



## **Political Connections on Board of Management and Banking Performance: Evidence from Indonesia**

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### **ABSTRACT**

This research aims to analyse the connection between political connection of the board of directors and board of commissioners and bank performance in Indonesia from 2007 to 2017. We use the data from all banks with several dependent variables return on asset and Z-score to measuring the banking performance and various independent variables, such as, board of directors and commissioners' political connection, board characteristics and bank specifics. The results showed that political connection of the board of directors and commissioners leads to a good performance in each bank. This is because political parties and other government agencies would want to show good reputation by giving good talents and insights in banks to increase their performance and the nation's economic condition. Banks with political connection would also get several advantages, such as, less risky loans given to firms with the same political connection.

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## INTRODUCTION

Based on Indonesia Corporate Governance Manual (2014), an organization must have a board of directors that is accompanied by commissioners, both with exclusively different functions. Commissioners are liable to supervise the policy made by the managements and to look after their performance generally, and directors have full authority to observe and give directions toward a firm's management on a daily basis. Pathan and Faff (2013) stated that organization's board structure and characteristic affect its performance. These characteristics are important as the corporate governance of banks will also affect a bank's performance (Mizan, 2018). So far, there has not been any previous research focusing solely on the commissioners and directors' political connection towards banks performance in Indonesia after the economic crisis in 1998 and bank consolidation and restructurization in 1999-2007 with the dissolution of the Indonesia Banking Restructuring Agency.

Khwaja and Mian (2005) shows that organizations with strong political connection will obtain easier access to loans from the government or banks with similar political connections too. Often threats such as job transfers or removals, as well as promotions are used to fulfil the loans needed. This will favour the creditors side but on the opposite side might harm the bank whenever such event occurs. Fu et al. (2017) shows the same result by using Indonesia as their sample. Rokhim (2005) finds that political connection will increase related lending in banking industries. It is caused by higher non performing loan and will decrease the banking performance. Moreover, related lending is one the trigger of banking crisis in Indonesia in 1997/1998. Agreeing with these other researches, Liang et al. (2013) also shows that there is a negative effect of political connection in banks toward the banks' performance and loan quality. Chen et al. (2018) also recently found that when there is a financial crisis, banks with political connection tends to underperform. This underperformance is also related to related lending problems and corruption. Therefore, previous researches imply that there is a negative impact for banks with political connection. In alignment with Berger et al. 2009 and Gul, 2006 where it shows that these types of agency problems are bad for banks' performance. Moreover, a research by Cheema et al. (2016) looks at the impact of political connection toward organisational performance in Pakistan that shows a negative impact of political connection toward organisational performance, which could happen because of management inefficiencies and lower profitability if they have to finance political activities. This result is aligned with a research by Haris et al. (2019) which also shows a negative effect of political connections in directors of banks towards each banks' profitability due to easy lending to politically connected firms at lower interest rates and conflicts of interest between political and non-political directors. These negative impacts from politics toward financial institutions are mostly results from bad systems, each country's economic situation, regulators and quality of managers (Chen et al., 2013). On the contrary, Sutopo et al. (2017) shows that there is a positive correlation of political connection towards banks performance due to lower cost of funding compared to others where political connection in Indonesia considered being more important than outside of Indonesia.

Researches in this topic have not reach its consensus due to different bank structure across the globe which urges this paper to see the effect of political connections towards bank performance in Indonesia. This research aims to see the specific impact of political connection within individuals across banks rather the overall board of commissioners and directors. For this research, we will not differentiate between the position of directors and commissioners. This is because Indonesia uses the two-tier board, where the political connection that affects the bank performance could be within the commissioners or directors.

### **An overview of political connections in banks**

In the banking sector, there have been many researches focusing on looking at the effect of commissioners and directors' political connection towards bank profitability. These researches have provided positive and negative implications from those connections toward banks. Faccio (2006) stated that banks that have political connection will give loans easily to other firms with the same political connection. This occurs because when firms with political connections are going bankrupt, many of their partners within that connection will gladly help them from going down, thus making the loan a less risky loan than with other firms with no connection. Banks that have political connection will also get easier access for financing and support from central bank, or other banks with the same connection. Furthermore, banks with political connection could also get fewer obligations to adhere into the regulations made in their sector.

Banks with political connection often needed that specific advantage because the banking sector is heavily influenced by external effects. The unstable environment urges banks to use political connections to help them build stability in their own bank (Kang, 2002). Gu et al. (2008) also stated that banks with political connection could also get more operational help from their partners that will eventually help strengthen their performance. Previous research on Indonesian banks by Sutopo et al. (2017) showed that banks in Indonesia with political connections have positive impact towards their profitability because of the low cost of funding made through those connections.

