

**COMPARATIVE MANAGEMENT STRUCTURE
AND INSTITUTIONAL PERFORMANCE
IN RURAL BANKING INSTITUTIONS**

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The Author

TABLE OF CONTENTS

I.	Introduction.	1
II.	A Framework for Relating Management Structure with Institutional Performance.	3
III.	The Survey	8
IV.	Review of Related Literature.	10
V.	Management Structure and Policies of RFIs	16
VI	Relating Management Structure and Policies with Operating Performance of RFIs	31
VII.	Concluding Remarks.	50
	References.	57

LIST OF FIGURES AND TABLES

Figure 1.	Management Structure as a Factor Influencing the Impact of External Forces on RFI Performance.	4
Table 1.	Breakdown of Respondent Banks.	9
2.	Performance Indicators by Bank Type Average	17
3.	Comparative Organization Structure, Average Number/Proportion.	19
4.	Pairwise Comparison of Organization Structure	20
5.	Comparative Degree of Decentralization.	22
6.	Education and Ownership of RFI Management	24
7.	Deposit Generation and Number of Respondent RFIs.	27
8.	Loan Administration and Number of Respondent RFIs	28
9.	Ownership Background of RBs and PDBs.	31
10.	Managerial Hierarchy and Scope of RFI Services, Mean.	32
11.	Staff Size and Overhead Cost, Mean.	34
12.	Branch Manager's Discretionary Authority on Loans, Mean.	35
13.	Ownership, Structure and RFI Performance.	37
14.	Multiple Regression of Return on Assets Ratio on Financial and Organizational Variables.	39
15.	Manpower Deployment Policies and Service Performance of RFIs.	41
16.	Management Marketing Policies and Deposit/Loans Performance	42
17.	Savings Campaign and Deposit Performance for RBs and PDBs	45
18.	Profitability Performance of RFIs	48

COMPARATIVE MANAGEMENT STRUCTURE AND INSTITUTIONAL PERFORMANCE IN RURAL BANKING INSTITUTIONS*

by

Cesar G. Saldaña**.

I. INTRODUCTION

Various government policies and programs have focused on the ways to expand and increase the quality of banking services in the rural areas. Most of these efforts were specifically directed at financing programs and regulatory policies meant to promote the effective participation of banking institutions in the rural financial system. Because of their economic importance

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The views expressed in this study are those of the author and do not necessarily reflect those of the Institute.

in the rural areas, policymakers need to regularly monitor their activities and performance.

The objectives of this study are: to describe and to evaluate the observed management structure, policies and practices of three major types of banking organizations operating in the rural areas. These private banking institutions - rural banks, private development banks and branches of commercial banks - represent the major part of the rural financial system. Interest in rural financial institutions (RFIs) is due to the ongoing reforms in the financial system which point towards allowing for increased free play of private incentives in financial markets. In the past, government banks like the Philippine National Bank and the Development Bank of the Philippines assumed a considerable role in rural finance.

In this study, the organizational and management characteristics of the three types of institutions are presented on a comparative basis, evaluated, and then related to their overall performance. The results are intended to contribute to a better understanding of how government policies and market conditions determine the management set-up of these institutions and influence their operating and financial performance.

A descriptive model of interaction between market, organizational structure and policy and institutional performance is presented in Section 2. This section also covers the operational definition of these variables including several hypotheses which are suggested by the descriptive model.

Section 3 describes the survey data. Section 4 reviews some government regulatory and policy initiatives which impinge on management structure and policy choices by RFIs. Related findings by prior studies are also reviewed. Section 5 covers the observed management structure and policies and analyzes the data for the three classes of RFIs on an individual and comparative basis. Section 6 extends the analysis to relate management structure and policies with overall financial and operating performance of the RFIs. The last section presents some conclusions of the study and suggests areas for extension and analysis.

II. A FRAMEWORK FOR RELATING MANAGEMENT STRUCTURE WITH INSTITUTIONAL PERFORMANCE

This study of the management aspects of RFIs adopts the familiar contingency model used in business policy and control.^{1/} The model simply states that an organization and management policies represent the firm's way of innovating to survive and grow in the face of prevailing regulation/legal structure in the marketplace. In short, management policies and practices are the RFI's means of competing. These are methods chosen by management to exploit opportunities available in the market while avoiding constraints of regulations or its own weaknesses (e.g., resource limitations). Self-interest behavior is at the core of this framework. The RFI will seek to maximize its returns (commensu-

^{1/}

For example, see Porter (1980) and Soriano (1976).

rate with risk) when selecting from among alternative policies available to the RFI management.

Management structure consists of organization structure, staffing, and policies guiding the operations of a bank. The impact of regulations and market changes on bank performance can be better understood in the context of this management structure of RFIs. In this study, these management aspects are described and related to the performance of individual RFIs.

The interaction of management structure with market conditions and regulations is reflected in a schematic diagram shown below:

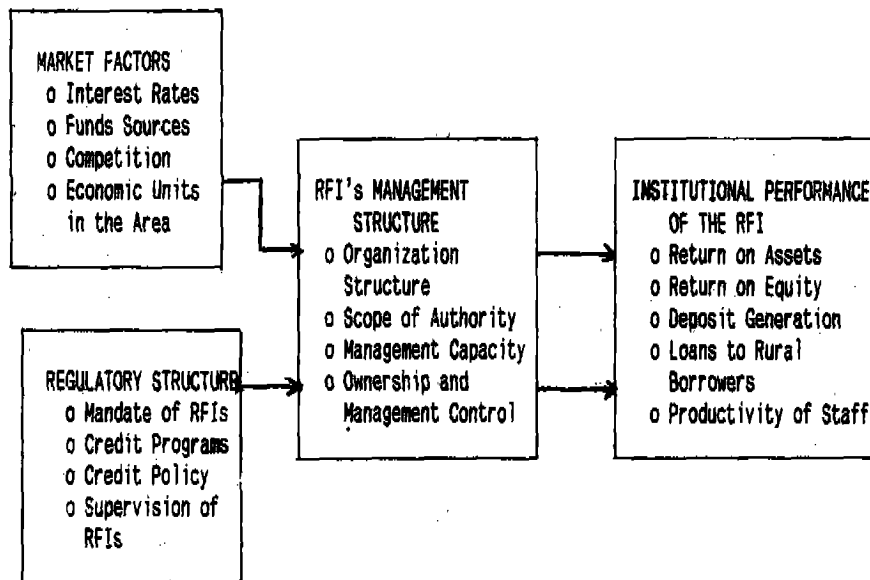


FIGURE 1. MANAGEMENT STRUCTURE AS A FACTOR INFLUENCING THE IMPACT OF EXTERNAL FORCES ON RFI PERFORMANCE

The organizational and management policy structure by RFIs should be seen as the main adaptive and adjustment mechanism available to these institutions. From a positive theory standpoint, the observed management structure of RFIs must reflect the best mechanisms available to RFIs for coping with market and regulatory conditions. It is implied that RFIs will design their own management structure in accordance with their self interest, rather than based on the "equity" objective of the government.^{2/} As reported in Tolentino (1987, p. 28), the government remains concerned with "how to ensure that rural farm subsidies, when channeled through RFIs, are not captured by the banker."

A number of implications emerge from the suggested descriptive framework. One, an RFI will design its organization and make its staffing decisions to suit available market opportunities. For any given set of market opportunities, it will seek cost-minimizing choices of organization structure and staff. Two, the regulatory structure will be primarily perceived as a constraint to the achievement of cost-minimizing choices. If there are differences in regulations or in mandates (e.g., size of capital across the RFI types), the effects should be seen first in the difference in management structure; overall performance will be evaluated later. Three, any planned regula-

^{2/}

Many RFI managements can claim that profitable results and growth in the rural market is not possible unless they service the agricultural lending needs of the local area. This is likely to be true in many cases, i.e., the efficiency and equity objectives need not be inconsistent.

tory change, (e.g., directed at "equity" considerations), should be evaluated in the context of the ability of the RFIs to eventually modify its management process in favor of "efficiency" or profits. For any given state of management structure, any such change in regulatory regime will have an adverse short-run effect on the efficiency of the RFI.

