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# Political Connection in the GCC Banks

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# Abstract

In the context of the Gulf Cooperation Council (GCC) region, the political connection has been subject to little scrutiny and the question of why this remains the case deserves further attention. This thesis aims to investigate the effect of political connection on the GCC banks taking into consideration two major crises: the global financial crisis of 2008, and the Qatar blockade crisis of 2017. The thesis provides several contributions to the political connection literature. Firstly, the author knows of no pre-existing empirical work that attempts to map the academic structure of political connection literature from extant bibliometric studies. Secondly, the study is the first to investigate the effect of political connection on banks' capital structure in the GCC countries using manually collected primary data. Thirdly, the present research provides several contributions to the political economy and corporate governance literature. Scarce attention has been afforded to diversity and political connection subject matter, especially in Gulf countries. In particular, the banking sector in the GCC countries is highly connected and most of the boards of directors include a large number of foreign directors, especially from the GCC region. The findings provide several important policy implications for policymakers, investors, and regulators. The study suggests a degree of caution with respect to governments regarding the amount of support that they provide to avoid sending an erroneous signal to both investors and markets. Certainly, estimates of political connections during periods of rising uncertainty can be perceived as an efficacious way to accurately estimate the banks' performance and can allow policymakers to design the best possible policies to increase its performance. Investors also need to carefully count for the political support and its negative effect during the crisis time. The blockade crisis has a clear significant effect on the banking sector and inflicted loss not only on Qatar but also on the boycotting countries (Lose-Lose situation).

# Declaration

This work has not been previously accepted in substance for any degree and is not being concurrently submitted in candidature for any degree.

Signed _____ (candidate)

Date _____

**STATEMENT 1**

This thesis is the result of my own investigations, except where otherwise stated. Where correction services have been used, the extent and nature of the correction is clearly marked in a footnote(s). Other sources are acknowledged by footnotes giving explicit references. A bibliography is appended.

Signed _____ (candidate)

Date _____

**STATEMENT 2**

I hereby give consent for my thesis, if accepted, to be available for photocopying and for inter-library loan, and for the title and summary page to be made available to outside organisations.

Signed _____ (candidate)

Date _____

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# Acknowledgements

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# Chapter 1

# Introduction

Political connection has a crucial impact on the output of firms. The economic, financial, and managerial implications of political connection have attracted the attention of numerous academics, policymakers and the public. The dynamics of political connection can be explained in the context of resource dependence theory. This theory states that powerful political ties are pivotal for firms' dependency. Political connection is one of the mechanisms that companies adopt to alleviate social, and global pressures. To reduce uncertainty, firms appoint politicians to their boards of directors. However, the effect of political connection on a firm's output is subject to considerable debate.

In the context of the GCC region, political connection has been subject to little scrutiny and the question of why this remains the case deserves further attention. Key challenges include data scarcity and difficulties in conducting field research, and methodological challenges associated with obtaining political connection data.

The importance of this thesis lies in the fact that it conducts an empirical analysis of the political connection and banks performance in the GCC region. This thesis comprises four chapters intending to enhance the political connection literature. Previous research has focused on empirically investigating the impact of political connection within various macro and micro contexts. However, few studies have investigated the effect of political connection in the GCC (Gulf Cooperation Council). The study also focuses on the association between political connection and the banking sector in the GCC countries which has been neglected in the literature.

This area of study is important and of interest within this region due to the various financial markets, including new markets, such as Dubai and Abu Dhabi which aim to attract investors and foreign capital inflows. It also encompasses established markets, such as those in Saudi Arabia, Kuwait, and Oman, which seek more effective reforms (Naceur et al., 2008). In the GCC countries, banks are the primary financial institutions. The banking sector dominates capital transactions by gathering money and finance investment (Naceur and Omran, 2011). One of

the single most important features of the banking sector in the GCC countries is that they are either domestically owned or dominated largely by government. The political and economic dominance of royal families in GCC countries is clear and it has a significant and strategic impact on the business environment and economic regional outcomes.

These fundamentals are deeply rooted in Arabic culture and history, such as in values, institutions and relations. The GCC states pride themselves in being the cradle of Arabism and this has deep socio-political consequences. For example, traditionalism governs political relations and favouritism determines social structure. All these factors combine to shape a resistant nature to change, and this is expected to continue into the future. Ruling families are one of the rigid pillars of the Gulf political system. These families have survived significant threats and obstacles to their rule and they have proved their ability to endure. This political situation is associated with numerous ambitious economic plans to diversify the structure of the economy: from one that is oil-based to one that is more sustainable, while retaining a strong financial and business environment. This alliance between the business sector and the political domain has resulted in increased academic interest regarding the study of the dynamics of political connection and its effect on the banking sector in GCC countries. The economic stability in several GCC countries was a result of the link -mostly through marriage alliances- between the rulers, tribal leaders and local merchant families. The merchant families help to meet the ruling needs as a trade of the political influence and protection (Kamrava et al., 2016).

