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DO POLITICAL CONNECTIONS AFFECT THE PERFORMANCE OF INDONESIAN REGIONAL DEVELOPMENT BANKS?

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Abstract: *This study was conducted with the aim of examining whether Regional Development Banks (RDBs) in Indonesia which fall under the category as Government-Linked Companies (GLCs) can maintain their independence in performance when political relationships exist between these GLCs and the government as the owner. Data for the study was obtained directly from the official websites of 26 RDBs from the year 2013 to 2016. The collected data was analyzed quantitatively using the Generalized Least Square (GLS) method. The results show that political connections have no effect on the RDBs performance. This finding is consistent with our previous research on RDBs which suggests that even though RDBs are government-owned banks, the operations of RDBs remain independent and professional.*

Keywords: *Regional Development Bank, Political Connections*

Introduction

Government ownership of companies is always a dynamic issue and subject to political and business criticisms. Thus, the topic provides a room for research study. Many researchers have examined the theme of government ownership in businesses. Among others, research by Lau & Tong (2008), Janang, Suhaimi, & Salamudin (2015) and Ting & Lean (2015) examine state-owned enterprises in Malaysia. Mak & Li (2001), Rodan (2004) and Ang & Ding (2006) research this issue in Singapore while Zou & Adams (2008) and Yen (2013) explore the topic in China. In Indonesia, Buchory (2014, 2016) and Harsanti, Ghozali, & Chariri (2016) also investigate the issue of government ownership. Interestingly, the use of the term government-owned companies also varies. For example, Malaysia and Singapore more often refer to government-owned companies as Government-Linked Companies (GLC). Indonesia and some other Asian countries, on the other hand, call it State-Owned Enterprises (SOEs) and in the United States the term Government-Sponsored Enterprises (GSEs) is commonly used.

Most studies conducted on GLCs focus on performance (e.g., Ab Razak, Ahmad, & Aliahmed Jober, 2011; Ang & Ding, 2006; Yeng Wai Lau, 2013). The specific group of research focusing on GLCs suggests a level of curiosity among researchers in the uniqueness of the GLCs and their operations. In fact, according to Huang, Xie, Li, & Reddy (2016), there are at least three weaknesses of GLCs, namely (i) the small opportunity to compete widely; (ii) the rapid development of markets; and (iii) competition with similar companies that can reduce the company's profit. Also, Huang et al. (2016) reveals the shortfalls of government ownerships in these companies. They also suggest that there are opportunities that can be utilized by the GLCs and one of them is the broad political connection.

Unique to Indonesia, government-owned enterprises also include the banking sector and there are several objectives for setting-up government-owned banks. Based on Law No. 19 year 2003 on State-Owned Enterprises, there are three major purposes of establishing state-owned enterprises. Firstly, to contribute to the development of the national economy and increase state revenues. Secondly, to become a pioneer of business activities that cannot be left to the private sector, and thirdly, to actively provide guidance and assistance to small and medium entrepreneurs. At present, 116 banks are operating in Indonesia and 30 of them are government-owned. These 30 government-banks can be further categorized as state-owned banks (4) and local government banks (26). They are often referred to as Regional Development Bank (RDB).

RDB in Indonesia has attracted a lot of interest in recent times. The local government established RDB for regional economic development, and on average has been more than 40 years old. The long-existence of RDBs suggests that these RDBs have had a long experience in the banking business. Almost all local government funds are placed in the RDBs and uniquely, every province in Indonesia has its own RDB. A study conducted by Amdanata & Mansor (2017) provides evidence that local government ownership of RDBs has no significant effect on the RDBs' performance. The finding also suggests that the RDBs have performed the banking activities professionally. Agustin (2016) also reports superior performance of RDBs in Indonesia based on comparisons of financial performance between sharia bank units of national banks and the RDBs' financial performance.

The findings of Agustin (2016) highlight an interesting point. Even though the RDBs are directly controlled by local governments, in addition to being regulated by the Central Bank of Indonesia (CBI) and the Indonesian Financial Services Authority (IFSA), the RDBs' performance was better than the sharia units of the private banks. Indirectly, according to Agustin (2016), the local government has strong influence on the performance of RDBs. Consistent with Agustin (2016), Abdallah & Ismail (2017) also document that the positive effect of corporate governance on performance is the highest when the majority of shareholders are government or local corporations. The findings of Agustin and Abdallah contradict those of Pina, Torres, & Bachiller (2011) who report that the non-ownership structure of savings banks, the lack of best practices of corporate governance mechanisms, and political presence have weakened the RDBs. Similarly, Shen & Lin (2012) conclude that government intervention also results in poor performance of the RDBs.

