International Journal of Social Science Research and Review

http://ijssrr.com
editor@ijssrr.com
Volume 7, Issue 9
September, 2024
Pages: 260-270

The Effect of Fulfillment of Governance Structure on Rural Bank's Performance and Financial Risk
(Study on Rural Banks (BPR) in the Working Area of the Financial Services Authority (OJK) Kediri)

Lya Dahlia; Putra Pamungkas

Faculty of Economics and Business, Sebelas Maret University, Surakarta, Indonesia

E-mail: lyadahlia27@gmail.com

http://dx.doi.org/10.47814/ijssrr.v7i9.2311

Abstract

This research aimed to evaluate the effect of the fulfillment of governance structure on Rural Bank's (BPR) performance and financial risk in the working area of the Financial Services Authority (OJK) Kediri before and after the implementation of Financial Services Authority Regulation (POJK) No. 4/POJK.03/2015. Using a counterfactual approach and difference-in-differences analysis method, this research measured the financial performance indicators of Return on Assets (ROA), Capital Adequacy Ratio (CAR), and Non-Performing Loans (NPL). The present research used a saturated sampling technique in which all members of the population were sampled, which then obtained a total of 630 research samples. The results of the research indicated that the fulfillment of governance structure had a significant negative effect on BPR profitability as measured by ROA, it did not have a significant effect on capital as measured by CAR, and it did not have a significant effect on credit quality as measured by NPL. These findings indicated that the implementation of governance structure, which aimed to improve compliance, had not provided the expected positive effect on BPR financial performance and risk. This research underlined the need to improve human resource competency and more effective operational cost management to achieve optimal benefits from implementing good governance.

Keywords: *Governance Structure; Financial Performance and Risk; Difference in Difference; Rural Bank*

Introduction

In the context of Indonesia banking, BPR plays a role as an important financial intermediary institution, especially in providing access to banking services to people who are not covered by general commercial banks such as farmers, fishermen, small traders, employees, retirees, and micro, small, and medium enterprises (MSMEs) actors. BPR also has different characteristics compared to general banks in terms of asset size, business scope, and limited office networks (Nopiana & Mufidatul, 2018). Although BPR has a significant role in the economy, especially in rural and remote areas, they face various challenges, including intense competition between BPRs and the emergence of technology-based financial companies that are increasingly developing in Indonesia (Raharjo et al, 2021). In this context, good governance is a crucial factor in ensuring BPR sustainability and financial stability (Kartini et al, 2020; Natigor, 2015). OJK has established various regulations to ensure that BPRs implement good governance, one of which is POJK No. 4/POJK.03/2015. However, based on existing data, there are still many BPRs in the working area of OJK Kediri that have not fully complied with the provisions of the established governance structure, for instance the existence of a Director in Charge of the Compliance Function (YMFK Director) and an Executive Officer (PE) for Compliance and Internal Audit.

This research used a counterfactual approach by comparing the financial performance of BPRs before and after the implementation of POJK No. 4/POJK.03/2015. The analysis was carried out by measuring financial performance indicators, namely Return on Assets (ROA), Capital Adequacy Ratio (CAR) and Non-Performing Loans (NPL), as well as the financial risks faced by BPRs. In addition, this research also evaluated the fulfillment of a more complex governance structure that includes the Board of Directors, Board of Commissioners, YMFK Director, and Executive Officers for Compliance and Internal Audit. The research data was collected from BPRs located in the working area of OJK Kediri which includes 10 districts and 3 cities in the former Kediri and Madiun Residency.

In addition, the role of OJK is also very important in supervising and regulating the banking sector, especially BPR, to ensure compliance with applicable regulations and encourage the implementation of good governance (Srinadi & Dwija Putri, 2022). As an institution responsible for regulating and supervising all financial services sector activities in Indonesia, OJK has the authority to ensure that BPR operates in a healthy and sustainable manner (La Ode Sumail, 2021). By implementing good governance, BPR can increase public and stakeholder trust, as well as improve their operational efficiency and financial performance (La Ode Sumail, 2021; Puspitasari & Handayani, 2020). Ultimately, it is expected that this research can contribute to efforts to improve the governance and financial performance of BPR in Indonesia, as well as support the development of a more inclusive and sustainable banking sector. Through good governance, BPR is expected to continue to play an important role as a pillar in the Indonesian economy, especially in providing financial services to people who have not been reached by commercial banks and supporting the growth of MSMEs in remote areas (Bezawada & Adaelli, 2020; Musah, Alhassan and Adutwumwaa, 2021). Based on this description, the study aimed to examine the effect of fulfilling the governance structure on the performance and financial risk of Rural Credit Banks (BPR) in the working area of OJK Kediri. The main focus of this research was to analyze the effect of the implementation of POJK No. 4/POJK.03/2015 concerning the Implementation of Governance for BPR, issued by the Financial Services Authority (OJK) in 2015.

