



EFFECTS OF CORPORATE GOOD GOVERNANCE ON FINANCIAL PERFORMANCE OF RURAL BANKS

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Abstract : Corporate Governance is a relationship between the bank's board, management, shareholders and other stakeholders. The main purpose of corporate governance is to enhance the net income of shareholders. The researcher aims to study the effect of Corporate Governance on the Financial Performance of the rural banks in Pampanga. It seeks to determine the impact of good corporate governance as an independent variable on financial performance as a dependent variable. Data for this study was gathered from two sources, Published Financial Statements of rural banks covering the year end report from 2016 to 2019 which were obtained on the BSP Data Center Data. On the other hand, the board characteristics is obtained from each rural bank who participated in the study. A quantitative approach of research has been followed to determine the impact of the qualifications of the Board of Directors in Pampanga and the implementation of good governance in their respective rural banks. A descriptive survey was employed because it provides an accurate portrayal or account of the characteristics of the Board of Directors. The statistical tool that was used in this study was linear regression. This statistical tool analyzed how Corporate Governance practices correlates to the financial performance of rural banks in Pampanga. The bank's financial performance was measured by the Return on Asset (ROA) and Return on Equity (ROE), wherein: $ROA = \text{Annual Net Income} / \text{Total Assets}$; $ROE = \text{Annual Net Income} / \text{Shareholders' Equity}$. Based on the foregoing findings of the study, it can be concluded that the rural banks in Pampanga were substantially backed-up by physical and financial assets to support their stable operations commensurate to their size. The directors in rural banks have attained appropriate educational qualifications to become members of the policy making body of the rural banks. They have also been knowledgeable in the practice of corporate good governance as reflected in their fairness to deal with the officers, staff and other stakeholders. The board of the rural banks in Pampanga are also well structured following the standards prescribed by SEC and BSP. However, not all parameters of the corporate good governance have been fully exercised by the board of the rural banks. There are still parameters that needs to be enhanced particularly in the aspects of effectiveness, independence and accountability. Both ROA and ROE are dependent on the level of practice of corporate good governance. It seems obvious that the better the management of the bank based on sound banking principles, the better it can generate income and attract investors. Further, economic shocks can be survived and can be mitigated if directors would adhere to sound banking principles and proper management practices.

INTRODUCTION

Rural Banking Industry in the Philippines has a vital role in the community. Most Rural Banks are privately owned and run by families. As of April 13, 2021, the number of operating rural banks had dropped to 434. These numbers were derived from the PDIC data presented in the report.

Also, a rural banking system is for a specific purposes. These were acceptable terms in the early stages, allowing small farmers, small merchants, and small business owners in rural areas to get credit at more affordable rates, in order to move things along faster.

Rural banks focus on serving the people who reside in rural areas, and thus promoting and expanding the local economy. The leaders and potential managers of a rural bank should be aware of the art and skill of leadership in general, especially of how it applies to that position. It is necessary to go through all the process of formulating a corporate plan and devising a strategy if a rural bank adopts the scheme.

In the wake of the Asian Economic Crisis in 1997, "corporate governance" started to become popular in the business press, and has kept on doing so ever since. In which there are no explicit reference links or connective threads between religion and violence in media, so violence does not invite or promote a resolution, but suppresses and precipitates and/disrupt religion. One of the major sources of vulnerability during the 1997 crisis was corporate governance.

The main purpose of corporate governance is to enhance the net income of shareholders. The value of a corporation is strengthened by maintaining a relationship with its stakeholders. The primary aim of good corporate governance in all firms is to secure the financial condition and enhance the value of shareholders. Corporate governance also establishes the objectives, like the strategies and controls of the business, but especially the plan of action and internal company disclosure.

It appears that ineffective directors, inadequate accounting records, lack of transparency, ineffective organizational policies, and lax legal enforcement of conduct exist in Asian nations. This is presumed to have helped lead to the current economic crisis in which banks, financial corporations, and non-financial corporations are failing to terminate unprofitable projects, recognize non performing loans, restructure or bankrupt bad performing enterprises and discipline banks.

