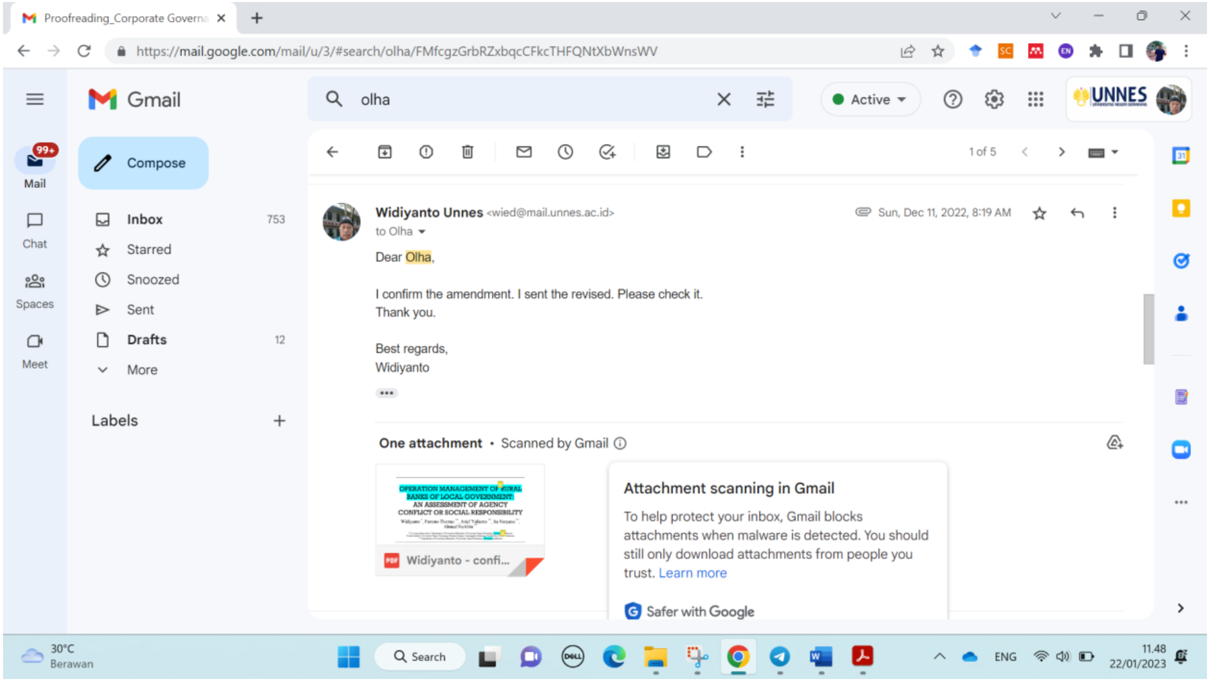
There are several things I would ask you to do **by Tuesday, December 13.** All comments are provided in the file attached.

Let me know if there are any comments or corrections with regard to the current form of the paper. If you are satisfied with the paper as it is, please confirm that you agree to publish the paper in its current form.

I am looking forward to hearing back from you.

