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Political Corruption, Political Connection and Bank Performance Responsibility

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Abstract:

Purpose: *To examine the Political Corruption, Political Connection and Bank Performance nexus.*

Design/Methodology/Approach: *The study follows a quantitative approach to its research objectives. Specifically, the study attempted to analyse political corruption, political connectedness and Bank profitability nexus for a panel of 15 commercial Banks for the time period of 5-years (2012-2016) using the GMM estimation.*

Findings: *The study found that political corruption, GDP growth rate and cost to income, capital adequacy and non-interest income to total asset ratio are statistically significant variables.*

Practical Implications: *These methods will have a momentous impact on the nature of relationships between political corruption, political connection and bank performance.*

Originality/Value: *based on the findings of the current study policy makers, anticorruption institutions, banks, via others can make informed decisions and judgments. This article is an original content with appropriate references.*

Keywords: *Banks, political corruption, political connection, GMM.*

JEL: *P16, G21, G280.*

Paper Type: *Research article.*

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1. Introduction

Evidence shows that corruption affects developing countries where there are weak institutions to fight against corruption. Political corruption, which is one type of corruption, is a destructive force and threatens the performance of politically connected firms. The consequence is worse in developing countries especially in Africa, where corruption is not penalized because of underdeveloped political institutions (Polona *et al.*, 2015). Like other firms, corruption affects the Bank sector. Huiying *et al.* (2018) studied the effect of politically connected firms on Bank's performance for the year 2007-2009. They stated that, in countries with weak governance, political corruption negatively correlate with Bank performance. According to this study government Bank CEO are even not penalized for their poor performance.

CEOs who are appointed because of their political affiliation lack the necessary qualifications, competence and experience that a firm demands. This hurt the performance of the firm. CEOs commit also political corruption as they are most likely not accountable and transparent. Islam *et al.* (2018) stated that financial reporting quality and credibility is compromised, which requires firms to pay high audit fee that enhances the firms overall expenses and reduces financial performance. Connected CEOs also pass poor lending decisions using political power which hurts firm's performance (Huiying *et al.*, 2018).

A tremendous amount of researches documented the political corruption, political connectedness and firm performance nexus. However, there is no general consensus about the relationship. Wan *et al.* (2017) analysed the effects of bank's political connection on bank performance and risk in China employing the hand collected data. They investigated positive relationship between political connection and Bank performance. According to the authors politically connected Banks had higher return on asset and lower default risk and credit risk. Yan *et al.* (2018) studied the value of political connection using evidence from Egyptian firms that were connected to President Mubarek for the period since 2011 up to the Egyptian revolution. They found that Mubarek's connection significantly contributed to the firm value (i.e. about 22.4%). Ferdinand *et al.* (2018) examined the Government ownership, financial constraint, corruption, and corporate performance using a sample of 8232 firms from 81 countries. The result show that government owned firms face lower financial constraint and achieve high financial performance. Huiying *et al.* (2018) and Yizhong *et al.* (2018) documented that CEOs have positive influence on firm performance. Political connections are more valuable in the absence of political corruption.

On the other side literature shows adverse relationship between political connection and firm performance. Huiying *et al.* (2018) examined the political connection-firm performance relationship using a panel of banks for the period 2007-2009. They found that political connection negatively affects operating performance by significantly increasing the bank default rate. Qingsong *et al.* (2017) studied the corporate

innovation and political connections in Chinese listed firms. The result indicates that political connections weaken the impact of corporate innovation on firm future performance. The authors also found that political connection reduces market competition and increases overinvestment in innovation which reduces firm performance.

Literature on corporate finance documented political connection-firm performance nexus focused on developed economies such as China ignoring the developing countries. But the relationship might be different in developing countries where there are poor institutional frameworks that can fight against political corruption. No study has been conducted, to the best of our knowledge that see political corruption, political connection, and Bank performance by linking the Resource dependency theory and Principal- Agent theory specifically in Ethiopian Banks. The study has three objectives: (1) to examine the relationship between political corruption and bank profitability; (2) to investigate the relationship between bank specific variables and bank profitability; (3) to investigate the relationship between macroeconomic variables and bank profitability. The outcome of the study will provide insight to policy makers, government bodies and other stakeholders about the correlation between political corruption, political connection, and firm performance and take appropriate measures that can reduce political corruption and other factors that alter the performance of banks.