In this study, the current market and regulatory regimes are taken as given and a descriptive analysis of the management structure of the three types of RFIs is conducted. Operational indicators of the key elements of management structure are identified and utilized.

Certain hypotheses can be generated from the relationship of management structure and performance, using the preceding framework. First, an RFI's management can be expected to optimize, within its legal prerogatives, the use of its resources. In banking, these are primarily the personnel, the physical branch network and the flow of funds. Second, management policies can be expected to be so designed as to minimize the impact of regulatory restrictions that adversely affect the RFI's funds generation and application. Third, for RFIs whose owners dominate management, policies are the means for resolving potential conflicts among the owner-management group, the government and the other minority holders.

Some preliminary questions on the relationship between performance and management are presented as follows:

1. If management wants to optimize resource utilization, what policies will it select for:
 - a) service offerings?
 - b) deployment of bank staff along service lines?
2. How does the RFI choose management policies to minimize regulatory restrictions and exploit available opportunities, specifically those related to:
 - a) retention of a certain percentage of deposits for lending in the local area?
 - b) deposit mobilization?
3. Is there a potential relationship between certain management policies and the condition whereby stockholders themselves manage the RFI? Specific questions which can be addressed are those related to:
 - a) returns to stockholders of the RFI;
 - b) lending to directors and officers and its impact on RFI performance.

The study involves an analysis of the operating policies of the three RFI types along certain measurable and qualitative criteria. The more quantitative indicators of management operating policies and practices are covered, in order to aggregate and highlight the comparative aspects of the issue across the RFI types.

III. THE SURVEY

The data used in this study was taken from a primary survey of 66 rural banks and branches of development and commercial banks. A questionnaire and an interview schedule were designed and pre-tested prior to the actual survey. A breakdown of the responding banks is shown in Table 1.

The 66 respondent banks are broken down into 23 rural banks, 16 unit and branch development banks, and 27 branches of commercial banks. These banks are spread out over 10 cities and 25 municipalities located in eight provinces from seven regions of the country.

The survey instruments used were of three types:

- (a) Documents submitted by the bank such as financial statements, organization chart, personnel data, and special schedules of selected financial information, e.g., Directors, Officers, Stockholders and Related Interests (DOSRI) loans;
- (b) A 14-page pre-tested questionnaire in two versions: one for unit banks and another for branch banks. Research assistants interviewed respondents to clarify responses and to follow-up questions with missing responses.
- (c) A two-page interview schedule for the more difficult and/or sensitive questions.

Table 1

BREAKDOWN OF RESPONDENT BANKS

Location	Rural Banks	Development Banks	Commercial Banks
Region I			
Pangasinan	3	2	4
Region III			
Nueva Ecija	0	4	3
Region IV			
Batangas	3	3	3
Laguna	0	3	4
Region V			
Camarines Sur	3	1	2
Region VI			
Iloilo	4	1	3
Region VII			
Negros Oriental	3	1	3
Region X			
Misamis Oriental	7	1	5
Total	23	16	27

The instruments covered the general areas of management structure, operating policies, and bank operating procedures and systems, including reporting and evaluation systems. Balance sheet and income statements for the period 1981-1986 were also requested including more detailed schedules for selected financial variables, e.g., DOSRI, number of deposit and loan accounts.

The questionnaire and interview schedule were generally well-covered by respondents but corresponding financial data submitted were incomplete. In particular, it was difficult to obtain financial statements from commercial bank branches. For most responding banks, problems were encountered in terms of differences in reporting formats, sometimes leading to gaps in line item information.

IV. REVIEW OF RELATED LITERATURE

RFIs operate within the regulatory framework set out by the 1980 financial reforms. Lamberte (1987) reviews the implications of the reforms on the operations and organization of the RFIs. From an operational viewpoint, the current regulatory environment reduced the differences between these financial institutions. However, important differences remain in key areas of minimum capitalization, limitation on ownership of enterprises, branching and reserve requirements. Lamberte cited rural banks as facing the most restrictions, particularly on investments and branching. However, rural banks enjoy lower reserve requirements compared to commercial and development

banks. It seems clear that these regulations were set out with the entire financial system in mind. However, seen only from the subset of the rural financial sector, the framework still allows for the operation of three institutions with vastly different equity bases ranging from a minimum of ₱500,000 for rural banks and ₱500 million for unibanks. A research question suggested is whether the differential reserve requirement can indeed offset this difference in resource base, as pointed out by Lamberte.

The reduction of functional differences among bank types may have been less effective due to the remaining differences in the resource base of banks. While development banks can legally offer services and open branches nationwide similar to commercial banks, the fact that these banks are smaller prevent them from availing of this legal opportunity. The same can be said about the opportunity for rural banks to open branches on a region-wide basis. The response of RFIs to the deregulated market environment can also be seen in the same context. Such banks may still be unable to enjoy benefits from any economies of scope (Lamberte 1987, p. 7) potentially available through deregulation.

Meyer (1987) conjectures that rural banks may be unable to take up the task of credit evaluation and lending in the absence of traditional Central Bank-initiated programs which specify their own rules and regulations. This can be taken as a comment to the potential lack of management capacity and inadequate organization of rural banks. Central Bank's attempt

to wean rural lenders from rediscounting and special credit programs was one of the agenda for the agricultural sector in the financial reforms of 1980-1985. Tolentino (1987) reviews the measures which Central Bank implemented to correct the agricultural portfolio of banks. He reports that few rural banks participated in these programs, indicating that the rural banks' arrearages condition still persists, at least up to 1986.

Previous studies on the behavior and performance of RFIs conclude that these institutions are driven by profit-seeking motives in responding to market and regulatory constraints. In his review of the causes of the decline in formal agricultural credit, Tolentino (1987, p. 5) concludes that "lenders, as profit-maximizing businessmen, seek to lend to those sectors where their combined cost of funds and supervision are relatively lower, under given rates charged on loans." Whenever legal restrictions on lending interest rates prevented RFIs from earning reasonable profits, RFIs can simply stop making loans to agriculture. Even under the current regime of deregulation, Tolentino reports that risk and default conditions in the agricultural loans market remain unattractive for lenders.

The RFIs' responses to regulation are consistent with profit-seeking behavior. A deposit retention scheme requires that at least 75 percent of the total deposits generated, net of reserves, should become part of the loan portfolio of the RFI in the same area. Lamberte (1987) found that on the basis of regionally-aggregated portfolios, commercial bank (KB) branches did not meet this legal requirement. Here was a case where

management policies apparently violated explicit regulatory restrictions. On the other hand, the effects of regulatory incentives appear more difficult to assess. Differential reserve requirements in favor of rural banks are intended to offset the cost advantages of larger banks. Lamberte was unable to trace this advantage to any superior profitability of rural banks (RBs) as compared to KB branches.

