Political Connection And Credit Risk Management: Its Effect On Bank’s Performance

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ABSTRACT

The present study examines the effect of political connection and credit risk management on Indonesian bank’s performance during the declining credit growth period. The present study involved 258 banks that registered in the Indonesian Stock Exchange from 2012 to 2017 as the sample of the study. Company political connection was measured using headcount index, credit risk management was measured by its credit risk value or NPL, and the company financial performance was measured based on Return on Asset. The data of the study were obtained from banks and Indonesian Stock Exchange annual report. The result of regression analysis showed that Indonesian bank’s political connection positively and significantly affected financial performance, and credit risk significantly affected bank’s financial performance. This result implied that banks in Indonesia needs political connection and improve their credit risk management in order to improve their financial performance during the declining credit growth period. The present study reveals a new fact that in order to maintain financial performance during the declining credit growth period, banking institution may utilize their political connection and improve their credit risk management.
INTRODUCTION

From 2012 to 2017, Indonesian banks’ credit growth declines. Statistical data exhibit that credit growth from 2012 until 2017 was 23.08 percent, 21.6 percent, 11.58 percent, 10.44 percent, 7.87 percent, and 7.86 percent, respectively. This decline indicates the bank ability in distributing the community funds which come from saving, current, certificate of time deposit, and time deposit in the form of credit. As a result, this affects bank’s Return On Asset (ROA). It occurs because of the fewer the credit is distributed, the lower the bank interest income. Meanwhile, the majority of Indonesian bank’s source of income is interest (Riyadi, 2015). Accordingly, bank needs various attempts to improve their performance during this declining credit growth decline. Some alternative attempts they make are by establishing political connection and carrying out risk management.

Indonesia is a democratic state. It holds general election every five years. In every general election, many candidates arise and bring their vision and mission for the community. By democratic system, this country holds many candidates who come from various background. A considerable campaign fund becomes the primary reason why the entrepreneur holds broader opportunity to participate in legislative or executive election. Nonetheless, in rentseeking theory, rent-seekers will attempt to gain benefits from the political connection they build with politicians (Krueger, 1974). A company is indicated as rent seeker by their poor audit quality and real earning management strategy to reduce its detection risk (Habib, Muhimmadi, & Jiang, 2017; Braam, Nandy, Weitzel, & Lodh, 2015). A rent seeker will always attempt to conceal rent-seeking transaction for it can be indicated as corruptive act.

The decline in credit growth makes the government projects become one of the most wanted credit absorptions by the bank. Accordingly, the bank needs to possess political connection with governmental apparatus or institution so that they can perform rent-seeking by lobby to gain credit absorption to the government project.

Many studies have shown the benefit of company political connection. Previous studies show that political connection can improve company performance (Chen, Li, Luo, & Zhang, 2017; Muttakin, Monem, Khan, & Subramaniam, 2015; Wu, Wu, Zhou, & Wu, 2012; Rumokoy, Neupane, Chung, & Vithanage, 2017; Ding, Jia, Wu, & Zhang, 2014). Besides, political connection makes a company easier to get the government project (Lehne, Shapiro, & Vanden Eynde, 2018).

Previous studies in Indonesian banking sector show that political connection can improve the bank reputation and reduce the financing cost (Nys et al., 2014; Sutopo et al., 2017). Accordingly, there is a probability that political connection can be used to improve credit absorption to the government project in order to improve the company performance.

On the other hand, there is an inconsistency on the effect of political connection on company performance. Other studies show that political connection may also decrease a company value (Chen et al., 2017; Wang, Xu, Zhang, & Shu, 2018; Chen, Liao, Lin, & Yen, 2018; Muttakin et al., 2015). Therefore, the ability of political connection in assisting Indonesian banks increase their credit absorption on government project in order to improve their performance during the decline of credit growth is still need to be studied.