However, there are also negative implications from these connections towards bank performance. Khwaja and Mian (2005) explained through their research of how banks with political connection could get threatened by firms with the same connection to give them loans, even though it will not be beneficial for the bank itself. Firms with the same political connection could do job transfers and removals for banks that refuses to give them loans. The government will also prioritize the creditors more than the shareholders in a bank to ensure that they have bank safety (Onali et al., 2016). This will ultimately affect banks to always adhere to the governments' interest without following their own interests. This agency problem will give a very bad effect towards bank performance (Berger et al., 2009; Gul, 2006). Previous research by Banerji et al. (2016) also shows that politically motivated intervention in the form of bailing out firms in financial distress could also impair banks' abilities to produce information used in the process of selection and monitoring the borrowing firm's projects. Moreover, politically connected banks could also exploit their connection to further maximize their profits and value by engaging in risky activities, resulting in a riskier bank during financial distress (Braham et al., 2020).

## LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

### Corporate governance in Indonesia

Board structures are divided into two types, that is, the one tier board and two-tier board (Jungmann, 2006). The one tier board is a system that is occupied with executive directors and non-executive directors. While the two-tier boards are separated into two entities, which is the management board and supervisory board. The management board will be occupied with the executive directors, whereas the supervisory board will be occupied by the non-executive directors. All firms in Indonesia usually uses the two-tier board structure, with commissioners in the supervisory board and directors in the management board. International Finance Corporation (2014) on Indonesia Corporate Governance Manual, stated that both commissioners and directors have different objectives in the firm. The commissioners' purpose is to monitor the directors' work and also as an adviser for the firm, while the directors' purpose is to be responsible for the firms' management and also to achieve the objective of the firm itself.

Moreover, in Indonesia evidence has shown that state owned banks and their subsidiaries gets their directors and commissioners chosen by the Minister of State-Owned Enterprises and the President of Republic Indonesia. Indonesia has four state owned banks and three subsidiaries from those banks, where the directors and commissioners are a representative of the government and ruling party. Furthermore, private and foreign banks in Indonesia also have ex-government officials, ex-party administrators, central bank and financial service regulators as members of their board of directors and commissioners, which shows that banks in Indonesia have a lot of political connection. Independent directors and commissioners work with the guidelines from Indonesia Corporate Governance Manual (2014), but in practice there is still alliances where they receive honorarium from the bank concerned.

In addition, the nomination and remuneration in state owned banks and their subsidiaries in Indonesia is also chosen by the minister of state-owned enterprises, where the minister is an agent from the ruling party. Because of this, they can appoint their members in the board of commissioners and directors. This also goes for private owned banks, because these banks are family owned, then to maintain continuity of their business, they need to appoint an impactful person that is close to the ruling party.

However, for this research, we have not discussed about the impact of independent directors and commissioners, audit committee, risk committee, remuneration committee, and nomination committee separately. In practice, the decision of the remuneration and nomination committee will not necessarily be approved by the bank owner, whether it is the Ministry of State Owned Enterprises and the President of Republic Indonesia, or if it's the owner of a private and foreign banks.

### **Political connections in business**

Firms are driven to have political connections because there are incentives from those connections, such as, getting better treatment from government firms, lower tax rates, and also to be chosen often to do government projects (Faccio, 2006). Politically connected firms could also get more help while in financial distress by getting a state intervention (Banerji et al., 2016). These connections are also needed by firms to eliminate uncertainty that stems from regulations made by governments that will affect firms (Hilman, 2005). Furthermore, when the market is not working effectively, firms could also do expropriation by the help of political connections to get rid of debts made by the firm itself (Bunkanwanicha et al., 2003). This could happen when there exists a large shareholder with lower ownership rights than control rights, which causes them to be vulnerable to entrenchment and would eventually increase their debt ratio to easily facilitate expropriation (Bunkanwanicha et al., 2003). Politicians and government will also want to always have a good relationship with firms to make sure they can always control what the firm will do to achieve their own purpose (Khwaja and Mian, 2005).

Political connections are usually made in countries with unstable economic conditions (Fisman, 2001). In developing countries such as Indonesia, political connections are even seen as one of the main determinants of firms' profitability that will influence investment decisions. In 2018, Indonesia got the ranking of 96 out of all the countries in the world for their corruption, based on the Corruption Perceptions Index. This shows that Indonesia is still suffering to combat money politics. This indicates that money politics still play a huge part in the economic condition in Indonesia. Kang (2002) agrees that every country have their own circumstances, which would make their external threats all differ too. That is why government institutes in each country will have different ways on seeing and developing growth in their own country hence the different type of connections available from the government to the people. Although money politics is generally seen as a negative impact to economic growth, there are certain conditions in which it can actually be beneficial. This could happen if there is a balance of power among a small and stable set of government and business elites, then money politics can actually reduce transaction costs and make long-term agreements and investments more efficient (Kang, 2002). Amore et al. (2013) also stated that political connections can be valuable all over the world, but the channels through which political rent is transferred to connected firms will vary from one country to another. However, in unstable countries, political connection will actually be a negative impact towards their economic condition. Indonesia, as a developing country, have an unstable condition (Fisman, 2001). Business sectors in Indonesia are majorly influenced by political connections happening within those firms, therefore making political connections as a negative implication towards Indonesia's economic condition.

