

The impact of political connections on cost of funding and bank performance of foreign exchange national bank

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Abstract

Political connection is an expensive resource that can be a source of competitive advantage for a bank. Banks that have political connections will be able to get funding at a lower cost because depositors feel that their funds are safe. The existence of low funding costs will have an impact on better bank performance. This study aims to examine the effect of political connections on bank funding costs and bank performance. The research sample uses 28 foreign exchange banks in Indonesia in the 2014-2017 period which are divided into politically connected and politically unconnected banks using multiple regression analysis. The results show that politically connected banks have cheaper funding costs and better performance than banks that are not politically connected. The implication of this research for banking institutions is that political connections are an advantage that can be used to obtain funds from the public at a lower cost and will be able to improve bank performance.

Keywords: political connections, cost of funding, bank performance

Abstrak

Koneksi politik adalah sumber daya yang mahal yang dapat menjadikan sumber keunggulan kompetitif bagi suatu bank. Bank yang mempunyai koneksi politik akan bisa mendapatkan pendanaan dengan biaya yang lebih murah karena deposan merasa dananya aman. Dengan adanya biaya pendanaan yang murah akan berdampak pada kinerja bank yang lebih baik. Penelitian ini bertujuan untuk menguji pengaruh koneksi politik pada biaya pendanaan bank dan kinerja bank. Sampel penelitian menggunakan 28 bank Devisa di Indonesia pada periode 2014-2017 yang terbagi menjadi bank yang terkoneksi politik dan yang tidak terkoneksi politik menggunakan analisis regresi berganda. Hasil penelitian menunjukkan bahwa bank yang terkoneksi politik mempunyai biaya pendanaan yang lebih murah dan kinerja yang lebih baik dibandingkan dengan bank yang tidak terkoneksi politik. Implikasi penelitian ini bagi institusi perbankan adalah bahwa koneksi politik merupakan suatu keuntungan yang bisa digunakan untuk memperoleh dana dari masyarakat dengan biaya lebih murah dan akan dapat meningkatkan kinerja bank.

Kata Kunci: koneksi politik, biaya pendanaan bank, kinerja bank

Introduction

Political connections is an expensive resource for companies. Companies that have political connections will have a competitive advantage (Wu & Rui, 2012). Political connections provide benefits: helping companies predict actions that will be taken by the government, asking the government to do something in the interests of the company or to prevent government actions that are against the company. The company wants a political connection to get convenience in every company activity, which in the end is expected to improve the performance of a company. Political connections very valuable for companies where their connections provide “privileges” such as preventing competition, can create industry barriers to entry, and increasing access to resources (Sutopo et al., 2017). According to Faccio (2006) a company is said to be politically connected if the board of commissioners or board of directors is a member of parliament, a minister, a head of state, or someone who has close relationships with politicians, either directly or indirectly and one of the shareholders at least 10%.

Many companies want to have political connections, both private companies and state-owned companies, one of the companies are banking. Being politically connected banks can also make it easier for banks to have greater access to funds, especially from government budgets and projects of state-owned companies with lower interest rates (Sutopo et al., 2017). Another benefit of political connections, Banks can be charge higher interest because it is supposed to have higher market power which can improve bank performance.

Research topics regarding political connections can affect performance are discussed in the research of Wulandari (2013). Bencheikh & Taktak (2017) Sutopo et al. (2017), Prabowo (2013) & Carretta et al., (2012) which states that politically connected companies have lower performance than politically unconnected companies (Wulandari, 2013). Meanwhile, according to Carretta et al. (2012) stated that politicians who hold executive roles on the board of directors have a negative impact on banking performance. However, some findings state that political connections provide a positive relationship to company performance, according to Bencheikh & Taktak (2017) which states that political connections offer advantages, so it is very possible for companies to work better than their competitors who are not politically connected. Sutopo et al. (2017) stated that political connections can improve bank performance being able to have greater access to funds and according to Prabowo (2010) politically connected banks have higher performance than banks that are not politically connected. Politically connected banks have lower funding costs than politically unconnected banks, which means that the higher performance of politically connected banks is driven by lower funding costs which can ultimately lead to higher interest margins (Sutopo et al., 2017). Based on the description above, the purpose of this study is to test whether political connections have a significant impact on cost of funding and bank performance at foreign exchange national banks.

Literature Review

The Impact of Political Connection on Cost of Funding

Politically connected banks have the privilege of having greater access to funds especially from government budgets and state-owned enterprise projects with lower interest rates and banks are more likely to be bailed out when banks have financial difficulties. Politically connected banks or state-owned banks have benefit in terms of getting lower deposit rates because Depositors consider that deposits in state-owned banks/politically connected bank are considered less risky because the government will save state-owned banks when facing financial difficulties (Sutopo et al., 2017). According to Bliss & Gul (2012) the negative impact of political connections for companies is that it can increase the cost of debt, because politically connected companies have a higher risk when there is a shift in political power or their political connections no longer have power. Based on argument above the hypothesis is:

H1: Political connection has a significant effect on cost of funding of banks.