In addition to political connection, during the period of decline of credit growth, banks needs to pay attention to their risk management in order to improve their financial performance. In this period, banks’ failure in maximizing credit interest income that affects ROA will be the responsibility of the agent. It becomes the agent’s responsibility because according to agency theory, the agent is appointed by the principal as the decision-maker in managing a company based on a mutually beneficial agreement (Jensen & Meckling, 1976). As an attempt to maximize financial performance, agent potentially performs high-risk matters. Therefore, it brings up loss potential for the company.

Djojosoodarso (2003) state that risk management refers to the managerial role activities in countering risks faced by the company. The activities consist of planning, organizing, arrangement, coordination, and supervision, and evaluation of the risk management program. Therefore, every attempt to maximizing the financial performance shall be accompanied by risk management in order to prevent loss. Previous theories explain that proper risk management will improve a company financial performance.

(Barton, Shenkir, and Walker, 2002; Hoyt and
Liebenberg, 2009; Nocco and Stulz, 2006; Kansil, Murni, and Tulung, 2017). The study conducted by Aebi, Sabato, & Schmid (2011) and Gordon, Loeb, & Tseng (2009) supported the theory by showing that risk management can improve company performance.

Besides, a study by Nair, Purohit, dan Choudhary (2014) found that one of the dimensions of risk management, namely risk assessment, negatively and insignificantly affect financial performance. That insignificant result is in contrast with the study conducted by Aebi et al. (2011) and Gordon et al. (2009). That result weakens the previous empirical proof stating that risk management positively and significantly affects financial performance. Therefore, this study aims to examine further the effect of risk management on banks’ performance in order to ensure the consistency of the result of the previous studies. However, this study focused only on credit risk management because the current problem is the decline in credit growth.

The presents study employed multiple linear regression to examine the effect of political connection and banks’ credit risk management on banks’ performance in Indonesia. Political connection was measured by using headcount index (Chen et al., 2017), the credit risk management was measured using Non-Performing Loans or banks’ credit risk in accordance with Bank Indonesia Circular Letter no. 6/23/DPNP of 2004 as the outcome of credit risk management, and financial performance was measured by using Return On Asset (Wu et al., 2012; Muttakin et al., 2015).

This study provides benefits for academic and practical field. In academic field, this study provides new empirical proof on the effect of political connection and credit risk management on the banks’ financial performance in Indonesia. Meanwhile, in practical field, this study showed that the Indonesian banks needs to possess political connection and properly perform credit risk management to improve banks’ performance during this declining credit growth period.

This article consists of some section. The first section is the background of the study, the second section is a literature review, the third section is research data and methodology, the fourth section is the explanation of empirical result, and the fifth section is the conclusion.

LITERATURE REVIEW

Political Connection and Banks’ Performance

The problem faced by banks in Indonesia from 2012 until 2017 is the declining performance due to the decline in credit growth. The decline in credit growth affects banks’ performance because most of the source of earnings of banks in Indonesia is credit interest. Besides, Act no. 10 of 1998 on Banking (article 1 paragraph (2)) states that Bank refers to a business that collects the community funds in the form of saving and distribute it to the community in the form of credit or other forms in order to improve the life standard of the community. The definition shows that credit distribution is the main activity of Indonesian bank, and credit interest is the primary source of earnings of banking in Indonesia.

That problems obligate banks to find a solution to maintain the credit absorption during the declining credit growth period. One of the credit absorptions that can be expected in this challenging period is credit absorption to the governmental sector. However, in order to obtain credit absorption to the governmental sector, banks should do rentseeking activity.

Rentseeking refers to an activity done by rent seekers to gain benefits from their political connection (Krueger, 1974). Therefore, in order to do rentseeking, a political connection is needed. According to rentseeking theory, in facing problems on performance decline due to decline in credit growth, banks should possess political connection to obtain credit absorption from governmental sector. The larger the political connection to the government, the larger the credit absorption from the governmental projects, meaning the improvement of financial performance.

