
CREDIT RECOVERY OF RURAL BANKS IN NUEVA VIZCAYA: A REVIEW OF INTERNAL CONTROL PRACTICES AND KEY FINANCIAL PERFORMANCE INDICATORS

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ABSTRACT

Rural banks play a crucial role in the economic development of rural communities by facilitating access to credit, enabling farmers, small businesses, and individuals to enhance their livelihoods and invest in productive activities. These financial institutions primarily generate revenue through the interest charged on loans extended to borrowers. However, the necessity of income generation also exposes them to various risks, particularly credit risk. Consequently, there is a critical need for effective safeguard mechanisms to ensure the efficient and effective operation of rural banks' credit delivery and recovery processes. This study aimed to assess the extent of compliance with internal control systems in the credit delivery and recovery processes of rural banks in Nueva Vizcaya and to examine its relationship with their financial performance, as measured by the CAMELS Model. Employing a descriptive correlational research design, the study found that the majority of respondents reported a very high level of compliance with the internal control system. In terms of financial performance, the rural banks demonstrated strong capital adequacy. However, their performance in other areas varied: earnings capability, liquidity, and sensitivity to market risk were rated as fair, while asset quality and management efficiency were rated as poor. Importantly, the study revealed no significant relationship between the extent of compliance with internal controls and the financial performance indicators. Therefore, it can be concluded that the level of compliance with internal control systems is not significantly associated with the financial performance of rural banks.

Keywords: access to credit, CAMELS model, credit risk, safeguard mechanism

INTRODUCTION

Rationale

Over the past 30 years, many advanced economies with well-established markets and long-standing banking systems have experienced notable bank failures or banking crises. Often, these failures stem from internal control deficiencies that allow unauthorized or illicit transactions to result in significant financial losses. An example is what happened to the largest banking firm in Europe, HSBC. Because of their poor money laundering procedures in 2012, it was subsequently fined \$1.9 billion (Sovaniski, 2021). Consequently, central banks remain vigilant about widespread bank failures because these can worsen cyclical recessions and potentially lead to a financial crisis. Today, numerous legal and regulatory reforms in the affected countries have been carried out to reduce the likelihood of future bank failures and mitigate costs (Basel Committee on Banking Supervision, 2004).

As to their primary objective, banks provide credit and earn revenue from interest charges (Mendoza & Rivera, 2017); however, managing these credits poses a significant challenge in banking operations. Boahene et al. (2012) emphasizes that credit quality is a foundational gauge of a bank's financial strength and stability. Hence, the presence of low-quality credit or poor loan standards and according to Basel Committee on Banking Supervision (2000), inadequate loan portfolio risk management and poor credit requirements for counterparties and borrowers, significantly contributes to bank failures. The importance of considering these factors is illustrated by the Philippine banking sector demonstrating robust performance, greatly improving profitability, liquidity, asset quality, and capitalization (Bangko

Sentral ng Pilipinas, 2013).

BSP Circular No. 871, Series of 2015 provides guidelines for internal audit functions and control systems for banks in the Philippines. Aligned with international standards to foster robust control environments in supervised financial institutions, this framework aims to ensure operational efficiency, accuracy of information, and compliance with regulations. Through this, banks are encouraged to establish a tailored internal control framework covering management oversight, risk assessment, control activities, information communication, and monitoring. By integrating these operations, banks can protect assets, ensure accurate reporting, and mitigate risks.

While some studies (e.g. Hanoon et al., 2021) revealed that banks that effectively implemented internal management elements demonstrated enhanced financial efficiency, COSO (2013) highlights the inherent limitations of internal control systems, acknowledging factors beyond an organization's control and the potential for human error and collusion. Effective internal controls aim to mitigate these risks but they cannot truly eliminate them. Instead, they provide reasonable assurance, rather than absolute assurance, regarding achieving operational, reporting, and compliance objectives. Additionally, following BSP Circular No. 871's Subsection X185.2, an efficient internal control system must continuously assess any substantial risks that could affect the bank's ability to meet its performance, information, and compliance goals. The risk assessment must also consider all the bank's risks and internal and external factors to the organization. This includes the complexity of the bank's structure, activities, and personnel, as well as industry changes, technology advancements, and economic conditions that could affect the internal control system. Under BSP Circular No. 871 Subsection 185.3, these control activities must also be integrated into the routine operations of the bank and all levels of employees.

One of the banks that comprise the Philippine banking system are regional rural and cooperative banks whose primary objective is to foster and grow the rural economy. They typically serve small borrowers such as farmers, business owners, market sellers, wage earners, educators, and cooperatives (Meslier-Crouzille et al., 2013). Republic Act No. 7353, also known as the Rural Banks Act of 1992, was enacted to establish, manage, and operate rural banks. It aims to promote comprehensive rural development by ensuring equitable distribution of wealth, income, and opportunities, increasing national production of goods and services, and improving living standards, especially for the less fortunate. Meanwhile, the Monetary Board of the Central Bank of the Philippines is tasked with developing rules and regulations for rural banks' establishment and operation to oversee their functions and provide credit facilities to rural communities.