To date, many studies on the effect of political connections on business performance conclude that political connections benefit firms by providing business opportunities, preferential access to financing, lower tax rates, preferential access to government funding, bailout possibilities and improved corporate performance (e.g., Chen, Luo, & Li, 2014; Claessens, Feijen, &

Laeven, 2008; Ferguson & Voth, 2008; Fisman, 2001; Wu, Wu, Zhou, & Wu, 2012). However, the issue of political connections has not been researched on GLCs involved in the banking sector.

Political and Corporate Conditions in Indonesia

After the economic crisis, Indonesia has made many improvements in various sectors to keep up with economic growth and development in order to compete effectively in the global economy. Laws, politics, and economics are the sectors that are of primary concerns to the government for reform. Many regulations were put in place to properly regulate these three sectors since they are interconnected. All parties are aware that the economic crisis that hit Indonesia in 1997 was caused by the weakness of corporate governance, added with the absence of legal and political certainty of corruption, collusion and nepotism practices that have taken root in Indonesia. The valuable lesson then becomes the background for Indonesia to implement various regulations so that the economic crisis will not repeat itself, and if repeated, Indonesia is ready to properly handle it.

It is possible that these government reforms may have contributed to local leaders being given opportunities which allow them to work for personal gain. By embracing the system of many parties and the provision of special autonomy, not all provincial leaders in Indonesia belong to the same party as the winning party in the national election. This condition sometimes causes local leaders to attempt to maintain their power. Furthermore, being involved in politics in Indonesia can be very costly. As such local leaders could be forced to use their political power and influence in the operations of companies operating in their areas. In addition to private companies, of course, the easy target would be companies owned by the local governments. According to La Porta, Lopez-De-Silanes, & Shleifer (2002) politicians use the existence of state-owned banks for their purposes. The magnitude of influence and ownership of this regional heads on the local government-owned companies may negatively affect their professionalism. As a result, these companies may avoid political connections with the authorities or with the government.

Literature Review

Political Connections

Relying on Resource-Dependence Theory (RDT), political connections are among the things that influence the company. Hillman, Withers, & Collins (2009) in their review suggests that although the environmental idea created may be the most overlooked idea by RDT field researchers, research in this field supports the following: (a) political action correlates with environmental dependency faced by companies, (b) companies facing the same environment tend to choose the same forms of political behavior to manage them, and (c) increased performance benefits for firms that create relationships with the political environment. Indirectly they claim that the action of RDT supports political action as an effort of company to improve company performance.

Previous studies describe political connections differently. For example, Faccio, M., Masulis, R. W., & McConnell (2006) mentions the political connection as a special relationship between company officials and politicians. On the other hand Fisman (2001) states that the political connection is the proximity of employers and companies to the regime and the family in power.

Claessens et al. (2008) include as political connections when companies provide certain facilities to government employees. According to Y. S. Chen, Shen, & Lin (2014) describe political relations as a relationship between company officials and politicians. They also state that the political connections between one country and another is not the same as the political connection of individuals. Ismail, Kamarudin, & Othman (2012) refers to political connections as when former government officials become high-ranking government-owned companies.

In the present study, political relation is defined as when government officials or retired government officials occupy high positions in government-owned companies. Many conditions occur in Indonesia, when many officials or retired elected officials become commissioners in the company. The role of the commissioner in determining the way the company in Indonesia is regulated by Law No. 40 year 2007 on Persero and is very comprehensive. This condition causes the position of the commissioner to be very significant. The government, as a party providing capital, entrusted the status of this commissioner to government officials or retired government officials. Therefore, having a political connection with the government has its advantages for companies to the extent that it is difficult to distinguish between the government and politics.

Regional Development Bank

Agency relationship is defined as a contract in which one or more persons as owners or shareholders or owners, appoint another person to do some work on behalf of the owner. Those at this point are always referred to as agents or management. A work that is maximized is to include the delegation of authority to make decisions. In this case the management is expected by the owner to be able to optimize the existing resources in the company to the maximum to gain profit.

If both parties maximize their role, it is reasonable that management will not always act in the best interest of the owner. This is very reasonable because in general the owners have long term welfare motives, otherwise management is more short term so that sometimes they tend to maximize profit for the short term by ignoring the sustainability of profit in the long term. To limit or reduce the likelihood of such discrepancies, the owner may determine the appropriate incentives for management by paying a monitoring fee in the form of a salary. With the monitoring cost management will always maximize the welfare of the owner, although management decisions in practice will be different from the wishes of the owner (Jensen & Meckling, 1976).

In relation to political connection, RDB has a vague, theoretical clash of theories between the theory agency and RDT. If it refers to the agency theory, then the owner of the political power of the government is the owner of the RDB. However, if viewed from the side of RDT, the government or political ruler is an environment that must be in condition to be able to improve company performance. but with current RDB positions, it is precisely the RDB that is under the pressure of the owner or political power.

