Performance of Politically Connected Banks during the COVID-19 Pandemic in Indonesia

Budi Wahyono

(The Graduate School of East Asian Studies, Yamaguchi University, Japan)

Abstract

This research aims to examine the relationship between political connections and bank performance during the COVID-19 pandemic in Indonesia, with data sample comprising banks listed on the Indonesia Stock Exchange (IDX). The study employed a panel data linear regression and found an insignificant positive influence of political connections on banks' profitability. However, the result also indicates marginally lower profitability in politically connected banks compared to non-connected peers, and the event-study methodology reveals the tendency for affiliated banks to obtain substantial negative abnormal returns during the pandemic. Therefore, there is a negative effect of COVID-19 on stock performance of politically connected banks.

Keywords: political connections, COVID-19, banks, Indonesia

1．Introduction

This study explores the ways political connections affect banks' performance during the COVID-19 pandemic in Indonesia. Furthermore, there have been several academic and public attention in the business world due to the impact of political ties (Wang et al., 2019). The findings of earlier research indicate companies benefit from political connections (e.g., Boubakri et al., 2012; Brockman et al., 2013; Carney et al., 2020; Duchin and Sosyura, 2012; Faccio et al., 2006; Goldman et al., 2009; Wang et al., 2019), but this does not typically boost firm performance (Gao et al., 2019). According to Liu et al. (2018), political connections lessens the corporation's value, and Faccio (2010) corroborates to reveal these firms perform lower compared to non-connected peers all over the country. Therefore, this research extends earlier studies by an introduction of the function of political connections during the COVID-19 outbreak in Indonesia.

　　The first Indonesian COVID-19 incident and death case was confirmed on the 2nd and 11th of March 2020 respectively. Subsequently, infected numbers increased (see Figure 1).
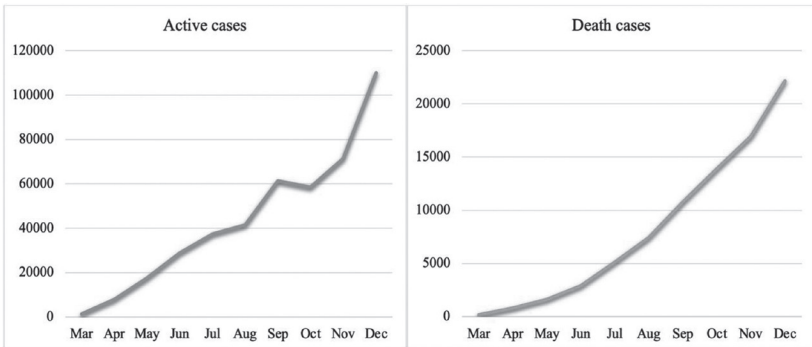

Figure 1. Monthly active cases and death cases caused by COVID-19 in Indonesia

The pandemic is influencing economic activities, and an instance is the negative response of the stock markets to growing cases (Al-Awadhi et al., 2020; Ashraf, 2020; Topcu & Gulal, 2020). Furthermore, transportation and tourism industries were impacted negatively, while information technology sector experienced positive effects. (Sherif, 2020). He et al. (2020) revealed less impact on the finance industry. The previous investigations were broadened by an exploration of the relationship between COVID-19 and one of the financial industries' performance, specifically, banks. Also, the function of political connections in this affiliation was introduced.

　　The Indonesian government implemented emergency steps during the pandemic, including social distancing measures and income support packages. Furthermore, every governmental intervention influenced economic activities differently. According to Ashraf (2020), there is a negative effect of social distancing processes on stock market returns, and a positive influence by income support packages. The Indonesian government via the Ministry of Finance declared tax incentives for companies on March 26, 2020, and this study posits politically connected firms enjoy advantages during COVID-19 from the affiliations. Amankwah-Amoah et al. (2020) claim an advancement in the gap between

politically connected firms and non-politically associated counterparts.

　　This research contends benefits are obtained by politically connected firms due to the outbreak, and the companies likely possess broader access to funding, with higher possibility of getting government financing or bail out（Duchin and Sosyura, 2012; Faccio et al., 2006）. Carney et al.（2020）discovered larger crisis-period accounting performance and stock returns among these firms. However, the political links promote insiders engaging in tunneling and devious acts（Hu et al., 2020; Jagolinzer et al., 2020）, with the firms possessing the tendency to expropriate minority shareholders.（Qian et al., 2012）. An earlier investigation revealed higher return on assets and lower risk among politically affiliated banks in the industry.（Hung et al., 2017）.