In 2013, Afriyie and Akotey conducted a study to investigate how credit risk management affects the profitability of rural banks in Ghana. While non-performing loans and the capital adequacy ratio were used as credit risk management indicators, the study used return on asset and return on equity ratios as profitability indicators. The study positively correlated non-performing loans and rural banks' profitability, indicating that these banks are still profitable despite higher loan losses. Furthermore, a positive but insignificant correlation was found between profitability and the capital adequacy ratio.

In the study of Mendoza and Rivera (2017), credit risk was found to have a statistically significant negative connection with profitability. The study's findings also revealed that capital adequacy has no appreciable effect on the profitability of Philippine rural banks. The study suggests that to support their plans, banks should employ improved risk-adjusted performance monitoring and identify the risk factors that have the biggest influence on their financial performance. Banks in rural areas are advised to use credit risk management procedures that outline the loan approval process while adhering to regulatory agencies' sound credit risk

management guidelines. Rural banks must also strengthen their internal control systems to ensure the strict implementation of internal procedures on loan operations.

With this context, this study focused on the credit delivery and recovery of Rural Banks in Nueva Vizcaya. It also included the review of internal control practices on credit delivery and recovery, specifically risk assessment and control activities, and the key financial performance indicators identified by the researchers using the study of Cabaron (2021) as a reference. The data used in assessing their financial performance was gathered through their financial statements for 2021 and 2022. The respondents were limited to the internal auditor, accountants, board of directors, managers, and employees/officers related to credit delivery and recovery of the three (3) main offices listed in the Rural Bankers Association of the Philippines (RBAP).

Statement of the Problem

This study aims to determine the extent of compliance with the internal control system on credit delivery and recovery of Rural Banks in Nueva Vizcaya and its relationship to their financial performance indicators. Conducted during the second semester of the academic year 2023-2024, it sought to answer the following questions:

1. What is the extent of compliance with the internal control system on credit delivery and recovery of Rural Banks in Nueva Vizcaya in terms of the following:
 - 1.1 Risk Assessment; and
 - 1.2 Control Activities?
2. What is the financial performance of Rural Banks in Nueva Vizcaya in terms of the following indicators:
 - 2.1 Capital Adequacy;
 - 2.2 Asset Ability;
 - 2.3 Management Efficiency;
 - 2.4 Earnings Capability;
 - 2.5 Liquidity; and
 - 2.6 Sensitivity to Market Risks?
3. Is there a significant relationship between the extent of compliance of the internal control system on credit delivery and recovery of Rural Banks in Nueva Vizcaya and their financial performance?

Statement of Null Hypothesis

There is no significant relationship between the extent of compliance of internal control systems on credit delivery and recovery of Rural Banks in Nueva Vizcaya and their financial performance.

METHODOLOGY

The study employed a quantitative descriptive-correlational research design to examine the extent of compliance with internal control systems in credit delivery and recovery, as well as the financial performance of rural banks in Nueva Vizcaya using the CAMELS model. Data were gathered through a structured, Likert-scale survey questionnaire adapted from previous studies and administered to 36 purposively selected respondents, including auditors, accountants, managers, and credit officers from three RBAP-member rural banks located in Solano, Bayombong, and Bambang. The instrument collected data on respondents' profiles, bank characteristics, and components of internal control systems such as risk assessment and control activities. Data were analyzed using Microsoft Excel, employing frequency distribution, mean, and standard deviation, while Pearson r was used to test the relationship between compliance

with internal control systems and financial performance indicators. The CAMELS model was applied to evaluate financial performance, and all procedures were conducted with consideration of accuracy, relevance, and confidentiality.

RESULTS AND DISCUSSION

Section 1. The Extent of Compliance with the Internal Control System on Credit Delivery and Recovery of Rural Banks in Nueva Vizcaya

1.2 Risk Assessment

The rural banks' extent of compliance with the internal control system on credit delivery and recovery in terms of risk assessment has an overall mean score of 3.63 (sd=0.342), which indicates a very high level of compliance.