Political connection in firms will have different implications, according to the firm's own sector. The positive and negative effect of political connection in the banking sector has already been explained in section 1 before. However, firms in other sectors also have positive and negative impacts from their political connections. Khwaja and Mian (2005) found that firms with political connection will have easier access to loans from banks with the same political connections. Fu et al. (2017) also stated that Indonesian firms with political connections will also have higher probability in getting a full amount of loans they needed from banks.

Still, there are also researches showing negative impact from political connection toward firms. Previous research by Shleifer and Vishny (1994) showed that firms with political connection are often working inefficiently. This behaviour is caused by political pressures that is originated from the politicians overseeing the firm. Ma et al. (2013) also stated that political connections in private firms are often used to get resources and to make sure the firms will adhere to the objective of the government and politicians related.

### **Hypothesis development**

Previous literature points out that political connections in board of directors and commissioners might play an important role in the banking sector. The primary focus of this paper is to examine the effect of the board of directors and commissioners' political connection toward banks performance in Indonesia. Previous studies

found that political connection could be a positive value for banks which will increase banks' profitability and decrease their risks (Faccio, 2006; Hung et al., 2017).

Specifically, this paper will examine the boards' each own political connection, a set of board characteristics, and banks' financial characteristics that might affect banks' performance.

### *Bank Performance*

The indicator of bank performance that is going to be used in this paper is return on assets and Z-score. The return on variable is one of the most used indicators in the banking sector to show banks profitability's. It will be able to show how efficiently the bank is using their assets to get their potential income (Liang et al., 2013), whereas the Z-score variable is used to show each bank's insolvency risks (Hung et al., 2017).

### *Political Connection*

Instead of using bank names as the cross-section variable, in this paper, we will use the individual names of directors and commissioners of each banks to further see their own impact from the political connections they have toward bank performance. We will use the dummy variable to see the effect of political connections toward bank performance, where directors and commissioners who used to be a member or is a member of the ministry, government or political parties will be given the value of 1. Directors and commissioners with no political connections will be given the value of 0.

### *Board Characteristics*

This paper will use directors and commissioners' gender, education, tenure, and position as a control variable to further explain the relationship of political connection and bank performance in Indonesia. We will use a dummy variable for the gender variable, with men using the value 0 and women using the value 1. For education variable, we will use the value 1 for bachelor's degree, 2 for master's degree and 3 for doctorate degree. The values given for education is only an ordinal variable, so we will only look at the order of the number. We will also use a dummy variable for the position variable, where commissioners will be assigned with the value 0, while directors will be given the value 1.

### *Bank Financial Characteristics*

To further explain the impact of political connection towards bank performance, we are also using several financial characteristics, which is, log total assets, equity to total assets, and operating expenses to operating income ratio. The log total assets variable is used to see the size of each banks and also as an indicator of banks profitability (Liang et al., 2013).

The equity to total assets variable is used to see the capitalization of banks (Liang et al., 2013), where a high capitalization usually means there is an increase in performance and decrease in risks (Hung et al., 2017). The last variable is used to see managerial efficiency in banks, which is the operating expenses to operating income ratio. High operating expenses to operating income ratio indicates that the bank is using too much expenses which shows that they are not running efficiently (Ariefianto et al., 2020; Chou et al., 2016).

Table 1 provides the definitions of each variable and the predicted relationship with bank performance.

Table 1 Definition of variables

| <b>Variables</b>                             | <b>Predicted sign</b> | <b>Measures</b>  |
|--|-----------------------|--|
| <b><i>Dependent variables</i></b>            |                       |  |
| ROA  |                       | Net income/total assets  |
| Z-score                                      |                       | (AverageROA+Equity/Assets)/Standard deviation of ROA   |
| <b><i>Independent variables</i></b>          |                       |  |
| Political Connection                         | +                     | Dummy variable equal 1 if director or commissioner has a political connection                |
| <b><i>Control Variables</i></b>              |                       |  |
| Gender                                       | -                     | Dummy variable equal 1 if director or commissioner is male, 0 if female                      |
| Education                                    | +                     | Dummy variable equal 1 for bachelors degree, 2 for masters degree and 3 for doctorate degree |
| Tenure                                       | -                     | Number of tenure   |
| Position                                     | +                     | Dummy variable equal 0 if commissioner, 1 if director  |
| Log total assets                             | +                     | Natural log of total assets  |
| Equity to total assets                       | +                     | Equity/Assets  |
| Operating expenses to operating income ratio | -                     | Operating expenses/Operating Income  |

## DATA AND RESEARCH METHODOLOGY

### Data

Our sample is an unbalanced panel of Indonesian banks during the period of 2007-2017. The sample of banks for each year will be different, as there are different numbers of banks in Indonesia every year. We include all banks in Indonesia, except for foreign banks and the rural bank. Financial information was mainly obtained from *Thompson Reuters Datastream*, *Indonesian Banking Directory* and each banks' financial statement. The data on detailed board characteristics, such as gender, tenure, education, position and political connection was hand-collected mostly from the individual banks' annual reports and other sources such as news releases. In this model, we will be using each directors and commissioners' names instead of the names of each banks. Hence, it will be fair for banks that does not have a large amount of political connection as to not be categorized together with banks that have a large amount of political connection.