The Impact of Political Connections on Bank performance

Political connections are identical with power, both individuals and groups, such as political connections that exist within a company. Politically connected companies will generally have several advantages, including having easier access and having market power. Research by Sutopo et al., (2017) states that political connections can improve bank performance because they get greater access to funds and can charge higher loan rates. In addition, politically connected companies are more likely to be rescued and can improve access to resources so that company performance is higher. The results of Prabowo's research (2010) state that the existence of political ties can increase company performance which is higher than companies that are not politically connected. Meanwhile, according to Carretta et al. (2012), states that politicians who hold executive roles on the board of directors have a negative impact on banking activities because politically connected executive board members do not have the capacity to assess loan quality and have an impact on bank profitability. According to Faccio (2010), regardless of the profits they earn, politically connected companies show poorer accounting performance than politically unconnected companies. Based on the argument the hypothesis is:

H2: Political connection has a significant effect on bank performance

The framework of this research is illustrated in Figure 1.

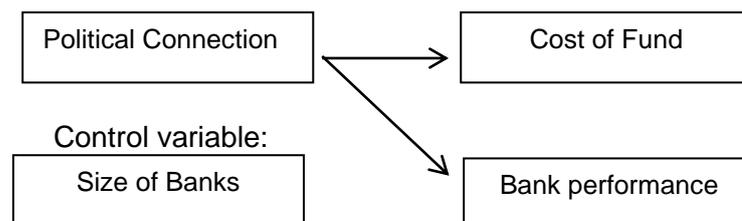


Figure 1. Framework

Research Methods

The sample used 28 foreign exchange banks consisting of 14 politically connected banks and 14 banks that are not politically connected. The sample banks are presented in Appendix 1. Politically connected banks are selected based on the following criteria: a) the bank is owned by the government or local government or b) the directors or members of the board of commissioners hold positions as members of the People's Consultative Assembly (MPR) for the 2014-2019 period, or c) Board of Directors or Board of Commissioners took office as a member of the cabinet of ministers of government period Joko Widodo, or d). Shareholders of at least 5% hold positions as members of the People's Consultative Assembly (MPR). Banks that are not politically connected are selected based on banks that do not meet the criteria as a politically connected bank and have total assets close to a politically connected bank.

Cost of funding (COF) is measured by the ratio of interest expense/deposit. Bank performance is measured using profit after tax/total assets (ROA). The political connection is measured by dummy variable, taking 1 for banks that are politically connected and 0 otherwise. We used Size of bank as control variable which measured by the natural logarithm of total Size. Bank size can affect funding costs and bank performance based on the theory of Too Big Too Fail policy (TBTF). Too big to fail" (TBTF) is a theory in banking and finance that asserts that certain corporations, particularly financial institutions, are so large and so interconnected that their failure would be disastrous to the greater economic system, and that they therefore must be supported by governments when they face potential failure. The implication of the theory TBTF is depositor consider big bank have lower risk as a result the bank will pay a lower interest rate and improve bank performance.

To estimate the impact of political connection on cost of funding and bank performance we test our hypothesis using multivariate analysis. The regression models are Following:

$$COF_{it} = \alpha + \beta_1 PC_{it} + \beta_2 Size_{it} \tag{1}$$

$$ROA_{it} = \alpha + \beta_1 PC_{it} + \beta_2 Size_{it} \tag{2}$$

Where COF is Cost of Fund, PC is political Connection, ROA is return on Assets and Size is size of the bank.

Result and Discussions

Descriptive statistic of variable is presented on table 1.

Table 1. Descriptive statistic

Variable		Average	Standar deviation	maximum	Minimum
COF (%)	PC	4.73	1.62	12.00	2.64
	NPC	5.61	2.36	11.54	1.19
ROA (%)	PC	2.59	0.76	4.73	0.90
	NPC	1.29	1.83	4.00	-7.47
Size	PC	18.06	1.45	20.84	16.59
	NPC	18.21	1.07	20.44	16.06

Note: PC: Political Connected, NPC: Non-Political Connected

Based on table 1, The average of ROA for political connected bank higher than non-politically connected bank. The standard deviation for political connected bank lower than non-political connected bank, it means that the data of ROA for non-political connected bank more variation than political connected bank. The average of COF for political connected bank lower than non-political connected bank. the standard deviation of COF for non-political connected bank higher than political connected bank. It means that data of COF on non-political connected bank more variation than political Connected bank. The average size of non-political connected bank higher than political connected bank and have lower variation than political connected. The descriptive statistic show that political connected banks have lower COF and higher ROA than non-political connected bank. The regression for model 1 presented on table 2.