A very high extent of compliance was observed by rural banks in the following parameters: the bank develops contingency plans for managing non-performing loans (NPLs) and potential write-offs (m=3.81, sd=0.401); the bank maintains open lines of communication to ensure a balanced and sustainable lending model (m=3.74, sd=0.443); the bank receives sufficient information to enable a comprehensive assessment of the true risk profile of the borrower (m=3.74, sd=0.394); the bank ensures compliance with relevant regulations and guidelines for managing risk in the banking sector (m=3.72, sd=0.454); the banks utilize the following risk mitigation strategies in credit practices: collateral assessment, insurance and risk - sharing arrangements, monitoring and early warning systems, regular training for employees (m=3.71, sd=0.403); the banks develop a comprehensive incident response plan to address operational disruptions promptly (m=3.63, sd=0.49); the bank's credit practices addresses the borrowers credit history (m=3.58, sd=0.5); the bank implements dual authorization processes and regular audits of disbursement activities (m=3.58, sd=0.5); the bank proactively works with borrowers to assess the impact of loan restructuring on the bank's cash flows and liquidity position (m=3.56, sd=0.773); and the bank takes into consideration scenario analysis in economic conditions when assessing individual credits and their credit portfolios under stressful conditions (m=3.54, sd=0.505).

This suggests that the banks have established a well-defined control in credit delivery as this is crucial for the safe and sound granting of loans. The banks also receive sufficient information to conduct a thorough evaluation of the true risk profile of the borrower or counterparty, such as the loan's purpose and the sources of repayment, as well as the current risk profile (including the nature and total level of risks) of the borrower or counterparty and collateral and their sensitivity to economic and market developments, the repayment history and the current repayment ability of the borrower, based on historical financial trends and future cash flow projections, under various scenarios and if applicable, the adequacy and enforceability of collateral or guarantees, including under various scenarios.

On the other hand, the parameter with the lowest average score was "the bank's credit practices address risk factors" with a mean of 3.29 (sd=0.499), which means that rural banks need to improve their credit practices to address the risk factors and continuously monitor the borrowers' profile to ensure that the loans were used for their intended purpose. Despite the low score, rural banks are still highly compliant in risk assessment.

The overall results indicate that the banks have complied with the standards set by the Monetary Board of the Bangko Sentral Pilipinas (BSP) as embodied in the Circular No. 871, series of 2015, incorporated in the Manual of Regulations for Banks of 2017, which indicates

that they have established a good internal control system in terms of Risk Assessment. This follows COSO Internal Control (2013), which emphasizes that risk assessment involves a dynamic and iterative process that identifies and analyzes risks to achieve the entity's objectives and provides a basis for determining how risks should be managed. Management should always consider possible changes in the external environment and within its business model that could affect its ability to achieve its objectives (COSO, 2013). Burrows (2023) emphasizes that effective risk management is critical for mitigating risks in the banking sector. By implementing a risk management framework, financial institutions can minimize losses, enhance efficiency, secure compliance, and foster confidence in the industry.

1.2 Control Activities

The rural banks' extent of compliance with the internal control system on credit delivery and recovery in terms of control activities is very high ($m=3.53$, $sd=0.404$). Rural banks observe a very high extent of compliance in the following parameters: the bank supervises loan utilization ($m=3.80$, $sd=0.406$); the bank supervises loan repayment ($m=3.71$, $sd=0.458$); the bank's credit file ($m=3.68$, $sd=0.440$); the bank discloses minimum information to borrowers such as the total amount to be financed, finance charges expressed in terms of pesos and centavos, the net proceeds of the loan, and the percentage of the finance charge ($m=3.64$, $sd=0.683$); the preparation and posting of loan records ($m=3.52$, $sd=0.625$); and the bank recovers the loan granted within the repayment period ($m=3.50$, $sd=0.625$). This suggests that these controls set by the rural banks to monitor the borrower's loan utilization and repayment closely were highly implemented to ensure that it is being used according to its purpose stated in the credit application and if borrowers are still capable of fulfilling their commitments. Loan supervision helps prevent defaults, minimize credit risk, and help build a positive relationship between banks and borrowers.

It is closely followed by a great extent of compliance that can be observed in the following parameters; the bank assesses the credit worthiness of the borrower before the granting of loans ($m=3.54$, $sd=0.657$); the preparation and posting of any subsidiary records of loans charged off ($m=3.47$, $sd=0.696$); the preparation and posting of loan records are performed or reviewed by persons who do not also issue official checks and drafts singly ($m=3.44$, $sd=0.652$); the bank recovers the loan granted within the repayment period concerning microfinance loans and livelihood support ($m=3.42$, $sd=0.770$); and the bank provides training to borrowers before receiving their loans ($m=2.94$, $sd=0.924$). This implies that even if observed as highly compliant, rural banks should still improve the segregation of duties to avoid fraud. The banks should also consider training the borrowers to help enhance or increase the likelihood of loan repayment.

The overall extent of compliance is very high, which means that the rural banks in Nueva Vizcaya are compliant with the internal control system set by the Monetary Board of the Bangko Sentral Pilipinas (BSP) as embodied in the Circular No. 871, series of 2015, incorporated in the Manual of Regulations for Banks of 2017. However, there are still areas that need improvement. Control activities by COSO (2013) are the measures put in place by the policies and procedures to ensure that management orders to reduce risks to accomplish goals are followed. These could be proactive or investigative, and they could include a variety of automated and manual tasks such as company performance evaluations, authorizations and approvals, verifications, and reconciliations. Choosing and creating control activities usually incorporates the division of labor. Management chooses and creates substitute control measures when job segregation is impractical.