2. Literature Review

This study built into two theories: The resource dependency view and the principal-agent theory. Resource based view argues that the firms (Barney, 1986, cited in Pankaj, 2010) obtain competitive advantage by obtaining valuable, rare, non-substitutable and imitable resources from the external environment. In other words how firms can minimize their dependence over others supplying the valuable resources. One of the streams this perspective is the political action and firm performance. According to this view, since firms are unable to reduce uncertainty and interdependence on the larger social system (including the government) they undertake other means to reduce the uncertainty and interdependence from these environmental contingencies. Pfeffer and Salancik (1990) noted that “the organization, through political mechanisms, attempts to create for itself an environment that is better for its interest” and that “organizations may use political means to alter the condition of the external economic environment.” In doing so, firms actively seek to “create” their environment by trying to shape government regulations that produce a more favorable environment. However, Mezner and Nigh (1995) found that firms heavily dependent on the government are more likely to engage in political activity. Similarly, Pankaj (2010) argued that as regulatory agency dependency increases (the agency controls more of the firm’s financial resources), managers are more favorably disposed toward political activity. Another stream is from the board of directors and firm’s performance. According to the RDT board of directors benefit firms by

bringing advice and counsel, channels of information flow, preferential access to resources, and legitimacy (Amy *et al.*, 2009).

Empirical evidence documented the political connection- firm performance nexus. Yizhong *et al.*, (2018) studied this relationship for the period between 2004 and 2014 in China's case. Their finding show that politically connected firms obtain more new investment projects and bank loans, improve corporate governance, and decrease information asymmetry as well. Amy *et al.* (2018) analyzed the politically connected CEOs, firm performance, and CEO pay nexus in China Banks and found that political connections of CEOs have a positive impact on both firm performance and CEOs pay. According to the authors the impact is stronger in less-developed regions. Ferdinand *et al.* (2018) also examined the Government ownership, financial constraint, corruption, and corporate performance from international evidence using a sample of 8232 firms from 81 countries. Results show that government-owned firms face fewer financial constraints and perform better.

Huiying *et al.* (2018) suggested that the resource dependency theory is more productive when it is complemented with other theories. Therefore, the aim of the study under question is to investigate the relationship between political corruption, political connection, and firm performance in Ethiopian commercial banks. Corruption has no boundary. It occurs at all levels of society and at all forms – public, private, locally, nationally and internationally. Suzan (1997) stated that corruption is a symptom of poor performance of the state. Weak countries retard and misdirect the economic growth. The Transparency International Survey (2017) indicated that all over the world police and representatives (e.g. Member of Parliament) were most corrupted. In the survey, the respondents (34% and 35%) said that business executives and government officials respectively are all or the most corrupted. The report also reveals Sub-Saharan African Countries are the most corrupted. According to the Global Financial Integrity (2004) report, Ethiopia has lost US\$16.5 billion from 1970 to 2008, making it one of the top ten African countries by cumulative illicit financial flows, where illicit financial flight is “*Transferring funds abroad without paying taxes, as well as complex schemes involving sophisticated corporate structures and organized criminal groups (OECD 2014a).*”

Politically connected firms can easily achieve their objectives since they gain access to critical resources. In recent years Ethiopian commercial banks have been suffering by currency crisis which is a vital resource. Politically connected firms minimize the problem using their political affiliation. Politically connected CEOs can also facilitate the illicit capital flight, as they represent their own interest and the interest of those who appointed them. The evidence, as to the existence of the problem at least at national level, is the recently detect \$10 million via others around Moyallie (see the web page of the ERCA at <http://www.erca.gov.et>). These kind of problems are common when the CEO'S agency dependency is high.

3. Data and Methodology

The purpose of the study is to empirically examine the relationships between political corruption, political connection, and firm performance using a panel of Ethiopian commercial banks for the time period 2012-2016. In Ethiopia there are 18 commercial banks (both private and state owned banks).

See https://en.wikipedia.org/wiki/List_of_banks_in_Ethiopia: Retrieved on Nov. 21, 2018. At November 21, 2018, there are 17 private commercial banks and 1 stated owned commercial bank. However, only 15 commercial banks (of which only 1 is stated owned) are selected for data collection and the remaining 3 banks that have no complete audited reports for the study period are excluded. In this study, secondary data sources (audited annual financial reports) are collected from each bank's web address (see https://en.wikipedia.org/wiki/List_of_banks_in_Ethiopia). In this study Bank profitability is measured by return on assets (ROA). Return on asset is the ratio of total profit after tax and total asset. To compute ROA annual Bank reports specifically balance sheet and income statement are examined.

