
RELIANCE OF RURAL BANKS ON THE 5CS OF CREDIT AND THEIR LOAN PERFORMANCE

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ABSTRACT

The 5Cs of credit are fundamental principles lenders use to assess borrowers' creditworthiness. This study aims to determine rural banks' extent of reliance on the 5Cs of credit, their loan performance and if a significant relationship exists between these variables. A structured questionnaire was used in gathering data using descriptive correlational research design. Data was analyzed using the following statistical tools: mean, standard deviation and Spearman Rho through IBM SPSS, while ratio analysis was used to measure loan performance. Findings reveal that rural banks have very high reliance on capacity, capital, collateral and character while high reliance was observed for conditions. Furthermore, it was found that rural banks in Solano, Nueva Vizcaya have exceeded the industry standard ratio for NPL indicating higher exposure to credit risk. The LLP ratio differed among banks, with some falling short of the minimum threshold for a favorable LLP ratio. This indicates that even though banks heavily emphasize the 5Cs, the loan performance does not align with the anticipated correlation. Lastly, it was revealed that no significant relationship can be established between the variables despite the moderate to high level of correlation. This could be a result of limited respondents and highly homogenous responses. For further studies, the researchers recommend that rural banks incorporate diverse financial indicators and improve collection practices, and for the future researchers to increase the number of respondents, expand the questionnaire and to explore qualitative research methods.

Keywords: borrowings, financial performance, LLP ratio, lending criteria, NPL ratio

INTRODUCTION**Rationale**

The rural banking system in the Philippines operates under the Rural Bank Act of 1992, a law enacted to facilitate credit access in rural areas under favorable conditions. Predominantly established within local communities, rural banks play a pivotal role in enhancing the local economy by offering essential financial services. Specifically, they extend credit to merchants and farmers, supporting them through the critical phases of production and marketing.

When banks provide loans to the public, they inevitably face credit risk—the possibility that a customer may fail or be unable to repay principal and interest according to the agreed terms (Triandaru, 2006). In the banking industry, these defaults are termed Non-Performing Loans (NPLs) (Kasmir, 2012). High NPL ratios are a significant concern for management as they jeopardize a bank's financial health and signal poor credit management. For instance, regulatory standards, such as those set by Bank Indonesia (Regulation No. 23/2/PBI/2021), often cap NPL ratios at 5% to ensure institutional stability. Ultimately, poor loan performance—defined as the failure of customers to fulfill repayment obligations (Taylor, 2019)—is a primary driver of bank failures worldwide (Agaba et al., 2022).

To mitigate these losses, banks must implement rigorous credit management procedures. A foundational tool in this process is the 5Cs framework (Byusa & Nkusi, 2012): character which refers to the borrower's reputation and reliability; capacity or the ability to repay the loan based on cash flow; capital or the borrower's personal investment in the venture; collateral or the assets pledged to secure the loan; and conditions, the external environment. By employing these criteria, lenders can precisely categorize loans according to risk, evaluate the present worth of collateral, and gauge the borrower's overall dependability (Mburu et al., 2020). Effective credit analysis ensures that the Board of Directors authorizes loans based on a

borrower's actual repayment ability rather than substandard lending practices (Ogoro & Onditi, 2016).

While numerous studies have analyzed lending criteria and financial access, there is a distinct lack of research focused on Solano, Nueva Vizcaya. Despite Solano housing the majority of rural banks in the province, no study has exclusively examined the extent to which these banks rely on the 5Cs and how this reliance impacts their specific loan performance.

The findings of this research serves several key stakeholders. Financial institutions will gain insights to develop efficient lending criteria, thereby reducing bad debt. Regulators (e.g., Bangko Sentral ng Pilipinas) will be better equipped to formulate policies aimed at improving rural loan performance. Borrowers and business owners will understand the necessary criteria to secure loans more promptly. This study will also expand the literature on rural lending practices, providing a valuable resource for future scholars.

Statement of the Problem

This study determined the extent of reliance of rural banks on the 5 Cs of credit in assessing the approval of business loan applications for MSMEs in Solano, Nueva Vizcaya, Philippines and measured their loan performance. This study was conducted during the first semester of AY 2023-2024; however, the financial indicators used were taken from the rural banks' financial statements for the year ended 2022.