Section 2. The Financial Performance Indicators of Rural Banks in Nueva Vizcaya on Credit Delivery and Recovery

2.1 Capital Adequacy

Table 1

The Financial Performance Indicators of Rural Banks in Nueva Vizcaya on Credit Delivery and Recovery Under the Capital Adequacy

Financial Ratio	Bank	2022	2021	2022	2021	Average	Rate
CAPITAL ADEQUACY	1	30.12%	32.14%	1	1	31.13%	1
	2	29.65%	29.01%	1	1	29.33%	1
	3	17.19%	15.61%	1	1	16.40%	1

Legend: 1-Strong (Bank is good in every aspect), 2-Satisfactory (Bank is primarily good but has several identified weaknesses), 3-Fair (Bank has financial, operational, or compliance weakness would that give reasons for supervisory concern), 4-Marginal (Bank has serious financial weaknesses that could damage future capability to ensure normal growth and development), 5-Unsatisfactory (Bank has critical financial weaknesses that give a probability of a failure to be extremely high soon).

The equity ratio computed as equity capital/total Assets was used to determine capital adequacy which entails maintaining appropriate capital to absorb potential losses and safeguard stakeholders' interests.

All rural banks performed consistently from 2021 to 2022, having an average rating of 1 with an equity ratio of 31.13%, 29.33%, and 16.40%. These results revealed that the rural banks performed excellently. A rating of 1 or those with an average of > 11% provides evidence that the rural banks are strong and good in capital adequacy. Espenilla (2007) calls for rural banks to have a risk-based capital adequacy ratio of 10%. This requirement is slightly lower than the 11 percent suggested by the CAMELS model as the highest rating for capital adequacy. This regulation aligns closely with the Basel II recommendations, emphasizing the importance of sufficient capital to manage risks effectively.

The consistently high performance of rural banks, as evidenced by their excellent average ratings and strong equity ratios from 2021 to 2022, suggests that these institutions are well-capitalized and financially stable. This strong performance, supported by adherence to capital adequacy standards slightly lower than the CAMELS model but in line with Basel II recommendations, implies that rural banks have a robust buffer against potential financial shocks. Consequently, stakeholders, including investors and regulators, can have increased confidence in the resilience and safety of rural banks. The high capital adequacy ratios not only protect against credit risks but also enhance the perception of rural banks as secured institutions, potentially attracting more investments and deposits. This overall stability fosters a healthier financial environment in rural areas, contributing to economic growth and stability.

2.2 Asset Ability

Table 2

The financial Performance Indicators of Rural Banks in Nueva Vizcaya on Credit Delivery and Recovery Under the Asset Ability

Financial Ratio	Bank	2022	2021	2022	2021	Average	Rate
ASSET ABILITY	1	12.69%	15.72%	5	5	14.21%	5
	2	11.43%	16.72%	5	5	14.07%	5
	3	4.18%	3.17%	3	2	3.67%	3

Legend: 1-Strong (Bank is good in every aspect), 2-Satisfactory (Bank is primarily good but has several identified weaknesses), 3-Fair (Bank has financial, operational, or compliance weakness would that give reasons for supervisory concern), 4-Marginal (Bank has

serious financial weaknesses that could damage future capability to ensure normal growth and development), 5-Unsatisfactory (Bank has critical financial weaknesses that give a probability of a failure to be extremely high soon).

The non-performing to total loans ratio was used to determine asset ability which refers to the proportion of a bank's loans categorized as non-performing assets (NPAs). The non-performing loans ratio serves as an indicator of the quality of the credit decisions of the bank management as the Bangko Sentral ng Pilipinas defines financial assets like loans and investments as non-performing if impaired, marked as doubtful or lost, in litigation, or unlikely to be fully repaid without foreclosing on collateral. Furthermore, loans are non-performing if payments are overdue or delayed by more than 90 days.

Ab-Rahim et al. (2018) found that banks with high loan loss provisions are likely to take on more risk. Additionally, Cayanan (2023) pointed out that more non-performing loans reduce the capital banks have for investment. Therefore, banks should have a lower ratio of non-performing loans to total loans.

From 2021-2022, results show that Bank 1 and Bank 2 were unsatisfactory and might make the probability of failure extremely high soon. However, one of the banks resulted in a strong rating in the aspect of asset ability. In 2021, while Bank 1 and Bank 2 had a rating of 5, which is unsatisfactory, Bank 3 resulted in a rating of 2, which is a satisfactory performance in its asset ability. In 2022, Bank 3 had a rating of 3, a fair performance.

