STATE-OWNED RURAL BANK PERFORMANCE: DO GOVERNMENT OWNERSHIP AND CORPORATE GOVERNANCE UNIQUENESS MATTER?

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ABSTRACT

It has been widely recognized that ownership structure has an impact on firm performance. This paper examines whether rural banks owned by government have poorer performance than those owned by private parties with the emphasis on corporate governance uniqueness of state-owned rural banks. 42 rural banks in Indonesia has been selected as the sample. MANOVA test is used to investigate the difference performance between the two types of the rural banks. The results show that state-owned rural banks perform poorer than their privately-owned counterparts. It is indicated by lower ROA ratio and higher OEOI and NPL ratios. The important implication of this finding suggets that government ownership impede boards of rural banks to implement good corporate governance practices in order to improve their banks performance.

Keywords: *ownership types, corporate governance, regulations, state-owned rural banks, performance.*

INTRODUCTION

It has been widely recognized that ownership structure has an impact on firm performance. Pioneered by Jensen and Meckling (1976) through their well known agency theory, it is described that a firm is a relationship between a principal (the owner who delegates work) and an agent (who manages the firm). Such a relationship results in two major problems for the firm. Firstly, a problem appears due to the different objective between the principal and the agent. Secondly, risk sharing between both parties as a consequence of distinct attitude towards such risks (Eisenhardt, 1989). Therefore, boards are required to monitor management to run the firm operations to ensure that the firm objective is aligned with the best interest of the owner (Hillman and Dalziel, 2003).

In practice, the owners of a firm consist of individuals (including families) and institutions (firms and government), and

some are concentrated and others are dispersed. In banking, types of ownership structure can be referred to foreign-owned banks, private domestically owned banks and state-owned banks (Berger et al, 2005). They find that state-owned banks have poor long-term performance (static effect), those undergoing privatization had particularly poor performance beforehand (selection effect), and these banks dramatically improved following privatization (dynamic effect), although much of the measured improvement is likely due to placing nonperforming loans into residual entities, leaving ‘‘good’’ privatized banks. Cornett et al (2010) also suggest that state-owned banks are characterized among other by low profit, low core capital and greater credit risk, especially in countries with greater government involvement and political corruption in the banking system. A research carried out by La Porta et al (2002) on government ownership of banks also indicates that slower subsequent financial development and lower economic growth in 1970 were triggered by higher state ownership of banks. Kim and Rasiah (2010) also reveal that in Malaysia there is a positive and significant association between the corporate governance and bank performance, and there is also a positive and significant foreign ownership and government-connected ownership variables as well as governance variables with different bank performance measures in foreign-owned banks and private domestically owned banks. Moreover, a research conducted by Huang (2010) indicates that there is a positive association between family-owned shares and commercial banks performance in Taiwan. Meanwhile, Iannotta et al. (2006) find that mutual banks and government-owned banks perform a lower profitability than privately-owned banks, despite their lower costs. Micco et al. (2004) also reveal that state-owned banks operating in developing countries indicate lower profitability and higher costs than their private counterparts; in contrast, ownership is not correlated with performance in industrial countries. In relation to bank lending behavior, Sapienza (2004) finds that the lending behavior of state-owned banks is influenced by the electoral results of the party affiliated with the bank. In other words, state-owned banks charge lower interest rate to the winning party-affiliated firms (mostly firms which are large and located in depressed

areas) than do privately-owned banks. Rather similar issue is also revealed by Dinc (2005) that state-owned banks expand lending during election years compared to private banks which is about 11% of their total loan portfolio.