　　There are likely differences in the advantages from political connections during economic distress, including financial crisis and COVID-19 pandemic. In addition, politically connected banks had larger loan default rates and inferior profitability compared to non-connected ones during the 2007/2008 global financial crisis.（H. K. Chen et al., 2018）. The present pandemic is an unanticipated incidence with unique uncertainty, and therefore the role of political connections likely differs from other occurrences. The arising research questions include the impact of political connections on banks' performance during the COVID-19 pandemic, and the answer entails investigating the effect on profitability of banks. Furthermore, the connection with regard to stock performance and function of political connections in this affiliation is examined.

　　The noteworthy and major empirical discovery in this study are as follows: while no significant influence of political connections on banks' profitability was found, the results indicate politically connected banks marginally possess lower profitability compared to non-connected peers. Furthermore, these banks experienced negative abnormal returns during COVID-19 pandemic.

2．Research method

2.1．Data and sample screening

　　The data employed comprised banks listed on the IDX, with the sample of 44 registered throughout 2019 Q2 － 2020 Q3. Also, there are 264 bank-quarter

observations provided, and further separated into before and during COVID-19 period. The first infection case was confirmed on March 2nd, 2020, and therefore, 2019 Q2 to 2019 Q4 is defined as pre-COVID-19 period, with 2020 Q1 to 2020 Q3 as COVID-19 stage. The independent, dependent, and control variable were political connections, bank performance, and bank characteristics respectively. Table 1 shows the definitions of all variables employed in this study.

Table 1. Variables definition

Variable	Definition	Data source
Political connections	A dummy variable, equal to 1 where politically-connected banks, and 0 otherwise.	Annual report, IDX and banks' official websites
Bank performance		
Returns on assets (ROA)	Ratio of net income to total assets (quarterly, percentage points)	Financial report (IDX) and banks' official websites
Returns on equities (ROE)	Ratio of net income to total equities (quarterly, percentage points)	Financial report (IDX) and banks' official websites
Bank characteristics		
Bank size	Natural logarithm of total assets	Financial report (IDX) and banks' official websites
Leverage	The sum of total short-term and total long-term liabilities divided by total assets	Financial report (IDX) and banks' official websites
Growth	The growth rate of the bank's total assets over the last quarter	Financial report (IDX) and banks' official websites

2.1.1.　Political connections

According to Faccio (2006) and Habib et al. (2017), a bank is politically connected where there is state-ownership or majority shareholders (with over 10% ownership stakes)/ top management are present or previous parliament members, ministers/ heads of state, individuals with close link[1] to top officials. Furthermore, names of board commissioners and directors were obtained from the IDX and the profiles mapped manually from the banks' annual reports and official websites. Also, shareholders' data were acquired from IDX.

---

1) Relationships are classified as relatives, friends, or well-known associates connected with a political party (Faccio, 2006).

2.1.2.　Bank performance

This investigation employs two bank performance measurement types, comprising returns on assets （ROA） and returns on equities （ROE）. In addition, ROA is measured by ratio of net income to total assets while ROE by same ratio to total equities, and this was computed using the quarterly financial report data obtained from IDX and banks' official websites.

2.1.3.　Bank characteristics

Three bank characteristics comprising size, leverage and growth, were employed as a control variable with potential to influence bank performance. Furthermore, bank size is measured by natural logarithm of total assets, while leverage constitutes the sum of total short-term and total long-term liabilities divided by total assets, with growth calculated as total assets growth rate over the last quarter. These bank attributes are computed according to quarterly financial reports, with the data obtained from IDX and company's official websites.

2.2.　Empirical model

The effect of political connections on bank performance during COVID-19 was investigated using OLS regression analysis. Also, a set of regressions were run using this model:

$$\text{Bank performance} = \alpha + \beta_1\,\text{PC} + \beta_2\,\text{COVID} + \beta_3\,\text{PC*COVID} + \text{Control} + \varepsilon \qquad (1)$$

where bank performance is substituted by ROA and ROE, PC is political connections, and COVID is a dummy variable equal to one if the bank's quarterly report end is within the COVID-19 period （2019 Q2 - 2019 Q4） and zero otherwise. There is also substitution of control with bank size, leverage, and growth.