The overall result indicates that Bank 1 and Bank 2 received an average rating of 5 due to a high proportion of non-performing loans. In contrast, Bank 3 received an average rating of 3, implying unsatisfactory and fair performance. This suggests that Bank 3 demonstrates better asset and credit decision quality than Bank 1 and Bank 2. These results of the rural banks' high non-performing loans ratio do not reconcile to the high extent of compliance with the internal control system on credit delivery and recovery, as revealed in table 7.

Karanja (2019) conducted a study on microfinance banks in Kenya, revealing that factors such as income level, age, and gender significantly influence loan repayment defaults, with high loan amounts granted to low-income borrowers correlating with increased default rates.

These findings imply that rural banks' high non-performing loan ratio may be due to broader variables beyond internal control practices, such as borrowers' income level, age, and gender, which have been shown to influence loan repayment defaults significantly.

2.3 Management Efficiency

Table 3

The Financial Performance Indicators of Rural Banks in Nueva Vizcaya on Credit Delivery and Recovery Under the Management Efficiency

Financial Ratio	Bank	2022	2021		2022	2021		Average	Rate
MANAGEMENT EFFICIENCY	5	135.37%	124.66%		5	5		130.02%	5
	2	58.41%	51.24%		5	5		54.82%	5
	3	58.34%	44.88%		5	4		51.61%	5

Legend: 1-Strong (Bank is good in every aspect), 2-Satisfactory (Bank is primarily good but has several identified weaknesses), 3-Fair (Bank has financial, operational, or compliance weakness would that give reasons for supervisory concern), 4-Marginal (Bank has serious financial weaknesses that could damage future capability to ensure normal growth and development), 5-Unsatisfactory (Bank has critical financial weaknesses that give a probability of a failure to be extremely high in the near future).

The total advances/loans receivable to total deposits ratio was used to determine management efficiency. This is in consideration of the bank's operational practices,

decision-making processes, allocation of resources, and overall management strategies to determine how efficiently it operates and generates returns while effectively managing risks. According to Majithiya and Pattani (2010), cited by Rozzani and Rahman (2013), high ratings show that a bank is growing well and has capable employees, which helps the bank expand in the future. Ideally, all banks should demonstrate strong growth and have competent employees who can contribute to the bank's future growth. This means that the lower the ratio of total advances to total deposits, the better or the less risky the bank's position is.

In 2021 and 2022, all banks attained a rating of 5, except for Bank 3 in 2021. This still resulted in an unsatisfactory average rating of 5 for all the banks. Although the ratings revealed an unsatisfactory performance, the ratio of total advances to total deposits may not apply to a rural bank because their primary source of loans is rediscounted loans, which refer to funds that rural banks borrow from larger financial institutions or central banks, using their existing loans or receivables as collateral. Rural banks do not rely heavily on customer deposits to finance their lending activities. Instead, they obtain liquidity by rediscounting their loan portfolio, providing them with additional capital to extend loans to their borrowers. Additionally, the research by Boadi et al. (2016), examining risk factors affecting the profitability of rural and community banks in Ghana, found that management efficiency did not have a notable impact on financial performance or profitability. It does not view management efficiency as a factor that positively influences rural banks' profitability or financial performance.

As a result, traditional metrics such as the total advances to total deposits ratio might not accurately reflect rural banks' financial health or lending capacity since their funding structure is significantly different from that of conventional banks. Therefore, alternative performance indicators that account for the unique funding mechanisms of rural banks should be considered to better assess their operational efficiency and financial stability.

2.4 Earnings Capability

Table 4

The Financial Performance Indicators of Rural Banks in Nueva Vizcaya on Credit Delivery and Recovery Under the Earnings Capability

Financial Ratio	Bank	2022	2021	2022	2021	Average	Rate
EARNINGS CAPABILITY	1	3.80%	3.62%	1	1	3.71%	1
	2	0.66%	1.17%	5	3	0.92%	4
	3	1.29%	0.84%	2	4	1.07%	3

Legend: 1-Strong (Bank is good in every aspect), 2-Satisfactory (Bank is primarily good but has several identified weaknesses), 3-Fair (Bank has financial, operational, or compliance weakness would that give reasons for supervisory concern), 4-Marginal (Bank has serious financial weaknesses that could damage future capability to ensure normal growth and development), 5-Unsatisfactory (Bank has critical financial weaknesses that give a probability of a failure to be extremely high in the near future).

The return on asset ratio computed as net income/total assets was utilized for earnings capability. According to Rahman and Islam (2018), a bank's earnings capability is crucial for evaluating its profitability and performance. This capability enables the bank to endure adverse shocks arising from operational risks.