Some previous studies show that political connection positively and significantly affects company performance (Chen et al., 2017; Muttakin et al., 2015; Wu et al., 2012; Rumokoy et al., 2017; Ding et al., 2014). It shows that political connection gives advantages to the company. However, that results is not consistent since there are some studies that found that political connection also leads to the decrease of company value (Chen et al., 2017;
Wang, Xu, Zhang, & Shu, 2018; Chen, Liao, Lin, & Yen, 2018; Muttakin et al., 2015).

In Indonesia, studies found that political connection can improve bank’s reputation and reduce financing cost (Nys et al., 2014; Sutopo et al., 2017). Nys et al. (2014) showed that the bank utilizes its political connection to improve its reputation so that the customer is interested in depositing their funds to the bank. Sutopo et al. (2017) reveal that political connection can improve the company financial performance because the political connection can lower the financing cost, so, it increases the profit margin.

However, the studies in Indonesia stands in a different background from the present study. The background of the problem of the present study was the bank’s declining performance due to the decline in growth. The present study exhibited whether Indonesian banks, by using its political connection, is able to improve credit absorption from the government project to improve its financial performance during the declining credit growth period. Therefore, the hypothesis of the study was formulated as follow:

H1: Political connection positively and significantly affect banks’ performance in Indonesia.

Credit Risk Management and Banks’ Performance

According to agency theory, the agent holds responsibility as a decision maker in managing a company based on a mutually beneficial agreement (Jensen & Meckling, 1976). Accordingly, Banks’ failure in maximizing credit interest earning that affect ROA or financial performance during the declining credit growth period will take the agent’s responsibility.

In declining credit growth period, credit risk can possibly increase. It occurs because the agent who runs the Bank as creditor potentially become less selective in conducting fit and proper test on their prospective debtors. This is caused by difficulties in gaining a debtor. In addition, political connection can possibly make the bank become looser in selecting their prospective debtor because the selection is based on political connection only, and pay less attention to other risky matters.

Risk management refers to the managerial role activities in countering risks faced by the company (Djojosoenadjar, 2003). The activities consist of planning, organizing, arrangement, coordination, and supervision, and evaluation of the risk management program.

Previous theories have stated the importance of risk management. It is stated that risk management will improve company financial performance (Barton et al., 2002; Hoyt and Liebenberg, 2009; Nocco and Stulz, 2006). Aebi et al. (2011) Supported the theory by showing that the company with Chief Risk Officer (CRO) exhibit better performance than those that do not. In the same vein, Gordon et al. (2009) state that risk management can improve company performance. However, a study conducted by Nair et al. (2014) found that one of the dimensions of risk management, namely credit risk assessment, negatively and insignificantly affect the financial performance of International Islamic Bank. This shows inconsistency. Accordingly, this still needs to be studied.

The present study examines further the effect of credit risk management on the bank’s performance. However, this study focused only on the decline in credit growth. This study focused only on the credit risk management. The lower credit risk means the better credit risk management and bank’s financial performance. Therefore, the hypothesis of the study was formulated as follow:

H2: Credit risk negatively and significantly affect the bank's performance in Indonesia.

RESEARCH METHODOLOGY

Sample

In order to test the hypotheses, the population of the study was all Indonesian banks in 2012-2017. Purposive sampling technique was used to select the sample. 258 banks that were registered in Indonesian Stock Exchange and provided annual report in 2012-2017 emerged as the sample of the study.

Dependent Variable

In this study, company financial performance was the dependent variable. The proxy of financial performance was Return on Assets (ROA), which was considered as profit before tax divided by asset book value. ROA refers to rentability ratio that is used to measure management’s ability in generating profit.
This ratio was used because currently, Indonesia faces a decline in credit growth. The decline in credit growth will affect profit because the primary source of Indonesian banks are credit interest income (Riyadi, 2015). Accordingly, the decline in credit growth will affect bank's rentability ratio. In addition, some previous studies also used ROA as the proxy of financial performance. (Wu et al., 2012; Muttakin et al., 2015).