Some regulatory restrictions seem to be less relevant at the RFI level. The minimum net worth to risk assets ratio is 8 percent for universal banks and 10 percent for other banks. Lamberte (1987, pp. 5-6) noted that the regulation is actually "an invitation for banks to expand their capital." However, it could also be a deterrent to asset expansion and loans by banks. Note that the ratio is only relevant at the unit bank level, i.e., at the RBs, development bank (PDB) and KB head offices rather than the branch bank. For example, Lamberte was unable to ascertain the "equity" of a KB branch. The implication is that, while the regulation affects RBs, it can be effectively ignored by the management of KB and PDB branches.^{3/}

Lamberte reports the comparative performance of the three RFI types on the basis of regionally-aggregated financial data. Some of the results have a direct relationship with the differential management policies that each RFI type appears to have adopted. First, KB branches' deposit mobilization is more

^{3/} It is a concern of head office and the branch ignores it except on instruction from the top.

extensive than PDBs and RBs. This finding suggests the need for a closer look into the organization and policies adopted by each RFI type regarding deposit mobilization. The situation is reversed in the case of loans. The loans to deposit ratios are much lower for RB branches than for PDBs and RBs in Lamberte's study.

Various conjectures related to management aspects are offered relative to the deposit and loans relationships for RFIs. Lamberte claims that KB branch management may have greater discretionary authority on raising deposits but very limited authority for originating loans. Meyer (1987, p. 6) suggests that the RB may be unable "to respond to the new unregulated environment where deposit mobilization is supposed to replace Central Bank funds." In the face of the apparent violation by some KB branches of the deposit retention scheme, Lamberte noted that this regulation is neither strictly followed by RFIs nor enforced by the banking authorities.

On this aspect of institutional performance, Lamberte (1987) found that for the 1983-85 period, the regionally aggregated loans of development and rural banks exceeded deposits. This finding highlights the importance of the Central Bank rediscounting and credit programs to these banks. Management have less incentive, under that regulatory regime, to develop the capacity for deposit generation. In contrast, Lamberte noted that in regions outside Metro Manila, branches of commercial banks are specializing in deposit generation to support lending at their head offices. These findings suggest certain basic

differences in organization and management which are explored in this study. The aggregated data in Lamberte's study also needs to be verified and related to the organization and management at the bank level.

Comparisons on the basis of profitability turned out to be more complicated using standard ratios in the Lamberte study. Due to the disparity in deposits and loans KB branches appear unprofitable. Without reasonable transfer price estimates for fund transfers from branch to head offices, reported revenues of KB and PDB branches are understated. Even the measure used in Lamberte's study -- net operating income as a ratio of operating income -- is clearly deficient in this respect. Given this system of accounting, cumulative net branch losses will result in negative equity for most KB branches ^{4/}. This situation makes return on equity, a traditional efficiency measure, meaningless when applied to unadjusted branch financial statements. Lamberte suggests that future studies should innovate on measurement techniques to arrive at the true picture of RFI performance.

In summary, the current evidence suggests a menu of adaptive policy mechanisms that RFI management follows, guided by its profit-seeking motive. Faced with a market condition of income regulation, the RFI seeks low cost internal arrangements. If the regime is one of deregulation, RFIs will seek highest portfolio

^{4/} Equity equals assets less liabilities of the KB or PDB branch

returns while keeping low-cost sources of funds. Agricultural loans will decrease if loan interest rates become too regulated or if urbanized loans yield more returns under deregulation. The alternatives open to management in dealing with regulatory conditions is more diverse. Incentives will either be taken or ignored. Restrictive regulations may either be followed or violated, the latter case even with or without penalties. Restrictions may have full impact on the management of unit banks in the rural areas but have no consequence on competing branches of regional/national banks in the same areas. RFI management may be required to simultaneously adjust to an incentive (e.g., lower reserve requirement) and a restriction (e.g., net worth to risk assets). Performance results come out of the adaptive responses of management by way of functional strategies (deposit policy, loans policy, etc.). However, extra care must be exercised when using summary indicators like profits due to the interaction of the measures with unique strategies pursued by RFIs.

V MANAGEMENT STRUCTURE AND POLICIES OF RFIs

1 Management Structure

The basic indicators of management structure used in the study are (a) organization structure (b) degree of decentralization (c) staffing and management background and (d) ownership. Organization structure is characterized further in terms of (i) the number of levels from the bank's chief operating officer to the bank's staff in face-to-face contact with bank client and (ii) the number and types of staff positions in

the bank organization. The degree of decentralization refers to the location of approval authority for deposit terms, loans to clients and investment of bank funds. Staffing and management background covers the mix of managerial and rank and file staff in the bank and the educational background of key officers. Finally, the distinction, if any, between management and ownership are explored.

These management structure variables will then be related to selected indicators of bank performance. The usual aspects are size, deposits loans and profitability. To provide an initial reference point, a summary of key performance indicators are shown in Table 2.

Table 2
PERFORMANCE INDICATORS BY BANK TYPE AVERAGE
(In thousand pesos)

	Rural Bank	Development Bank	Commercial Bank
1 Bank Size			
a) Total Assets	P10 440	P21 823	P70,480
b) Premises	97	260	1,372
2 Deposit Generation			
a) Amount	3,722	14,406	67,148
b) Number of Accounts	4,434	3,772	10,131
3 Loans			
a) Amount	7,137	10,838	6,165
b) Number of Accounts	980	237	63

a/
Excludes outstanding transfers to Head Office for branches of commercial banks

The size and complexity of a bank's organization structure depends on bank size, range of services, personnel expertise and prevailing regulatory structure.^{5/} Assuming a certain degree of mobility of the labor force, personal expertise can be controlled by a bank through proper hiring and personnel development policies. The scope of services offered by all three types of banks are similar. Only commercial bank branches offered other significant bank services such as telegraphic transfers, drafts/managers' checks, foreign exchange services, and L/Cs. Nevertheless, the great disparity in asset size and in relative importance of each banking function makes for organization structure differences. An extensive branch structure for commercial banks can also lead to differences in managerial authority compared to unit banks like RBs and PDBs with less branches in far-flung places.

Unit banks can be expected to maintain more organizational levels compared to branch banks. Unlike unit banks, branches of commercial banks can maintain common support services at the central office or regional level. Well-developed operating guidelines may also allow KB branches to operate with comparatively less need for supervision. Instead of the value of financial assets held by a bank, the number of accounts may be a better indicator of an RFI's workload and consequent need for a more extended supervisory hierarchy. Table 3 shows a comparison of organization structure indicators for the three types of RFIs.

^{5/} Reference can be made to standard bank management textbooks like Johnson and Johnson (1985).

Table 3

**COMPARATIVE ORGANIZATION STRUCTURE
AVERAGE NUMBER/PROPORTION
(Standard Deviation)**

	B	A	N	K	S	
	Rural	Development	KB Branch	Significance		^a
1. Number of Levels	4 (0.94)	3.5 (0.90)	3.6 (0.52)	N.S.		
2. Plantilla Positions						
a) Number	9.15 (3.36)	8.46 (3.33)	8.31 (2.89)	.03		
b) Per cent of Total Personnel	84% (10%)	76% (27%)	57% (25%)	0.002		
3. Hierarchical Mix						
a) Proportion of Managerial/ Supervisory Positions to Total Staff	28% (8%)	27% (9%)	20% (13%)	0.12		
b) Average Number of Customer Accounts Per Manager/Supervisor	3,995 (2,336)	1,985 (1,614)	2,450 (1,211)	N.S.		

^{a/}

Kruskall-Wallis (K-W) One-Way ANOVA (corrected for ties)
Chi-Square significance: N.S. - Not Significant at 0.2
S(Level) - Significant (level)

Among a sample of 39 RFIs, RBs turned out to have the highest average number of organization levels followed by KB branches and PDBs. Given the small sample size and unknown distributional characteristics of the data, a non-parametric test (Kruskall Wallis One-Way ANOVA) was used to compare the distribution of levels across three bank types. The test,

essentially based on comparative ranking, shows no significant difference in number of levels. RBs and PDBs maintain a higher proportion of distinct positions in their organization compared to KB branches. This is likely to be explained by the diversity in primary and support functions in unit banks compared to reliance by KB branches for central support staff at their corporate groups. Another possible explanation may be the difference in the number of deposit and loan accounts handled by unit banks compared to KB branches.