In this aspect, results were different for the 3 rural bank respondents. In 2021, Bank 1 attained the highest rating of 1 or a ratio of 3.62%, within the range of >1.5%. Banks 2 and 3 resulted in a rating of 3 and 4 with a ratio of 1.17% and 0.84%, respectively. In 2022, Bank 1 maintained a strong position, still rating 1. Bank 2 decreased its ROA to 0.66%, which also resulted in a decrease in rating of 5. Bank 3 increased its ROA to 1.29%, resulting in an increased rating of 2.

Overall, bank 1 attained a rating of 1 or an average ratio of 3.71%. This indicates that the bank's return on assets (ROA) was strong and could perform excellently. Bank 3 had a rating of 3 or an average ratio of 1.07%, indicating fair performance. Bank 2 attained a rating of 4 or an average ratio of 0.92%, an analysis of marginal performance. Therefore, in this aspect, Bank 1 was more efficient and effective in utilizing its assets for income generation than Bank 2 and Bank 3.

As the study determined the earnings capability ratio, it is significant to highlight the research of Amanah (2020), which stated variables influencing the return on assets ratio (ROA) of rural banks in the long term and short term. One of these is the non-performing loan, which revealed a negative and significant effect on earnings capability. This means that an increase in non-performing loans leads to the possibility of problems in cash flows and liquidity. This affects the bank's ability to maximize profits, leading to a lower return on assets ratio. These findings may be true for Banks 2 and 3 but not for Bank 1, which showed a high non-performing loans ratio as shown in table 10, and still attained a high return on assets ratio. Afriyie and Akotey's (2013) research highlights a notable positive correlation between non-performing loans and the profitability of rural banks. These results suggest that rural banks still generate profits despite experiencing higher loan losses.

For Gupta and Shukla (2021), the main concern of earnings capability is the portion of earnings from core banking activities in the total earnings of a bank to ensure sustainability in earnings. This leads to the reason that one possible factor that the result of the study deviates from previous findings is the inclusion of other income from non-core banking activities or those other than interest income on lending operations on the computation of the ratio, specifically to the numerator, which is net income.

2.5 Liquidity

Table 5

The Financial Performance Indicators of Rural Banks in Nueva Vizcaya on Credit Delivery and Recovery Under Liquidity

Financial Ratio	Bank	2022	2021	2022	2021	Average	Rate
LIQUIDITY	1	20.32%	31.48%	1	1	25.90%	1
	2	72.81%	76.40%	4	4	74.61%	4
	3	61.05%	77.12%	2	4	69.09%	3

Legend: 1-Strong (Bank is good in every aspect), 2-Satisfactory (Bank is primarily good but has several identified weaknesses), 3-Fair (Bank has financial, operational, or compliance weakness would that give reasons for supervisory concern), 4-Marginal (Bank has serious financial weaknesses that could damage future capability to ensure normal growth and development), 5-Unsatisfactory (Bank has critical financial weaknesses that give a probability of a failure to be extremely high in the near future).

Liquidity is measured in the ratio of net loans over deposit and short-term funding. It refers to the ability of the bank to convert its assets to satisfy its short-term obligations. Rahman and Islam (2018) argue that a high liquidity ratio indicates the bank's ability to manage liquidity risk, particularly in stable conditions effectively; however, this is not always the case. The bank may not maximize its earnings potential if the ratio is too low. Under the CAMELS Model, a ratio of <60% would attain the highest rating of 1, and a ratio of >80% would result in the lowest rating of 5.

In 2021, Bank 1 attained the highest rating of 1 or a ratio of 31.48%, which is within the range of <60%. Banks 1 and 2 resulted in a rating of 4 with a liquidity ratio of 76.40% and 77.12%, respectively. In 2022, Bank 1 maintained a strong position, still rating 1. Bank 2 could not increase its rating as it remains 4, considered marginal performance. Bank 3 lowered its ratio to 61.05%, resulting in an increased rating of 2.

Overall, results show that on the liquidity ratio, Bank 1 attained a rating of 1 or an average liquidity ratio of 25.90%, which indicates that it has a better liquidity status than Bank 2 and Bank 3. It is interpreted as a strong ability to meet short-term liabilities using its current assets. Bank 2 and 3 had a rating of 3 and 4 or an average of 69.09% and 74.61%, which is fair and marginal performance, respectively. Samuel (2018) highlights the importance of effectively managing banks' short-term liquidity liabilities and loan commitments. Failure to do so can raise funding costs, increase risk in unrated asset categories, and significantly impact profitability and overall performance.

However, determinants of liquidity were analyzed in the study of Boadi et al. (2016) in Ghana, one of which indicated a negative and significant effect between profitability and liquidity of rural banks. The study emphasizes that banks' high liquidity status limits investment prospects, which is likely to increase banks' profitability. This means that an increase in liquidity results in a decrease in profitability.

With these findings, banks must carefully strategize their liquidity management to avoid excessive risk and cost while ensuring they do not overly restrict their profitability potential by holding too much liquidity.