Best regards,
Olha

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1 of 5
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to Olha
Sun, Dec 11, 2022, 8:19 AM
Dear Olha,
I confirm the amendment. I sent the revised. Please check it.
Thank you.
Best regards,
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Widiyanto - confi...
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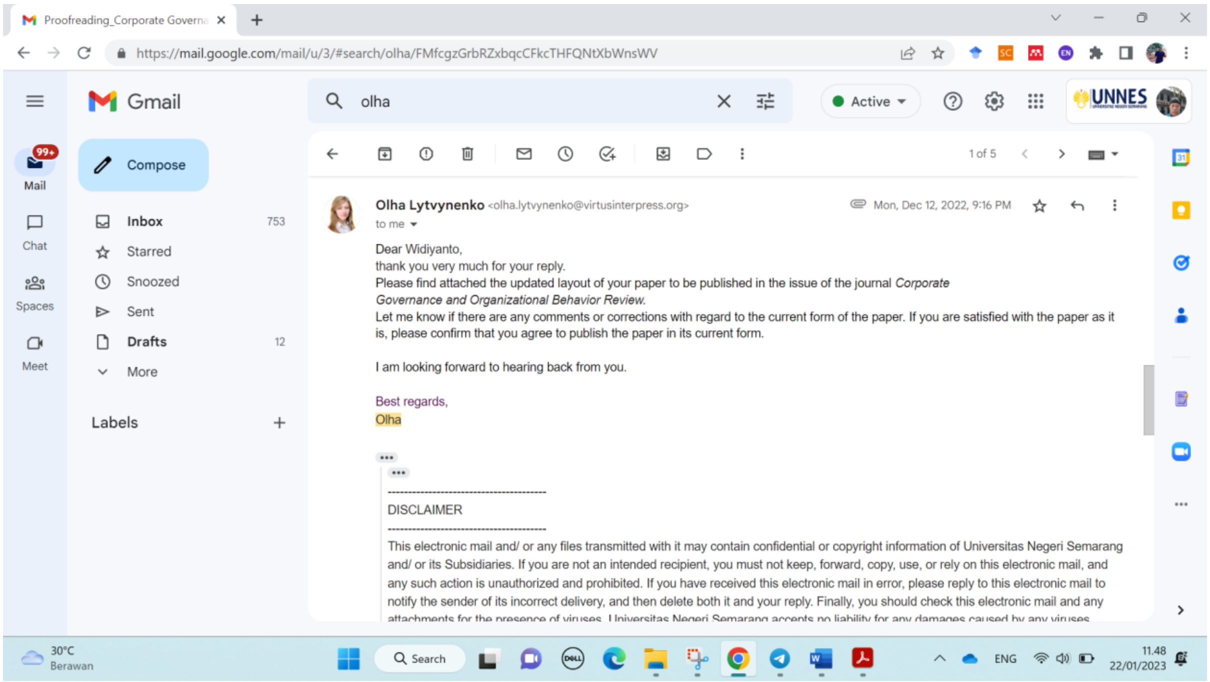
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Let me know if there are any comments or corrections with regard to the current form of the paper. If you are satisfied with the paper as it is, please confirm that you agree to publish the paper in its current form.
I am looking forward to hearing back from you.
Best regards,
Olha
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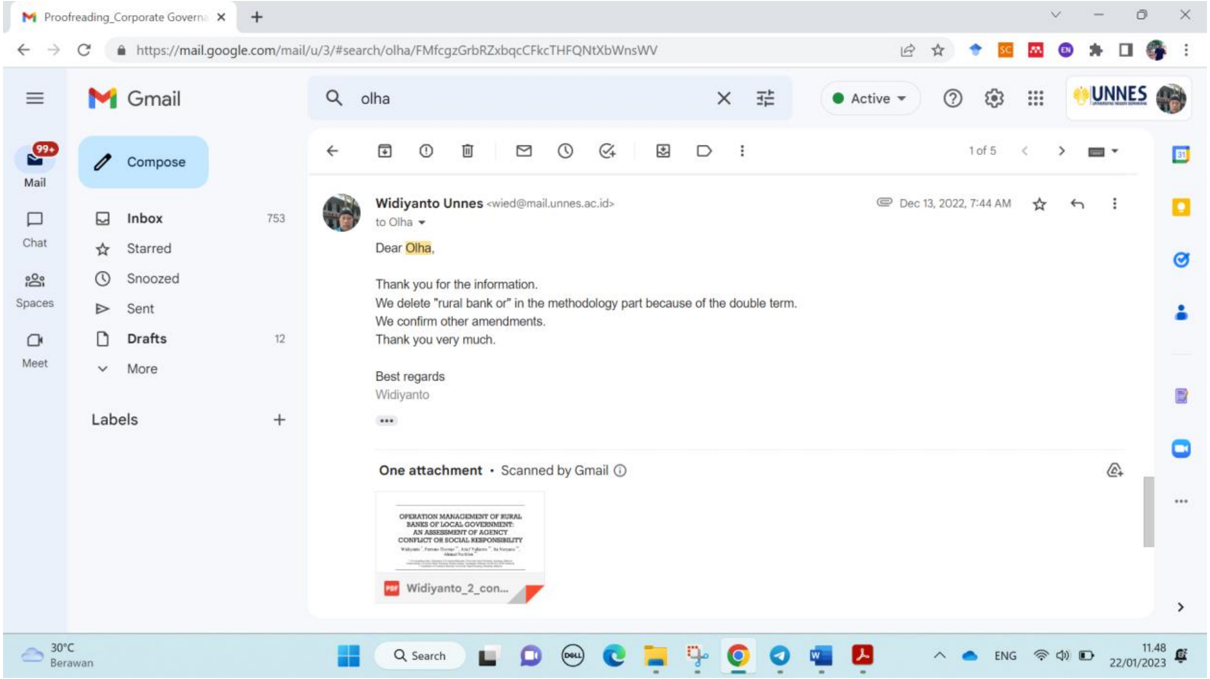
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1 of 5