Based on Law No.13 year 1962 on Basic Provisions of Regional Development Banks, the main objective of RDB is to provide financing for the implementation of regional development efforts to succeed national development. The Act also states that the implementation of such businesses involves lending for investment purposes, expansion, and renewal of regional development projects in the region concerned.

As locally government-owned banks RDBs have an advantage in raising public funds, especially from the local governments where the RDB was established. Almost every local government places government funds in RDB. One of the objectives of RDB is to finance the development of provincial and district governments. However, the provincial governments have limitations in loan financing and collections of loan payments. The governments can only raise taxes and restricts the community. Also, the government can not engage in government to business activities, so that the usual agreements of business to business cannot be done. Therefore, the RDBs as intermediary institutions are needed to support the provincial government in in conducting fund-raising activities and fund disbursement.

Local researchers in Indonesia have reviewed the RDB. Call it Suryanto (2015), Buchory (2014, 2016) who examines the RDB. There are also several studies of efficiency-related RDBs as performed by Abidin & Endri (2009); and Sutanto (2015) and all of their research has shown positive results. However, the study only revolves around the influence of financial ratios on RDB performance, not to mention external problems that actually have an effect on RDB performance.

However, with their status as government-owned banks and the dynamic political conditions of each region, the operational activities and objectives of the RDBs are at risk of being subject to political influence and power which eventually may disrupt the efforts of RDBs to achieve their goals.

Pina et al. (2016) conducted a study of 45 savings banks in Spain and report that banks which are influenced by politicians produce low performance. According to them this is due to politicians as holders of power having a strong influence on the policies of companies under the control of the government. Similarly, Sapienza (2004) also supports the finding and concludes that politicians have a strong influence on government-owned companies.

Accordingly, the hypothesis in this study is:

H_1 : Political connections influence the performance of Regional Development Banks in Indonesia.

Methodology and Data

The sample of this research consists of 26 RDBs in Indonesia. The data used are bank data from the years 2013 to 2016 or a total of 104 bank years. The bank data was sourced from the Annual Reports of RDBs and downloaded from the official website of each RDB. The study adopted and modified the research model from Agustin (2016); Bliss & Gul (2012); Y. Chen et al. (2014). Chen and Agustin used the Return on Assets (ROA) of the company in measuring the performance of the company's financial. In this study ROA represents an independent variable. The dependent variable is political connection (POLCON) which is measured by comparing the number of government-linked commissioners, i.e., senior government officer (SGO); former SGO and politician.

To test if political connection influenced bank performance the natural logarithms of board of directors (BOARDSIZE), natural logarithms of the asset (ASSETS), leverage (LEV), Nonperforming Loan (NPL) and Loan to Deposit Ratio (LDR) were used as panel data with pooled ordinary least square (OLS), random effect and fixed effect analysis using the following model:

$$PERF_{it} = \beta_0 + \beta_1 POLCON_{it} + \beta_2 AGE_{it} + \beta_3 lnASSETS_{it} + \beta_4 lnBOARDSIZE_{it} + \beta_5 LEV_{it} + \beta_6 asinNPL_{it} + \beta_7 LDR_{it} + \varepsilon_{it}$$

Where:

PERF	=	Profit before tax and interest on outstanding loans;
POLCON	=	Commissioners are Senior Government Officers or retired Senior Government Officicers or politicians. This variable using the dummy variable; 1 refers to if the Commissioners are Senior Government Officers and 0 if not.
AGE	=	Age of the RDB
ASSET	=	Total assets of the company
BOARDSIZE	=	Size of Directors
LEV	=	Leverage
NPL	=	Non Performing Loan
LDR	=	Loan to Deposit Ratio

Results and Discussion

Table 1 shows the results of the regression model. After doing Hausman Test, the Random Effect model was performed and the analysis suggests that POLCON has no significant effect on the RDBs performance. The Fixed Effect model also produces similar finding. Durbin-Watson Statistic shows a value of 1.976434 which is below 2 and thus, indicating that there is no autocorrelation problem.

Based on the output in Table 1, the Random Effects model results in the adjusted R-square value of 0.1073 while the Fixed Effect model shows the value of 0.6238 for the adjusted R-square. All variables of AGE, ASSETS, BOARDSIZE, LDR and LEV show no significant effect on the RDBs performance except for the NPL ($p=0.0004 < 0.01$). Together, all of the independent variables have a significant influence on the performance of the RDBs at the 10 per cent confidence below ($p = 0.0783$). Although none of the independent variables have a significant influence on the RDBs' performance other than the NPL, the F-test result ($p = 0.011472 < 0.05$) suggests that simultaneously the independent variables affect the performance of the RDBs at a degree of confidence level below 5 per cent.