Independent Variable

Political connection and credit risk were employed as the independent variable. Political connection shows the bank’s political strength as a rent seeker in influencing the government's strategic decision to gain benefit or rent from it. While credit risk exhibits the bank's ability in performing risk management to control its credit risk.

In the present study, Bank's political connection was measured using the headcount index (Chen et al., 2017). The political connection was measured using the number of the commissioner, director, and owner who held political connection. In order to analyze the political connection held by the commissioner, director, and the owner, the researcher analyzed their profile in the bank's annual report. When it was not enough to reveal their political connection, the researcher accessed the website showing their political connection.

Bank’s credit risk was measured based on Non-Performing Loan (NPL), in accordance with Bank Indonesia Circular Letter no. 6/23/DPNP of 2004. NPL depict the bank’s performance in carrying out its credit risk management. The fewer the NPL, the better the bank's credit risk management because the bank's credit risk is smaller.

Controlling Variable

The controlling variables in the present study were growth, leverage, age, and firm size (Muttakin et al., 2015; Nys et al., 2014). Growth was measured based on the growth ratio of company’s total asset, Leverage was measured based on the total debt divided by total asset, Age was measured based on the bank’s age, and Size was measured based on Log natural of bank's total asset.

Data Analysis

Hypotheses of the study were tested using multiple regression analysis. The multiple regression equation model used in this study was as follow:

\[ ROA = \alpha + \beta_1 (KonPol) + \beta_1 (Risiko Kredit) + \varepsilon \] (1)

\[ ROA = \alpha + \beta_1 (KonPol) + \beta_1 (Risiko Kredit) + \sum_{i=2}^{n} \beta_i (Kontrol) + \varepsilon \] (2)

Regression model 1 is the model used to analyze the effect of political connection on Indonesian bank's performance (hypothesis 1). Regression model 2 is the model used to analyze the effect of political connection and credit risk on the bank's financial performance.

Table 1. Variable Definition

| Variable Calculation |
|-----------------------|
| Dependent |
| ROA (Return On Asset) | Pretax earning / asset book value (Wu et al., 2012; Muttakin et al., 2015). |
| Independent |
| Political connection | Headcount index (Chen et al., 2017) |
| Credit risk | Non-Performing Loans (Nys et al., 2014) |
| Control Group |
| Growth | Growth ratio of company’s total asset (Muttakin et al., 2015) |
| Leverage | Total asset (Muttakin et al., 2015) |
| Age | The age of the company (Muttakin et al., 2015) |
| Firm Size | Natural log of total assets (Muttakin et al., 2015) |

RESULT AND DISCUSSION

Sample

The data of the sample of the study were shown in table 2. Based on the sample selection, forty-three banks that were registered in Indonesia Stock Exchange that consistently provided an annual report from 2012-2017. Panel data was used to enhance the number of samples, prevent bias, and to make a more generalizable result.
Table 2. Sample

|                        | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|------------------------|------|------|------|------|------|------|
| Government-owned bank  | 4    | 4    | 4    | 4    | 4    | 4    |
| Foreign Exchange       | 26   | 26   | 26   | 26   | 26   | 26   |
| National Private Bank  | 9    | 9    | 9    | 9    | 9    | 9    |
| Non-Foreign Exchange   | 26   | 26   | 26   | 26   | 26   | 26   |
| National Private Bank  | 9    | 9    | 9    | 9    | 9    | 9    |
| Regional Development Bank | 3   | 3    | 3    | 3    | 3    | 3    |
| Mixed Bank             | 1    | 1    | 1    | 1    | 1    | 1    |
| Total                  | 43   | 43   | 43   | 43   | 43   | 43   |

Descriptive Statistic

Table 3 shows the result of descriptive statistic. The result of the descriptive statistic shows that there were 258 subjects of the study ROA was in the range of -0.134 to 0.176 with average of 0.011 below the median of 0.013. ROA indicated that the average performance of Indonesian banks had not been optimum, there was still negative ROA value, indicating that there were banks that incurs losses. It was found that the Indonesian banks holds quite high average of political connection (31.5%) above the median (29.7%). The same condition also occurred in credit risk where its value was above the median. The value of 0.000 on risk credit refers to the value of 0% on bank’s NPL. Growth, leverage, and size also showed the same thing; its value was above the median. While the difference occurred on variable company's age, its value was below the median, meaning that there were more new banks than the old ones that survived in Indonesia.