## 1.1 Study aims/Objectives

Financial institutions and banks are the most affected by external contingencies, and crisis uncertainties. Hillman (2005) argued that to mitigate the high level of uncertainty, financial institutions are more likely to build external ties (e.g., board directors' political connections). This would provide protection against major events or crises through government financial support.

This thesis aims to investigate the effect of political connection on the GCC banks taking into consideration two major crises: the global financial crisis of 2008, and the Qatar blockade crisis of 2017.

In this study, the author first explore the political connection literature. The study analyses political connection literature from 2000 to 2020. It presents a catalogue of the influential aspects resulting from a bibliometric meta-analysis of political connection literature. Advanced data visualization techniques of political connection literature are employed. Metrics considered include countries, authors, articles, and topics. The analysis considers the research papers that empirically investigated

the effect of political connection on firms' output which will help to cultivate our knowledge about political connection literature.

The study also explores the association between capital structure and political connection in GCC banks. Empirically, very little is currently known about the determinants of the capital structure of developing firms. Moreover, most previous literature has focused on the firm level and has ignored the capital structure of banks and financial institutions (Antoniou et al., 2008).

The study also investigates the Qatar blockade crisis. The narrative of this crisis is as follows. The crisis started in June 2017 when a coalition of countries led by Saudi Arabia, the United Arab Emirates, Egypt, and Bahrain resulted in a rift between Qatar and its Gulf neighbours. The alliance took the decision to blockade Qatar and cut diplomatic and economic ties and imposed a list of demands for Qatar to end the crisis. Qatar remained defiant and denied the charge and accused its neighbours of seeking to interfere and curtail its sovereignty. A 2018 IMF report concluded that Qatar was able to mitigate the crisis through governmental measures which relied upon its extensive economic resources. However, the crisis added further complications to a region that was already dealing with concurrent civil wars, growing regional tensions between Iran and Saudi Arabia, and several Arab spring uprisings. The whole region was affected negatively by the crisis.

The study is the first to investigate the effect of political connection on banks' profitability in Bahrain, before and after the blockade crisis, between 2015 and 2019, and to explore its effect on one of the boycotting countries. Bahrain offers a suitable context to test the effects of political connections on banks' performance because of its centrality in the banking sector in the region. Banking sector assets in 2018 stood at over US$192 billion, more than five times the annual GDP of Bahrain and accounted for over 85% of total financial assets (Central bank of Bahrain report 2018). In the GCC, the banking sector is primarily domestically owned. Furthermore, all GCC countries have limits upon foreign ownership except Bahrain. However, Bahrain has sizeable joint ventures in the domestic banking system with foreign investors, mostly from within GCC countries (Al-Hassan et al., 2010). Hence, this study investigates the effect of the Qatar blockade on banks' profitability in Bahrain.

Finally, the study investigates the effect of politically connected boards of directors on Bahraini banks risk from 2015 to 2019. The study aims to answer two questions by exploiting the Qatar blockade crisis as an exogenous shock: - Does political connection have a positive or negative impact on banks' risk? - What is the impact of foreign directorship on banks' risk in Bahrain? The constitution of the board of directors is a key element in the performance and risk profile of firms. Moreover, resource dependence theory identifies the board of directors as a form of

capital which affects the provision of resources and a firms' performance and risk profile. Firms endeavouring to increase capital occasionally invite important customers, key suppliers, foreign investors, or politicians to serve on their board to increase their profitability and decrease their risk. Foreign directorship potentially delivers a precious international skill-set and external expertise to the corporations Carter et al. (2003). However, some researchers have argued that foreign directorships are potentially less effective and could increase conflicts and weaken the role of the board, which could adversely affect the companies' performance.

Board diversity has attracted the interest of researchers from various disciplines. Previous research has found a positive link between board diversity and company performance (Carter et al., 2003; Dalton et al., 1998; Mak and Yuanto, 2003; Yermack, 1996). There are also a growing number of studies which investigate the relationship between board diversity and corporate governance in developed countries (Adams and Ferreira, 2009), and innovation in banks (Bantel and Jackson, 1989). However, the effect of political connection and foreign directorship on the banks' risk in the developing counties is not sufficiently addressed. The study uses DID to investigate the causal effect of political connection on the banks' risk in Bahrain by exploiting the recent crisis in the region.

Hence, the thesis aims at investigating the effect of political connection on Banks in the GCC during the financial crisis and Qatar blockade crisis.