Nonetheless, studies on the impact of the ownership structure on rural banks performance seem to be scanty and the emphasis of the previous studies is also different. Hein et al (2005) define rural banks as banks which focus their activities on local communities, gathering deposits, lending within a restricted trade area and have less than USD1 billion in assets. Furthermore, they mention several uniqueness of the community banks compared to larger banks. Amongst the uniqueness are that the banks emphasize their activities on human-aided transactions on lending and deposit side (or focus more on relationship banking than transactional banking), the source of income are higher from the interest than noninterest, and their ownership is more concentrated in fewer shareholders and the owners are more actively involved in managing the banks. A study by Lerin (2009) on rural banks in the Philippines shows some characteristics that most of them comply with corporate governance mechanisms (in terms of board chairman's and board member's responsibilities, board committess and issues guidelines), have few branches and about 6 – 15 employees in each branch. Meanwhile, Ibrahim (2010) who studied rural banks in India reveals that performance of rural banks in India has significantly improved after amalgamation process which has been initiated by the Government of India.

With regard to regulatory issues on banks in general, several researchers have also different results. Mullineux (2006) suggests that regulations are required to establish the good corporate governance of banks in order to balance the interests of depositors and taxpayers with those of the shareholders. Barth et al (2004) also argue that several guidelines in policies (force accurate information disclosure, empower private-sector corporate control of banks, and foster incentives for private agents to exert corporate control) are recommended to promote bank development, performance and stability. Another study conducted by Chortareas et al (2011) also find some interesting issues on bank efficiency that (1) improved operation efficiency of banks is strengthened by capital restrictions and

official supervisory powers, (2) higher bank inefficiency levels are the outcome of interventionist supervisory and regulatory policies such as private sector monitoring and restricting bank activities, and (3) bank efficiency are more pronounced in countries with higher quality institutions as the beneficial effects of capital restrictions and official supervisory powers (interventionist supervisory and regulatory policies). Furthermore, Pasiouras et al (2009) argue that banking regulations increase cost and profit efficiency of banks, however, restrictions on bank activities reduce cost efficiency but improve profit efficiency.

In Indonesia, ownership structure of rural banks is not much different from that of commercial banks. They are owned by government (in this case by local government) and private parties (individuals, families or institutions). In general, from a regulatory point of view, the banks comply with the banking authority (Bank of Indonesia) regulations. Nevertheless, the ownership types have also a practical consequence on corporate governance implementation of the banks since the banks should comply with one of two different regulations. As for privately-owned rural banks, they should comply with companies act, whereas for their state-owned counterparts it is anchored in local government regulations. For privately-owned banks day-to-day business operations, the compliance with the companies act has been a common situation since other private nonbank companies also do the same. On the contrary, state-owned rural banks should comply with local government regulations, not the companies act which lead them to have unique characteristics in their corporate governance practices (the uniqueness is relatively different from those as indicated by Hein (2005) as explained above). In practice, such uniqueness widely affect their performance.

LITERATURE REVIEW

The Uniqueness Of State-Owned Rural Banks

In Indonesia, one of general guidelines for rural banks to run their businesses is regulated under Bank Indonesia Regulation No.8/26/PBI/2006 concerning Rural Banks. This regulation also stipulates such issues on corporate governance as ownerships, board of directors and supervisory board. Nevertheless, other

regulations pertaining corporate governance that rural banks should also comply with are (i) companies act for privately-owned rural banks (which should commonly either publicly- or privately-owned firms abide by as well), and (ii) Minister of Local Affairs, local government and governor's regulations for state-owned rural banks, and to some extent, issues on such local government regulations should also be aligned with central government regulations, especially those related to procurements.

As previously mentioned on the uniqueness issues raised by Hein et al (2005), in this study, such issues are more specifically focused on the uniqueness of corporate governance of state-owned rural banks. The term "state-owned" in this research refers to the ownership of local government. The most important thing to underline here is that the uniqueness appears due to regulations the state-owned rural banks should abide by and it is a common situation for those banks operating throughout the country. On the contrary, the privately-owned rural banks compliance with merely Bank Indonesia regulations shows no particular corporate governance uniqueness. In practice, such corporate governance uniqueness has relatively wide effects on the state-owned rural banks in its association with the efforts of improving their performance. Based on some several local government regulations, among characteristics identified as the corporate governance uniqueness of those rural banks are as follows:

First, the rural banks are owned either by both provincial and municipal/regency government, or by municipal/regency government only. When the banks are owned by both government, the ownership composition comprises 51% shares of provincial government and 49% shares of municipal/regency government. Second, employees and organization are regulated as follows: (i) for rural banks owned by both government, organization structures and general guidelines on employees are determined under the governor's decree, and employee procurements are carried out by the board of directors with the recommendations of the supervisory board and the approval of the general meeting, and (ii) placement, appointment and dismissal of employees are determined by board of directors with the approval of supervisory board; in case of

disagreement, the general meeting will take them over.

Third, supervisory board members are bureaucrats (representatives) of the local government, however, they can be appointed from professional and independent third parties. In relation to its type of ownership as explained above, for rural banks owned by both provincial and municipal government, the administrators appointed to the supervisory board should be the representative of the government, respectively. However, for those owned by municipal government only, the individuals assigned for the occupation are completely from its administrators. Meanwhile, members of the board of directors of state-owned rural banks can be either the combination of professionals and promoted employees, entirely professionals, or completely promoted employees. The appointment and issues related to tasks and responsibilities of the board of directors stipulated in the local government regulations refer to Bank Indonesia regulations.

Fourth, members of the board of directors who were previously the banks employees can be reemployed to fill middle management positions at the banks, such as division heads and internal control officers, as long as they have not been qualified in the retirement policy. To some extent, the retired board members can also be appointed to be the board members of other state-owned rural banks in the region.

Fifth, the banks are injected with capital by the local government every year after local development budget is approved by the local house of representatives. Such a practice refers to a common mechanism in governmental budgetary system in Indonesia that profitable state-owned companies pay dividends to the state cash and then the state will reallocate them to the state-owned firms. Through such a procedure, state-owned rural banks commonly have higher capital amount (but not consequently higher capital adequacy ratio due to high nonperforming loans) than privately-owned banks. The proposed hypothesis (null hypothesis) is that the corporate governance uniqueness of state-owned rural banks deterioriate their performance compared to those of privately-owned banks.

RESEARCH METHODS

To analyze the impact of the corporate governance uniqueness of the state-

owned rural banks on their financial performance, a test is carried out by using the following procedures. First, sample are all rural banks operated in Indonesia during the period 2007 – 2012. Those samples are obtained from Bank of Indonesia (the central bank of Indonesia). It is started from December 2007 due to the the technical issue of avalibilaty. Moreover, to make possible of capturing relatively complete movements of the banks performance, data are demonstrated on quarterly basis. Second, performance indicators consist of return on assets ratio (ROA, or gross income divided by average total assets), operational expense to operational income ratio (OEOI) and non performing loans ratio (NPL, or unqualified loans of substandard, doubtful and loss divided by total loans)[1]. The reasons of using such variables can be explained as follows: First, ROA ratio describes the ability of the bank productive assets (for those rural banks commonly contain loans and placement to other banks) to generate income. The higher the ratio, the better the bank productive assets contribute to the bank performance. Second, OEOI ratio shows the efficiency level of the banks. The lower the ratio, the better the efficiency level of the bank operations. Third, NPL ratio illustrates prudent principles in managing risks, particularly credit risk, since most of the bank asset portfolios are loans. The lower the ratio, the better the the quality of the bank loans, then the lower the credit risk faced by the banks which in turn impacting on a better performance of the banks. Then, data was examined by using multivariate analysis of variance (MANOVA) to compare financial performance between state-owned and privately-owned rural banks (distinction test). Why MANOVA? Because, as previously mentioned, dependent variables consist of more than one variable which are ROA, OIOE and NPL, and independent variables comprise two types of ownership which are local government and private individuals or institutions.