Independent variables and their measurements

Political connectedness: Is one determinant factor for bank profitability. It is a dummy variable. If a particular Bank's CEO is formerly or currently served as government official, deputies, committee members, political returns it takes value of 1, otherwise, 0.

Political corruption: Is another deterministic factor for financial performance of Banks. The Transparency International glossary of anti-corruption defined political corruption as the abuse of entrusted power by political leaders for private gains (https://www.transparency.org/research/gcr/gcr_political_corruption). In this regard the annual Transparency international corruption perception index report (2017) is referred to measure political corruption. According to the report the Sub-Saharan African (average value of 32) and Eastern Europe and Central Asia (average score 34) are the least performing regions.

Control variables

Capital ratio: Is one of the determinant factors of Bank profitability measured as the ratio of total capital to total assets (Rahman *et al.*, 2015). The authors stated that capital strength has a positive impact on Bank's financial performance.

Credit risk: It might be measured either by non-performing loan to total loan ratio or total loss loan provision to total loans ratio affecting Bank's profitability (Rahman *et al.*, 2015; Eze, 2014)).

Asset size: In most finance literature, total assets of the banks are used as a proxy for bank size. Bank size is represented by natural logarithm of total asset ($\log A$) and expected to have positive effect on performance.

Total loan to total assets: Banking activities are also influenced by liquidity risk (Liquidity) which refers to the risk of not having enough cash reserves to meet the demands of withdrawals from depositors (Rahman *et al.*, 2015; Eze 2014).

Non-interest income to total asset ratio (NIITAR): It affects Bank's performance. We expect a positive relationship between NIITAR and bank's performance because non-interest income increases Bank's profitability.

Cost-to-income ratio: Is the ratio of employee salaries and benefits and total after tax profit. Cost-to-income ratio is expected to have inverse relationship with performance.

GDP growth rate: Is a macroeconomic variable that affects firm performance. World Bank data is employed to measure GDP growth rate.

Inflation: Inflation also affects bank's profitability. Data related to inflation is also obtained from World Bank.

The econometric model that consist dependent variable bank profitability (ROA) and specific independent bank profitability determinants is presented as follows:

$$ROA = \beta_0 + \beta_1 X1PCRR + \beta_2 CNNit + \beta_3 CARit + \beta_4 CRRit + \beta_5 BSIZit \\ + \beta_6 NIITARit + \beta_7 COIRit + \beta_8 LIQRit + \beta_9 GDPit \\ + \beta_{10} INFLit + uit + \epsilon it$$

where, t=time series; i=cross-section of Banks; u= time invariant error term; ϵ = stochastic error term that varies with time.

4. Econometric Analysis and Results

The descriptive statistics of the dependent and independent variables has been presented below. As it can be seen from Table 1 the maximum bank profitability in the study period is 6.667% rounded. The minimum bank profitability is 0.0000498%. The average or mean bank profitability is 2.82% rounded. The standard deviation of bank profitability is 1.12%. Table 1 shows that the maximum capital adequacy ratio of banks is 38.24%. The minimum capital adequacy ratio of banks is 0.43 % rounded. The mean and standard deviation of capital adequacy ratio of banks is 14.66% and 57.18% rounded respectively. As we can see from Table 1 presented below the maximum credit risk ratio of banks is 4.53% and the minimum credit risk ratio of banks is 0.36% the mean and standard deviation of credit risk ratio are 0.41% and 0.84% respectively. The maximum value of non- interest income ratio of banks is 7.84% and the minimum value non- interest income ratio is 0.000013%. The mean and standard deviations of non-interest income ratio are 3.4% and 0.15% respectively.