## 1.2 Study Contribution

The thesis provide several contributions to the political connection literature. Firstly, the study is the first to investigate the effect of political connection on banks' capital structure in the GCC countries using manually collected primary data. The author manually collected information and affiliations concerning the royal families and parliament members from government websites and trusted media outlets. The Orbis database was also used to obtain information about boards of directors in the GCC banks. Secondly, the author knows of no pre-existing empirical work that attempts to map the academic structure of political connection literature from extant bibliometric studies. Thirdly, , the present research uses network analysis and community detection to understand social clustering within the field. Fourthly, this study incorporates the leading literature produced to date, from several world countries to elucidate the relationship between political connection and six major research streams. Fifthly, the study fills the gap in the literature concerning the relationship between political connection and capital structure in the GCC countries. Sixthly, the contribution of this study focuses on the banking sector in the GCC countries: this focus remains scarce in the literature. Seventhly, this study

is the first to link board of directors' connections with risk-taking behaviour in the post-financial crisis era in the banking sector.

Eighthly, the study fills in an important gap in the literature because it constitutes the first examination of the impact of political connections on the performance of banks in Bahrain. To the best of the author's knowledge, the role of political factors in Bahrain has not been examined in relation to the banking system. Ninthly, the paper is the first to investigate the effect of the Qatar blockade on the banking sector as one of the most recent financial, economic and political crises in the region.

Tenthly, the present research provides several contributions to the political economy and corporate governance literature. Scarce attention has been afforded to diversity and political connection subject matter, especially in Gulf countries. In particular, Bahrain is a rich but developing country with a unique economic, legal and cultural environment which deserves further investigation. Bahrain is one of the boycotting countries, the present research also investigates the effect of the blockade on its banking system. In addition, the banking sector in the GCC countries is highly connected and most of the boards of directors include a large number of foreign directors, especially from GCC countries. In response to this, the study extends the current literature by providing evidence of the effect of foreign directorship on banks' risk.

## 1.3 Policy Implications

The findings provide several important policy implications for policymakers, academics, investors, and regulators who are interested in the GCC region. The study suggests a degree of caution with respect to governments regarding the amount of support that they provide to avoid sending an erroneous signal to both investors and markets, which may affect economic growth negatively in the long run. Indeed, the results suggest that banks may receive a different level of support as other calls as made of each country's finances.

Given the connection between the economies of the Gulf countries, it is important to investigate the effect of such an event on the main banking sector of the region and as a boycotting country as well. Thus, the study offers insight into the economic consequences of the boycotting decision on the banking sector and recommendation to the policymakers. Certainly, estimates of political connections during periods of rising uncertainty can be perceived as efficacious way to accurately estimating the profitability of financial markets and the economy, and can allow policymakers designing the best possible policies to increase banks' performance. Collectively, these findings help us better understand the effect of political connection on the banking sector in the region. Political capital can affect the competitiveness ability

of banks which can have negative consequences on the economy in the distress times.

Investors also need to carefully count for the political support and its negative effect during the crisis time. Our findings are important to the GCC policymakers who need to carefully monitor the connection of the banking sector on the GCC blockade before taking any decision against any of its countries as the effect is obviously negative on the banking sector in Bahrain as one of the boycotting countries. The blockade crisis has clear significant effect on the banking sector and inflicted loss not only on Qatar but also on the boycotting countries.

Regulators should emphasize methods to mitigate the risk during the crisis time to avoid its negative impact on profitability and to avoid future instability in the financial sector.

I believe this paper provides insights to understand the effect of the Qatar blockade crisis as an exogenous shock on finance and how political connection influence bank profitability. The results suggest that political connection exert a negative causal impact on banks' profitability during the crisis. The results provide apparatus for the political rent-seeking literature in the GCC banking.

the present research provides several contributions to the political economy and corporate governance literature. Scarce attention has been afforded to diversity and political connection subject matter, especially in Gulf countries.

This thesis would be of great benefit to academics who are interested in the GCC region and the field of political economy, banking and corporate governance and provide several insights to understand the dynamics political connection.

# Chapter 2

# Political Connection:A Literature Review

## 2.1 Introduction

In recent years, interest in the effect of political connections has been considerable, starting with the seminal work of Fisman (2001), who investigated the effect of political connections on firms' performance in Indonesia. The political connection is the power of politicians to connect with the banks to finance firms that politically support them, in return for the likelihood of greater political or financial support (Andrianova et al., 2012).

However, Khwaja and Mian (2005) argued that the favors received by the firms depend on the degree of the politician's power and whether their party holds power. Markgraf and Rosas (2019), who explored the effect of political ties with the politician themselves, found that mayors with a political connection to a savings bank were more likely to win re-election than non-politically connected mayors. In a similar vein, Agrawal and Knoeber (2001) and Akey (2015) argued that political connection is one of the most powerful tools that can affect firms' sales, appropriations, and taxation. The firms' donations to the political party can be viewed as a contribution to building political networks. Further, as Fan et al. (2007) and Acemoglu et al. (2016) noted, in countries with weak property rights and low investment rates, political connections had a strong, negative effect on the performance of firms and the quality of governance. All these developments heighten the requirement to analyses the domain of political connection in greater depth.