As in the case when a statistical difference is found, a pair-wise statistical comparison can be made using another non-parametric test, the Kolmogorov-Smirnov (K-S) Two-Sample Test. The conclusion regarding the organizational structure difference between unit banks and KB branches is borne out in Table 4.

Table 4

PAIRWISE COMPARISON OF ORGANIZATION STRUCTURE

=====

1. Plantilla Position as

Percent of Total Personnel

.0023 ^{a/}

RB Vs. PDB

(N.S.) ^{b/}

RB Vs. KB

(0.001)

PDB Vs. KB

(0.08)

2. Hierarchical Mix

Proportion of Managerial/
Supervisory Staff to Total
Staff

12 ^{a/}

RB Vs. PDB

(N.S.) ^{b/}

RB Vs. KB

(0.13)

PDB Vs. KB

(0.14)

=====

^{a/}

K-W One-Way ANOVA: All Three Bank Types

^{b/}

K-S Two-Sample Test

Table 3 also shows a difference in the hierarchical mix of these banks' personnel. Again, RBs and PDBs have more managerial and supervisory personnel in contrast to the larger rank and file staff of KB branches. This finding indicates lesser control^{6/} over RBs as compared to KB branches. There are several operational explanations in this regard. The expertise of the managerial/supervisory personnel in the RBs may not be sufficient in supervising units with diverse functions. On the other hand, KBs may simply be operating a staff involved in fewer banking functions compared to unit banks. The pairwise comparison for managerial mix in Table 4 also shows significant statistical differences along the above direction.

The aspect of decentralization is evaluated in the context of a multi-branch and a unit bank environment. One way is to consider the degree of latitude exercised by the manager (of a unit bank) or the branch manager (of a PDB or KB branch) in loans approved and decisions on deposit terms. Under a centralized authority structure, the manager refers more decisions to a Committee or President (for unit banks) or to an Area Head or Central Office (for PDB or KB branches). The results on a comparative basis are summarized in Table 5.

KB branch managers are allowed much higher loan approval limits than the PDB managers although the latter's limits are

^{6/} Defined as the number of organizational units handled by a manager. See Koontz and O'Donnel (1984)

Table 5.

COMPARATIVE DEGREE OF DECENTRALIZATION
Mean (Standard Deviation)

	B	A	N	K	S	
	RB	DB			KB	Significance ^{a/}
=====						
1. Maximum Loan Approval Limit of a Manager						
Amount (in thousand pesos)	₱8,667 (6,673)	₱43,750 (41,908)			₱651,667 (837,972)	0.0001
2. Level of Organization When Decision on Deposit Terms are Made						
a) Board	50.0%	18.8%			4.4%	
b) President/Top Management at H.O.	-	68.8			69.6	
c) Manager	18.8	12.5			-	
d) Board and Manager	31.2	-			-	
e) Board and H.O.	-	-			13.0	
f) H.O. and Manager	-	-			13.0	
	-----	-----			-----	
	100.0%	100.0%			100.0%	

=====

^{a/}
K-W One-Way ANOVA

not far behind.^{1/} Disregarding other factors, higher loan approval limits correspond to a "decentralized" set-up. Factors such as better knowledge of local conditions, availability of

^{1/}
Interpreted here in a distributional sense. KB (branches) has a distribution which is skewed to the right. Most loan limits for KB branch managers are in the range of PDB's except for a few exceptions with very high limits. One KB reported branches with loan approval limits of ₱2 million, resulting in the large mean and standard deviation values. Various industry sources questioned the adherence of KBs to the actual exercise of such large approval limits in practice.

centrally administered guidelines and faster or more personal service are some reasons for allowing PDB and KB branch managers more discretion on loans. These reasons are normally absent for RBs and more accessible branches of PDBs. While PDB and RB managers must pass on loan approval to a Credit Committee or the Board, these decisionmaking units can be readily convened on short notice.

Furthermore, the degree of discretion allowed to lower level officers for loans may be related to the importance given by top management to the lending function. Generally, policies and decisions for the more critical functions are expected to be centralized and if decentralized, are centrally monitored. From a performance standpoint, it would be interesting to find out whether actual average loans are within the approval limits set by RFIs as a matter of policy.

Deposit policies and decisions are considered top management prerogative for all RFI types (Table 5). The competitiveness of the RFIs are especially sensitive to deposit terms. Decisions related to deposits are also less frequent and closely related to how the RFI positions itself relative to the market and the regulatory environment.

As can be expected, the background of RFI managers are mostly related to business or law. This implies prior training and familiarity by RFI managers with business management and legal aspects. A summary of this finding is shown in Table 6.

Results also indicate that most presidents or managers of RBs are stockholders of their respective banks.

Table 6

EDUCATION AND OWNERSHIP OF RFI MANAGEMENT

	RB	DB	KB
1. Educational Background of RFI Managers			
a. Business or Law	61.1%	81.8%	92.3%
b. Other Fields	38.9	18.2	7.7
2. Ownership and Management: Number of banks or branches which are			
a) Owner-Managed	18	3	0
b) Not Owner-Managed	1	10	24
	19	13	24

2. Management Policies and Operating Decisions

RFI management policies can be systematically described and compared in terms of the two key functional areas in banking, namely, deposit generation and loans administration. In addition, the banking business is concerned with adequacy of capital and of returns. Both aspects are joint consequences of deposit and loans policies adopted by management relative to the goals assigned to it by the owners. All these aspects are now presented in comparative form.

Deposit Generation

Table 7 shows relevant data and statistical results for deposit generation. References to item numbers in Table 3 are noted in parenthesis.

Except for five RBs, all surveyed RFIs reported that there are existing written policies on deposits, specifically, terms and interest rate schedules (Item 1). Among KB and PDB branches, such deposit policies are set by head office/top management. A number of RBs indicated that such policies are decided by the manager although majority of RBs point to their Board of Trustees (Directors) as the deposits policymaker. Except for six RBs, the RFIs' deposit performance is regularly reviewed (Item 2). The deposit review function is one of the main responsibilities of the RFI manager (and jointly with the Area Head in the case of KB branches). Most KB branches carry out this evaluation function monthly while some branches do it daily (Item 3). RB and PDB branches meanwhile, conduct their review monthly, quarterly or annually.

The nature of deposit campaigns depends on the RFI type. KBs anchor their campaigns on a motivated internal bank staff by giving them incentives to contact more people and enlist them as depositors. On the other hand, KB and PDB branches' campaigns are comparatively more customer-oriented, usually with raffle prizes to depositors and TIPID movement schemes. Certain differences also arise on who initiates and how long the deposit campaigns will be across RFI types. Most RB and PDB deposit campaigns are

initiated by the branch whereas for KB branches, the mandate comes from the head office (Item 4). Most RB savings campaigns last only from one to six months compared to six months to one year for PDB and KB branches (Item 5).

Loans Administration

Table 8 summarizes the relevant data and statistical inferences in which the conclusions in the following paragraphs are based. Reference to items in the table are noted in parenthesis. Many surveyed RFIs decide to lend based on written loan policies (Item 1) set by the Head Office or Board of Directors.^{8/} However, a significant number of rural banks operate without such written policies, leaving the lending decision to operating management. The preparation of a loans budget is a regular activity of loans administration for all RFI types (Item 2). There is a clear difference as to the organizational location of this activity. PDB and KB branches centralize this planning role at the branch manager or head/area office level. In contrast, RBs delegate the responsibility to lower level staff including the loan appraiser, credit and collection staff and the cashier.

^{8/}

Except for RBs where the modal response to the question: "Who sets loan policies?" is "Central Bank" (nine out of 22 respondents).