Table 2 Sample Size

| Year | Number of Bank |
|------|----------------|
| 2007 | 105            |
| 2008 | 107            |
| 2009 | 104            |
| 2010 | 108            |
| 2011 | 103            |
| 2012 | 112            |
| 2013 | 109            |
| 2014 | 108            |
| 2015 | 108            |
| 2016 | 108            |
| 2017 | 106            |

### Empirical methodology

We use two models for each dependent variable specified as the following:

$$\begin{aligned}
 ROA_{it} = & \alpha_0 + \alpha_1 PC_{it} + \alpha_2 Gender_{it+} + \alpha_3 Education_{it} \\
 & + \alpha_4 Position_{it} + \alpha_5 Tenure_{it} + \alpha_6 LogTA_{it} + \alpha_7 ETA_{it} \\
 & + \alpha_8 OE\ to\ OI_{it}
 \end{aligned} \tag{1}$$

$$\begin{aligned}
 ZSCORE_{it} = & \alpha_0 + \alpha_1 PC_{it} + \alpha_2 Gender_{it+} + \alpha_3 Education_{it} \\
 & + \alpha_4 Position_{it} + \alpha_5 Tenure_{it} + \alpha_6 LogTA_{it} + \alpha_7 ETA_{it} \\
 & + \alpha_8 OE\ to\ OI_{it}
 \end{aligned} \tag{2}$$

with each variable specified as *ROA* is bank's return on assets; *ZSCORE* = bank's Z-score; *PC* = dummy variable is used for political connection, with the value of 1 if a director or commissioner has a political connection, and 0 otherwise; *Gender* = directors and commissioners' gender, with the value of 1 if a director or commissioner is a female, and 0 if male; *Education* = directors and commissioners' education level, with the value of 1 for bachelor's degree, 2 for master's degree, and 3 for doctorate degree; *Position* = directors and commissioners' position, with the value of 1 if it's a director, and 1 if commissioner; *Tenure* = directors and commissioners' tenure; *Log TA* = log of total assets; *ETA* = equity to total assets; and *OE to OI* = operating expenses to operating income.

In each model, *i* goes from all Indonesian banks' directors and commissioners, except for foreign banks and rural banks and *t* takes the values of the years from 2007 – 2017.

### Bank performance

In this research, we will be seeing bank performance through their profitability and risk. Following previous literature (Hung et al., 2017; Liang et al., 2013) we use two bank performance measures in our analysis. Return on Asset (ROA) is calculated with net income divided by total assets. This measurement is used to indicate bank profitability and will show how efficient a bank uses its assets to make income (Liang et al., 2013). The Z-score will show insolvency risk in each bank, where a high Z-score will show a bank with low insolvency risk, vice versa (Hung et al., 2017; Boyd and De Nicolo, 2005). These two variables are used as dependent variables to show bank's performance through their profitability and to reflect a bank's probability of insolvency through Z-score (Hung et al., 2017).

*Board political connections*

An individual will be considered to have a political connection if they used to be a member or is still a member of the ministry, government or political parties. We will use dummy variables to simplify the end result of our regression. Previous literatures which have already been mentioned in the literature review section before shows that political connection usually gives positive and negative implication toward bank performance. However, researches by Faccio (2006), Hung et al. (2017) and also Sutopo et al. (2017) showed that banks with political connection will give better performance than banks without political connection because of several things, such as, lower tax rates, less risky loans and lower cost of funding.

*Board characteristics measures*

Following the previous literature by Hung et al. (2017), we measure board characteristics from four variables: gender, education, tenure and position. Previous research made by Hung et al. (2017) showed that men directors and commissioners improves banks performance more than women directors and commissioners. They also stated that a shorter tenure of each directors and commissioners will lead to better performance by banks. Whereas higher education will produce higher profitability and lower risk for banks. Furthermore, the position of directors improves bank performance more than commissioners, in accordance to previous literature by Lefort and Urzua (2008) which showed that directors are more connected to banks managerial implications and day to day operations. For this research, we only use a dummy to differ between directors and commissioners, in the future, it will be better to make it into a percentage to further see the impact of political connection from each position. These variables are used as control variables to further explain the effect of political connections to banks.

*Bank financial characteristics*

We will also be using bank financial characteristics to control our regression. According to previous literature (Hung et al., 2017; Liang et al., 2013; Chou et al., 2016) we measure bank financial characteristics from three aspects: bank capitalization, profitability and managerial efficiency. Log total assets will be used to measure bank size where according to Liang et al., (2013), an increase in bank size will lead to an increase in bank profitability. However, previous research by Abadi et al. (2014) also shows that non performing loans is included in bank asset, which could increase risk in banks too. From our data, we see that along with the increase of log total assets, we get an increase in non performing loans too, which will eventually show that an increase in asset could also produce higher risk for banks.