Measuring political connection is burdened with difficulty. When the impact of political connection on firms' value and other aspects is analysed, differences between measurements of political connections need to be carefully considered. Prior literature has employed various indicators. For instance, Agrawal and Knoeber

(2001) used employment in government or political party, and the possession of a law degree by a member of the board of directors as a proxy for political connection. They argued that directors who hold a law degree have experience in dealing with the government in an administrative or legal proceeding. Fisman (2001) created an index reflecting the degree of political connection of firms in the political system of Indonesia. Here politically connected firms linked to President Suharto's sons and daughters obtained the highest score. Similarly, Chen et al. (2017) used an index to capture the strength of political connections via individuals, such as the CEO, board chair, directors, and other senior firm officers. Likewise, Kim et al. (2012) used a political alignment index to measure the political ties for each firm and its proximity to political power.

Meanwhile, some researchers use more direct measurements. For example, Faccio et al. (2006) measured political connection by the number of politicians maintained by the firm. Li et al. (2012) used CEO affiliation with government as the measurement of political connections. Moreover, Carretta et al. (2012) categorized a bank as politically connected if a politician sat on the board of directors.

Other literature streams utilise the experience and background of the firms' board of directors. Khwaja and Mian (2005) classified the firms as politically connected if one or more of the board of directors ran for election, had previously worked in the government or was elected to Parliament. Goldman et al. (2009) used the political background of directors to identify politically connected firms. Finally, some studies utilised the firms' contributions toward elections. Akey (2015) measured political connection by using firms' political contributions to the U.S. senators and representatives. Then, they compared the returns of those firms that donated to winning and losing candidates. Moreover, Blau et al. (2013) used the lobbying expenditures as an indicator of political engagement. Goldman et al. (2009) used the capital donations made by firms to the Republican and Democratic Parties in the USA as an indicator of political connection. Similarly, Tahoun (2014) used political contribution and ownership as a measurement of political connection in firms. Tahoun (2014) argued the uniqueness of his measurement as it reflects the mutual benefits that firms and politicians enjoy.

Political connections have a crucial impact on the growth of firms and countries. Resource dependence theory states that the need for connections is a function of the firm's dependence. The political connection is a mechanism for companies to survive social and global pressures. To reduce uncertainty, firms appoint politicians to the boards of directors. However, the effect of political connection on the firm's output is subject to debate. Previous research has focused on empirically investigating the impact of political connection at the macro and micro levels. However, the present research moves beyond simply measuring the impact of political connection:

it analyses the evaluation of political connection literature over several years.

This chapter presents a catalogue of the influential aspects resulting from a bibliometric meta-analysis of political connection literature. The metrics considered in this study include countries, authors, articles, and topics. Advanced data visualization techniques of political connection literature are employed. This chapter analysed 138 papers from the Science Direct website over the period 2000–2020, empirically investigating the effect of political connection on firms' output. The study first establishes a list of key journals, then identifies the principal articles, and generates citation networks. Following this, the study exploits the VOS viewer program to generate a visualization of the literature analysis.

In terms of substitutability, the scope of this study provides identification of the following most relevant research streams: (1) the value of political connection; (2) political connection and finance; (3) political connection in banks; (4) political connection and debt; (5) management and political connection; and (6) political connection and governance.

Further, the study discusses each stream after representing it through a cartographic analysis, including co-authorship, countries, and time networks. Lastly, but of great importance, the meta-analysis review allows research gaps in the previous work to be discerned, providing a new direction and springboard for future research efforts.

This analysis provides three primary contributions to enhance the understanding of political connection research. Firstly, to the best of my knowledge, no pre-existing empirical work has attempted to map the academic structure of political connection literature from extant bibliometric studies. Secondly, the present research uses network analysis and community detection to understand social clustering within the field. Thirdly, this study incorporates the leading literature produced to date, from several world countries to elucidate the relationship between political connection and the six aforementioned research streams.

## 2.2 Methodology

To understand the networks of political connections, this study employs methods to trace and analyse the connections and the information on the top research articles. To find the pattern, firstly, the study identifies the key journals and articles to conduct the citation network and analysis.