Table 7

DEPOSIT GENERATION AND NUMBER OF RESPONDENT RFIs

	B RBs	A PDBs	N KB	K Branches	S Significance
1. <u>Deposit Policies</u>					.035
a) With Formal/Written Policies	16	16		25	
b) No Written Policies	5	0		0	
2. <u>Monitoring of Deposits</u>					.03
a) Regular Review	15	16		23	
b) No Regular Analysis	6	0		0	
3. <u>Incentives for Deposits Generation</u>					.09
a) Presence of Staff Incentives	6	8		1	
b) No Staff Incentives	15	7		10	
4. <u>Decisions on Savings Campaign</u>					
a) Board or Head Office	4	5		10	
b) Manager	13	5		12	
c) Other Officers	4	1		4	
5. <u>Duration of Savings Campaign</u>					
a) One Month	2	2		1	
b) Three to Six Months	4	2		7	
c) One Year	1	3		3	
d) Other	3	2		1	

a/
Chi Square Test. N.S. at 0.2

Table 8

LOAN ADMINISTRATION AND NUMBER OF RESPONDENT RFIs

ITEM	BANKS			Significance ^{a/}
	RBs	PDBS	KB Branches	
1. <u>Loan Policies</u>				0.1
a) With Formal/Written Policies	14	14	21	
b) No Written Policies	7	2	2	
2. <u>Loan Budget</u>				N.S.
a) Regularly Prepared	17	13	21	
b) Not Prepared	5	3	2	
3. <u>Major Competitor for Loans</u>				
a) Rural Banks	8	5	0	
b) PDBs	2	5	4	
c) KB branches	4	11	21	
d) Others	2	2	2	
4. <u>Loan Collections</u>				N.S.
a) Incentive to Staff	5	6	8	
b) No Incentives	17	9	13	
5. <u>Loan Restructuring</u>				0.15
a) Written Guidelines	16	14	18	
b) No Formal Guidelines	6	1	1	

^{a/}

Chi Square. N.S. at 0.2.

With regard to competition in the loans market, many PDB and most KB branches perceive other KB branches as their main competitors in their area of operations (Item 3) Likewise, most RB and many PDB branches perceive other RBs and PDBs as their competitors This finding demonstrates segmentation in the loans market of RFIs reflecting a difference in loans market targets or clientele across RFI types Personal visits/contacts by the bank staff is regarded by the RFIs as the most effective way of advertising loan services aside from posters, souvenirs and giveaways .

The importance of loan collection is emphasized by all RFIs thus, incentives in the form of merit increases and bonuses are given for effective collection efforts by the bank staff (Item 4) The branch manager reviews the loan portfolio of all RFIs regularly. Every RFI respondent (except one PDB branch) maintained a system for monitoring past due accounts by means of status reports on loans outstanding Problems on loans are dealt with based on existing guidelines for loan restructuring (Item 5) However, a significant number of rural banks do not have such guidelines To help minimize these contingencies, many RFIs provide incentives to borrowers for early or prompt loan repayment through interest rebate, increased assurance of new loans and interest discount on new loans .

Ownership Background

Management policies of RFIs are related to the ownership background The geographical distance between KB branches and

their NCR head offices leads to an "arms-length" relationship between KB owners and branch managers, manifested in formal management policies. On the other hand, the situation of RBs and to some extent, PDB branches, is different. Table 9 shows that most RBs are managed by stockholders^{9/} while few PDBs surveyed are under the same management. Stockholders of rural banks have concurrent ownership of a number of other businesses, including other financial institutions, manufacturing, trading and service enterprises.

Certain respondents claimed advantages in relationship of the RFI with other businesses such as: (a) intercompany financial assistance, particularly with other financial enterprises held by the RFI owner; (b) use of RB staff and facilities for transactions of the other thrift bank holding; (c) expanded client base for multiple businesses; (d) use by the other businesses of the RFI as depository bank and creditor and (e) "learning experience" from the RFI enables the stockholders to set up other financial institutions. No corresponding disadvantages of holding other businesses were reported by RFI managers in the survey.

These findings on deposits, loans and ownership are indicative of the more observable characteristics of RFI management. Their limitation lies mainly from the

^{9/}

Defined as cases when the president or general manager of the RFI is also a stockholder.

Table 9

OWNERSHIP BACKGROUND OF RBs AND PDBs

	RBs (n=19)	PDBs (n=13)
1. Ownership and Management (Number)		
a) Owner-Managed	18	7
b) Manager is Not a Stockholder	1	10
2. Other Businesses Owned by RFI Stockholders		
a) RBs, PDB, Thrift Banks, etc.	10	3
b) Real Estate/Agri-based	8	0
c) Service Enterprises	11	0
d) Manufacturing	4	0
e) Merchandising	3	1

inability of questionnaires to capture the subjective and judgemental element of management policymaking.

VI. RELATING MANAGEMENT STRUCTURE AND POLICIES WITH OPERATING PERFORMANCE OF RFIs

1. Management Structure and RFI Performance

The structural features of the RFIs' organization can be related to its performance. Several questions which can be raised are as follows:

- Can the larger number of staff positions in unit banks be possibly explained by their larger number of deposit and loan customers (compared to PDB and KB branches)?

- b) Is there a relationship between the size of the organization and personnel overhead cost of an RFI?
- c) Can the difference in loan approval limit among the RFI types be possibly related to the typical client group serviced by the respective RFI's?
- d) Can ownership and organizational structure significantly add to an understanding of RFI financial status and performance?

The difference in number of managerial staff positions of unit banks may be possibly explained by relative diversity in services and size of client base. An extensive deposit generation and lending operations as shown by the large number of clients served, can justify a more extensive staffing plan. This relationship is reflected in the ratio of the number of deposit and loan accounts to the number of staff positions in the RFI. The result shown in Table 10 supports this claim. PDB and KB

Table 10

MANAGERIAL HIERARCHY AND SCOPE OF RFI SERVICES
Mean (Standard Deviation)

	B	A	N	K ^{b/}
	Rural	Development		KB Branch
Number of Accounts Serviced				
Per Bank Manager/Supervisor ^{a/}	3,995 (2,336)	1,985 (1,613)		2,450 (1,211)

^{a/} K-W One-Way ANOVA: N.S.

^{b/} K-S Two-Sample Test for Each Bank Pair: All N.S.

branches service relatively fewer clients which may help explain its leaner organization.

Personnel cost is an overhead expense which is normally allocated by banks and used in pricing loans. Higher cost structures can then influence RFIs' profitability and competitiveness in the market place. Table 8 (Item 1), shows that each RFI type has a different level of compensation for its staff. This may be due to inherent differences in qualifications, local job market and requirements. Meaningful comparisons should then be made only within each RFI category. In determining whether the organization size is related to the overhead cost of an RFI, the ratio of staff positions to total personnel is related to the ratio of personnel compensation cost to total assets in which a positive relationship holds. Although an organization may increase its staff, the corresponding resource generated by the new staff may lower the latter ratio. The result in Table 11 (Item 2) shows significant positive relationship - more staff is associated with higher overhead cost - for KB branches but not for PDBs and RBs.

It seems more difficult to relate the difference in loan approval limit of RFIs to their lending performance. Comparisons across RFI types would not be valid if there are "clienteles" effects, e.g., if traders go to RB branches while farmers go to RBs. A possible approach for controlling loan portfolio characteristics in assessing the degree of decentralization of

Table 11

**STAFF SIZE AND OVERHEAD COST
Mean (Standard Deviation)**

	B A N K S				
	RB	PDB	KB	Branch	Significance ^{a/}
1. Difference Across RFI Types					
Average Compensation Per Employee (Pesos Per Year)	28,810 (8,880)	35,210 (24,720)	59,800 (21,210)		.049
Total Compensation as a Per Cent of Assets, Net of Premises	0.04 (0.02)	0.03 (0.03)	0.02 (0.01)		.013
2. Relationship Between Compensation as Per Cent of Assets and Staff Positions as a Per Cent of Total Personnel (Kendall's Correlation Coefficient Tau)					
	N.S.	N.S.	0.04		

^{a/}

K-W One-Way ANOVA

lending authority is to take the ratio of the manager's lending limit to the RFI's average loan size. The result in Table 12 shows that the degree of lending discretion given to RB and KB branch managers appear to be comparable after considering the loan sizes normally handled by each RFI type.