The cost to total asset ratio of Banks is reported in the Table below. The maximum and minimum cost to income ratio values is 490.45% and 16.07% respectively. The mean and standard deviation values of cost to income ratio of banks are 73.97% and 9.97% respectively. The maximum liquidity ratio of banks for the study period is 87% or 0.87, which means there is one birr of asset for one birr of liability. The minimum ration should be 1. So in the study period banks have more liabilities than their assets which cause a liquidity risk. The mean value of liquidity is 73.97% and the standard deviation is 9.97%. The Table also reports macroeconomic determinants of bank profitability such as GDP growth, inflation and corruption perception index. The maximum growth of GDP is 10.58% and the minimum growth of GDP is 7.56%. The

mean and standard deviation for GDP growth are 9.49% and 1.19% respectively. It can be seen that the maximum value of inflation is 24.1% and the minimum inflation value is 7.3%. The mean and standard deviation values of inflation are 11.4% and 6.47% respectively. Table 1 presents the descriptive statistics of bank's profitability and its determinants.

Table 1. Descriptive statistics

Variables	Observation	Mean	Std. Dev.	Min	Max
ROA	75	0.028	0.011	0.000	0.067
CAR	75	0.147	0.057	0.004	0.382
CRR	75	0.004	0.008	-0.004	0.045
NIITAR	75	0.034	0.015	0.000	0.078
COIR	75	0.688	0.583	0.161	4.905
LIQUR	75	0.740	0.100	0.070	0.870
INFL	75	11.400	6.473	7.300	24.100
BSIZ	75	20.316	6.332	2.398	24.045
PCRR	75	33.200	0.403	33.000	34.000
GGDP	75	9.488	1.193	7.562	10.582
ROE	75	0.302	0.668	0.000	5.862
CNN	75	0.467	0.502	0.000	1.000

Source: Authors' Computations.

4.1 Correlation Analysis

Rebekić *et al.* (2015) defined correlation coefficients (r) as measures of statistical relationships. The authors stated that correlation coefficient show the degree of the relationship between variables. The value of correlation coefficient ranges between +1 and -1. Overall, $r > 0$ indicates positive relationship, $r < 0$ repents negative relationship, $r = 0$ indicates no relationship between the variables. Ranjit (*n.d*) stated that correlation matrix is one of the mechanisms that can be examined to check the presence of multicollinearity. Hawking (1983 cited Ranjit (*n.d*)) defined the term multicollinearity as a situation in which there is an exact or nearly exact linear relation among two or more of the independent variables either because of mistake or lack of understanding. In the correlation matrix below one can see that any of the correlation coefficient values have exact or nearly exact values which indicate that there is no multicollinearity problem.

The correlation matrix shows that bank profitability positively correlates with CAR, NIITAR, LIQUR, and BSiz. CCAR and NIITAR are statistically significant at 1%. It can also be observed from the correlation matrix that bank profitability negatively correlated with CRR, COIR, PCRR, INFL, GGDP and CNN. COIR, PCRR and GGDP are negatively correlated with bank profitability and are statistically significant at 1%, 5%, 10% level respectively. Table 2 shows the results of Pearson's Correlation Coefficients.

Table 2. Correlation Table

Variables	ROA	CAR	CRR	NIITAR	COIR	LIQUR	INFL	BSIZ	GGDP	PCRR	CNN
ROA	1.000										
CAR	0.076	1.000									
CRR	-0.107	0.005	1.000								
NIITAR	0.265	-0.165	0.261	1.000							
COIR	-0.526	-0.071	-0.039	-0.033	1.000						
LIQUR	0.007	-0.437	-0.522	0.134	0.208	1.000					
INFL	0.060	0.150	0.035	0.136	-0.199	-0.294	1.000				
BSIZ	0.091	0.307	0.038	0.239	0.155	0.010	-0.058	1.000			
GGDP	0.129	-0.006	-0.068	0.034	-0.030	0.088	-0.279	0.183	1.000		
PCRR	-0.180	-0.083	0.057	-0.114	0.163	0.099	-0.319	-0.145	-0.813	1.000	
CNN	0.097	-0.339	0.040	0.013	0.150	0.135	0.000	-0.225	0.000	0.000	1.000

Source: Own study.

4.2 Econometric Findings

Table 3 below reports the GMM estimates of bank profitability and its determinants. The GMM estimator is applied in this regard due to the following advantages it possesses. Elitza (2007) stated that the GMM estimators are designed for panel data models and are appropriate especially when the number of time periods (T=5) in the data is smaller than the number of resections (N=15) in the panel. The author also argued that GMM estimators are appropriate to handle the endogeneity, autocorrelation. As it can be seen from the GMM estimation Table, capital adequacy ratio (CAR) positively and significantly (at 1% level) affects bank profitability. The result is similar with previous studies such as Mohamed (2015), Antonio (n.d) and Panayiotis *et al.* (2008) who found a positive relationship between capital adequacy and bank profitability. But the result contracts with the findings of Andreas and Gabrielle (2011). The other factor that determines bank profitability is non-interest income to total asset ratio (NIITAR). NIITAR is positively correlated with bank profitability and is significant at 5% level. The result is similar to the findings of Deger and Adem (2011) and Mohammad *et al.* (2015).