３．Results and discussions

3.1.　Descriptive statistics

Table 2 displays the summary figures of samples employed during the pre and COVID-19 periods （from 2019 Q2 to 2020 Q3）, and Panel A shows the descriptive

statistics. Furthermore, findings indicate 63.64% of the sample constitutes politically connected banks, while average bank performance based on ROA and ROE is 0.68% and 3.16% respectively. The bank characteristics presented mean values of 31.18% (bank size), 0.77% (leverage), and 0.03% (growth), while the results of Pearson correlation matrix on the variables are displayed in panel B. Generally, the findings indicate small correlations between variables, and therefore, little concern regarding multicollinearity.

Table 2. Descriptive statistics and correlation matrix

	PC	ROA	ROE	Bank size	Leverage	Growth
Panel A: Descriptive statistics						
Mean	0.6364	0.6836	3.1633	31.1830	0.7710	0.0291
S.D.	0.4820	2.1065	11.4456	1.7985	0.1842	0.1117
Median	1.000	0.3396	2.3943	30.8637	0.8298	0.0135
Panel B: Correlation matrix						
PC	1					
ROA	−0.0946	1				
ROE	−0.0441	0.9247***	1			
Bank size	0.4295***	0.0772	0.2057***	1		
Leverage	0.2576***	−0.3879***	−0.2777***	0.2464***	1	
Growth	−0.1289**	0.1263**	0.0515	−0.1172*	−0.1895***	1

Note: *** p < 1%, ** p < 5%, * p < 10%. PC is political connections. S.D. is standard deviation. Correlation analysis are using Pearson correlation.

3.2　Univariate analysis

This compares bank characteristics and performance between the politically connected and non-connected counterparts. Table 3 shows the findings of this comparison.

Table 3. Comparison of bank characteristics and performance between politically
connected and non-connected

Variable	Pre-COVID-19 period		COVID-19 period		Difference	
	PCB	nPCB	PCB	nPCB	t-test 1	t-test 2
ROA	0.7441	1.3548	0.3225	0.5385	− 0.9404	− 1.0184
ROE	2.8613	7.6107	1.2513	2.5904	− 1.4543	− 1.4151
Bank size	31.7520	30.1279	31.7798	30.1982	5.8442***	5.8071***
Leverage	0.8021	0.7322	0.8116	0.6845	1.9432*	3.0647***
Growth	0.0307	0.0755	0.0058	0.0207	− 1.4978	− 0.9093

Note: *** $p < 1\%$, ** $p < 5\%$, * $p < 10\%$ （two-tailed）. PCB is politically connected banks and nPCB is non-politically connected. t-test 1 shows the difference between politically-connected banks and non-connected peers on ROA, ROE, bank size, leverage, and growth during pre-COVID-19 period. t-test 2 is for the difference between politically-connected banks and non-connected peers during COVID-19 period.

Table 3 shows the variations in bank characteristics （size, leverage, and growth） and performance （ROA and ROE） for the before and during COVID-19 period. Furthermore, the only difference was revealed in bank size and leverage, therefore indicating politically connected banks possess substantially higher assets and leverage compared to non-connected counterparts at both tested periods. However, no significant difference in ROA and ROE of both was found, with the mean for non-politically connected banks being marginally higher compared to those connected politically.

Figure 2 and Figure 3 display ROA and ROE trends at the research periods. Generally, non-politically connected banks perform better both in ROA and ROE.