Secondly, 138 important articles in well-known journals, which capture diversity within the field, were chosen. Moreover, this study utilises the bibliometric analysis in three steps. Firstly, I collected the papers of interest from the Web of Science (WoS) database. The study inserts the keywords, and the website provided the

Table 2.1: The Top 50 Articles in political connection in Google Scholer and Web of Science

| **Authors** | **Web of Science** | **Google scholar** | **Top 50 GS** | **Top 50 WS** |
|---|---|---|---|---|
| Faccio (2006) | 1002 | 3536 | 1 | 1 |
| La Porta, Lopez-de-Silanes,& Shleifer, (2002) | 716 | 3193 | 2 | 4 |
| Fisman,(2001) | 805 | 2882 | 3 | 2 |
| Khwaja & Mian (2005) | 662 | 2297 | 4 | 5 |
| Fan, Wong,& Zhang (2007) | 804 | 2244 | 5 | 3 |
| Faccio, Masulis & McConnell (2006) | 657 | 2117 | 6 | 6 |
| Scharfstein,& Stein, (2000) | 518 | 2059 | 7 | 8 |
| Bonin, Hasan,& Wachtel(2005) | 394 | 1508 | 8 | 11 |
| Claessens,Feijen,& Laeven,(2008) | 408 | 1449 | 9 | 10 |
| Molyneux & Thornton (1992) | 257 | 1438 | 10 | 20 |
| Sapienza (2004) | 357 | 1429 | 11 | 13 |
| Li, Meng,Wang & Zhou (2008) | 498 | 1335 | 12 | 9 |
| Dinc,(2005). | 319 | 1200 | 13 | 16 |
| Agrawal & Knoeber (2001) | 338 | 1159 | 14 | 15 |
| Goldman, Rocholl, & So (2009) | 349 | 1046 | 15 | 14 |
| Berger, Hasan, & Zhou (2009) | 371 | 1038 | 16 | 12 |
| Leuz & Oberholzer-Gee (2006) | 274 | 871 | 17 | 18 |
| Chaney, Faccio,& Parsley (2011) | 257 | 843 | 18 | 19 |
| Ferraz & Finan,(2011) | 153 | 803 | 19 | 28 |
| Micco, Panizza, & Yanez (2007) | 218 | 788 | 20 | 23 |
| Morck & Yeung (2004). | 256 | 743 | 21 | 21 |
| Johnson, Kaufmann, McMillan, & Woodruff (2000) | 182 | 704 | 22 | 26 |
| Johnson & Mitton (2003) | 527 | 699 | 23 | 7 |
| Cooper, Gulen, & Ovtchinnikov (2010) | 224 | 691 | 24 | 22 |
| Hillman (2005) | 280 | 665 | 25 | 17 |
| Boubakri, Cosset, & Saffar (2008) | 190 | 629 | 26 | 25 |
| Faccio (2010) | 205 | 581 | 27 | 24 |
| Goldman, Rocholl & So (2013) | 133 | 450 | 28 | 31 |
| Duchin & Sosyura (2012) | 132 | 444 | 29 | 32 |
| Boubakri, Guedhami, Mishra & Saffar (2012) | 148 | 443 | 30 | 29 |
| Khanna (2000) | 132 | 440 | 31 | 33 |
| Ferguson & Voth, (2008). | 131 | 434 | 32 | 34 |
| Lensink, Meesters, & Naaborg (2008) | 160 | 434 | 33 | 27 |
| Mian, Sufi, & Trebbi (2010) | 93 | 373 | 34 | 46 |
| Kedia & Rajgopal (2011) | 120 | 358 | 35 | 37 |
| Acemoglu, Johnson, Kermani, Kwak & Mitton ( 2016) | 54 | 355 | 36 | |
| Chen, Su,& Sun (2011) | 144 | 349 | 37 | 30 |
| Faccio & Parsley (2009) | 121 | 347 | 38 | 36 |
| Seidel, Polzer & Stewart (2000) | 110 | 344 | 39 | 39 |
| Brown & Dinc (2005) | 73 | 310 | 40 | |
| Houston, Jiang, Lin & Ma (2014) | 94 | 295 | 41 | 45 |
| Francis, Hasan, & Sun (2009) | 109 | 290 | 42 | 40 |
| Correia (2014) | 69 | 271 | 43 | |
| Wu, Wu, Zhou & Wu (2012) | 126 | 271 | 44 | 35 |
| Cohen, Coval & Malloy (2011) | 52 | 251 | 45 | |
| Bunkanwanicha & Wiwattanakantang (2009). | 82 | 242 | 46 | 47 |
| Amore & Bennedsen (2013). | 73 | 239 | 47 | |
| Andrianova, Demetriades & Shortland (2008) | 51 | 239 | 48 | |
| Fogel (2006) | 95 | 237 | 49 | 44 |
| Fraser, Zhang & Derashid (2006) | 81 | 236 | 50 | 48 |
| Vidal, Draca & Fons-Rosen (2012) | 111 | 103 | | 38 |
| Sun, Mellahi & Wright (2012) | 102 | 193 | | 41 |
| Chen, Ding & Kim (2010) | 97 | 203 | | 42 |
| Neilson, Pritchard & Yeung (2014) | 96 | 179 | | 43 |
| Bliss & Gul (2012) | 76 | 207 | | 49 |
| Cull, Li,Sun & Xu (2015) | 76 | 181 | | 50 |

most relevant and cited articles. However, the WoS database results were not very accurate as they neglected seminal papers in political connection literature. Finally, the study selected keywords to help us find and include all the relevant, most cited, and recent articles manually.