Banks can increase profitability by enhancing their non-interest/non-operating income. Bank size and liquidity ratio have positive but statistically insignificant influence on bank profitability. Imad and Thair (2011) also found similar results. As it can be observed from the GMM estimation in Table 3 below political corruption is inversely related with bank profitability and statistically significant at 5% level. This shows that banks can improve their profit by reducing corrupt practices. Banks should be careful especially in the provision of loan and asset valuation (for collateral) which are suspected to be the main source of corruption in the banking sector. GDP growth rate is negatively correlated and a statistically significant determinant of bank profitability. The finding is analogous to previous studies. Andreas and Gabrielle (2011) studied determinants of bank profitability before and during the crisis. Evidence from Switzerland found that annual GDP growth rate is negatively correlated and significantly affecting bank performance. However, it contradicts with some other findings such as by Imad and Thair (2011) who found positive but statistically insignificant relationship between GDP growth rate and bank profitability.

Table 3 presents that inflation is negatively affecting bank profitability but insignificantly. This shows banks are not that much affected by inflation in the study period. However, since inflation negatively correlate with profitability, banks should be able to make themselves ready enough to respond to it. The costs to income ratio negatively and statistically affect the performance of banks.

Table 3. Dynamic Panel- Data Estimation, One- Step Difference GMM

VARIABLES	ROA	ROA	ROA	ROA	ROA	ROA	ROA	ROA
L.ROA	-1.289**	-0.508**	-0.457*	0.001	0.045	0.043	0.049	0.074
	-0.533	-0.242	-0.227	-0.157	-0.162	-0.163	-0.156	-0.151
CAR		0.055	0.048	0.049	0.051	0.045	0.046	0.060
		-0.048	-0.045	-0.037	-0.037	-0.038	-0.038	-0.038
CRR		-0.27	-0.319**	-0.217	-0.209	-0.191	-0.195	-0.143
		-0.164	-0.155	-0.134	-0.13	-0.132	-0.133	-0.13
NIITAR			0.311**	0.256**	0.276**	0.255**	0.256**	0.250**
			-0.124	-0.104	-0.102	-0.106	-0.107	-0.103
COIR				-0.007***	-0.007***	-0.007***	-0.007***	-0.007***
				-0.001	-0.001	-0.001	-0.001	-0.001
LIQUR				0.009	0.015	0.019	0.019	0.030
				-0.029	-0.028	-0.028	-0.028	-0.027
INFL					-0.000	-0.000	-0.000	-0.000
					-0.000	-0.000	-0.000	-0.000
BSIZ					0.000	0.000	0.000	0.000
					-0.000	-0.000	-0.000	-0.000
GGDP						0.000	0.000	-0.012*
						-0.000	-0.000	-0.006
CNN							0	0
							0	0
PCRR								-0.038*
								-0.019
Observations	45	45	45	45	45	45	45	45
Banks	15	15	15	15	15	15	15	15

Note: *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$ indicate 1%, 5%, and 10% significance level

Source: Authors' Computations.

The major cost of banks is employees' salaries, privileges and benefits. Banks can increase their profitability by reducing these costs when necessary but it should be with caution so as not to demoralize their employees. Andreas and Gabrielle (2011) found negative and statistically significant relationship between cost to income ratio and bank profitability. Table 3 reports the negative and insignificant relationship between credit risk ratio and bank profitability.

5. Conclusion and Implications

The aim of the study was to determine the relationship between political corruption, political connection and bank profitability for a panel of 15 commercial Banks in a period of 5-years (2012-2016). In this regard the GMM estimation was applied due to the nature of variables and the data itself. Based on the result of the GMM estimation the researcher concluded that the cancer of political corruption is also affecting the banking sector. GDP growth rate and cost to income are significant factors that determine bank profitability. The bank's financial performance is positively and significantly affected by capital adequacy and non-interest income to total asset ratio.

This research can be expanded by incorporating other determinants of bank profitability and considering recent bank financial data and qualitative data.

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