To measure capitalization, we use the equity to total assets ratio which is calculated by dividing total equity with total assets. A higher capitalization will lead to higher profitability and lower risk (Hung et al., 2017). For managerial efficiency, we use operating expenses divided by operating income. This ratio is a crucial ratio for banks, where a higher value of this ratio shows that a bank is not working efficiently (Chou et al., 2016).

Table 2 reports the descriptive statistics for the dependent and control variables used excluding the dummy variables. The average of our ROA is 0.0181, Z-score is 4.4302, political connection is 0.1641, gender is 0.1140, education is 1.4777, position is 0.5553, tenure is 11.4832, log total assets is 17,9282, equity to total assets ratio is 0.0210, Z-score is 4.4302 and operating expense to operating income ratio is 0.8284.

Table 2 Descriptive statistics

| Variable                                      | Obs   | Mean    | Std. Dev. | Min      | Max     |
|---|-------|---------|-----------|----------|---------|
| <b>ROA</b>                                    | 9,854 | 0.0181  | 0.0317    | -0.8286  | 0.1504  |
| <b>Z-score</b>                                | 9,854 | 4.4302  | 4.5647    | -18.9585 | 36.8541 |
| <b>Political Connection</b>                   | 9,854 | 0.1641  | 0.3704    | 0.0000   | 1.0000  |
| <b>Gender</b>                                 | 9,854 | 0.1140  | 0.3178    | 0.0000   | 1.0000  |
| <b>Education</b>                              | 9,854 | 1.4777  | 0.6068    | 1.0000   | 3.0000  |
| <b>Position</b>                               | 9,854 | 0.5553  | 0.4969    | 0.0000   | 1.0000  |
| <b>Tenure</b>                                 | 9,854 | 11.4832 | 5.8631    | 2.0000   | 53.0000 |
| <b>Log Total Assets</b>                       | 9,854 | 17.9282 | 4.1287    | 11.3931  | 27.7470 |
| <b>Equity Total Assets</b>                    | 9,854 | 0.0210  | 0.0467    | -0.0032  | 0.9056  |
| <b>Z-score</b>                                | 9,854 | 4.4302  | 4.5647    | -18.9585 | 36.8541 |
| <b>Operating expenses to Operating Income</b> | 9,854 | 0.8284  | 0.3076    | 0.0068   | 9.0633  |

This table reports summary statistics on key variables. The sample is an unbalanced panel covering all Indonesian banks except for rural banks and foreign banks in the period 2007–2017. See Table 1 for variable definitions.

The minimum value for our ROA is -0.8286 which occurred in Bank Barclays Indonesia in 2010. This bank has acquired Bank Akita back in 2009, where it always has bad performance. In the end of 2010, they withdrawer all of their investments in Indonesia. For the equity to total assets, our minimum value is -0.0032 which happened in Bank Barclays Indonesia too back in 2009, where they just had acquired Bank Akita. Lastly, for our Z-score variable, our minimum value is -18.9585 given by Bank Alfindo’s low capital in 2007. The central bank even published news reports stating that Bank Alfindo is the bank with the lowest capital in Indonesia in 2007, and is required to do a merger or acquisition in order to operate.

**Panel Data Estimation Regression Model**

*Breusch and Pagan LM Test*

We will do the Breusch and Pagan Lagrange Multiplier Test to see which estimation is better, the pooled least square model or the random effect model. The hypothesis used is:

$H_0$ : using the Pooled Least Square (PLS) (restricted)

$H_1$ : using the Random Effect Model (unrestricted)

After doing the test for the first model, we have this result:

Table 3 Breusch and Pagan LM Test (ROA)  
Breusch and Pagan Lagrangian multiplier test for random effects  
ROA[name,t] = Xb + u[name] + e[name,t]  
Estimated results:

|                  | Var              | sd = sqrt(Var) |
|------------------|------------------|----------------|
| ROA              | 0.00100          | 0.03166        |
| e                | 0.00010          | 0.01400        |
| u                | 0.00010          | 0.01110        |
| Test: Var(u) = 0 |                  |                |
|                  | chibar2(01) =    | 211.70         |
|                  | Prob > chibar2 = | 0.00000        |

By looking at the result, we can see that the probability is under 0.05. This means that using the random effect model will be the better estimator for this model. Then, we do the same method for the 2<sup>nd</sup> model, which uses the Z-score. Below is the result of the test:

Table 4 Breusch and Pagan LM Test (Z-score)  
Breusch and Pagan Lagrangian multiplier test for random effects  
ZSCORE[name,t] = Xb + u[name] + e[name,t]  
Estimated results:

|                  | Var              | sd = sqrt(Var) |
|------------------|------------------|----------------|
| ZSCORE           | 20.8377          | 4.5648         |
| e                | 9.7925           | 3.1293         |
| u                | 10.1429          | 3.1847         |
| Test: Var(u) = 0 |                  |                |
|                  | chibar2(01) =    | 4,653.83       |
|                  | Prob > chibar2 = | 0.0000         |

Based on this result, the probability shows a value under 0.05. We can conclude that the use of random effect model will also be the better estimator for this model. The result of these tests showed a consistent result, which is to use the random effect model for this regression. According to Brooks (2008), random effect model will not erase time-invariant variables, such as the gender variable in this research. Which means the random effect model will be the better estimator. Other than that, with the number of directors and commissioners that are way larger than the research period results in many parameters to be estimated, hence, the random effect model is more suitable (Brooks, 2008). Because of this, without using the Chow and Hausman Test, for this research we will use the random effect model.