According to Muhammad Ali, "The Importance of Corporate Governance in a Firm's Financial Performance," the factors measured by a company's board of directors are the firm's ownership, effectiveness, size, and structure, as well as the structure and location of the board, and independence of the board. Firm financial performance is measured by the Return on asset (ROA), and equity performance is defined as Return on Investment (ROI) (ROE). Corporate governance is a system of rules designed to ensure that directors and management act in the best interests of the bank, as well as protect shareholders, creditors, creditors, and other participants.

ZA Shdn, indicated that corporate governance could be measured through these elements:

- Board Ownership
- Board Structure
- Board Size
- Independence of Board
- Independence of Audit Committee
- CEO Duality

J.D. Wolfensohn, former president of the World Bank, put forth the following thoughts about the role of corporations in today's economy: "Corporate governance is important today as national governance". And endorses the great progress that corporations have made in our economic, social, and political lives, as well as the global reach of corporations.

As noted by Professor Gregory and Mr. Simms (1999), a significant push for corporate governance reform and lowering of corrupting influences is due to this desire to improve the industry's bottom line. Corruption and cronyism prevent the efficient allocation of investment and economic development in corporations, according to these authors. On the other hand, corrupt practices within corporations are often observed in institutions lacking strong governance. Such practices undermine competition and decrease investment, which hinders economic growth.

This study found that corporations are governed differently in various countries and industries based on the society's moral and economic values as well as the characteristics of their ownership. According to renowned governance expert (Mill, 1998), lack of shareholder protection due to financial disclosure, insufficient financial disclosures, and failure of managing owner control are caused by accepting lending and investing practices supported by the majority shareholders, rather than by careful risk assessment. Corporate governance, according to the Wall Street Journal, is the practice of accountability by shareholders, officers, and professional managers, and market considerations." In principle, it is the duty of directors to protect shareholders' rights.

Base on the (Revised Code for Corporate Governance), corporate governance is the framework of rules, systems, and processes in the corporation that governs the performance by the Board of Directors and Management of their respective duties and responsibilities to the stockholders.

(Kirkpatrick, 2015), suggests that the importance of qualified board oversight function and risk management is essential, but often neglected, governance aspect in large companies. Possible weaknesses in board composition and competence have been manifested for some time and are widely debated.

According to the Millstein Report (1998), corporate governance takes place within the corporation, and such it depends very much on investors, board managements for its successful implementation. The report noted that for corporate governance to be effective in the capital, it must focus on four essential areas:

- Fairness by ensuring the protection of stockholders' rights in particular the rights of the depositors and borrowers.
- Transparency by the timely disclosure of adequate, transparent, and comparable information concerning corporate performance, governance, and ownership. Accountability by clarifying governance roles and responsibilities and through voluntary efforts to ensure the convergence of managerial and shareholder interests
- as monitored by the Board of directors. Responsibility by ensuring corporate compliance with other laws and regulations.

NEED OF THE STUDY.

The researcher aims to study the effect of Corporate Governance on the Financial Performance of the rural banks in Pampanga. It seeks to determine the impact of good corporate governance as an independent variable on financial performance as a dependent variable. It emphasizes the importance of proper implementation of the policies and procedures and its effects or impact on the financial performance of the rural banks.

As a result of the increasing numbers of closed banks in the Philippines, this study will analyze the implementation of Good Governance of the Board of Directors and its effect on the rural banks' financial status in Pampanga. The researcher would like to know if there is a significant effect on the bank's financial capacity in implementing the policies and procedures. Also, the researcher would like to know the importance of a qualified board oversight function and risk management that causes some rural banks to be placed under receivership by the Philippine Deposit Insurance Corporation (PDIC) or under Prompt Corrective Action (PCA) by the Bangko Sentral ng Pilipinas (BSP).

RESEARCH METHODOLOGY

Data for this study was obtained from two sources. Published Financial Statements of rural banks covering the yearend report from 2016 to 2019 which were obtained on the BSP Data Center Data. And on the other hand, the board characteristics is obtained from each rural bank who participated in the study. The study included eleven (11) rural banks.

A quantitative approach of research will be followed to determine the impact of the qualifications of the Board of Directors in Pampanga and the implementation of good governance in their respective rural banks. A descriptive survey will be employed because it provides an accurate portrayal or account of the characteristics of the Board of Directors.