Table 6

The Financial Performance Indicators of Rural Banks in Nueva Vizcaya on Credit Delivery and Recovery Under the Sensitivity to Market Risk

Financial Ratio	Bank	2022	2021	2022	2021	Average	Rate
SENSITIVITY TO MARKET RISK	1	62.68%	67.30%	4	3	64.99%	4
	2	84.98%	26.45%	1	5	55.71%	5
	3	148.96%	208.65%	1	1	178.80%	1

Legend: 1-Strong (Bank is good in every aspect), 2-Satisfactory (Bank is primarily good but has several identified weaknesses), 3-Fair (Bank has financial, operational, or compliance weakness would that give reasons for supervisory concern), 4-Marginal (Bank has serious financial weaknesses that could damage future capability to ensure normal growth and development), 5-Unsatisfactory (Bank has critical financial weaknesses that give a probability of a failure to be extremely high in the near future).

Sensitivity to market risks is computed as current assets minus current liabilities over total capital. Aspal and Dhawan (2016) explained that assessing a financial institution's vulnerability to changes in market conditions, such as shifts in interest rates, exchange rates, and asset prices, is crucial as these changes directly affect the bank's ability to earn profits.

In 2021, Bank 3 attained the highest rating of 1 or a ratio of 208.65%, which is within the range of >80%. Banks 1 and 2 resulted in a rating of 3 and 5 with a ratio of 67.30% and 26.45%, respectively. In 2022, Bank 3 maintained a strong position, still rating 1. Bank 1 resulted in a decreased ratio of 62.68%, which also resulted in a decreased rating of 4. Bank 2 significantly increased its ratio to 84.98%, resulting in an increased rating of 1 from its lowest rating in 2021.

Overall, Bank 3 attained a rating of 1, which is an excellent performance compared to Bank 1 and 2. This is considered that the bank can identify, measure, monitor, and control market risk (Dash, 2017). The study of Ekinci (2016), which investigated the effect of market risk on bank performance, revealed a positive and significant effect on bank performance. This means that effective management of exchange rates and exchange risk can lead to improved returns and greater stability for banks. Banks that adeptly handle these risks will likely experience positive financial outcomes, with increased returns and reduced volatility.

On the other hand, Banks 1 and 2 resulted in a rating of 4 and 5, interpreted as marginal and unsatisfactory performance, respectively. A low sensitivity rating indicates that rural banks

may not be cautious enough when granting loans to borrowers. Their loan portfolios could become problematic, leading to a higher proportion of non-performing loans as they fail to adapt to market conditions (Cabaron, 2021). This implies that despite the strong compliance with internal control systems for credit delivery and recovery, the rural banks still face a high ratio of non-performing loans, negatively impacting their sensitivity rating. The rural banks' low sensitivity rating reflects their vulnerability to market risks and inability to adapt their loan portfolios in response to changing market conditions, further jeopardizing their financial stability and performance.

Section 3. Significant Relationship in the Extent of Compliance of the Internal Control System on Credit Delivery and Recovery of Rural Banks in Nueva Vizcaya and Their Financial Performance Indicators

Table 7

Relationship in the Extent of Compliance of the Internal Control System on Credit Delivery and Recovery of Rural Banks in Nueva Vizcaya and Their Financial Performance Indicators

Statistics		Risk Assessment	Control Activities
Capital Adequacy	Correlation	-0.122	0.011
	Sig.	0.477	0.947
	N	36	36
Asset Quality	Correlation	-0.087	0.047
	Sig.	0.613	0.785
	N	36	36
Management Efficiency	Correlation	-0.313	-0.236
	Sig.	0.063	0.166
	N	36	36
Earnings Capability	Correlation	-0.32	-0.251
	Sig.	0.057	0.14
	N	36	36
Liquidity	Correlation	0.323	0.26
	Sig.	0.055	0.126
	N	36	36
Sensitivity to Market Risk	Correlation	0.058	-0.075
	Sig.	0.737	0.662
	N	36	36

**Level of significance 0.01*

Capital adequacy has a negative relationship to risk assessment ($r = -0.122$) and a positive relationship to control activities ($r = 0.11$). However, there is no significant relationship between capital adequacy and risk assessment and control activities. The same result can be seen in asset ability. It has a negative relationship to risk assessment ($r = 0.087$) and a positive relationship to control activities ($r = 0.047$). However, there is no significant relationship between the variables. Management efficiency has a negative relationship with risk assessment ($r = -0.313$) and control activities ($r = -0.236$). However, there is no significant relationship between management efficiency, risk assessment, and control activities. Earnings capability also has a negative relationship with risk assessment ($r = -0.320$) and control activities ($r = -0.251$). However, there is no significant relationship between the variables. For liquidity, the result is the opposite of what can be observed in management efficiency and earnings capability. Liquidity positively relates to risk assessment ($r = 0.323$) and control activities ($r = 0.260$). Despite the positive relationship, there's still no significance. Meanwhile, sensitivity to market ratio has a positive relationship to risk assessment ($r = 0.058$) and a negative relationship to control activities ($r = -0.075$). However, there is no significant relationship between the variables tested.