RESULTS AND DISCUSSION

Table 1 presents the descriptive statistics of variables. In general, results

[1] The complete components of five-tier loan classifications based on the Bank for International Settlements (BIS) are pass, special mention, substandard, doubtful and loss. Nevertheless, for rural banks in Indonesia, such classifications exclude special mention loans.

indicate that there are differences in performance between state-owned rural banks and privately-owned rural banks based on ROA, OEOI and NPL ratios. For state-owned rural banks, average ROA ratio is lower than that of privately-owned rural banks, or 2.95% compared to 3.54%. It means that state-owned rural banks productive assets have lower ability to generate income than those of privately-owned counterpart owned rural banks. Meanwhile, average OEOI ratio of state-owned rural banks is 81.65%, whereas the same ratio for their privately-owned counterparts is relatively lower, or 79.94%. It indicates that the efficiency level of state-owned rural banks is relatively lower than that of their Furthermore, average NPL ratio of state-owned rural banks is much higher than that of private-ly owned rural banks, or 9.71% compared with 5.86%. It shows that credit risk faced by state-owned rural banks is higher than that of privately-rural banks.

Table 1. Descriptive Statistics of Variables

Ownership Types	Mean	Std. Deviation	N
ROA-State-owned	2.9476	.51456	21
ROA-Privately-owned	3.5367	.53066	21
Total	3.2421	.59614	42
OEOI-State-owned	81.645	2.0522	21
OEOI-Privately-owned	79.944	2.7359	21
Total	80.795	2.5391	42
NPL-State-owned	9.71	1.627	21
NPL-Privately-owned	5.86	1.243	21
Total	7.79	2.417	42

Table 2. The Results of MANOVA Test

Effect		Value	F	DF	Sig
Intercept	Pillai's Trace	1.000	153801.671[b]	3.000	.000
	Wilks' Lambda	.000	153801.671[b]	3.000	.000
	Hotelling's Trace	12142.237	153801.671[b]	3.000	.000
	Roy's Largest Root	12142.237	153801.671[b]	3.000	.000
Ownership	Pillai's Trace	.775	43.667[b]	3.000	.000
	Wilks' Lambda	.225	43.667[b]	3.000	.000
	Hotelling's Trace	3.447	43.667[b]	3.000	.000
	Roy's Largest Root	3.447	43.667[b]	3.000	.000

In the meantime, Box's Test reveals Box's M value of 30.117 and F-test is relatively robust with significance level of 0.000 (lower than 5%). It means that variance/covariance matrix of dependent variables (ROA, OEOI and NPL) is different. As a consequence, null hypothesis which stipulates that variance/covariance matrix is similar is rejected. Although such a result is in contrast to MANOVA assumption, the analysis can be proceeded. Furthermore, to check whether the ownership types affect the dependent variable group, the result can be observed from the Wilk's Lambda value (this parameter is used to measure the effect of independent variables on more than two dependent variables). It shows that F-test value for Wilk's Lambda is 43.667 with a significance level of 0.000. It suggests that a relationship between the ownership types and the rural banks performance exists. Levene's Test also indicates that the three dependent variables are significance at 5% level implying that those variables have similar variance and that is aligned with MANOVA asumption. Table 2 exhibit the results of MANOVA test.

Finally, the result of Test of Between-Subjects Effects (Table 3) which examines the effect of ANOVA univariate of each factor (the ownership type) on dependent variables reveals that F-test value for those dependent variables is significance at 5% level. It suggests

that the distinction of the ownership type has an impact on performance divergence between state-owned rural banks and privately-owned rural banks. Nevertheless, among the three performance indicators, only NPL ratio is significantly affected by the ownership type differences. It is indicated by the Adjusted R Squared of 64.1%, while the same values of those for ROA and OEOI ratios are much lower of 23.1% and 9.3%, respectively. In other words, the effect of ownership types is relatively substantial on the deterioration of NPL performance. On the contrary, other factors than the ownership types probably play a considerable influence on ROA and OEOI. Based on such results, it can be suggested that local government ownership and corporate governance uniqueness result in poor performance for state-owned rural banks.