3.3.　Multivariate analysis

Table 4 shows the findings of panel data regression for the relationship between political connections and bank performance during the COVID-19 pandemic.
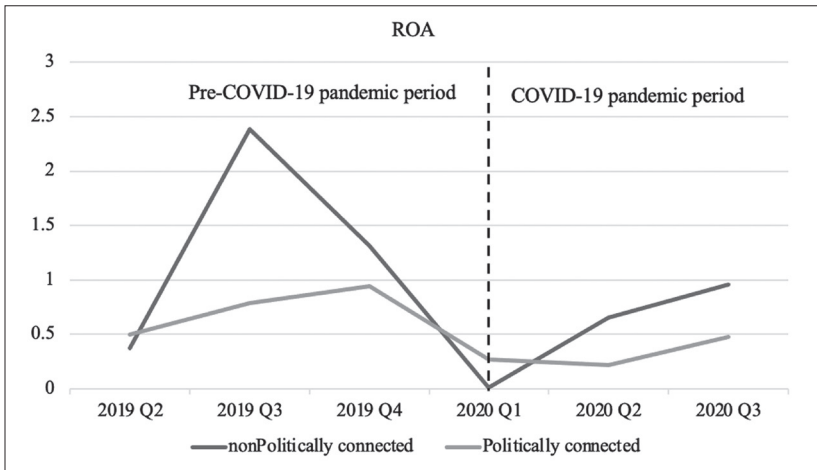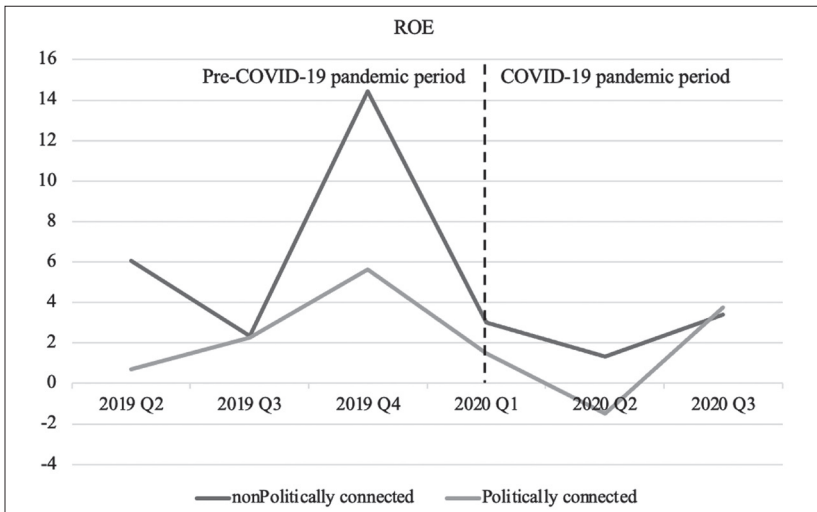
Figure 2. Trend in ROA

Figure 3. Trend in ROE

Table 4. The Impact of political connections on bank performance during
COVID-19 pandemic

Variables	ROA (1)	ROE (2)
Intercept	− 2.9083* (1.5433)	42.7434*** (13.7706)
Political connections	− 0.6614 (0.4959)	3.5683 (2.6894)
COVID-19	− 1.0329 (0.7252)	− 4.7349 (3.9997)
Political connections x COVID-19	0.6659 (0.6946)	2.3573 (3.8516)
Bank size	0.2585*** (0.0424)	2.1278*** (0.4302)
Leverage	− 4.8789*** (1.2075)	− 21.4184*** (6.8697)
Growth	0.6304 (2.6891)	− 1.3838 (11.5924)
Observations	264	264
R-Squared	0.2168	0.1870

Note: *** $p < 0.01$, ** $p < 0.05$, and * $p < 0.1$. The figures in brackets are heteroscedasticity-robust standard errors.

Table 4 in model （1） indicates political connections possess insignificant positive effect on ROA during the COVID-19 pandemic. Also, Table 4 in model （2） affirms same, and therefore, there is no significant influence of political connections on banks' profitability during the pandemic.

3.4. Further analysis

The primary analysis implies political connections insignificantly affected banks' profitability during COVID-19, and subsequent further investigation was performed to discover the impact on stock performance. In addition, event study methodology was employed to discover whether political affiliation was beneficial for banks during the pandemic. Particularly, cumulative abnormal returns （CAR） surrounding the event date （first confirmed Indonesian case March 2nd, 2020） was calculated as the difference between expected and actual returns. The basic market model utilized to calculate expected returns are shown below:

$$R_{i,t} = \alpha_i + \beta_i R_{m,t} \tag{2}$$

where $R_{i,t}$ is the observed arithmetic return for security i at day t, also α, β, and