Table 3. Descriptive Statistic

| Variable        | N   | Mean | Med  | SD  | Max  | Min  |
|-----------------|-----|------|------|-----|------|------|
| ROA             | 258 | 0.011| 0.013| 0.024| 0.176| -0.134|
| Political       | 258 | 0.315| 0.297| 0.191| 0.818| 0.000|
| Connection      | 258 | 1.743| 1.530| 1.345| 6.980| 0.000|
| Credit risk     | 258 | 0.175| 0.132| 0.345| 2.647| -0.991|
| Growth          | 258 | 0.876| 0.860| 0.490| 8.551| 0.144|
| Leverage        | 258 | 39.504| 41.000| 15.818| 76.000| 14.000|
| Age             | 258 | 30.348| 30.132| 1.851| 34.656| 26.687|

The result of the Regression Test

The researchers examined the effect of political connection on company performance. Two regression equations were employed in this study. The first equation examined the effect of political connection on the company's performance. The Second equation examined the effect of political connection and risk management on the company's performance along with the controlling variable. Table 3 exhibits the result of model 1 and model 2 regression test.

The result of model 1 regression equation test showed that H1 and H2 are accepted. By adjusted r-square of 0.235, model 1 showed that the political connection positively and significantly affects the company’ performance by P-value of 0.002 and credit risk negatively and significantly affect the company performance by P-value of 0.000. Lower credit risk means better credit risk management. Therefore, the result showed that better credit risk management means better financial performance.

Regarding political connection, this result support the previous studies showing that political connection is still vital for a company to improve its financial performance (Chen et al., 2017; Muttakin et al., 2015; Wu et al., 2012; Rumokoy et al., 2017; Ding et al., 2014). Besides, regarding the risk management, this result is consistent with previous studies showing that the better risk management leads to better company performance (Barton et al., 2002; Hoyt and Liebenberg, 2009; Nocco and Stulz, 2006; Aebi et al., 2011; Gordon et al., 2009).

The result of model 2 regression test also supported the result of model 1 stating that H1 and H2 are accepted. The test result showed that the political connection positively and significantly affects the company’ performance by P-value of 0.006 and credit risk negatively and significantly affect the company performance by P-value of 0.000. The adjusted r-squared of model 2 was 0.238. The value is higher that that of model 1 because model 2 contains the controlling variable.

Regarding the effect of political connection on banks' performance, this result supports previous studies conducted in Indonesia (Nys et al., 2014; Sutopo et al., 2017). Besides, the result of the study also supports previous studies showing that political connection will provide ease in gaining
government project (Lehne, Shapiro, & Vanden Eynde, 2018). Therefore, the bank’s political connection will affect its credit absorption on the government infrastructure sector. With regard to the effect of credit risk on the banks’ performance, it was found that the lower the credit risk, the better the banks’ financial performance is. Lower credit risk means better banks’ risk management. This result is consistent with previous theories and studies showing that the better risk management leads to better company performance (Barton et al., 2002; Hoyt and Liebenberg, 2009; Nocco and Stulz, 2006; Aebi et al., 2011; Gordon et al., 2009). (Barton et al., 2002; Hoyt and Liebenberg, 2009; Nocco and Stulz, 2006; Aebi et al., 2011; Gordon et al., 2009).