Table 12

BRANCH MANAGER'S DISCRETIONARY AUTHORITY ON LOANS
Mean (Standard Deviation)

	B A N K S ^{a/}		
	RB	KB Branch	Significance ^{b/}
Branch Manager's Lending Limit	P8,667 (6,673)	P651,667 (837,972)	.0001
Average Loan Size	P11,127 (10,937)	P 93,529 (58,005)	.0001
Manager's Lending Limit as Percent of Average Loan Size	135% (132%)	1,102% (1,491%)	N.S.

^{a/} Insufficient data on PDB branches.

^{b/} K-S Two-Sample Test

The theory regarding the potential conflict between ownership and management is still not well-established. It is posited ^{g/} that control and efficiency problems arise if owners delegate the management of the firm to professional managers. In such a case, managers might allocate to themselves corporate prerequisites and still not work as hard (as compared to an owner who manages the business himself). In a sense, this is related to the question of the optimal number of organizational levels which makes for corporate efficiency. By simultaneously acting as a manager, an owner eliminates one more layer that separates him

^{g/} For example, see Horngren (1986), Van Horne (1983).

from the source of revenue - the client. An often-recommended management strategy to cut costs and increase profits is to reduce organizational layers separating the chief operating officers from the bank's clients.^{9/}

An immediate problem arises in comparing RFIs according to the owner's role in management. As previously shown, most RBs are owner-managed while most PDB and all KB branches are not. Consequently, a comparison on owner versus management basis cannot be practically distinguished from that of a comparison of RBs and PDBs as separate groups. For example in Table 13, it is indicated that the return on assets of owner-managed RFI's is significantly lower while its equity base is not significantly different from non-owner managed RFIs.

But the same result holds true for RBs relative to PDB branches as well.^{10/}

A simultaneous evaluation of the ownership and organizational structure variables (level) can be made by including them in a multiple regression involving return on assets. One would expect the return on assets ratio to be significantly related to key a balance sheet ratio like deposit to loans ratio and productivity indicators like the ratio of

^{9/}

Reference to Johnson and Johnson (1985, p. 32).

^{10/}

As Table 10 (item 1) shows, K-S test using RFI type as basis yields significance level of .0001 for return on asset. There is no significant difference in equity percentage for RBs and PDBs.

Table 13

OWNERSHIP, STRUCTURE AND RFI PERFORMANCE
Mean (Standard Deviation)

	B A N K		
	RB	PDB Branch	Significance ^{a/}
1. RFI Type Analysis:			
a) Per Cent of Total Owned-Managed	95%	21%	
b) Return on Assets	0.02 (0.07)	0.08 (0.03)	.0001
c) PerCent of Equity to Net Assets	0.70 (0.43)	0.56 (0.44)	N.S.
2. Owner Type Analysis:			
	B A N K		
	Not Owner Managed	Owner- Managed	
a) Return on Assets	0.05 (0.04)	0.03 (0.07)	.02
b) Per Cent of Equity to Net Assets	0.24 (0.42)	0.73 (0.43)	N.S.

^{a/}
K-S Two-Sample Test

compensation to assets. The question is whether ownership and organization levels significantly increase the explanatory power of the regression.

The regression analysis uses return on assets ratio for 1986 as the dependent variable. A clarification on this measure is that since commercial bank branches transfer a large proportion

of branch deposit to their respective head offices, interest income on such transferred funds was imputed to the branch using the average annual Manila Reference Rate (MRR). This methodological step is equivalent to an assumption that the branch lends out its funds to head office at the current prime lending rate. Regression results were not significant for average compensation, ratio of personnel compensation to assets, deposit to loan (both net loans and the sum of net loans and "due from head office" account) ratio, and deposits to total assets ratio.

Organizational variables such as management by stockholder/owner and the number of organizational levels showed somewhat better results, but these were at best significant at the 10 percent level. Table 11 shows the results of this latter evaluation wherein the signs are as expected, i.e., more levels in organization and ownership by management are negatively related to return on asset. Correlation analysis also showed that average loan size and number of accounts per bank officer are highly correlated with return on assets. However, due to the small sample in this initial data, a valid regression analysis cannot be done.

Table 14

**MULTIPLE REGRESSION OF RETURN ON ASSETS RATIO ON
FINANCIAL AND ORGANIZATIONAL VARIABLES**

Explanatory Variable	Variables in the Regression		
	1, 2 and 3	1 and 2	2 and 3
	Regression Coefficient (t-value) (significance level of t-statistic)		
1. Deposit to Net Loans	-0.003 (-0.434) (0.669)	0.0018 (0.274) (0.786)	
2. Number of Organizational Levels	-0.026 (-1.798) (0.087)	-0.027 (-1.831) (0.080)	-0.018 (-1.350) (0.190)
3. Dummy for Owner-Manager	-0.044 (-1.495) (0.150)		-0.034 (-1.254) (0.222)
4. Intercept	0.172 (2.919) (0.008)	0.138 (2.350) (0.027)	0.136 (2.760) (0.011)
5. \bar{R}^2	0.153	0.071	0.104
6. F of Regression Significance of F-Value	2.44 (0.0924)	2.00 (0.1574)	2.51 (0.1025)
7. Number of Cases	25	27	27

The preceding table shows that the organizational structure of unit banks are associated with higher financial cost structures. The ownership aspect is more ambiguous. RBs are managed completely by its owners unlike other RFI types, thus any analysis-based on the ownership variable reflects all other RFI type-related characteristics. The average loan size and

number of accounts per officer variables deserve further investigation in future studies. These variables are potentially indicative of economies of scale in RFI operations which are eventually reflected in its profit performance.

2. Management Policies and RFI Performance

Given the preceding background on differential management policies pursued by RFIs, the analysis proceeds along the possible implications on: (a) services offered and deployment of staff, (b) deposit mobilization and loans performance, and (c) overall returns and benefits to the RFI stockholders.

Services Offered and Staffing

The RFI management's manpower deployment policy is a significant indicator of the relative importance placed by management on its service lines. A classification of bank staff into three categories, namely deposits, loans and administrative support showed that rural banks allocate more managers and staff for loans while KB branches emphasize deposits and administrative support (see Table 15). In this regard, PDBs operate more like KB branches rather than RBs.

Table 15 shows the results of this analysis. The concentration by KB and some PDB branches on deposit services is supported by the study's preceding findings on deposit management policies. Central or area head control of deposit policies, regular and more frequent review of balances, and incentives-based deposit generation programs support the emphasis

Table 15

**MANPOWER DEPLOYMENT POLICIES
AND SERVICE PERFORMANCE OF RFI's**
Mean (Standard Deviation)

	B	A	N	K	S	
	RBs	PDBs	KBs	KBs	KBs	Significance ^a
1. Number of Personnel in:						
a) Deposits	1.17 (1.11)	1.31 (1.14)	1.93 (2.32)			-
b) Loans	2.7 (1.61)	0.88 (1.54)	0.41 (0.84)			-
c) Administrative Support	3.83 (2.57)	4.25 (2.74)	4.0 (4.31)			-
2. Percentage of Personnel to Total						
a) Deposits	0.12 (0.10)	0.18 (0.12)	0.24 (0.12)			.02
b) Loans	0.31 (0.10)	0.08 (0.12)	0.05 (0.08)			.0001
c) Administrative Support	0.42 (0.12)	0.56 (0.12)	0.56 (0.10)			.004
3. Service Performance						
a) Deposits to Loans	0.52 (0.34)	1.68 (1.60)	41.38 (58.45)			.0001
b) Deposits to Assets	0.37 (0.23)	0.68 (0.30)	0.96 (0.06)			

^{a/} Kruskal-Wallis (K-W) One-Way Analysis of Variance.

of KB and PDB branches on deposits. These management policies may also be related to a "clientele" effect on the RFI's deposit profiles. As shown in Table 16, the average deposits at KB branches are much larger than those of PDBs and RBs.