**Classic Assumption Test**

To make sure we get the best results from each regression, we should do tests to see if there is any violation which will make the model to not be BLUE (Best linear Unbiased Estimator) anymore. The violations that are going to be tested is heteroskedasticity, autocorrelation and multicollinearity. In this research, since we are using the random effect GLS model, so the heteroskedasticity and autocorrelation have already been removed. Because of that, we will only do a test to see if there is any multicollinearity.

*Multicollinearity Test*

To test for any multicollinearity in regression estimation, we can see from each correlation in each variable. If any variable has a value of coefficient correlation above 0.8, then there is a multicollinearity (Nachrowi, 2008). These are the results for the multicollinearity test for each model.

Table 5 Multicollinearity Test (ROA)

|                                       | ROA     | Political Connection | Gender  | Education | Tenure  | Position | Log Total Assets | Equity Total Assets | Operating Expense to Operating income |
|---------------------------------------|---------|----------------------|---------|-----------|---------|----------|------------------|---------------------|---------------------------------------|
| ROA                                   | 1.000   |                      |         |           |         |          |                  |                     |                                       |
| Political Connection                  | 0.0663  | 1.000                |         |           |         |          |                  |                     |                                       |
| Gender                                | -0.0383 | -0.0347              | 1.000   |           |         |          |                  |                     |                                       |
| Education                             | 0.0542  | 0.2164               | -0.0413 | 1.000     |         |          |                  |                     |                                       |
| Tenure                                | 0.0337  | -0.0007              | 0.0051  | -0.1642   | 1.000   |          |                  |                     |                                       |
| Position                              | -0.0006 | -0.3347              | 0.1357  | -0.1015   | -0.0967 | 1.000    |                  |                     |                                       |
| Log Total Assets                      | 0.0300  | 0.1178               | 0.0320  | 0.1933    | -0.1303 | 0.207    | 1.000            |                     |                                       |
| Equity Total Assets                   | -0.0010 | -0.0439              | 0.0137  | -0.0461   | 0.0375  | 0.1017   | -0.1598          | 1.000               |                                       |
| Operating Expense to Operating Income | -0.8458 | -0.0609              | 0.0351  | -0.0579   | -0.0156 | 0.0033   | -0.0588          | 0.0289              | 1.000                                 |

Note: The table presents the results of Multicollinearity test for the ROA model

Table 6 Multicollinearity Test (Z-Score)

|                                       | Z-score | Political Connection | Gender  | Education | Tenure  | Position | Log Total Assets | Equity Total Assets | Operating Expense to Operating income |
|---------------------------------------|---------|----------------------|---------|-----------|---------|----------|------------------|---------------------|---------------------------------------|
| Z-score                               | 1.000   |                      |         |           |         |          |                  |                     |                                       |
| Political Connection                  | 0.0599  | 1.000                |         |           |         |          |                  |                     |                                       |
| Gender                                | -0.0501 | -0.0350              | 1.000   |           |         |          |                  |                     |                                       |
| Education                             | 0.0398  | 0.2155               | -0.0408 | 1.000     |         |          |                  |                     |                                       |
| Tenure                                | 0.1276  | 0.0013               | 0.0045  | -0.1636   | 1.000   |          |                  |                     |                                       |
| Position                              | 0.0132  | -0.3350              | 0.1362  | -0.1008   | -0.0972 | 1.000    |                  |                     |                                       |
| Log Total Assets                      | 0.0330  | 0.1176               | 0.0314  | 0.1928    | -0.1305 | 0.0196   | 1.000            |                     |                                       |
| Equity Total Assets                   | 0.1161  | -0.0439              | 0.0136  | -0.0461   | 0.0374  | 0.0017   | -0.1595          | 1.000               |                                       |
| Operating Expense to Operating Income | -0.2031 | -0.0604              | 0.0357  | -0.076    | -0.0149 | -0.0025  | -0.0616          | 0.0288              | 1.000                                 |

Note: The table presents the results of Multicollinearity test for the Z-score model

By seeing the results above, there is no multicollinearity within each variable used in this research, because no value of the coefficient correlation is bigger than 0.8. The biggest correlation found is in the model with ROA as the dependent variable, we found the correlation between education and political connection with the value of 0.2164. Moreover, in the model with Z-score as dependent variable, the highest coefficient correlation was also found in the correlation between education and political connection, with the value of 0.2155. The highest correlation value in the ROA model towards the dependent variable is in the political connection, with the value of 0.663. However, the Z-score model shows that the tenure variable has the highest value towards the dependent variable, with the value of 0.1276.