Table 3. Tests of Between-Subjects Effects

Source	Dependent Variable	Type III Sum of Squares	df	Mean Square	F	Sig.	Noncent Parameter	Observed Power[d]
Corrected Model	ROA	3.643[a]	1	3.643[a]	13.336	.001	13.336	.946
	OEOI	30.396[b]	1	30.396[b]	5.197	.028	5.197	.604
	NPL	155.713[c]	1	155.713[c]	74.322	.000	74.322	1.000
Intercept	ROA	441.483	1	441.483	1616.050	.000	1616.050	1.000
	OEOI	274165.713	1	274165.713	46879.794	.000	46879.794	1.000
	NPL	2545.461	1	2545.461	1214.948	.000	1214.948	1.000
Ownership type	ROA	3.643	1	3.463	13.336	.001	13.336	.946
	OEOI	30.396	1	30.396	5.197	.028	5.197	.604
	NPL	155.713	1	155.713	74.322	.000	74.322	1.000
Error	ROA	10.927	40	.273				
	OEOI	233.931	40	5.848				
	NPL	83.805	40	2.095				
Total	ROA	456.053	42					
	OEOI	274430.040	42					
	NPL	2784.979	42					
Corrected Total	ROA	14.571	41					
	OEOI	264.327	41					
	NPL	239.518	41					

Table 4. Independent Sample t-test

Dependent Variable	OWNERSHIP TYPES	Mean	Std. Error	95% Confidence Interval	
				Lower Bound	Upper Bound
ROA	State-owned	2.948	.114	2.717	3.178
	Privately-owned	3.537	.114	3.306	3.767
OEOI	State-owned	81.645	.528	80.579	82.712
	Privately-owned	79.944	.528	78.877	81.010
NPL	State-owned	9.710	.316	9.072	10.349
	Privately-owned	5.860	.316	5.221	6.498

Based on the above findings, it is obvious that distinctions in ownership types affect rural banks performance. For state-owned rural banks in particular, the ownership type also emerge some uniqueness in their governance characteristics which influence their boards in dealing with the business operations. Thus, those results support previous research findings that state-owned rural banks have relatively poor performance than their private counterparts (Cornett et al, 2010; Micco et al., 2004). In terms of bank efficiency, such results also support the conclusions of Chortareas et al (2011) that higher bank inefficiency levels are the outcome of interventionist supervisory and regulatory policies. With regard to the results, some implications emerge at regulatory and practical levels.

At regulatory level, local government regulations tend to inhibit boards of state-owned rural banks to implement good corporate governance practices to their banks. As a consequence, this leads the banks to have relatively poorer performance than privately-owned rural banks. Thus, local government should consider that state-owned rural banks are entities which have different objectives from local government institutions. They are undoubtedly profit-oriented entities which formulate strategies and policies based on business opportunities and risk considerations. In their operations, they compete not only with their private counterparts, but also with other commercial

banks and cooperatives as nonbank institutions. Therefore, such relatively more technical regulations for state-owned rural banks provided by the local government result in restricted movements for the banks to take business opportunities and market potential. Those regulations often impede the bank boards to effectively determine business strategies and policies. Furthermore, compliance with such regulations often takes much time for boards to follow procedures before taking a business decision, even for such uncomplicated regular business matters as employee recruitment and purchasing of assets and inventory. As indicated by Barth et al (2004) that policies that rely on guidelines that force accurate information disclosure, empower private-sector corporate control of banks, and foster incentives for private agents to exert corporate control work best to promote bank development, performance and stability. It is also aligned with a conclusion of Pasiouras et al (2009) that restrictions on bank activities reduce cost efficiency. Hence, revoking some restrictive clauses of the regulations and allowing the boards to perform their duties independently and professionally is deemed to improve the banks performance.