The researcher is also taking an insider view of the subject being studied, being currently the Independent Auditor also the Chairperson of the Audit Committee of a rural bank and a former Chief Compliance Officer for seven (7) years.

3.1 Population and Sample

The respondents of the study will be the Board of Directors of member banks of the Pampanga Federation of Rural Banks (PFRB), or those in the middle management with independent functions like the Chief Compliance Officers. A convenient place will be chosen by the researcher to save time and expense. A sample of eleven (11) rural banks will be selected out of seventeen member banks of the Pampanga Federation of Rural Banks.

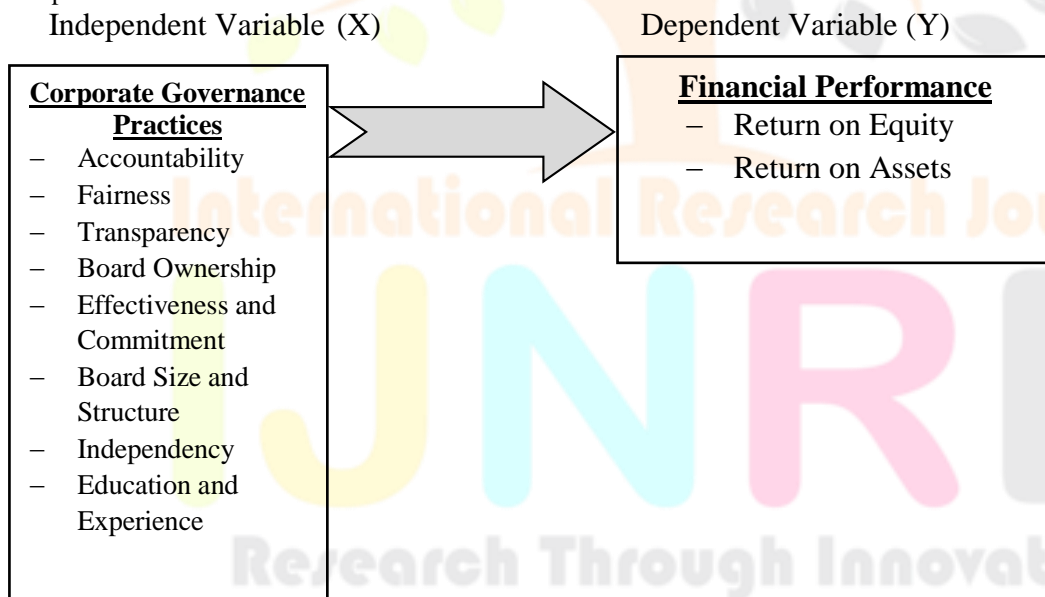
3.2 Data and Sources of Data

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3.3 Theoretical/Conceptual Framework

This study is theoretically anchored on investigating the major factors why rural banks are placed under Prompt Corrective Action, particularly the implementation of good governance and its effect to the financial performance of the rural banks in Pampanga.

The study will also explore some mechanisms of corporate governance like ownership, effectiveness, size and structure, independence, education and experience, transparency, accountability, and fairness and their impact on the likelihood of the financial performance of the rural banks.



3.4 Statistical tools and econometric models

The statistical tool that was used in this study is linear regression. This statistical tool analyzed how Corporate Governance practices correlates to the financial performance of rural banks in Pampanga. The bank's financial performance was measured by the Return on Asset (ROA) and Return on Equity (ROE), wherein: ROA= Annual Net Income/Total Assets ; ROE= Annual Net Income/Shareholders' Equity

IV. RESULTS AND DISCUSSION

Financial Profile. One rural bank got the highest average total assets amounting to 42.5 billion pesos and on the contrary another rural bank has only 155 million pesos of its total assets. The average asset size of rural banks in Pampanga is at 7.8 billion level. It can be considered that rural banks in Pampanga are substantially backed –up by capital to support their operations.

The highest average net income that has been posted by a rural bank in Pampanga is 333.6 million and the lowest is (Php 893,000). There is a wide gap between highest earners and low earners among rural banks in Pampanga. Although the income is just proportionate to their assets. The average rural bank in Pampanga would earn at around 23 million pesos a year.