Specifically, the study answered the following research questions:

1. To what extent do rural banks rely on the following lending criterion in assessing the business loan application of MSMEs?
 - 1.1 Borrower's Capacity
 - 1.2 Borrower's Capital
 - 1.3 Borrower's Collateral
 - 1.4 Borrower's Character
 - 1.5 Borrower's Condition
2. What is the loan performance of the rural bank in terms of the following indicators?
 - 2.1 Non-Performing Loan (NPL) Ratio
 - 2.2 Loan Loss Provision (LLP) Ratio
3. Is there a significant relationship between the extent of reliance on the 5Cs of credit and the loan performance in terms of its stated indicators?

Statement of Null Hypothesis

There is no significant relationship between the extent of reliance on the 5Cs of credit and the loan performance.

METHODOLOGY

The study employed quantitative, descriptive-correlational research design and was conducted in Solano, Nueva Vizcaya, the province's business center with a high concentration of rural banks. From nine registered rural banks identified through the Business Permit and Licensing Office, five were selected using convenience sampling—two based on accessible online financial statements and three based on lower cost of data access. Data were gathered using an adapted questionnaire from Jimoh (2013) on lending criteria. Mean and standard deviation were used to assess the extent of reliance on the 5Cs of credit in loan approvals for MSMEs, while ratio analysis—specifically the Non-Performing Loans Ratio (Gross NPL/Total Loan Portfolio) and Loan Loss Provision Ratio (Allowance for Credit Losses/Gross NPL)—was applied to evaluate loan performance. Spearman Rho was then used to determine the relationship between reliance on the 5Cs and loan performance.

RESULTS AND DISCUSSION

Section 1. The Extent of Reliance of Rural Banks on the 5Cs of Credit

Table 1

Summary of the Extent of Reliance of Rural Banks on the 5Cs of Credit

5 Cs of Credit	Mean	SD	QD
Borrower's Capacity	3.98	0.05	Very High Reliance
Borrower's Capital	3.86	0.18	Very High Reliance
Borrower's Collateral	3.90	0.20	Very High Reliance
Borrower's Character	4.00	0.00	Very High Reliance
Borrower's Condition	3.30	0.83	High Reliance

Results show very high reliance on all the Cs except for condition. This could be because the statements under condition cannot be ascertained by the respondents as it may not be a basis for the granting of loan.

If the 5Cs were to be ranked in the order of reliance, character would come first followed by capacity, collateral, capital and condition respectively. However, the margin of difference between 5Cs, with the exception of condition, is very small. It could be inferred that each C is equally important regardless of rank.

Section 2. Loan Performance of Rural Banks

Table 2

Summary of Loan Performance

	Non-Performing Loan (NPL)	(LLP) Ratio
Bank A	12.24%	57.39%
Bank B	12.96%	37.31%
Bank C	13.07%	43.07%
Bank D	12.32%	96.23%
Bank E	10.08%	84.44%

The industry standard for the NPL ratio, set by the BSP, should not exceed 7.49%. However, all the banks have surpassed this threshold, which increases their exposure to credit risk. Elevated NPL ratios across the board suggest that a considerable portion of loans in all five banks is underperforming, indicating poor loan performance.

Two banks meet the minimum required loan loss provision (LLP) ratio of 78.98%, while three fall below the threshold. Banks A, B, and C have low LLP ratios, making them more vulnerable to financial difficulties, such as reduced profitability and potential liquidity crises. In contrast, Banks D and E, despite high non-performing loan (NPL) ratios, maintain higher LLP ratios, reflecting more conservative risk management. Low LLP ratios in most banks indicate poor preparedness for loan losses, which could lead to tighter lending standards, reduced credit availability, and weakened financial health. Banks with sufficient provisioning, like D and E, are better positioned to manage risks and maintain operations.