Literature Review

Agency Theory

In its implementation, corporate strategy often develops gradually to adapt to market changes. Within a company, there is a relationship between the principal (shareholder) and the agent (manager) where the agent is mandated to manage the company in the interests of the principal. However, conflicts of interest often occur because managers may have different personal goals from shareholders (Davies, 2014). Agency theory, developed by Jensen & Meckling (2012), examines the costs arising from the relationship between principal and agent, including monitoring costs, costs to ensure that agents act in the interests of the principal (bounding costs), and residual losses when decisions made by the agent are not in accordance with the wishes of the principal. Due to this conflict, management may not always make decisions that maximize shareholder wealth. This is often caused by managers' incentives to maximize personal interests, lack of internal oversight, or manipulation of financial statements (Arslan & Alqatan, 2020). Therefore, agency theory is used to explain the potential misalignment between management policies and shareholder objectives, which can affect the company's financial performance

Governance

Corporate governance is a mechanism for organizing, controlling, and managing a business with the aim of increasing prosperity and accountability (Cadbury committee, 1992). Corporate governance involves the role of the Board of Directors who is responsible for setting strategic goals, exercising leadership, and overseeing the company's operations in accordance with the law and shareholder decisions (Bezawada & Adaelli, 2020). Shareholders play a role in appointing the Board of Directors and auditors to ensure proper governance. According to Haryati & Kristijadi, (2015), good governance is important for creating a system of checks and balances that prevents misuse of resources and supports company growth. The objectives of implementing good governance include reducing agency costs, reducing capital costs, maximizing share value, encouraging professional and transparent management, and maintaining the sustainability of the company's business (Kartini et al, 2020). In the context of banking, good governance involves the application of the principles of openness, accountability, responsibility, independence, and fairness in accordance with OJK Regulations. The governance structure of Rural Banks (BPR) must include the Board of Directors, Board of Commissioners, compliance function, and internal audit to ensure compliance with regulations and manage risks properly. Good governance is expected to support optimal financial performance and protect stakeholder interests (Nopiana & Mufidatul, 2018).

BPR Financial Performance

BPR financial performance is used to assess the BPR health level. Initially, the assessment of BPR health levels used the CAMEL method (Capital, Assets, Management, Earning, and Liquidity). However, based on POJK No. 3/POJK.03/2022, the assessment is now refined with a risk approach that includes risk profiles, governance, profitability, and capital (OJK Board of Commissioners, 2015). This research will look at the financial performance of BPR through three financial ratio indicators including: (1) Profitability which measures the ability of BPR to generate profits and support sustainable operations as measured by the Return on Assets (ROA) ratio. ROA shows how efficiently BPR uses its assets to generate profits, (2) Capital which describes the financial ability of BPR to absorb potential losses. BPR capital consists of core capital and supplementary capital, which is measured through the calculation of the Capital Adequacy Ratio (CAR) which compares the amount of capital to Risk Weighted Assets (RWA), and (3) Credit Quality which is used to assess the quality of BPR's productive assets, which are classified into five categories: current, special attention, substandard, doubtful, and poor. A decrease in credit quality, such as default or bad credit, is calculated as a Non-Performing Loan (NPL), which indicates a higher credit risk.

Framework of Thinking

This research framework refers to several previous studies that aim to determine the effect of the implementation of POJK No. 4/POJK.03/2015 concerning the Implementation of Governance for BPRs, especially the governance structure for BPR financial performance, namely profitability and capital and credit quality as presented in Figure 1.