The use of WoS has been the standard, whereas Google Scholar offered results of inconsistent accuracy (Falagas et al., 2008). Google Scholar presented all the benefits and drawbacks of the internet. It sometimes offers unique options in the scientific field. For example, using a web search option allowed obtaining free full articles from various websites, whereas using WoS or other databases did not offer free access if the article is not an open-access one. The access might be illegal, but this is a characteristic of the internet: information is abundant. Results from Google Scholar are displayed in relation to frequency of user visits, not in relation to another index of the publication quality. Therefore, I selected WoS for more accurate results (Falagas et al., 2008). Table 2.1 shows the clear difference in the number of citations of the top 50 articles in political connection literature.

Secondly, the study revised the papers carefully and put them on one list on the WoS account from 2000 to 2020. This had to be conducted with great caution. Using an easily formed threshold (e.g., the article must be cited several times) is perilous as it ignores journal-specific and time-related characteristics, and the risks are arbitrary. For example, in a high-ranked journal, the number of citations is much higher for old articles than that for recently published ones. Finally, the study transfers the data to a format that the VOS viewer program could read and analyse. I explored the previous literature review that investigated political connection topics and the networks, and finally analysed who associates with whom.

In mapping political connection literature, the current study found evidence of multiple communities, particularly, six clusters from the top 138 research papers in the top journals covering 2000–2020. The study performs six tracks to our meta-literature analysis. Firstly, the study depicts political connection literature based on the country and year. The VOS viewer program outputs depend on co-citation analysis that refers to the frequency of the articles being cited together, thus implying a strong connection between them.

## 2.3 Political Connections Citation by Country and Years

The effect of political connections varies across countries. Previous studies showed that the effect of political connections is ample in developing countries with corruption and weak institutions, whereas it is unclear in the developed countries with good

institutions. Using across-country surveys, Chong and Gradstein (2010) found that firms' perception of being politically influential is related to the institutional quality of each country. A high level of institutional quality in a country exhibits a high level of political influence, especially in large firms. Claessens et al. (2008) explored the effect of political connections on access to finance in Brazil for various reasons. First, the political ties with the business are widespread. Second, Brazil is an emerging country and has limited institutional development. The results indicated a positive association between firms' contributions to the candidates in election and the benefits they receive, especially if they support the winning candidate. Malaysia is a country that has been analyzed extensively (Faccio, 2006; Fisman, 2001; Fraser et al., 2006; Gomez et al., 1999; Gul, 2006; Johnson and Mitton, 2003).

The researchers found evidence that political connections had a positive effect on stocks value, performance, debt, and bailout actions. Bunkanwanicha and Wiwattanakantang (2009) studied the effect of political connections in Thailand. In 2001, a group of businessmen entered the election, and they won and formed a government led by Thaksin Shinawatra. This unique event offered an opportunity to measure the importance of political connections in Thailand. A weak institutional and legal environment allowed the leaders to use their power to pursue their private interests and gain privileges from the government. Schoenherr (2019) found that after the elections in South Korea, the winning party appointed members of its network as CEOs of government banks and firms. The CEOs serve as intermediaries between the government and private firms in allocating government contracts. The government, in return, allocated more contracts to the private firms with political ties.

Numerous studies investigated the effect of political connections in China. As figure 2.1 shows, several frequently-cited papers studied the effect of political connections in China. Political connections play a vital role in forming the business structure in China. Cull et al. (2015) identified the importance of the political connections factor in explaining firm investment behaviour and financing conditions in China. The efficiency of corporate investment affected by factors related to informational asymmetry and agency problems. Further, findings of Li et al. (2019) indicated that political connections increased the stock price synchronicity. This finding suggested that firms with political ties were more likely to avoid disclosing full financial information, which offers less informative stock prices and causes asymmetric information problems. Francis et al. (2009) examined the effect of political connections on share prices in China. They found that political connections had a positive impact on the offering price. In addition, Wu et al. (2013) found evidence that political connections improved the firms' ability to raise capital from public markets, especially in less regulatory-restricted countries.