Section 3. Test of Significant Relationship Between Extent of Reliance on the 5Cs of Credit and their Loan Performance

Table 3

Significant Relationship Between Extent of Reliance on the 5Cs of Credit and Their Loan Performance

		NPL	LLP
Capacity	Spearman's rho	-.354ns	.707ns

	p-value	.559		.182
	QD	Moderate Negative Relationship		Very Strong Positive Relationship
Capital	Spearman's rho	-.112ns		.671ns
	p-value	.858		.215
	QD	Very Weak Negative Relationship		Strong Positive Relationship
Collateral	Spearman's rho	-.354ns		.707ns
	p-value	.559		.182
	QD	Moderate Negative Relationship		Very Strong Positive Relationship
Character	Spearman's rho	-	-	-
	p-value	-	-	-
	QD	-	-	-
Condition	Spearman's rho	.103ns		.205ns
	p-value	.870		.741
	QD	Very Weak Positive Relationship		Weak Positive Relationship

Legend: Very Strong Relationship (≥ 0.70); Strong Relationship (+0.40 – +0.69); Moderate Relationship (+0.30 – +0.39); Weak Relationship (+0.20 – +0.29); Very weak Relationship (+0.01 – +0.19); No Relationship (0 – +0.009); ns- not significant

Table 3 presents the correlation analysis to test the relationship between the 5Cs of credit, non-performing loan (NPL) ratio and loan loss provision (LLP) ratio. No significant relationship can be established between the variables despite the moderate to high level of correlation. This means that a high relationship result is only limited to the five banks who participated in the study and generalization among similar types of banks cannot be done. Thus, the null hypothesis is accepted since there is not enough evidence to reject it. This could be a result of limited respondents and highly homogenous responses.

Spearman's rho correlation results revealed moderate negative relationship between capacity and NPL ratio ($\rho = -.354ns$; $p = .559$). This implies that there is not enough evidence to support the claim that these variables are related. On the other hand, capacity was found to have a very strong positive relationship with the LLP ratio which is supported by the computation ($\rho = .707ns$; $p = .182$).

An analysis of the relationship between capital and NPL ratio and LLP ratio was tested for significance. From the computed Spearman's rho correlation, it was found that capital and NPL ratio have a very weak negative relationship ($\rho = -.112ns$; $p = .858$). Conversely, LLP ratio and capacity are revealed to share a strong positive relationship ($\rho = .671ns$; $p = .215$).

The result of Spearman's rho correlation showed a moderate negative relationship between collateral and NPL ratio ($\rho = -.354ns$; $p = .559$). In contrast, correlation results of collateral and LLP ratio displayed a very strong positive relationship ($\rho = .707ns$; $p = .182$).

As for character, data was invalidated since there is only one type of response.

Lastly, through Spearman's rho correlation, condition was revealed to have a very weak positive relationship with the NPL ratio ($\rho=.103$ ns; $p=.870$). Similarly, condition and LLP ratio also have a weak positive relationship ($\rho=.205$ ns; $p=.741$).

The findings of this research differ from those reported by Agaba et al. (2022), which identified a strong positive correlation between credit risk assessment and loan performance. This significant correlation suggests a linear relationship, implying that financial institutions with rigorous credit risk assessments are more likely to achieve successful loan outcomes.

Moreover, non-performing loans, acting as an indicator of credit risk, significantly and positively affect the likelihood of a bank defaulting (Puspitasari et al., 2015). To enhance profitability and mitigate high NPL levels, it is crucial to implement specific strategies for managing non-performing credit. For example, necessary actions include exercising caution when granting loans to customers, conducting thorough monitoring of credit usage, conducting on-the-ground assessments of potential customers' actual situations, and employing the 5C credit analysis to evaluate loan cash flows effectively.

However, in this study, despite the five (5) banks showing high to very high reliance on the 5Cs of credit, the NPL ratio is still high which is contrary to the relationship found in many researches. This could probably be attributed to poor collection controls despite having good controls in the process of granting loans. Additionally, the ratios were taken from the 2022 financial statements which means that some of the loans may have been impacted by the pandemic hence the unpredictable relationship. Furthermore, aging of receivables was not conducted by the researchers which could have had a potential impact on the data gathered for the ratio analysis.