Rm,t are the intercept, slope, and return on the IHSG (Composite Stock Price Index) for day t respectively. To compare, the capital asset pricing model (CAPM) is used as follows:

$$R_{i,t} = R_f + \beta_i(R_{m,t} - R_f) \tag{3}$$

where $R_{i,t}$ is the return of security i at day t, R_f is the risk-free rate, and $R_{m,t}$ is the return on IHSG for day t. Based on (MacKinlay, 1997), 120 trading days is employed as an estimation window from -140 to -20 before the event date, both for the market model and CAPM. Lastly, the significance of the CAR is analyzed using a t-test, and findings indicate a significant impact on stock prices by the event where CAR was substantially different from zero (M. H. Chen et al., 2007).
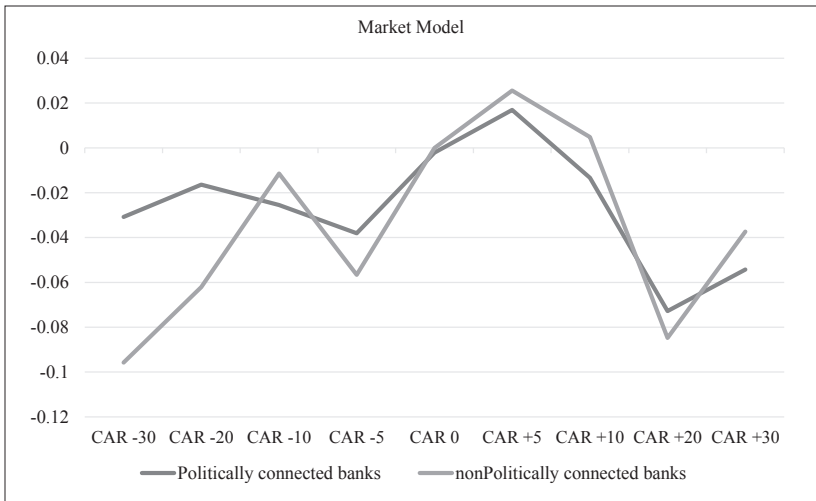

Figure 4. The trend in CAR using the market model

Figure 4 displays CAR mean for each event window employing the basic market model. The findings indicate politically connected banks mostly gain less abnormal returns compared to the non-affiliated. Also, Figure 5 presents CAR mean for each event window using CAPM. The results are similar to the market model and show the stocks of politically connected banks perform lower both before and during the COVID-19 outbreak.
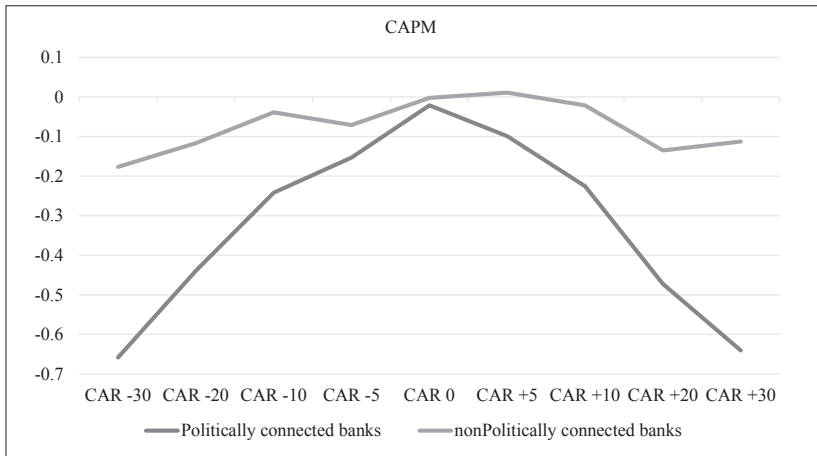
Figure 5. The trend in CAR using the CAPM