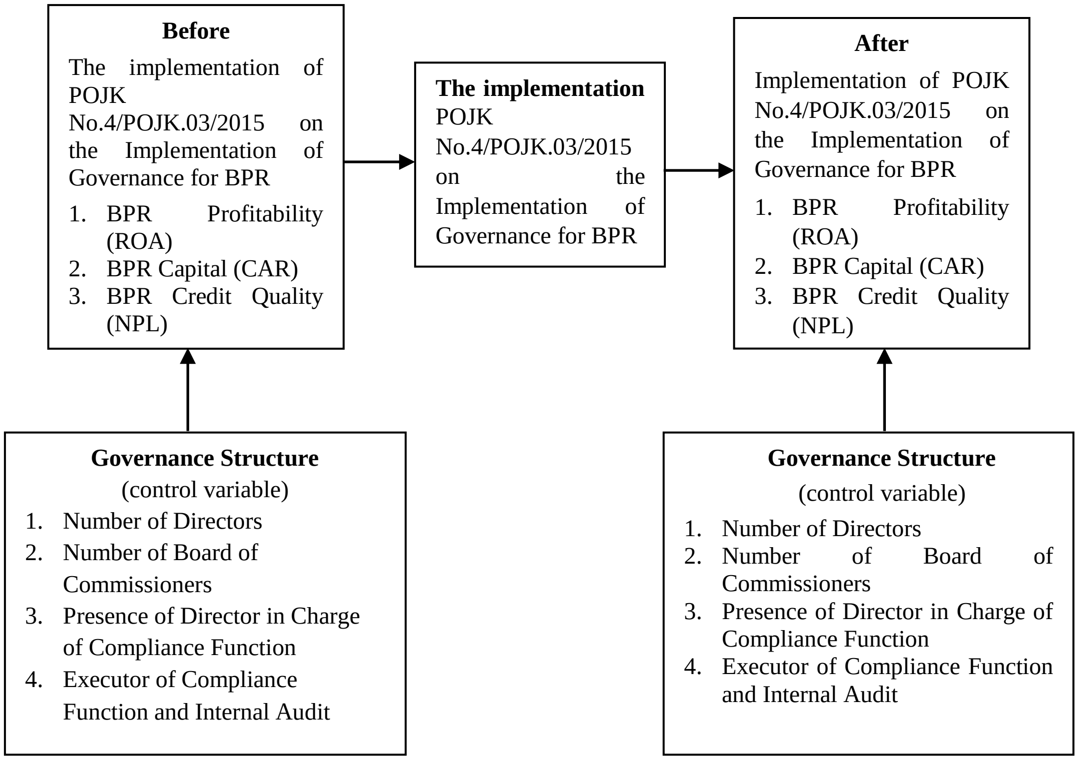

Figure 1. Thinking Framework
Source: Processed data, 2024

Hypothesis Development

1. The Effect of Fulfilling the Governance Structure on BPR's Profitability

The BPR governance structure, especially the number of directors and board of commissioners, has a significant effect on profitability as measured using Return on Assets (ROA). According to POJK, BPR with core capital of less than IDR 50 billion must have a minimum of two directors, which usually consist of an Operational Director and a Business Director. This division of tasks allows focus on each operational area and achievement of credit targets that affect BPR's profitability (Mirchandani, 2018). The director in charge of the compliance function, as well as compliance officers (second line of defense), and internal audit (third line of defense) also play an important role in ensuring that BPRs comply with internal and external regulations, and avoid potential losses (Kassim, 2015). Research shows that the number of compliance and internal audit function implementers has a positive effect on bank compliance, which in turn can improve financial performance (La Ode Sumail, 2021). The Board of Commissioners is tasked with overseeing the strategies implemented by the Board of Directors. Research shows that the number of Board of Commissioners has a significant and positive effect on ROA, which means that good supervision can increase BPR profitability. Therefore, the fulfillment of an effective governance structure can increase BPR profitability (La Ode Sumail, 2021; Rashid et al, 2020).

H1: Fulfillment of the governance structure has a positive effect on BPR profitability.

2. The Effect of the Fulfillment of Governance Structure on BPR Capital

The completeness of the governance structure in BPR, as regulated in the POJK on Governance, aims to ensure that BPR operational activities run in accordance with the established business plan

(Mirchandani, 2018; Rashid et al, 2020). A good governance structure helps BPR to achieve targets set by shareholders while still complying with applicable internal and external regulations. Achieving business targets, including profit, has an effect on increasing BPR capital because profit is an important component in calculating capital (Bezawada & Adaelli, 2020). In addition, the existence of a Director who is responsible for the compliance function is very important to ensure that BPR complies with applicable provisions, including meeting the minimum capital requirements. Research conducted by Widiastuty and Djuminah (2023) shows that the implementation of good governance in BPR has a positive effect on BPR's financial performance. This means that effective governance not only helps BPR in complying with regulations but also improves its financial performance.