Overall, the researchers observed a negative correlation (inverse relationship) between the 5Cs and NPL ratio. Conversely, a direct relationship between NPL ratio and loan loss provision (LLP) ratio was noted. It means that the more likely it is for customers to default (NPL ratio), the more provisions are created to cover for these defaults. The banking business manages and protects itself from non-performing loans (NPLs) using various credit policies, one of which involves increasing the loan loss provisions (LLPs). LLPs, also known as provisions for bad debts (Ozili & Outa, 2017), are funds set aside to cover expected losses from missed loan payments. When a bank anticipates a loan default, it must record a "provision" in the income statement to create an LLP account on the balance sheet. If a loan's principal and interest become uncollectible, the loan balance is reduced by using the LLPs that were reserved on the balance sheet (Angklomkiew et al., 2009).

CONCLUSION AND RECOMMENDATIONS

Conclusion

1. The rural banks exhibit a very high reliance on borrower capacity, with an overall mean score of 3.98, and similarly high reliance on borrower capital (mean score of 3.86) and collateral (mean score of 3.90). The greatest emphasis was placed on the borrower's character, reflected by an average score of 4.00, while reliance on the borrower's conditions, though significant, was comparatively lower with an average score of 3.30.
2. Despite this substantial reliance on the 5Cs of credit, the results indicated suboptimal loan performance. The Non-Performing loan (NPL) ratios for the banks ranged from 10.08% to 13.07%, all of which surpassed the Bangko Sentral ng Pilipinas (BSP) industry standard of 7.49%, signifying poor loan performance. This higher incidence of loans not being repaid as agreed can lead to financial strain and reduced profitability. Additionally, the loan loss provision (LLP) ratios varied considerably, with Bank D exhibiting the highest ratio at 96.23% and Bank A the lowest at 37.31%, indicating significant differences in how banks manage potential loan losses.

3. Correlation analysis found no significant relationship between reliance on the 5Cs of credit and the loan performance indicators (NPL and LLP ratios). This suggests that the degree of dependence on these credit standards does not directly influence loan performance as measured by these financial indicators

Recommendations

For the Rural Banks. It is recommended that they incorporate diverse financial indicators beyond the traditional 5Cs of credit to enhance loan performance and credit assessment, ensuring a more understanding of a borrower's repayment ability. Moreover, it is suggested that banks should improve collection practices as this could be the reason for a high NPL ratio despite the high reliance on the 5Cs of credit. It could be achieved by developing customized repayment plans tailored to individual borrowers' financial circumstances, including graduated repayment schedules, temporary payment reductions, and effective loan restructuring, which can help borrowers manage their repayments more effectively. This approach aims to improve overall debt repayment performance and reduce the risk of default. Finally, to strengthen financial stability and ensure adequate coverage against potential credit losses, it is recommended that rural banks enhance their loan loss provisioning practices by increasing loan loss provisions, developing and implementing a comprehensive risk management strategy, enhancing credit assessment models, and regularly reviewing and adjusting provisioning practices to align with evolving risk conditions and regulatory requirements.

For the Owners of Businesses. In availing loans, business owners should enhance their understanding and application of these criteria when seeking loans or credit facilities. The 5Cs—character, capacity, capital, collateral, and conditions—are crucial in determining loan eligibility and terms. By aligning the business practices with the 5Cs of credit, the business owners can increase their chances of securing favorable financing from rural banks which is vital to the growth and sustainability of the business.

For the Government. The government may implement nationwide financial literacy programs to educate rural borrowers on the importance of maintaining good credit, understanding loan terms, and managing debt. Furthermore, they should foster an environment where researchers are supported in gathering data for future studies.

For the School of Accountancy and Business. It can incorporate the findings of the study in course discussions particularly in internal control and financial management. This could include letting the students scrutinize and compute financial ratios from actual audited financial statements of rural banks. This experience is geared to provide accounting students ideas of the real-world operations of financial institutions thus making their education more holistic.

For Future Researchers. They may explore additional metrics and use various loan performance indicators to identify critical factors influencing loan repayment. Future researchers could also increase the number of respondents to enhance the reliability and generalizability of the findings. Additionally, expanding the questionnaire to include new categories will allow for the collection of more detailed data, facilitating deeper analysis of factors influencing loan performance. Moreover, they could perform aging of receivables in order to arrive at a more accurate data for the financial ratios. Finally, they may explore qualitative research methods to further assess and gauge the lending practices and controls employed by rural banks which would further study the limitations of this study.

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