Widiyanto Unnes <wied@mail.unnes.ac.id>
to Olha
Dec 13, 2022, 7:44 AM
Dear Olha,
Thank you for the information.
We delete "rural bank or" in the methodology part because of the double term.
We confirm other amendments.
Thank you very much.
Best regards
Widiyanto
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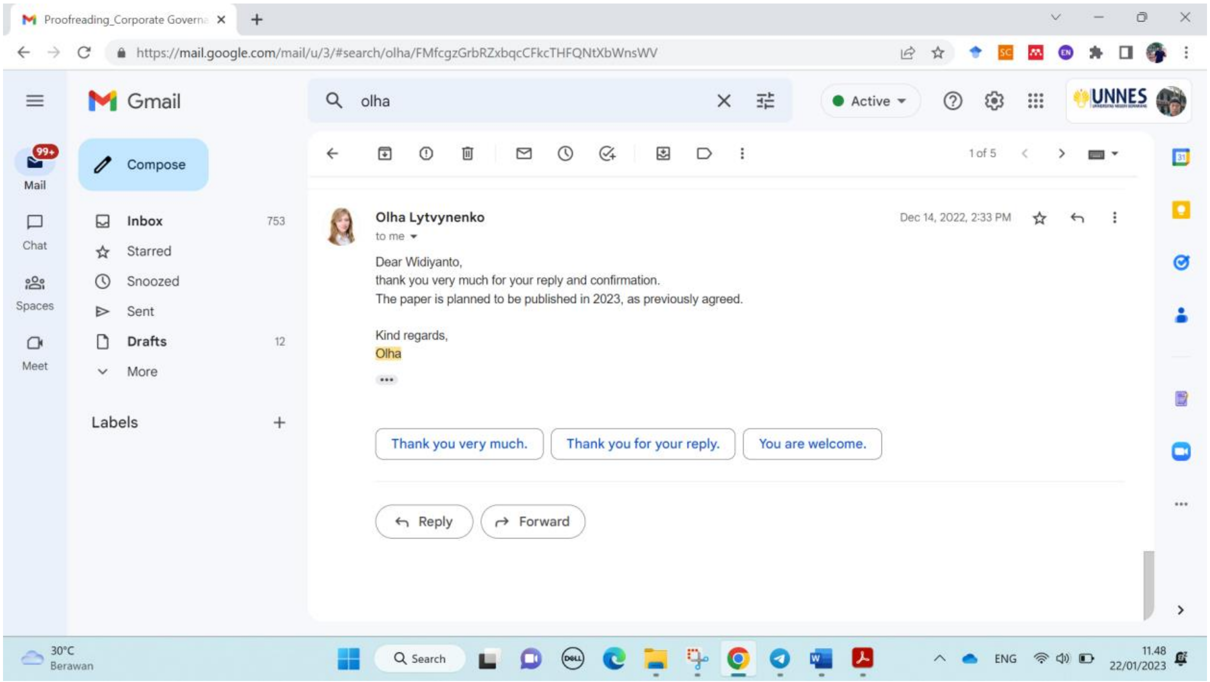
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Olha Lytvynenko
to me
Dec 14, 2022, 2:33 PM
Dear Widiyanto,
thank you very much for your reply and confirmation.
The paper is planned to be published in 2023, as previously agreed.
Kind regards,
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Thank you very much.
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You are welcome.
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We are delighted that a successful collaboration has been established and we are looking forward to new scientific cooperation!