Table 16
MANAGEMENT MARKETING POLICIES
AND DEPOSIT/LOANS PERFORMANCE
Mean (Standard Deviation)

	B	A	N	K	S	Significance ^{a/}
	RBs	PDBs	PDBs	KBs		
A. <u>Deposit/Loans (Thousand Pesos)</u>						
1. Average Deposits	3.7 (3.7)	14.4 (10.3)		67.1 (41.6)		.0001
2. Loan Approval Limit	8.7 (6.7)	43.8 (41.9)		651.6		.0001
3. Average Loan Size	11.1 (10.9)	222.6 (218.6)		93.5 (58.0)		.0001
a) RB vs. PDB or KB						.0001 ^{b/}
b) PDB vs. KB						N.S. ^{b/}
B. <u>Correlation Analysis</u>						
Loan Limit and Average Loan Size: Kendall's Tau				0.24		
Significance				0.16		

^{a/}
K-W One-Way ANOVA

^{b/}
K-S Two-Sample Test.

Given the present data, it is difficult to explain why KB branches lend so little compared to the large pool of low-cost deposit funds they normally generate. Several suggestions can be made based on Table 16. First, commercial banks encourage their branch managers to lend to large borrowers by allowing them higher loan approval limits at their level. The difference in loan approval limits among the three RFIs is quite significant (per (A2) in Table 16). Second, the loans clientele appears to be of statistically different sizes for the three RFIs (see (A3)). KB and PDB branches do "wholesale" lending while RBs take care of "retail" loans. This suggests market segmentation and possible specialization of each RFI type in certain segments. Third, the "large" segment of the local loans market appear to be limited compared to the resources available to KB branches. Fourth, smaller local loans may not be able to pay high interest if KBs pass on the higher transaction costs associated with this clientele.

Another interesting question is whether the average loan size of an RFI is related to the discretionary authority allowed to the manager. A positive relationship suggests that the manager has a role in expanding the client base of the RFI to include larger clients. A statistical test (Section B in Table 16) correlating the RFI manager's loan approval limit to the RFI's actual average loans per account was done for RBs (being the only case with sufficient data). The result indicates a slight tendency of positive relationship between the manager's lending limit and the average loan size of the bank. For the

limited sample of this study, RBs which allowed higher lending authority to their managers are able to reach out to larger borrowers.

An appropriate summary is a response on the comment in Lamberte (1987) that disparity in deposits performance by KB branches may be due to wide discretionary authority enjoyed by KB branch managers for raising deposits but not for originating loans. The results in this study suggest the opposite. Deposit policies and initiatives are made at head office and the branch manager is given a lending limit which is far higher than the local loans market. This implies that head office policy is the main factor which determines branch operations. Once the head office mandates a deposit priority, the performance of the branch is primarily determined on this basis. The higher lending limit given to managers may even serve as a deterrent because it appears to be set in relation to head office lending norms (e.g., designed to avoid high transaction costs) rather than the market faced by the branch office.

Deposit Mobilization and Loans Performance

The limited survey data on savings campaigns can be used to evaluate whether such efforts are potentially fruitful. Since KBs appear to have far greater deposit generation capacity, the test of any relationship between savings campaigns and deposit generation will be done only for RBs and PDBs. Data is available on savings campaigns for these RFIs, shown in Table 17.

Table 17

**SAVINGS CAMPAIGN AND DEPOSIT
PERFORMANCE FOR RBs AND PDBs**

=====			
B A N K S			
	RBs	PDBs	Significance ^{a/}

1. Savings Campaign (Per Cent of RFIs)			N.S.
a) With active campaign	71.4	68.8	
b) No active campaign	28.6	31.2	

B A N K S			
	With Campaign	No Campaign	

2. Deposits to Assets (Mean)	0.69	0.37	.02
(Standard Deviation)	(0.31)	0.29	

=====

^{a/}
Chi Square

From this table, the propensity to undertake deposit campaigns is statistically equivalent for RBs and PDBs. The resource generation performance of RFIs which undertake deposit campaigns is superior to those which do not, for the survey sample. Meyer (1987, p.6) conjectured that some RBs may have problems in their aggressive deposit mobilization program due to image problems among customers. The evidence in this study indicates otherwise. RFIs undertake such campaigns through a combination of person-to-person promotion, staff incentives and prizes and give-aways to customers. Evidently, deposit campaigns

in the rural sector are not impersonal in approach and well-managed RFIs can think of an appropriate approach to avoid the problem cited by Meyer (1987).

The wide disparity in deposits generation across RFI types carries over to loans performance. Rural banks lend more relative to deposits while PDB and KB branches generate far more deposits than they can (or are prepared to) lend in the local area.^{11/} Excluding the extreme case of KB branches once more, the relative deployment of bank staff for loans and deposit functions is a significant indicator of the financial (loans to deposit) performance of the RFI. This can be seen in Table 15 - the loans to deposit ratio is significantly different for pairs of RFI types.^{12/} Hence while the loan approval limits of KB branches and PDBs far exceed those of RBs', there are just not too many sizeable loans in the rural areas. Given this loan market, the relative number of staff assigned to these functions is actually a good indicator of the financial portfolio of RFIs.

Ownership, Management and Operating Performance

The operating strategies followed by the management of RFIs can be expected to influence their summary operating performance. For example, would the lack of deposits to finance lending by RFIs lead to lower rates of profitability? Is the concentration

^{11/}

The result for PDBs may be somewhat contaminated since some PDBs in the survey are unit banks while others are branches.

^{12/}

Significance of K-S Two-Sample Test are for RBs and PDBs: .002; for RBs and KBs: .0001.

of staff on deposits function among PDBs and KBs associated with a lower overhead cost structure and higher profitability? These questions may be addressed using the profitability ratios as starting point.

A technical question needs to be resolved in the case of KB branches. When deposits for these banks far exceed their loans, the branch income statement would show large deposit interest expense but minimal lending interest income. These losses are aggregated in branch books leading to a negative equity position for some branches. From the viewpoint of the head office, such problems are entirely immaterial to operating decisions and disappear with periodic consolidation of branch accounts for bank-wide financial reporting. For some commercial banks, branches are evaluated based on "contribution margins", in which a transfer pricing policy is implemented. The scheme involves imputing interest income on transfers by branches of their deposit funds to head office. In this study, return on assets is calculated for KB branches (due to the absence of "equity") and branch "profits" include an imputed income based on the Manila Reference Rate (MRR). In KB branches which use transfer prices, the profit figure is not adjusted. A comparison of return on assets is shown in Table 18.