## RESULTS AND DISCUSSIONS

### Basic regression results

The main objective of this paper is to study the impact of political connection in each directors and commissioners on bank performance and risk. We use random-effect regressions with panel data. We regress each performance variable, and then check for robustness by using new dependent variables. We report the main empirical results, including the results of regressing ROA and Z-score on all variables in Table 7 and Table 8.

Table 7 ROA on all variables

| ROA                                    | Coef.   | P> z      |
|--|---------|-----------|
| Political Connections                  | 0.0023  | 0.006**** |
| Gender                                 | -0.0001 | 0.839     |
| Education                              | 0.0011  | 0.023***  |
| Tenure                                 | 0.0001  | 0.001**** |
| Position                               | 0.0007  | 0.174     |
| Log Total Assets                       | -0.0008 | 0.094**   |
| Equity Total Assets                    | 0.0138  | 0.000**** |
| Operating Expenses to Operating Income | -0.0813 | 0.000**** |
| _cons                                  | 0.0817  | 0.000**** |
| R <sup>2</sup>                         | 0.7164  |           |
| Prob > Chi2                            | 0.0000  |           |

Note: The table presents the results of regressing ROA on various board and financial variables. The table reports the regression coefficients, t-statistics (in parentheses), Chi<sup>2</sup> probability and adjusted-R<sup>2</sup>. The definitions of variables are in Table 1. \*Significant at 15% level, \*\* Significant at 10% level, \*\*\* Significant at 5% level, \*\*\*\* Significant at 1% level

Table 8 Z-Score on all variables

| ZSCORE                                 | Coef.   | y         |
|--|---------|-----------|
| Political Connections                  | 1.1696  | 0.000**** |
| Gender                                 | -0.5492 | 0.024***  |
| Education                              | 0.2734  | 0.031***  |
| Tenure                                 | 0.1195  | 0.000**** |
| Position                               | 0.6474  | 0.000**** |
| Log Total Assets                       | -1.0943 | 0.000**** |
| Equity Total Assets                    | 14.385  | 0.000**** |
| Operating Expenses to Operating Income | -1.7082 | 0.000**** |
| _cons                                  | 5.1456  | 0.000**** |
| R <sup>2</sup>                         |         | 0.0542    |
| Prob > Chi2                            |         | 0.0000    |

Note: The table presents the results of regressing Z-score on various board and financial variables. The table reports the regression coefficients, t-statistics (in parentheses), Chi<sup>2</sup> probability and adjusted-R<sup>2</sup>. The definitions of variables are in Table 1. \*Significant at 15% level, \*\* Significant at 10% level, \*\*\* Significant at 5% level, \*\*\*\* Significant at 1% level

Table 7 and 8 shows that political connection has a significantly positive relationship with ROA at the 1% level across both models, which is consistent with previous empirical studies (e.g. Faccio, 2006; Hung et al., 2017; Sutopo et al., 2017). This positive relationship supports the hypothesis that directors and commissioners' political connection will improve bank performance in Indonesia, which can be caused by lower cost of funding, tax rate, and less risky loans made to firms with political connections too. Other than that, political parties and other government agencies would also want to achieve their own objectives, which is by showing high reputations in banks with talents and preferential treatments that they've given to the banks in order to eventually help them finance their own projects in the future (Faccio, 2006).

Gender in the ROA model shows that there are no significant relationship, while in the Z-Score model it shows that there is a negative and significant relationship on the 5% level. This is in accordance to the hypothesis and previous study by Hung et al. (2017) where male directors and commissioners have larger effect on bank performance rather than female directors or commissioners.

Both models show that there is positive significant relationship of education with bank performance, on the 5% level. This is consistent with previous research made by Hung et al. (2017) where higher education level will also improve bank performance. However, for both models the tenure variable shows negative significant relationship on the 1% level, which is in contrary with previous study (Hung et al., 2017). This means that in Indonesian banks, their performance will increase along with the increase of the boards' tenure.

The log total assets variable shows negative significant relationship, both on the ROA and Z-score model. This is also inconsistent with previous literature (Hung et al., 2017; Liang et al., 2013) where they stated that high log total assets will increase bank's profitability. We can conclude by seeing this result that banks in

Indonesia will have an increase on their risk by having an increase in their total assets. This usually happens because of credit risk caused by non performing loans in their asset (Abadi et al., 2014).

Equity to total assets ratio shows positive significant relationship on the 1% level for both models, which is in accordance to previous literature by Hung et al. (2017). This means that a high capitalization in Indonesian banks will increase their profitability and lower their risks. Last but not least, for the operating expenses to operating income ratio, the result shows that this ratio has a negative significant relationship. Where a higher value of operating expenses to operating income ratio shows inefficient banks (Chou and Buchdadi, 2016).

The  $R^2$  in table 7 shows that approximately 71% of the variations in the ROA of banks in Indonesia can be explained when we include 1 independent board variable, four control board variables and three control financial variables. Table 8 shows a value of 5% for their  $R^2$  which shows that the variations in the Z-score of banks in Indonesia can be explained by 5% when we use 1 independent board variable, four control board variables and three control financial variables. Both models have a  $Chi^2$  probability of 0,000 which is significant and indicates that both models are optimal models to be used.