Best regards,
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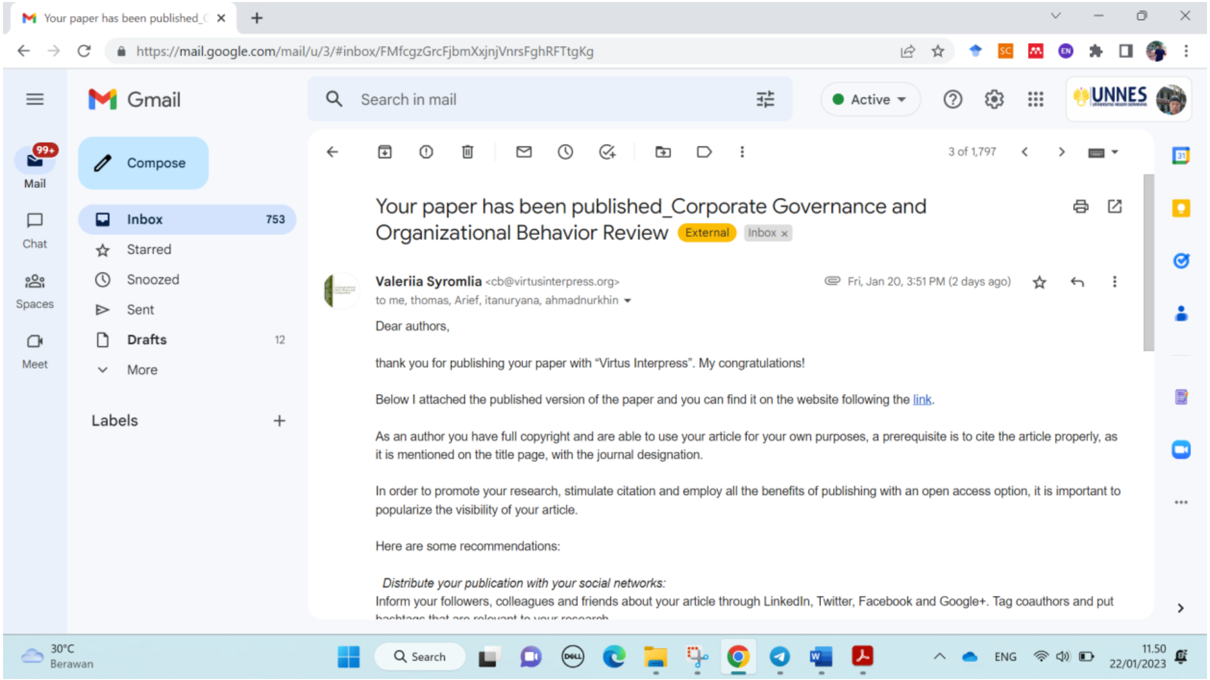