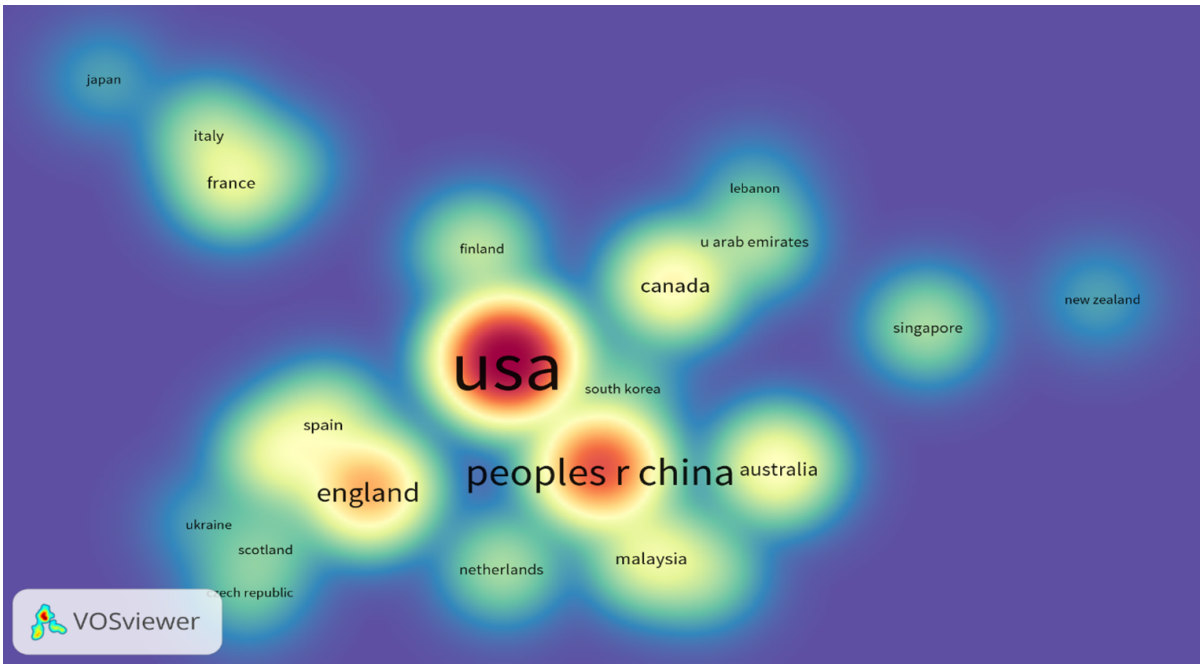


Figure 2.1: The Visualisation of Cited Country Density Through a Heat Map

In a similar vein, Chan et al. (2012) showed that Chinese firms with political ties opposed no financial constraints. Political connections in China enable firms to evade taxes and litigation announcements. In this respect, Firth et al. (2011) found a significant negative impact of litigation announcements on the stock prices of firms with political connections. Nevertheless, politically connected firms were more likely to appeal against and receive favourable petition outcome. Moreover, Lin et al. (2018) found evidence that political connection decreased the tax authority's ability in restraining tax avoidance. Regarding the performance, Wu et al. (2012) investigated political connection of the private and state-owned firms. They found that political connection increased private firms' performance and reduced the effective tax rates. Li et al. (2012) found a significant positive association between firm diversification and political connection in China.

For the developed countries, most of the cited articles investigated political connections in the United States as figure 2.1 demonstrates. Even though the United States is a well-established country with strong institutions, the effect of political connections on firms' outputs is obvious. The United States corporations and special interest groups spend billions of dollars annually to lobby Congress and federal agencies. Borisov et al. (2016) used event studies (exogenous shock) to evaluate the lobbying value to the firms. They focused on an event that happened on January 3, 2006, when the prominent Washington, D.C. lobbyist Jack Abramoff was found guilty of bribing government executives. This event was described as the biggest public corruption scandal in a generation. Borisov et al. (2016) found evidence that lobbying is valuable, especially for firms with a weak code of ethics and policies

against bribery and corruption. Similarly, Akey (2015) found that in the U.S. congressional elections, the loss of a connection to the Senate resulted in a loss in future sales of $1.9 billion in the following year.

In Britain, Braggion and Moore (2013) seminal study investigated the association between politicians and firms in Britain in the late Victorian era. They found evidence that the election for a new tech director increased value of firms with political connections by 2.5%. Amore and Bennedsen (2013) exploited the difference-in-differences method to examine the effect of political connections on Danish firms' profitability as one of the lowest corrupted countries. They found that the more powerful the connection is, the highest the operating returns are. Correspondingly, Haselmann et al. (2018) exploited the unique dataset on members of an elite service club in Germany to explore the effect of political connections on resource allocation. They found that firms with political connections misallocated the resources and paid out funds to the owner instead of making investments.

