

# Operation Management Of Rural Banks Of Local Government:An Assessment Of Agencyconflict Or Social Responsibility

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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

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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.

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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 et 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. Hidayat (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

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.

### 2.3. 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 & Giouvriss, 2020). Banks that do M&A on a large scale can reduce systemic risk, deal with good profitability, and support geographic diversification stability (Hassan & Giouvriss, 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 is 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-merger and acquisition (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 behaviour; conversely, when

regulations are loose, risk-taking is reduced (Abdel-Baki et al., 2011; 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 et al., 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 loan deposit ratio (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 rural banks (*Bank Perkreditan Rakyat, BPR*) has a significant positive impact on their lending to micro, small and medium enterprises (MSMEs) in West Java Indonesia. These results underscore the importance of rural banks 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, Li et al. (2022) report 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 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 address 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 gaps in the relationship between the risk and lending policy of the banks. There is a significant impact of credit risk on bank loans (Birhanu et al., 2021). Other findings show that the technical efficiency of rural banks 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). Another study found the impact of risk on the financial performance of the bank (Wood & McConney, 2018).

And the hypothesis of this study is 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 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 return on assets (ROA) deviation to measure systematic risk in the banking sector (Li & Malone, 2017). 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 capital adequacy ratio (CAR), net profit margin (NPM), and return on equity (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 follows.

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

### 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						
Variables	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						
Description	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

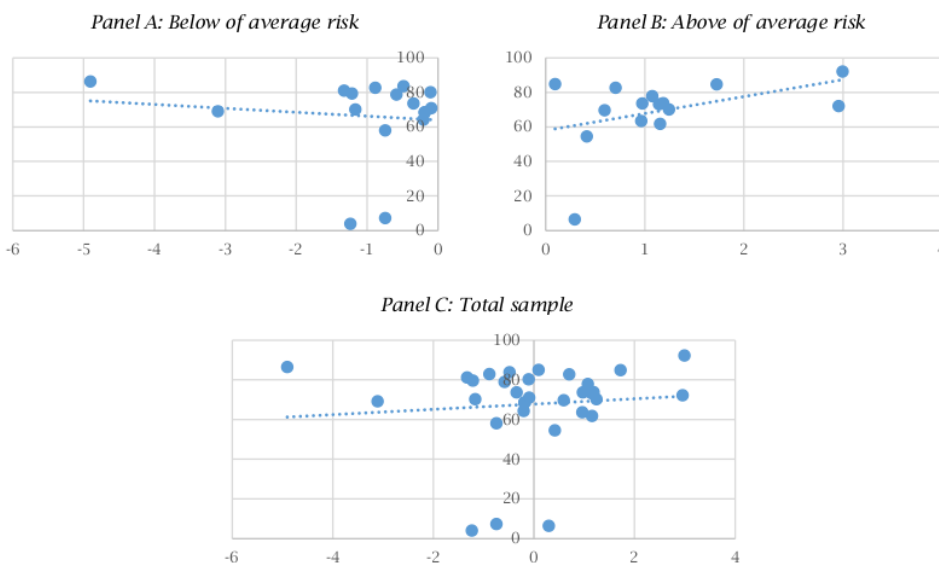
	All	Above of average risk	Below of average risk
Intercept	53.55687*	94.03775	31.65501
CAR	15.78906	0.781942	27.68302
NPM	-34.2657	-159.465	81.96898
ROE	81.05045	21.95035	97.06267
Multiple R	0.117915	0.251162	0.281081
R Square	0.013904	0.063082	0.079006
Adjusted R Square	-0.09175	-0.19244	-0.13353
Standard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

Note: \* sig. 5%.  
Source: Author's data analysis.

Table 2 shows that risk cannot determine the lending of rural banks in Indonesia. There is no significant influence of risk on LDR. Other variables

also have a significant value of more than 0.05. So, there is no significant impact of CAR, NPM, and ROE on LDR.

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, 2013) and the thickness of the agency conflict (Noerdin, 2016).

The risk-taking behaviour 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 small and medium-sized enterprises (SMEs) rather than agency conflict (Agung et al., 2001; 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, 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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