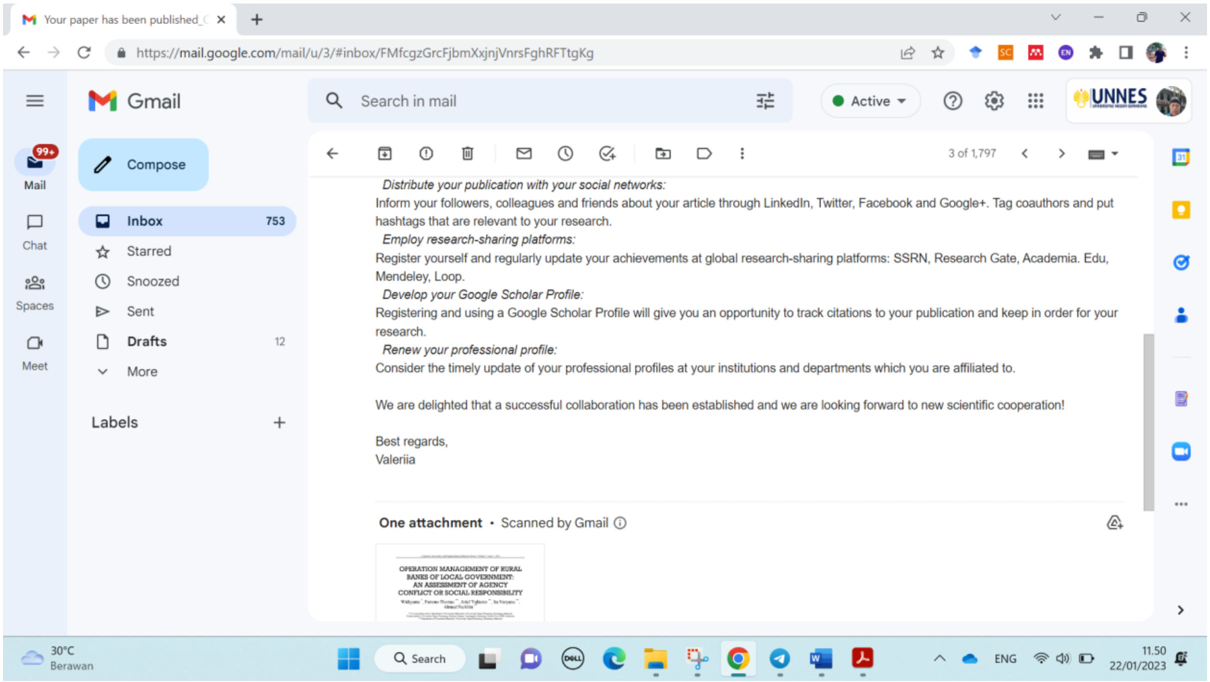

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OPERATION MANAGEMENT OF RURAL BANKS OF LOCAL GOVERNMENT: AN ASSESSMENT OF AGENCY CONFLICT OR SOCIAL RESPONSIBILITY

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Abstract

Rural banks with local government ownership as majority shareholders aimed to increase public welfare and earn profits. state-owned banks (also state-owned enterprises (SOEs)) also have agency conflict, which may increase due to increased political content. Post-merger and acquisition (Post-M&A) due to the COVID-19 pandemic increases rural bank risk in lending. The research objective is to determine the impact of increased risk on rural bank lending. Data were collected from 32 annual reports of rural banks in Indonesia. Documentation was used to collect the data. Loan deposit ratio (*LDR*) is the dependent variable, the risk is the independent variable, and capital adequacy ratio (CAR), net profit margin (*NPM*), and return on equity (*ROE*) as the control variables. The technique of analyzing data is an analysis of covariance. The result show banks with below-average risk have a greater difference (0.0393) than above-average risk (0.0347). Another result indicates that *LDR* is not determined by the bank's health or the business risk of the debtor. Government demands through financing in local government, and it ignores risks and produces risk-taking behavior of managers. The government, as the majority shareholder, has a more effective monitoring role. Corporate social responsibility (CSR) oriented to society demand has been produced from rural banks owned by the government.

Keywords: Agency Conflict, Social Responsibility, Rural Bank, Local Government Ownership

Authors' individual contribution: Conceptualization — W., A.Y., and P.T.; Methodology — W. and A.Y.; Software — A.Y. and A.N.; Validation — W. and P.T.; Formal Analysis — W. and I.N.; Investigation — W. and A.Y.; Resources — I.N. and A.N.; Data Curation — I.N. and A.N.; Writing — Original Draft — W. and I.N.; Writing — Review & Editing — W. and A.Y.; Visualization — A.Y. and A.N.; Supervision — I.N. and A.N.; Project Administration — I.N. and A.N.; Funding Acquisition — W. and P.T.

Declaration of conflicting interests: The Authors declare that there is no conflict of interest.