H2: Fulfillment of governance structure has a positive effect on BPR capital.

3. The Effect of Fulfillment of Governance Structure on the Quality of BPR Credit

The Board of Commissioners is responsible for overseeing the business strategy carried out by the Board of Directors, including ensuring the implementation of the principle of prudence in credit distribution (Kartini et al, 2020). The minimum number of the Board of Commissioners stipulated in the governance provisions is expected to improve the supervisory function of credit distribution, so that credit quality is maintained according to the maximum limit set by the authorities. Research conducted by La Ode Sumail (2021) showed that better supervision by the Board of Commissioners has a negative effect on Non-Performing Loans (NPL), meaning that the better the supervision, the lower the NPL level. Fulfilling the number of Directors in accordance with the provisions of BPR governance allows for a clear division of tasks and responsibilities, with the Business Director focusing on credit distribution and the Director in Charge of the Compliance Function reviewing the process (Puspitasari & Handayani, 2020). This is important to ensure that credit distribution is carried out with the principle of prudence, minimizing the risk of default, and maintaining credit quality. Research by Bezawada and Adavelli (2020) supports this finding by showing that the number of Directors is negatively related to Non-Performing Assets (NPA). Internal Audit also plays an important role by conducting post-credit disbursement audits to ensure that the credit distribution process is in accordance with applicable regulations. The audit report is provided to the President Director, including if there are indications of irregularities, to minimize the risk of credit failure due to non-compliance with the provisions (Nopiana & Mufidatul, 2018; Puspitasari & Handayani, 2020).

H3: Fulfillment of the governance structure has a negative effect on BPR credit quality.

Research Method

This research used a counterfactual approach by comparing the financial performance of BPR before and after the implementation of POJK No. 4/POJK.03/2015. The research data was taken from BPRs located in the OJK Kediri working area, which covers 10 regencies and 3 cities in the former Kediri and Madiun Residency. A total of 70 BPRs were sampled in this study with research duration from 2012 to 2020 (9 years). The sampling technique used saturated sampling in which all members of the population became research samples because the research required very detailed and accurate data from each member of the population. Thus, there were 630 total samples in this research. This research analyzed various financial performance indicators, such as Return on Assets (ROA), Capital Adequacy Ratio (CAR), and Non-Performing Loans (NPL) as indicators of financial risk faced by BPRs. In addition, this study also assesses the fulfillment of a more complex governance structure, including the Board of Directors, Board of Commissioners, Director in Charge of Compliance Function (YMFK), and Executive Officer (PE) of Compliance and Internal Audit. The operational definition of the variables is presented in Table 1. The panel data regression model will be used in analyzing data that combines time series data with cross-sectional data (Rumayya & Husna, 2021). The regression equation will be written as follows:

〖ROA_it= α+β_1 S_it+ β_2 T_it+β_3 K_it+ε_(i.t);i=1,2,…N;t=1,2,…T ..... (1)

〖CAR〗 _it= α+β_1 S_it+ β_2 T_it+β_3 K_it+ε_(i.t);i=1,2,…N;t=1,2,…T..... (2)

〖NPL〗 _it= α+β_1 S_it+ β_2 T_it+β_3 K_it+ε_(i.t);i=1,2,…N;t=1,2,…T..... (3)

There are three regression models that will be compared, including (1) Profitability (2) Capitalization and (3) Credit Quality. The difference in difference method will be used to evaluate the effect with a quasi-experimental approach. This technique looks at the difference due to intervention through a combination of two methods, namely the comparison of before-after groups and treatment-control groups (Samad, 2010). It seeks considerations from evaluations that estimate the effect of treatment or policies by comparing the results in the treatment group to the control group with data after the implementation of the policy and it is assumed to have different results (Fredriksson & Oliveira, 2019).