Overall, the extent of compliance with the internal control system in terms of risk assessment and control activities has no significant relationship with the financial performance indicators on credit recovery and delivery of the rural banks.

The results are supported by Cayanan (2023), who found that credit risk management practices do not significantly affect capital adequacy or earnings capability. This is measured by the Capital Adequacy Ratio (CAR) for capital adequacy and Return on Assets (ROA) for earnings capability. The study conducted by Ofei et al. (2020) on banks in Ghana also revealed that control activities did not have a statistical significance on the financial performance of banks in Ghana.

These findings differ from the study by Mwendu and Njogu (2021), who found a positive impact between internal controls, specifically risk assessment and information and communication systems, and the financial performance of Kenyan banks. Similarly, Ayimpoya et al. (2020) discovered that the control environment, risk assessment, and control activities positively and significantly impact financial performance. Hussaini and Muhammad (2018) also discovered a positive and significant relationship between bank performance and the four components of internal control: monitoring, risk assessment, control activities, and control environment. The study of Khalif (2022) in Somalia also agrees that control activities and financial performance are significantly correlated.

As the results of the study deviate from most findings that internal control systems and financial performance are significantly correlated, it can be inferred that while internal control practices on credit delivery and recovery are essential for risk management and ensuring operational efficiency, it is not a guarantee of the collectability of loans because external conditions can change unexpectedly. A study by Wirananda et al. (2022) looked at the role of internal controls over sales, receivables, cash receipts, and cash disbursements. They found that while internal controls are essential for managing receivables, they can't fully ensure collectability because of external factors like economic conditions and changes in customer financial stability. Thus, rural banks should still take into consideration other unpredictable factors.

CONCLUSION AND RECOMMENDATIONS

Conclusion

1. The majority of the bank respondents observed a very high extent of compliance with the standards set by the Monetary Board of the Bangko Sentral Pilipinas (BSP) as embodied in the Circular No. 871, series of 2015, incorporated in the Manual of Regulations for Banks of 2017 which indicates that they have established a good internal control system in terms of Risk Assessment and Control Activities. However, there are still areas that need improvement.
2. The financial performance of rural banks in Nueva Vizcaya on credit delivery and recovery applying the CAMELS model was strong in capital adequacy. The rural banks also had fair performance in earnings capability, liquidity, and sensitivity to market risk but poor performance in asset ability and management efficiency.
3. Compliance with the internal control system on credit delivery and recovery regarding risk assessment and control activities is unrelated to financial performance.

Recommendations

For the Rural Banks in Nueva Vizcaya. It is recommended that rural banks in Nueva Vizcaya focus on improving the practices that only result in a high extent of compliance. Specifically, in terms of risk assessment, attention should be given to the bank's credit practices addressing risk factors such as the non-supervision of loans, diversion of loan funds by borrowers, the stability and adequacy of the borrower's income, and the conditions of the local market.

Regarding control activities, areas for improvement include proper segregation of duties for individuals responsible for charging off loans, issuing checks and drafts, and handling cash, which may provide opportunities for fraud. Rural banks should also enhance their control activities on credit delivery and recovery by thoroughly assessing the creditworthiness of borrowers before granting loans and providing appropriate training to borrowers before loan disbursement. Additionally, efforts should be made to ensure the recovery of microfinance and livelihood support loans within the designated repayment period.

The rural banks in Nueva Vizcaya should also consider assessing their financial performance using the CAMELS model. It is highly recommended that they focus on enhancing their non-performing loans ratio and total advances to total deposits ratio—key indicators of asset ability and management efficiency—which have shown poor performance and could lead to serious financial weaknesses. However, it is important to note that the ratio of total advances to total deposits used in management efficiency may not apply to a rural bank as these types of banks do not rely heavily on deposits from their customers to finance their lending activities but rather also from the rediscounting of loans.

For the School of Accountancy and Business. It is recommended that the School of Accountancy and Business professors incorporate various models of financial performance indicators into their discussions, such as the CAMELS model used in this study. This should include integrating figures from the actual audited financial statements of rural banks or other banks in general. This can prepare and inspire more accounting students by providing a glimpse into an actual institution's real-world operations and outcomes.

For Future Researchers. There should be a wide array of research locales for future researchers to conduct the study to compare the extent of their compliance with the internal control system and financial performance indicators. They may consider the qualitative type of research through interviews to examine and determine the extent of compliance with the internal control system of the rural banks. They may further study the limitations of this study. Also, using financial performance indicators other than the CAMELS rating. Specifically, financial performance indicators that are related to credit delivery and recovery.

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