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1. INTRODUCTION

Agency conflict, *ex-ante*, and information asymmetry led to a conflict of interest between managers and external shareholders who are not directly involved in firm management (Cariola et al., 2005; Jensen & Meckling, 1976). The conflict of interest worsens when state-owned enterprises (SOE) make a larger appropriation than non-SOE (Rashid Khan et al., 2020). SOE is characterized by political interests and corporate expropriation, resulting in greater agency conflict between principals and agents than non-SOEs.

The presence of political connections provides benefits in increasing company performance because they have more access to financing, and profitable projects (Wati el al., 2020). The resulting agency cost is greater because of the behavior of managers pursuing political connections with the government and ignoring the company's interests, which leads to lower productivity (Harris et al., 2016); lower quality of financial reports (Wati et al., 2020).

To sum up, the situation is similar in the banking sector. State-owned banks (also SOEs) also have agency conflict, which may increase due to increased political content. Since banks were privatized and owned by the government (SOE), long-term performance was static or no different; the result was that the legacy of pre-privatized long-term loans increased post-privatization (Berger et al., 2005). The wider impact is due to the increase in government ownership in banking resulting in a slowdown in the development of the financial sector and economic growth (La Porta et al., 2000).

Our study was conducted in rural banks owned by a local government and experienced a decline in performance due to the COVID-19 pandemic. Hidajat (2020) states rural banks are banks that accept deposits and provide short-term credit to rural communities. Rural banks are financial institutions that are close to the community. As a result, the Financial Services Authority (*Otoritas Jasa Keuangan, OJK*) in February 2020 conducted a merger and acquisition (M&A) in the hope of increasing performance resulting in increased free cash flow and survival capabilities (Maama et al., 2017). In addition, if the government owns it, the ability of performance monitoring resources is better than others (Noerdin, 2016). M&A produces more resources so that managers with discretionary power make greater use of them for their interests and shareholders (Jensen & Meckling, 1976). They prevent any mechanism that could reduce control (Nogueira & Kabbach de Castro, 2020), exacerbated by the presence of political connections.

Many types of research on the benefits and costs of companies with political connections have been carried out; therefore, we add the impact of political connections in terms of the lenders (banking sector), which is still limited (Amdanata & Mansor, 2018). The research question of this paper is what the impact of increased risk on rural bank lending? So, we investigate the effect of risk on the loan deposit ratio of rural banks.

This paper is structured as follows Section 2 reviews the relevant literature and explains the hypotheses development. Section 3 analyses the methodology that has been used to conduct empirical research. Section 4 shows the results. Section 5 presents the discussion. Section 6 describes the conclusion of this paper, including the recommendations and the limitations.

2. LITERATURE REVIEW

2.1. Merger and acquisition (M&A) in bank

We define M&A, as Maama et al. (2017) state, as a merger as a strategy of combining resources to achieve common goals, and each entity still owns part of the company. The acquisition is a long-term agreement when one company buys another company. The direct impact of M&A on shareholders or when a merger occurs, shareholders' shares experience dilution, and the acquisition results in shareholders not having discretionary power. Agency conflicts are exacerbated when managers use larger resources when M&A is carried out. When the company's size increases, managers try to increase their welfare by ignoring shareholders' welfare.

M&A often allows companies to develop a competitive advantage by increasing flexibility, growth, and shareholder value. Common M&A motives include strategic growth, talent growth, preparation for an initial public offering (IPO) or exit, and entering a new geographic or demographic market. Originally M&A was a description to reframe a company. Over the years the traditional subject of M&A has been broadened to cover takeovers and issues related to corporate restructuring, corporate control, and changes in corporate ownership structure.

2.2. Agency conflict in merger and acquisition (M&A)

The agency conflict begins with a paper (Akerlof, 1970) on the used car market, with the analogy of plum (good quality car) and lemon (bad quality car). A transaction failure occurs when both parties have an information imbalance. When the seller has better information about the plum car than the buyer, the buyer only buys all the cars (plum or lemon) at the average price of the two; as a result, all the cars offered are lemon cars. The presence of asymmetric information has produced an adverse selection problem between rural banks and debtors. SOE banking is more politically connected and is faced with trade-offs between solving agency problems and corporate social responsibility (CSR) oriented.