Table 1. Operational Definition of Variables

Variables	**Scale**	**Measuring Instrument**	**Description**
Profitability	Ratio	ROA= Net Profit Total Asset x 100%	Dependent (Y_1)
Capitalization	Ratio	CAR= Modal ATMR x 100%	Dependent (Y_2)
Credit Quality	Ratio	NPL= Total NPL Total Credit x 100	Dependent (Y_3)
Implementation of POJK No.4/POJK.03/2015	Category	Dummy Variable 0 (*non-comply*) 1 (*comply*)	Independent (X_1)
Time	Category	Dummy Variable 0 (before the policy) 1 (after the policy)	Independent (X_2)
Number of Directors	Category	Dummy Variable 0 (*non-comply*) 1 (*comply*)	Control (K_1)
Number of Board of Commissioners	Category	Dummy Variable 0 (*non-comply*) 1 (*comply*)	Control (K_2)
Director in Charge of Compliance Function	Category	Dummy Variable 0 (*non-comply*) 1 (*comply*)	Control (K_3)
Executive Compliance and Internal Audit Officer	Category	Dummy Variable 0 (*non-comply*) 1 (*comply*)	Control (K_4)

Source: Processed data, 2024.

Based on the illustration in Figure 2, the DiD method must have four groups that are compared, namely the treatment group (BPR Comply) and the control group (BPR Non-Comply) as well as a comparison of the time period determined based on the time period before and after the implementation of POJK policy No. 4/POJK.03/20215 concerning the Implementation of Governance for BPR.

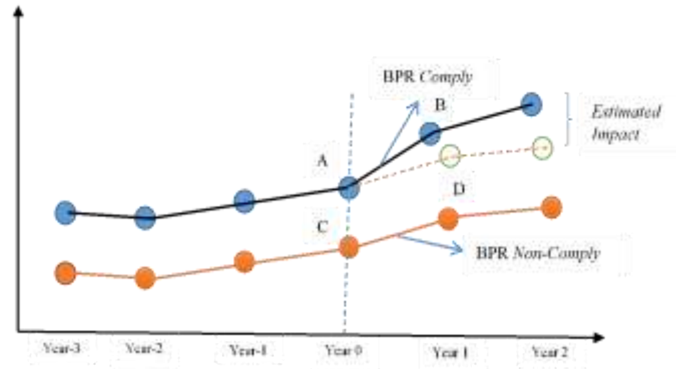

Figure 2. Illustration of the Difference in Differences Method
Source: Processed data, 2024

The basic assumption in applying the DiD method is that the treatment group and the control group must have the same time trend before the policy is implemented (Sihombing et al, 2022; Suprayitno, 2021) so that the results of the DiD method are taken from the difference or difference between the trend of the treatment group and the trend of the control group or called the estimated effect (Samad, 2010). In the analysis using the difference in difference method, there are assumptions that must be met, namely the parallel trend assumption, which is the most important thing to ensure the validity of the DiD model. This assumption requires that the treatment group and the control group will follow the same trend over time if the intervention is not given (Pischke LSE, 2005; Suprayitno, 2021). In the DiD method, hypothesis testing is carried out to determine whether the intervention or treatment has a significant effect on the outcome variable. The criteria for the results of this hypothesis test involve analyzing the interaction coefficient between the time variable and the treatment (Samad, 2010). The analysis required to test the hypothesis with the DiD method approach is: Determination Coefficient Analysis, Effect Significance Test, Coefficient Test (β3).

Result

Before entering the effect analysis, a correlation analysis between variables will be carried out. This was done to see if there is a strong linear relationship between the independent variables. Table 2 shows the VIF values for all independent variables on each dependent variable. All VIF values <10 so it is concluded that there is no multicollinearity between the independent variables.

Table 2. VIF Values

Variables	VIF	1/VIF
X_t	3.94	0.2538
X_s	1.16	0.8637
K_1	1.23	0.8132
K_2	1.13	0.8840
K_3	3.76	0.2658
K_4	1.98	0.5040

Source: Processed STATA output, 2024

After the correlation test, the next was the heteroscedasticity test. This research will use the Breusch-Pagan test to see the presence of heteroscedasticity. This test was needed in analyzing financial data where the data often changes over time and is highly dependent on past volatility. Based on the results presented in table 3, all p-values for the profitability, capitalization and credit quality variables are greater than the significance level of 5% so that it is stated that all residual variants are constant and free from the assumption of heteroscedasticity.

Table 3. Breusch-Pagan Test

Dependent Variables	Prob > Chi^2
Profitability	0.3482
Capitalization	0.6569
Credit Quality	0.6729

Source: Processed STATA output, 2024.