The regression output provides evidence that the POLCON coefficient on RDB performance is (-0.12). This result indicates that POLCON has a negative but insignificant effect on the RDBs performance ($p= 0.4649 > 0.05$) and thus, the hypothesis is rejected. The finding indicates that RDBs in Indonesia operate professionally since there is no evidence of significant political influence on the RDBs performance. These findings are similar to studies conducted by Amdanata & Mansor (2017); Berkman & Galpoththage (2016); Faccio (2010); and Saeed, Belghitar, & Clark (2016). The result, however, is inconsistent with the conclusion by Bencheikh & Taktak (2017); and Coulomb & Sangnier (2014).

Table 1: Regression Result

Variable*	Fixed Effects				Random Effects			
	Coefficient	Std. Error	t-Statistic	Prob.	Coefficient	Std. Error	t-Statistic	Prob.
C	8.890115	4.582923	1.939835	0.0564	3.868450	2.173779	1.779597	0.0783
POLCON	-0.133123	0.193959	-0.686348	0.4947	-0.125912	0.171592	-0.733785	0.4649
AGE	-0.050536	0.114773	-0.440309	0.6611	-0.013288	0.035857	-0.370595	0.7118
lnASSETS	-0.355938	0.813064	-0.437773	0.6629	-0.014532	0.210376	-0.069076	0.9451
lnBOARDSIZE	0.130600	0.563423	0.231798	0.8174	-0.078703	0.509978	-0.154327	0.8777
LDR	0.005327	0.009631	0.553042	0.5820	0.006419	0.007675	0.836326	0.4050
LEV	-0.000762	0.029482	-0.025848	0.9795	0.018890	0.021084	0.895931	0.3725
asinNPL	-0.073814	0.038337	-1.925386	0.0582	-0.109883	0.029665	-3.704190	0.0004

Effects Specification

	Cross-section fixed (dummy variables)	Weighted Statistics
R^2	0.740693	0.168058
Adjusted R^2	0.623822	0.107395
S.E. of regression	0.617814	0.627422
Sum squared resid	27.10031	37.79121
Log likelihood	-77.63764	
F-statistic	6.337705	2.770372
Prob(F-statistic)	0.000000	0.011472
Mean dependent var	2.949519	1.314337
S.D. dependent var	1.007306	0.664095
Durbin-Watson stat	2.751495	1.976434
	Hausman ($P > 0.05$)	0.188100

*Sample: 2013 2016; Periods included: 4; Cross-sections included: 26; Total panel (balanced) observations: 1

Conclusion

Politics in Indonesia is unique since election winners in each province can be different from other regions which make the political map in each area also different. However, the pattern of interactions between the RDBs and political winners is almost the same, that is, local leaders tend to have a strong influence in controlling the RDBs, including in the selection of the president or director. This suggests that potential RDB owners and holders of political power in the regions will make use of the RDB for enormous political gain. As with putting a person in the company stewardship, this is of course already violate the principles of corporate governance that has been running in Indonesia

However, seeing the bad experiences faced by Indonesia when hit by the economic crisis caused the government of the Republic to make many regulations related to the banking industry, not least the RDBs. The central government, such as realizing that the cost of politics in Indonesia is very expensive, sooner or later will make the local political authorities will glance at the RDB for political purposes.

Therefore, the government has set up many barries to protect the RDB from political interests. At this time, banks in Indonesia have many regulations that prevent them from deviating from the main task. Strict supervisions are conducted by Central Bank of Indonesia since 2014 and furthermore banks in Indonesia are also overseen by the Indonesian Financial Services

Authority. In addition, the Indonesian government has also issued a special Corporate Governance Guideline for the banking sector. These various regulations and regulatory bodies cause banks to run the banking operations professionally. Local governments as owners can provide wide economic access to the RDBs and also have direct access to control the RDBs and maintain the required level of professionalism in running these local government-owned companies

Amdanata & Mansor (2017) has investigated whether RDB as a bank owned by local government utilizes local government facilities to improve their performance. In other words, the RDB competes with other banks in the area by utilizing their status as state-owned banks. The results show that the relationship is negative, meaning that RDB has no competitive advantage to the local government. While in this study, the emphasis of research is whether local government as the owner utilizing RDB for political purposes, was also negative. These results indicate that RDB in Indonesia has run the regulations and apply the principles of corporate governance with a consistent.

For further research, researchers can try to compare with other government-owned companies engaged in many fields, to find out whether the GLCs have been professional and run the principles of good corporate governance properly.

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