Information asymmetry, ex-post, agency conflict, and incomplete contracts result in agency conflict, where the agent acts not in the interests of the principals. They choose projects with low risk to produce low yields; the results are not to the preferences of shareholders (La Rocca et al., 2007).

Principles-agent theory (PAT) does not only occur in M&A transactions but it has also been broadly defined, there is a principal-agency relationship whenever one individual is based on the actions of another. Both seek to achieve their optimal goals. Subject goals interact and conflict with each other. One of the subjects performs an action to achieve the goal. This action has an impact on the interests of other subjects. Agents can act opportunistically; he pursues their goals without regard to other subjects. One party (principal) is a certain party (agent) to performs tasks for him. This phenomenon of conflicting interests and information asymmetry is quite often the reason for the failure of M&A transactions.

In an M&A transaction, company A cannot be sure to have all the information about the quality of company B before the contract is made. sometimes greater than savings funds; the result is increased welfare. They do empire building (Jensen & Meckling, 1976), and although the risk is high, credit is still given. In other words, the increase in *LDR* is not determined by banking value but based on the interests of managers. Cariola et al. (2005) describes the non-banking sector as an overinvestment problem due to the behaviour of managers. They allocate company resources to high-risk projects because if the project fails, it becomes the responsibility of the debtholders.

The agency conflict in emerging markets is crucial, starting with the paper (La Porta et al., 2000). He reports that, on average, 42% of the top 10 banks are owned by governments and are common in poor and property-poor countries. The increased risk of *LDR* results in a greater probability of bankruptcy. With labour oversupply conditions, rural bank managers may lose their jobs and find it difficult to find other jobs (Agarwal & O'Hara, 2007). They will find it difficult to find another job in extreme conditions if the rural bank goes bankrupt because it loses its reputation (Hernández-Lagos et al., 2017).

The M&A strategy for rural banks has had an impact on bank policy in general. The government's role as the dominant ownership will also affect the post-M&A banking strategy. Therefore, the study of bank performance after the M&A and the COVID-19 pandemic will be more interesting. Financial and non-financial indicators as well as internal and external factors will be able to investigate these impacts more comprehensively. The quality of service will be better or will it experience a significant decline. Product and service innovation will be an interesting theme to be studied more deeply.

6. CONCLUSION

Since post-M&A, due to the COVID-19 pandemic, most rural banks of SOE have higher *LDR* than average. Local government as majority shareholders does not only act for business interests but demands to increase public welfare. This study aims to analysis the impact of risk on *LDR* post-M&A of rural banks in Indonesia. The result is that the *LDR* is not determined by the risk characteristics of the debtor, either above or below the average risk. In addition, the control variable shows that it does not determine the *LDR*, which can be explained through the agency conflict. Managers who act in the interests of shareholders override the interests of customers. It is proven that rural bank health ratios such as *CAR*, *NPM*, and *ROE* do not determine *LDR* significantly. The compensation of rural bank managers is determined by the quantity of credit granted, not by the credit quality. The presence of information asymmetry results in managers and majority shareholders having superior information than customers, then they provide greater credit than customer deposits.

The implication of this research is how rural banks management can manage loans after M&A properly, paying attention to the interests of customers and of course the interests of shareholders. Although risk does not prove to have a significant effect, loan management is very important to maintain the possibility of increasing profitability in the future. The characteristics of customers can be studied more carefully by management so that the distribution of financing becomes safer and more prudent.

The scope of data observations is one of the limitations of this study. The data obtained are very limited. Although the results of the analysis can be used as a reference for policymakers, especially the relationship between risk and rural bank financing policies. Future research can increase the range of data analyzed and add other important variables related to the loan deposit ratio. The impact of the COVID-19 pandemic is very interesting to study more deeply. Research on the determinants of bank risk is also interesting, as has been done in previous studies with various variable sizes and research object settings (Mashamba & Gani, 2022).

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