### Robustness checks

We conduct robustness checks by using two new dependent variables. We will be using net interest margin to replace return on assets where they will eventually measure bank profitability. For the Z-score variable, we will use non performing loans, where it will show risks in each banks. We expect that political connections in each directors and commissioners will have a positive relationship with net interest margin, and a negative relationship with non performing loans. In table 9 and 10, we will report our robustness regression results.

Table 9 NIM on all variables

| NIM                                    | Coef.   | Probability |
|--|---------|-------------|
| Political Connections                  | 0.4817  | 0.0010****  |
| Gender                                 | -0.2518 | 0.1230*     |
| Education                              | 0.1128  | 0.1780      |
| Tenure                                 | 0.0125  | 0.1030*     |
| Position                               | 0.1419  | 0.1010*     |
| Log Total Assets                       | -0.0857 | 0.0000****  |
| Equity Total Assets                    | 1.2213  | 0.0010****  |
| Operating Expenses to Operating Income | -0.9449 | 0.0000****  |
| _cons                                  | 9.1355  | 0.0000****  |
| $R^2$                                  | 0.0691  |             |
| Prob > Chi2                            | 0.0000  |             |

Note: The table presents the robustness test results of regressing NIM on various board and financial variables. The table reports the regression coefficients, t-statistics (in parentheses),  $Chi^2$  probability and adjusted- $R^2$ . The definitions of variables are in Table 1. \*Significant at 15% level, \*\* Significant at 10% level, \*\*\* Significant at 5% level, \*\*\*\* Significant at 1% level

Table 10 NPL on all variables

| NPL                                    | Coef.   | Probability |
|--|---------|-------------|
| Political Connections                  | -0.1040 | 0.1570      |
| Gender                                 | -0.0563 | 0.4970      |
| Education                              | -0.0018 | 0.9660      |
| Tenure                                 | -0.0174 | 0.0000****  |
| Position                               | -0.1602 | 0.0010****  |
| Log Total Assets                       | -0.0369 | 0.0000****  |
| Equity Total Assets                    | -0.8794 | 0.0000****  |
| Operating Expenses to Operating Income | 0.7388  | 0.0000****  |
| _cons                                  | 3.1532  | 0.0000****  |
| $R^2$                                  | 0.0603  |             |
| Prob > Chi2                            | 0.0000  |             |

Note: The table presents the robustness test results of regressing NPL on various board and financial variables. The table reports the regression coefficients, t-statistics (in parentheses),  $Chi^2$  probability and adjusted- $R^2$ . The definitions of variables are in Table 1. \*Significant at 15% level, \*\* Significant at 10% level, \*\*\* Significant at 5% level, \*\*\*\* Significant at 1% level

Table 9 and 10 shows that political connection on net interest margin and non performing loans is consistent with our hypothesis, where it leads to higher bank profitability and lower risk in Indonesian banks. These results are significant at the 1% level and 20% level, which is consistent with our basic regression results and previous literatures (Faccio, 2006; Hung et al., 2017; Sutopo et al., 2017). Other control variables used also on average have the same effect on bank performance as our basic regression results.

## CONCLUSIONS

We use a panel data of all Indonesian banks except rural banks and foreign banks operating in Indonesia from 2007-2017, the result suggest that political connection from either side – boards of director or commissioner – yield a positive and significant effect towards bank performance measured by ROA or Z-score as our dependent variables. Whereas boards characteristic such as gender, in this case men, higher education level, longer term of office, cause a positive impact to the bank by high level of significance with the exception of *gender* to ROA. Furthermore, when using ROA and Z-score as a dependent variable, every controlling variable lays a positive impact to banks performance, besides operating expenses to operating income *ratio*. Overall, we discover that the board of directors and commissioners' political connection, bank financial characteristics and certain characteristics of bank board play a significant role in banks across Indonesia.

The findings of this paper have several implications. For managerial to ponder the characteristic of their board of director and commissioners composition and for regulators to take into account the correlation and to use the information wisely, adjusting the policy to be equitable for all related parties involved including shareholders, clients, investor, government, and the bank itself. Due to some limitation to this research, we suggest that the next related paper or research to incorporate more dependent and independent variables and also to lengthen the time period of research with expectations of better represent the situation.

Regulators should also monitor closely to make sure that no banks will be used as political devices and would be giving away their financing privileges freely, either by using their business segments or by creating corporate social responsibility programs only to achieve political parties' objectives, which will eventually injure each banks performance by increasing their non performing loans or decreasing their profitability. Based on this result, Indonesia could also use the recommendation given from Chen et al. (2013) for Taiwan financial institutions to improve its supervision system, regulators, quality of managers, ruling party, the country's economic situation or other kinds of major financial-influencing factors. It is also aligned with previous recommendation made by Braham et al. (2020) where politician-bank network should be considered by regulators and market participants.

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