At practical level, such local government regulations often result in some problems to the state-owned rural banks to run their business and penetrate potential markets. To some extent, such regulations can be considered as counter-productive matters as boards of the state-owned rural banks cannot take actions and policies autonomously and professionally. Some evidences which describe practical implications of such regulations are: First, the appointment of supervisory board members often involves mayor who to some extent is prone to select those as his “representatives” at the banks either to open access to or accommodate his certain interests. In a worse case, the mayor tries to compel his will even though he realizes that the proposed candidates do not have experiences in banking industries as one of requirements clearly stipulated in the banking authority regulations.

Second, it sometimes occurs that a supervisory board member of provincial representative does not have adequate time to evaluate bank performance reports, develop business discussions with the board of directors and carry out on-site monitoring. These situations often become an important

obstacle for some boards of directors to make strategic decisions and plans to improve their banks performance. Third, the organization structure including job descriptions of employees which is attached to and part of the local government regulation often does not suit those bank business scales and complexities, even though it is subject to the needs of the rural banks. So far, there are no significant changes or adjustments to the banks organization structure by taking business environment into account.

Fourth, as previously mentioned, it takes time to fulfill the needs of employees. It is because boards must follow a relatively long process of procurements procedures which are stipulated in the local government. Otherwise, disobedience will be considered as misconduct by bank examiners. The process entails several phases of planning, notification, applications acceptance, selection, the appointment of probationary employees and the appointment of employees. Besides, the procurements should be carried out by a committee in which its members not only consists of the bank boards (board of directors and supervisory board), but also the owner representatives. In fact, the needs to recruit employees or fulfill vacant positions should be immediately accomplished to make possible for the banks to operate appropriately and take advantages from business opportunities. Moreover, a rather inevitable consequence of the recruitment process is that the local government administrators sometimes recommend their incapable or inexperienced relatives in the process. Such a condition often puts the bank boards in a difficult situation between upholding professionalism and independence, and accommodating local executive interests. The relatively same procedure is also applied to the procurement of fixed assets and inventory.

Fifth, due to worker-related procedures in the local government regulations which require regular employee promotion (held twice a year) and salary increase, performance assessment and evaluation are a dilemma to implement. For example, although a marketer cannot achieve monthly or annual target of loan disbursement which contributes to poor performance of the bank, boards cannot postpone his regular salary increase more than two years. In a worse case, boards cannot either impose sanctions to or even

dismiss bad performed employees due to their status of administrators' relatives.

CONCLUSION

Ownership types have long been considered to impact on firm performance. In this study, such a conclusion is also evident that ownership types affect rural banks performance. The effect emerges from the existence of corporate governance uniqueness of the rural banks. In this case, the uniqueness is obvious for state-owned rural banks, whereas privately-owned rural banks do not show the same issue. Based on MANOVA test, statistical results reveal that state-owned rural banks have poorer performance than their private counterparts with regard to ROA, OEOI and NPL ratios. Among the three ratios, NPL has a significant effect on the state-owned rural banks performance. The most important implication from the results is that local government regulations impede boards of state-owned rural banks to apply good corporate governance practices in taking business decisions and policies professionally, independently, effectively and effciently. Hence, local governments as the bank owners should consider to lessen or even remove some restrictive articles in the regulations, particularly clauses which are considered overly technical. Besides, allowing the banks to comply with banking authority regulations and their internal business policies is reckoned to improve their performance.

This study has some limitations to explain a comprehensive phenomenon of rural bank corporate governance practices in their relation to performance. It only examines and provides results for the performance distinction through a different test with a particular emphasis on state-owned rural banks. It seems that a theoritical model with a regression analysis can offer a more inclusive explanation to clarify this issue. Besides, further research can consider to examine the effect of the ownership types of privately-owned rural banks on their performance. It is because private rural banks are also considered to have different characteristics of their governance practices. Dispersed individual shareholders, concentrated shareholders (with one or more controlling shareholders), family shareholders, insider ownerships, or a combination among them are features regarded as conditions which influence ownership-performance relations.

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