Table 5. The impact of COVID-19 pandemic on banks' stocks performance

Event Window	Market model		CAPM	
	PCB [26]	nPCB [15]	PCB [26]	nPCB [15]
[−30,0]	− -0.0307	− 0.0957	− 0. 6581***	− 0.1767
	(− 1.4244)	(− 1.0831)	(− 2.8813)	(− 1.7138)
[− 20,0]	− 0.0164	− 0.0621	− 0.4390***	− 0.1166
	(− 0.8587)	(− 0.7890)	(− 2.8820)	(− 1.3338)
[− 10,0]	− 0.0255	− 0.0114	− 0.2420***	− 0.0390
	(− 1.4301)	(− 0.1909)	(− 2.9118)	(− 0.6108)
[− 5,0]	− 0.0381**	− 0.0566	− 0.1533***	− 0.0709
	(− 2.0611)	(− 1.3914)	(− 3.2000)	(− 1.7270)
[0,0]	− 0.0021	0.00001	− 0.0213*	− 0.0023
	(− 0.3104)	(0.0005)	(− 1.9775)	(− 0.1075)
[0,5]	0.0169	0.0256	− 0.0993*	0.0109
	(0.6131)	(0.6827)	(− 1.8172)	(0.2766)
[0,10]	− 0.0133	0.0048	− 0.2252**	− 0.0217
	(− 0.4591)	(0.0561)	(− 2.3827)	(− 0.2445)
[0,20]	− 0.0728*	− 0.0847	− 0.4724***	− 0.1354
	(− 1.8144)	(− 0.6862)	(− 2.9559)	(− 1.0453)
[0,30]	− 0.0543	− 0.0374	− 0.6408**	− 0.1124
	(− 1.1109)	(− 0.3139)	(− 2.7541)	(− 0.8448)

Note: *** p < 1%, ** p < 5%, and * p < 10% (two-tailed). The number of total banks included in each group is in brackets. The figures in parentheses are t-statistics. PCB is politically connected bank, nPCB is nonpolitically connected banks.

Table 5 shows the significance test of CAR from the market model and CAPM using t-test. The findings indicate politically connected banks possess significantly negative abnormal returns both in the market model and CAPM, prior to the event date. Furthermore, the market model reveals the negative significant abnormal returns is found only in the event window [-5,0] of five days before the event date, while CAPM shows this occurred in all event window. However, non-politically connected banks obtained insignificant negative abnormal returns for the market model and CAPM. Subsequent to the event date, CAR estimate displays statistical negative significance for politically connected banks in the market model and CAPM. Therefore, politically connected banks were significantly negatively affected by COVID-19 while the market value of non-affiliated ones post the event date was impacted negatively but to an insignificant extent.

4．Conclusions

The study aims to investigate the impact of political connections on banks' performance during the COVID-19 pandemic in Indonesia, and the outbreak's effect on stock performance. The findings indicate non-politically connected banks possess marginally higher profitability compared to the connected ones, with an insignificant difference. Therefore, political connections possess insignificant influence on banks profitability. Furthermore, the COVID-19 pandemic was revealed to negatively affect stock performance in politically connected banks, while the counterparts were insignificantly impacted. Therefore, this research found during the pandemic, investors respond negatively to politically connected banks.

References

Al-Awadhi, A. M., Alsaifi, K., Al-Awadhi, A., & Alhammadi, S.（2020）. Death and contagious infectious diseases: Impact of the COVID-19 virus on stock market returns. *Journal of Behavioral and Experimental Finance, 27*. https://doi.org/10.1016/j.jbef.2020.100326

Amankwah-Amoah, J., Khan, Z., & Wood, G.（2020）. COVID-19 and business failures: The paradoxes of experience, scale, and scope for theory and practice. *European Management Journal*. https://doi.org/10.1016/j.emj.2020.09.002

Ashraf, B. N. (2020). Stock markets' reaction to COVID-19: Cases or fatalities? *Research in International Business and Finance, 54*. https://doi.org/10.1016/j.ribaf.2020.101249

Boubakri, N., Guedhami, O., Mishra, D., & Saffar, W. (2012). Political connections and the cost of equity capital. *Journal of Corporate Finance, 18*, 541-559. https://doi.org/10.1016/j.jcorpfin.2012.02.005

Brockman, P., Rui, O. M., & Zou, H. (2013). Institutions and the performance of politically connected M&As. *Journal of International Business Studies, 44*(8), 833-852. https://doi.org/10.1057/jibs.2013.37

Carney, R. W., Child, T. B., & Li, X. (2020). Board connections and crisis performance: Family, state, and political networks. *Journal of Corporate Finance, 64*. https://doi.org/10.1016/j.jcorpfin.2020.101630

Chen, H. K., Liao, Y. C., Lin, C. Y., & Yen, J. F. (2018). The effect of the political connections of government bank CEOs on bank performance during the financial crisis. *Journal of Financial Stability, 36*, 130-143. https://doi.org/10.1016/j.jfs.2018.02.010