**Robustness Test**

Robustness test was conducted to ensure that the result of the study is consistent and last longer. In order to perform a robustness test, the researchers separate the sample into two categories, government-owned bank, and private bank. Government-owned bank consists of government bank and a regional development bank. This separation was done because government-owned bank and regional development bank are the banks with a direct connection to the government because they are held by the government.

| Variable      | Model Government-owned bank | Model Private Bank |
|---------------|----------------------------|-------------------|
| KonPol        | 0.032                      | 0.020             |
| Credit risk   | -0.016                     | -0.008            |
| Growth        | 0.122                      | 0.066             |
| Leverage      | 0.149                      | 0.079             |
| Age           | -0.000                     | 0.002             |
| Size          | -0.002                     | 0.001             |
| Adjusted R-squared | 0.770                  | 0.194             |
| F-Statistic   | 23.99                      | 9.598             |
| Prob(F-statistic) | 0.000                  | 0.000             |
| Total Observations | 42                      | 216               |

Table 4. The result of the Regression Test

| Variable      | Model 1         | Model 2         |
|---------------|-----------------|-----------------|
| KonPol        | 0.022           | 0.020           |
| Credit risk   | -0.008          | -0.008          |
| Growth        | -0.003          | 0.557           |
| Leverage      | -0.001          | 0.789           |
| Age           | 0.000           | 0.187           |
| Size          | 0.001           | 0.427           |
| Adjusted R-squared | 0.235       | 0.238           |
| F-Statistic   | 40.405          | 14.379          |
| Prob(F-statistic) | 0.000         | 0.000           |
| Total Observations | 258            | 258             |

This table shows the regression result of equation model 1, 2, and 3. ROA equals to EBIT divided by asset book value. KonPol refers to political connection index, which was measured using headcount method. PI refers to the number of the audit committee as a moderator variable. PC_Index*IC is the interaction between political connection index and moderator variable. Growth refers to asset growth. Leverage represents the debt ratio towards the asset. Age refers to the age of the company. Risk refers to the banks’ non-performing loan. Size refers to the Log Natural of the company total assets and shows the significance level of 10%, 5%, dan 1%.
credit growth period. Regarding the effect or credit risk on performance, the result of robustness test showed that credit risk negatively and significantly affects the bank’s performance, both government-owned bank and the private bank. Lower credit risk means better bank’s risk management. Accordingly, it can be concluded that risk management is vital for the bank, both governments owned, and private bank.

CONCLUSION

The present study examined the effect of political connection and risk management on bank’s financial performance during the declining credit growth period. Regarding the effect of political connection on bank’s performance, the result of this study indicated that political connection might benefit the bank in improving its performance during the declining credit growth period. The result support H1 stating that political connection positively and significantly affect the bank’s performance in Indonesia and private bank political connection more significantly affect the financial performance than the government-owned bank does. Besides, the result of the study also supports H2 stating that credit risk significantly affects the bank’s performance in Indonesia. This indicated that risk management could improve the bank’s performance during the declining credit growth period.

Regarding political connection’s effect on performance, the result of the study implied that banks in Indonesia needs to hold political connection. The bank’s political connection can improve their financial performance, even during the declining credit growth period. Bank’s political connection will affect its credit absorption on the government’s infrastructure sector due to easy access to the responsible parties of government projects. Besides, the political connection also brings more advantages for the private bank rather than for the government-owned bank in the attempts of improving their performance during the declining credit growth period.

Regarding the effect of risk management on the bank’s performance, the result of the study implied that the bank in Indonesia needs to perform risk management as good as possible in facing macro declining credit growth. The bank’s better risk management means better the bank’s performance.

There was some limitedness in this study. The result of the study had not explained what bank could perform in order to manage the risk that potentially occurs due to political connection. The bank’s political connection can improve the bank’s financial performance by improving its credit absorption to government projects. However, large credit absorption can also endanger the bank if it does not properly manage the risk that potentially occurs due to its political connection.

The future study can be conducted based on the limitedness and implication of the current study. The future study can pay attention to the the bank’s internal controlling factors and other factors that potentially manage the risk that potentially occurs due to its political connection.
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