The Parallel Trend Assumption test is conducted to avoid biased and unreliable analysis results in the difference in difference analysis method. Table 4 shows the p-value of the interaction between the time variable and the treatment variable.

Table 4. Parallel Trend Assumption Test

Dependent Variable	X_tX_s
Profitability	0.961
Capitalism	0.236
Credit Quality	0.543

Source: Processed STATA output, 2024

Based on the p-value in table 4, the results of the interaction between the time variable and the treatment variable have greater value than the significance value of 5%. Thus, it is stated that the parallel trend assumption for all dependent variables is met.

Tabel 5. Hasil Uji Hipotesis

Hypothesis	Variable	R Square	Coef.	P > |t|	Result	Direction
Hypothesis 1	Profitability	0.167	-2.337	0.036	Significant	Negative
Hypothesis 2	Capitalization	0.145	-8.954	0.203	Not Significant	Negative
Hypothesis 3	Credit Quality	0,211	0.001	1.000	Not Significant	Positive

Source: Processed STATA output, 2024

Based on table 5, the coefficient of determination value on the profitability variable is 16.7%, capitalization is 14.5% and credit quality is 21.1% which means that all independent variables are able to explain the dependent variable less than 50% for all dependent variables while the rest is explained by other variables outside the model. Furthermore, the effect test is carried out by looking at the value of p>|t| where only the profitability variable has a p-value less than its significance level of 5% while the capitalization and credit quality variables have values greater than 5%. Thus, it is concluded that only hypothesis one has a significant effect.

Discussion

The findings of research are that the fulfillment of the governance structure according to POJK No. 4/POJK.03/2015 has a significant effect on the decline in BPR profitability, which is measured using the Return on Asset (ROA) ratio. In general, good governance is expected to improve financial performance and these results differ from previous studies that showed a long-term positive effect from the implementation of governance. This decline in profitability is caused by several factors, including: (1) increased operational costs in the short term, the implementation of governance policies requires adjustments to the organizational structure and recruitment of additional staff in meeting new provisions so that in the short term it will increase operational costs. If these additional operational costs are not balanced with increased productivity in the management ranks, operational income will not be able to offset the increase in costs. (2) Limited competence and human resources. Many BPRs do not yet have competent human resources to fill new positions such as Director in Charge of Compliance Functions, Compliance Executive Officers, and Internal Audit. This is often caused by a mismatch in educational background, work experience, and lack of relevant training, which ultimately has an effect on the implementation of less effective governance.

Meanwhile, there is no significant effect on the fulfillment of the governance structure on BPR capital because BPR governance policies focus more on compliance values, supervision, and risk control than on increasing capital. In addition, adjustments to governance policies require additional costs that reduce profit margins, thus reducing BPR's ability to increase capital. From the shareholder side, there are restrictions on additional capital deposits due to the decline in BPR profitability, at least until the final deadline for fulfilling the amount of core capital set until 2024. In addition, the fulfillment of the governance structure on credit quality also has no effect due to the ineffectiveness of the compliance function due to lack of competence and limited staff and suboptimal supervision of the board of commissioners in monitoring and discussing credit. Then, the credit committee does not always consider the results of compliance reviews in making credit decisions that should be carried out to minimize credit risk. Internal audits are also not fully effective because credit examinations are not examined in-depth.

Conclusion

Fulfillment of BPR governance structure according to POJK No. 4/POJK.03/2015 has various effect on BPR financial performance. First, fulfillment of governance structure has a significant negative effect on profitability as measured by ROA ratio, mainly due to increased operational costs that are not offset by increased business expansion. Second, there is no significant effect on BPR capital as measured by CAR ratio because the policy focuses more on compliance and supervision than capital increase. Third, fulfillment of governance structure also does not have a significant effect on credit quality as measured by NPL ratio, which is caused by the ineffective implementation of compliance, supervision, and credit decision-making functions.

Limitations

This research only covered BPR in the OJK Kediri area in the period 2012 to 2020, thus the results might not apply to all BPR in Indonesia. There was too much difference in duration between the period before and after the implementation of the policy causing the conclusion to tend to be a short-term effect after the implementation of the policy was carried out. Therefore, it did not provide long-term results. Finally, this research had not considered other factors such as employee work background, staff education, macroeconomic conditions, other government policies, and market dynamics that might influence the results of the research.

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