Chen, M. H., Jang, S. C. (Shawn), & Kim, W. G. (2007). The impact of the SARS outbreak on Taiwanese hotel stock performance: An event-study approach. International *Journal of Hospitality Management, 26*(1), 200-212. https://doi.org/10.1016/j.ijhm.2005.11.004

Duchin, R., & Sosyura, D. (2012). The politics of government investment. *Journal of Financial Economics, 106*, 24-48. https://doi.org/10.1016/j.jfineco.2012.04.009

Faccio. (2006). Politically Connected Firms. *The American Economic Review*. https://doi.org/10.1257/000282806776157704

Faccio, M. (2010). Differences between Politically Connected and Nonconnected Firms: A Cross-Country Analysis. *Financial Management*, 905-927.

Faccio, M., Masulis, R. W., & Mcconnell, J. J. (2006). Political connections and corporate bailouts. *Journal of Finance, 61*(6), 2597-2635. https://doi.org/10.1111/j.1540-6261.2006.01000.x

Fu, J., Shimamoto, D., & Todo, Y. (2017). Can firms with political connections borrow more than those without? Evidence from firm-level data for Indonesia. *Journal of Asian Economics, 52*, 45-55. https://doi.org/10.1016/j.asieco.2017.08.003

Gao, W., Huang, Z., & Yang, P. (2019). Research in International Business and Finance Political Connections, Corporate Governance and M & A Performance: Evidence from Chinese Family Firms. *Research in International Business and Finance, 50*, 38-53.

https://doi.org/10.1016/j.ribaf.2019.04.007

Goldman, E., Rocholl, J., & So, J.（2009）. Do politically connected boards affect firm value. *Review of Financial Studies, 22*（6）, 2331-2360. https://doi.org/10.1093/rfs/hhn088

Habib, A., Haris, A., & Jiang, H.（2017）. Political Connections and Related Party Transactions: Evidence from Indonesia. *International Journal of Accounting, 52*（1）, 45-63. https://doi.org/10.1016/j.intacc.2017.01.004

He, P., Sun, Y., Zhang, Y., & Li, T.（2020）. COVID-19's Impact on Stock Prices Across Different Sectors—An Event Study Based on the Chinese Stock Market. *Emerging Markets Finance and Trade, 56*（10）, 2198-2212. https://doi.org/10.1080/1540496X.2020.1785865

Hu, Y., Wang, C., Xiao, G., & Zeng, J.（2020）. The agency cost of political connections: Evidence from China's File 18. *Pacific Basin Finance Journal, 64.* https://doi.org/10.1016/j.pacfin.2020.101426

Hung, C. D., Jiang, Y., Hong, F., Tu, H., & Wang, S.（2017）. Bank political connections and performance in China. *Journal of Financial Stability, 32,* 57-69. https://doi.org/10.1016/j.jfs.2017.09.003

Jagolinzer, A. D., Larcker, D. F., Ormazabal, G., & Taylor, D. J.（2020）. Political Connections and the Informativeness of Insider Trades. *Journal of Finance, 75*（4）, 1833-1876. https://doi.org/10.1111/jofi.12899

Liu, F., Lin, H., & Wu, H.（2018）. Political connections and firm value in china: An event study. *Journal of Business Ethics, 152,* 551-571. https://doi.org/10.1007/s10551-016-3316-2

MacKinlay, A. C.（1997）. Event Studies in Economics and Finance. *Journal of Economic Literature, 35*（1）, 13-39.

Qian, M., Pan, H., & Yeung, B. Y.（2012）. Expropriation of minority shareholders in politically connected firms. *SSRN Electronic Journal.* https://doi.org/10.2139/ssrn.1719335

Sherif, M.（2020）. The impact of Coronavirus（COVID-19）outbreak on faith-based investments: An original analysis. *Journal of Behavioral and Experimental Finance.* https://doi.org/10.1016/j.jbef.2020.100403

Topcu, M., & Gulal, O. S.（2020）. The impact of COVID-19 on emerging stock markets. *Finance Research Letters, 36.* https://doi.org/10.1016/j.frl.2020.101691

Wang, Y., Yao, C., & Kang, D.（2019）. Political connections and firm performance: Evidence from government officials' site visits. *Pacific Basin Finance Journal, 57.* https://doi.org/10.1016/j.pacfin.2018.05.003