The highest stockholders' equity also belongs to the top grosser rural bank in terms of income. That rural bank has a stockholders' equity of 3.3 billion pesos. Considerably, these two financial metric goes hand in hand. The lowest stockholders' equity is at 29 million having also the lowest net income. Average stockholders' equity among rural banks in Pampanga is a 243 million pesos.

Corporate Good Governance practices of the Directors. Education and experience of the directors are the most observable parameters under the context of corporate good governance practices which has a mean rating of 6.77 (very highly observable). This was followed closely by the board size and structure with a mean rating of 6.75 (very highly observable). Making it to the third rank is the parameter for fairness with a mean rating of 6.21 (highly observable). The lowest mean rating belongs to effectiveness and commitment which only got 5.43 (highly observable).

It depicts a picture that the directors in rural banks of Pampanga are well qualified in terms of their educational attainment to sit as a member of policy making body of a rural bank. Also, the rural banks are well structured and has regulated the number of their board of directors. Directors have also practiced fairness in the exercise of their power as policy making body for the rural banks. On the contrary, there is a room for improvement with regards to the practice of effectiveness and commitment as it possesses the lowest mean rating as well as on the areas of independence (6.02) and accountability (6.09), having also lower ratings among the corporate good governance practices.

Significant relationship on the rural banks' ROA and ROE with regards to the Corporate Good Governance practices of the Directors. There is a significant relationship between the practice of corporate good governance and the level of rural banks' return on assets (ROA). The R square value of 0.800 between the relationship of ROA and the eight (8) parameters of corporate good governance practices suggests that it has significant effect of the ROA being reliable predictors. Only one (1) model has been generated by the regression analysis which incorporates all the independent variables of the corporate good governance practices.

The R square value of 0.967 indicates a strong relationship between ROE and the eight (8) parameters of corporate good governance practices. It suggests that the eight parameters of corporate good governance practices play a big part in attaining a stable financial condition among rural banks. This confirms that the standard for corporate good governance practices promulgated by SEC and BSP are real indicators to establish a sound level of banking practices among rural banks. Only one model has been generated between ROE and the eight parameters which has been all included.

Conclusions

Based on the foregoing findings of the study, it can be concluded that the rural banks in Pampanga are substantially backed-up by physical and financial assets to support their stable operations commensurate to their size. Some rural banks have garnered substantial level of income and have attracted substantial investments based on their indicated equities.

The directors in rural banks have attained appropriate educational qualifications to become members of the policy making body of the rural banks. They have also been knowledgeable in the practice of corporate good governance as reflected in their fairness to deal with the officers, staff and other stakeholders. The board of the rural banks in Pampanga are also well structured following the standards prescribed by SEC and BSP.

However, not all parameters of the corporate good governance have been fully exercised by the board of the rural banks. There are still parameters that needs to be enhanced particularly in the aspects of effectiveness, independence and accountability.

Both ROA and ROE are dependent on the level of practice of corporate good governance. It seems obvious that the better the management of the bank based on sound banking principles, the better it can generate income and attract investors. Further, economic shocks can be survived and can be mitigated if directors would adhere to sound banking principles and proper management practices.

Recommendations

The following recommendations are hereby offered out of the result of the aforesaid findings and conclusions.

Despite being well structured and appropriately educated, the board should also consider further equipping themselves with the core knowledge of risk management which is very important in considering the enhancement of effectiveness and accountability of handling strategic concerns and growth planning. The board must have a solid knowledge of the bank's direction in the future especially in facing social and economic disruptions. The board must articulate a coherent and sound strategic direction for the bank in order to explicitly outline specific targets and directions that will be cascaded down to the lowest level of the organizational hierarchy.

To hasten the dynamic growth of the banks, the board should also consider equipping the board sub-committees with proper and appropriate knowledge to handle risk management concerns that affects and can affects the total operation of the bank. The board should also consider appointing independent members that will serve as non-executive directors. This will mitigate internal fraud and will improve the visioning capacity of the board having other experts joining as market experts to help the board craft sound policies pertaining to managing risks and strategic actions. Transparency should also be considered by the board. This will include the aspects of notices of strategic intent and directions of the banks to the stakeholders as well as how the bank is being position in terms of its risk appetite.

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