Table 18

PROFITABILITY PERFORMANCE OF RFIs
Percent (Standard Deviation)

	B	A	N	K	S	
	RBs	PDBs	KB	Branches		Significance
1. <u>Return on Assets, Net of Premises</u> (Percent)						
a) All three RFI types	1.96 (7.02)	7.66 (3.07)		2.41 (1.78)		.0001 ^{a/}
b) Pairwise Comparisons						
i) RBs and PDBs	-	-		-		.0001 ^{b/}
ii) RBs and KBs	-	-		-		N.S.
iii) PDBs and KBs	-	-		-		.002
2. <u>Adjusted Return on Assets, Net of Premises</u> (Percent)						
(Net Income + Management Fees + Directors Fees) to Assets, Net of Premises	2.67 (7.45)	7.70 (3.04)		N.A.		.001

^{a/} K-W One-Way ANOVA

^{b/} K-S Two-Sample Test. N.S. at 0.20

With the previously described procedure for adjustment of KB branch income, the highest return on asset (ROA) ratio can be found in PDBs followed by KB branches and RBs. It is likely that the ROA for KB branches is understated to the extent that their actual income includes a margin over MRR and the income imputation method is applied on ending branch balances for transfer to head office without considering turnover.

It can be recalled that these rural banks, and private development banks differ on the basis of the ownership variable. Since in most cases, RB stockholders also manage the bank, their personal (or family) income consists of both net profits of the bank and management/directors' fees. If return on assets is adjusted to include this type of bank expenses for both RFI types, the adjusted returns are still statistically different (see Item 2), i.e., rural banks have lower returns. It should be pointed out that the key performance variable is the returns on equity, particularly in evaluating the incentive, and success of owners, in their profit seeking undertaking. Unfortunately, the lack of data did not allow the application of this measure in this study.

The analysis of the incentives to owners and interaction with the management choices is not complete without consideration of DOSRI loans. From the responses given by unit banks regarding the "advantages" of having stockholders with other business interests, it shows that owners can obtain further incentives or benefits through (DOSRI) loans to their other businesses. In concept, the profit to the owner-managers of RFIs is equal to the sum of the net income of the RFI plus their management/directors fees plus advantages gained through any below-market interest rates on DOSRI loans. It is in this context that Tolentino (1987) points to the possibility that rural bankers capture the gains from subsidies to other intended beneficiaries ("The rural bank failed, but the rural banker got rich").

What analysis can show the effects of DOSRI? One approach may be to obtain a correlation of return on assets to the amount of DOSRI loans by RFIs. If DOSRI loans are concessionary in favor of the other businesses there should be a negative correlation between these two variables. The correlation expected is reversed if the loan is concessionary in favor of the RFI. The result: Kendall's Correlation Coefficient Tau ^{13/} of + 0.06 has a significance level of only 0.38. This result could be due to the intervening effect of RFI's expenses in deriving return on assets. Hence another approach may be to look at the average gross interest (income) yield on loans and correlate this with the size of DOSRI for each RFI. Unfortunately, the data in the survey is not sufficient to allow an analysis of the yields on loans of the RFIs. Also, as previously explained, the results may differ when returns on equity is used. These would be interesting subjects for future inquiry.

VII. CONCLUDING REMARKS

The results presented in the paper, while preliminary, show the relevance of analyzing organization and management structure toward understanding the differential characteristics and performance of the three types of RFIs. Unit banks - RBs and to some extent, PDBs - are organized for a balanced offering of deposit and loan services within their own regulatory restrictions. These RFIs tend to show more organizational

^{13/}

The range of Tau is -1 to +1.

levels, hierarchical in staff relationships, and organizational positions compared to branches of KBs. The authority given to RFI managers appear to be more of a function of bank size (and so, RFI type) than management policy. Many decisions remain centralized, especially on key deposits and lending policy aspects. Management structure was also found to be associated with overall RFI performance. The hierarchical and multi-level structure of unit banks is related to the higher overhead cost structure and lower return on asset performance of these banks.

Many of the conclusions derived in this study support previous findings about the operations of RFIs and how one RFI type differs from another. The major ones are now cited by way of summary. First, like rural banks and private development banks, unit banks operate more like community banks, serving the deposits and lending needs of the local area. Commercial bank and development bank branches are not as oriented to community banking, being subject to central decisionmaking authority on deposit and loans policy. At this time, the evidence appears to indicate the dominance of two factors: the profit motive of RFIs and the effects of a regulatory/incentive structure designed to favor loans to urban, large-scale ventures as cited in Tolentino (1987). Hence, KB and PDB branches are predominantly operated as deposit-taking branches. Second, it was found out that RFIs can conduct savings mobilization campaigns and substantially benefit from them. The range of operating strategies available to management in this regard

appears sufficient to overcome common concerns associated with small banks.

Third, the issue of "small" lending portfolio by commercial banks in the local area may be associated with a combination of factors like: (a) a "clientele" effect; (b) poorly developed loans market; and (c) a continuing signal from bank head offices that large loans are encouraged. The higher salary and cost structures of commercial banks appear to be a deterrent for developing their branches into community banking. These factors also make larger loans a prerequisite for profitability of loan accounts. Fourth, given the current state of small loans market, management's deployment of its staff into loans and deposit functions already serve to indicate whether it emphasizes loans or deposits. Policymakers interested in periodic assessment of the banking functions of RFIs can avoid the high costs of financial audits by looking instead at this surrogate indicator.

Fifth, the ownership aspect of RFIs appears to be a key variable in management decisions and RFI performance. Policymakers should view its proposed regulatory schemes in relation to the incentives to owners in a total context. In this respect, innovations need to be made regarding traditional ratios. This ownership variable is the counterpart of the head office in the case of commercial bank branches. Policy analysts should interpret regulations in the light of the wider options available to commercial banks toward a better understanding of intended effects.

Recommendations are not as easy to specify. What clearly emerges is an impression that a number of current conditions must be addressed in order to bring about an organized development of the rural financial system. One condition is the competition of "restricted" rural banks and "centralized" commercial bank branches. Profit-seeking behavior (and restrictions or lack of it) made rural banks more community-based and commercial bank branches more centralized in loans.

An initiative to make thrift banks establish correspondent relationships with commercial banks may enable them to operate more like branches. On the other hand, the exhortations by policymakers for commercial bank branches to be more "community and small business-oriented" will not necessarily be followed by RFIs unless rural loans grow larger (e.g., local businesses develops). Alternatively, commercial banks can acquire more thrift banks in order to enjoy these banks' lower cost structures and be more "community oriented." The findings here can also be applied to branch banking. In a recent news item,^{14/} a banker suggested that Central Bank should give incentives for banks to open branches in the countryside. This study suggests that Central Bank should first reexamine the role of branch banks in the countryside in the context of the range of services prior to granting "incentives."

^{14/} "PCIB seeks easier bank branch rules, The Journal, August 30, 1988.

Policymakers also need to look into innovative means of monitoring RFI performance along key variables that reflect the development of rural finance. A better understanding of branch operations and the actual incentives to owners and managers of rural financial institutions should enable government and analysts to understand the impact of planned regulations and credit programs. This is one area wherein technical development is needed by researchers and analysts to enable them to understand issues such as whether financial subsidies intended for certain beneficiaries are "captured" by the banker in the rural areas.

There are also significant limitations of the study, foremost of which is the fact that the management aspects analyzed in the study are mainly of the "quantitative" variety. For example, the measures of structure, levels and manager-staff distributions variables do not necessarily describe fully the various dimensions of organizational structure. The methodology adopted here merely addresses the need to combine the results across all RFIs surveyed into a "sectoral" picture. This means that there are research possibilities involving case studies of these RFIs. Such microstudies can address the other interesting but more qualitative management and organizational features. The framework offered in this study is useful in case studies as starting point and basis for comparison of results with a "sectoral" management study.

Another limitation is the apparent lack of reference to related issues that mainly affect management structure. For example, results of studies on borrower and lender transaction costs, special government credit programs, transfer pricing policies and savings capacity and mobilization in rural areas may indicate influences in the management of RFIs. There are contemporaneous studies on these aspects which need to be evaluated.

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