Table 2. The Regression Results

Variable	Coefficient	Standard error	T statistic	Sig.
Constant	22.71	2.25	10.05	0.00
K_POL	-1.02	0.31	-3.28	0.00
Size	-0.93	0.12	-7.60	0.00
F stat	32.96			
Sig. F	0.00			
R square	0.37			

Dependent variable: COF

Based on Table 2, the Impact of Political connection on COF is negative and significant at level 1%. It means that Cost of Fund political connected bank lower than non-political connected bank. Politically connected banks have the privilege of obtaining funding from the government budget at low interest rates. In addition, depositors see the risk of a politically connected bank/government-owned bank having a lower risk so that depositors are willing to invest funds for lower interest rates.

The results of this study are in line with the research of Sutopo et al., (2017) which states that politically connected banks can benefit in terms of getting lower deposit rates because deposits in state banks are considered less risky by depositors because the government is more likely to save when face financial difficulties. As explained earlier, politically connected banks, especially state-owned banks, are given special privileges, and it is even more likely that the government will save banks when they experience financial difficulties. One of the factors that can affect the cost of funds is the interest rate paid, so with the existence of political connections, banks can be facilitated in obtaining lower deposit rates compared to banks that are not politically connected. Banks are competing to reduce the cost of funds in order to achieve low loan interest rates, so that banks are more aggressive in increasing bank third party funds (DPK) in order to reduce bank funding costs. However, if the bank has political connections, the government will indirectly provide the bank with cheaper funding costs.

The control variable bank size has a significant negative effect on bank funding costs. This means that the larger the size of the bank, the easier it will be to get funds from the public at low cost. This result is in accordance with the theory of economies of scale in banking which states that with increasing bank

size, banks can produce products or services cheaper than competitors so that depositors will be more interested in them. This result also confirms the theory of Too Big Too Fail policy in banking that asserts that certain corporations, particularly financial institutions, are so large and so interconnected that their failure would be disastrous to the greater economic system, and that they therefore must be supported by governments when they face potential failure. The implication of the theory TBTF is depositor consider big bank have lower risk as a result the bank will pay a lower interest rate. The regression for model 2 presented on table 3

Table 3. The Regression Results

Variable	Coefficient	Standard error	T statistic	Sig.
Constant	-6.00	1.80	-3.31	0.00
K_POL	1.36	0.25	5.45	0.00
Size	0.40	0.09	4.05	0.00
F stat	21.83			
Sig. F	0.00			
R square	0.28			

Dependent variable: ROA

Based on table 3 the impact of political connection on bank performance is positive and significant at level 1%. It means that political connected bank have higher ROA than non-political Connected bank. Political connection gives privileges to banks to get convenience in every activity in terms of obtaining government-owned projects. Politically connected banks can increase access to resources so that bank performance can be higher. The results consistent with Sutopo et al., (2017) that stated political connections can improve bank performance because they get greater access to funds and can charge higher loan rates. In addition, politically connected companies are more likely to be rescued and can improve access to resources so that company performance is higher. The results also consistent with Prabowo's research (2010) that the existence of political ties can increase company performance which is higher than companies that are not politically connected.

The result in-consistent with Carretta, Farina, Gon, & Parisi (2012) findings that politicians who hold executive roles on the board of directors have a negative impact on banking activities because politically connected executive board members do not have the capacity to assess loan quality and have an impact on bank profitability.

Political connections, especially in state-owned banks, all activities are fully controlled by the government. The reason the government holds full power in the bank because the government wants to maintain a stability and avoid diversion from irresponsible parties, thus whatever happens to the bank is the responsibility of the government. By The existence of political connections, banks get special privileges from the government by getting convenience in every company activity and easy to get projects from the government and it is very likely that banks will be saved by the government when banks face financial difficulties. Banks must be more effective in utilizing the existence of these political connections to the maximum, by improving performance so that banks are able to manage their assets and increase bank income.

Citing data from the Financial Services Authority (OJK) state that the net profit of state-owned banks in 2017 reached Rp. 73.9 trillion compared to private banks of Rp. 62.1 trillion. The ROA value of state-owned banks is also superior by 2.78% compared to private banks 1.97%, which means that state-owned banks in obtaining profits are superior due to the funding structure of state-owned banks being cheaper than private banks. The control variable size also have positive impact on bank performance. It means that the bigger of bank size can improve bank performance because of economies of scale TBTF in banking Industry.

Conclusion

We investigate the impact of political connection on cost of funding and bank performance. The result shows that political connection bank have lower cost of funding and better performance than non-political connected banks. The results also shows that size of bank have negative impact on cost of funding and positive impact on bank performance.

The implication of the result support Resource based theory that state political connection is an advantage for banks to get access on lower cost of funding and increase bank performance. The implication of research related to bank size is that banks should increase the size of banks so that they can get funding at lower costs so that they can ultimately improve bank performance. One way to increase the size of a bank is by merging with other banks

The research have several limitation. first the samples used only 28 Foreign Exchange National Bank. the second is that the coefficient determination (R²) for model 1 and model 2 only 28,6% and 37.7% The suggestion for the next research should use broader sample and added the determinant factor of COF and bank performance.

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