## 2.4 Political Connections Authorship Ties

Figure 2.2 illustrates the relative composition of authors in each of the seven communities, through a bubble map. It provides a visualisation of the author and citation analysis for political connection literature. The larger the size of the circles, the larger the number of citations of the author. The names refer to the authors' last names. Noteworthy, VOS viewer uses small letters and does not allow editing or capitalizing the letters of the authors' names. The figure visualises the various streams found in the literature.

The figure represents the number of citations in various colours and sizes, each colour reflecting a different stream of literature and various sizes signifying the number of citations of each author. The linking lines between the cycles represent the co-citations between authors. For example, figure 2.2 shows that the highest number of citations is the work of Faccio, across her various publications.

VOS viewer output classified the articles into six clusters of literature. Communities are organised according to a hierarchical clustering algorithm that sorts communities based on similarity. Reading through each cluster and determining their similarities, this study found that the larger the size of the circles, the larger the number of author citations in that cluster's collection of articles. The red cluster connects the value of political connection literature. Political connection and finance association are depicted in green. Meanwhile, the dark blue cluster links the articles related to banks' political connection, and the yellow cluster reflects the articles that investigate the relationship between debt and political connections. Furthermore, the purple cluster explores the association between management and

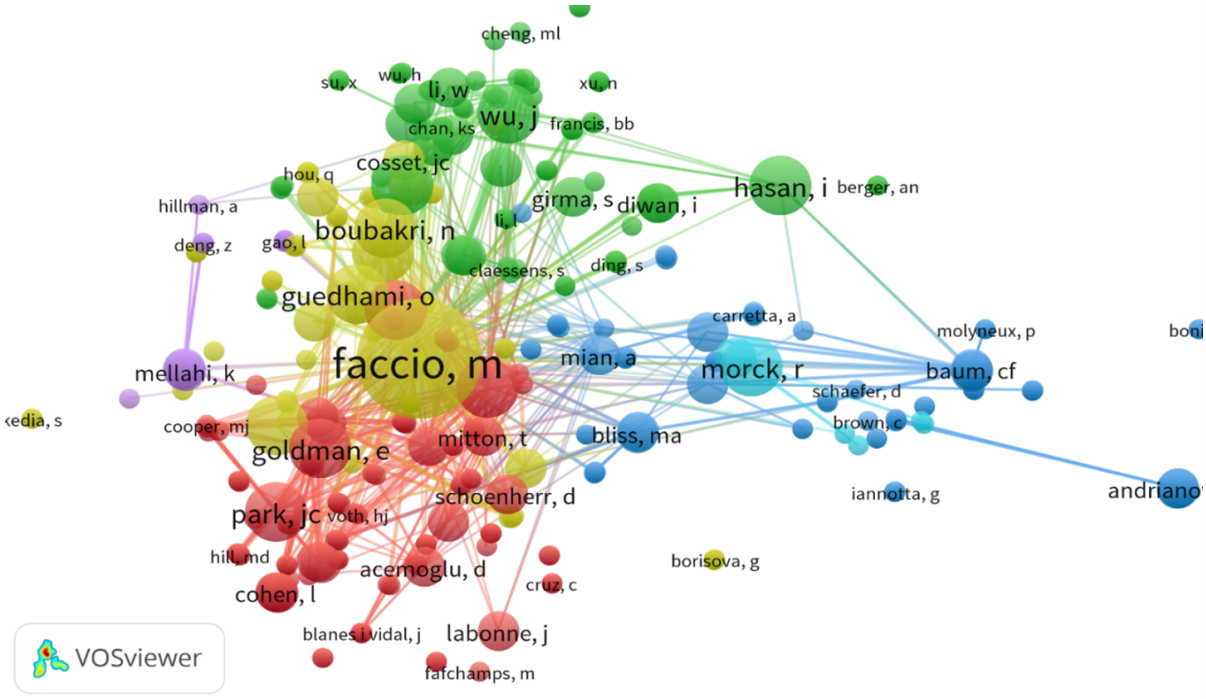


Figure 2.2: The Visualisation of the Author and Citation Analysis

political connections. Finally, the light blue cluster contains articles that discuss political connection and governance.

The next section analyses the composition of these community clusters from the 2000 to 2020 network. This takes us beyond the simple description of political connection literature and into the exploratory landscape of asking its meaning and why it looks the way. Each cluster contains many high-quality research papers and reflects a list of scholars, which I can identify and gather information about. To sum up, this study uses network analysis and community detection to understand social clustering within political connection literature to widen our understanding of political connection research.

### 2.4.1 The Red Cluster: Value of Political Connection

Prior research pointed out that the motivation of firms to become politically connected is to provide a form of protection and support (Faccio et al., 2006; Fisman et al., 2012; Yu, 2010). Chen et al. (2014) argued that political connection has an important impact on countries, financial markets, stocks value, long-term performance, growth, corruption, bailout actions, taxation, management, and decision-making. Cole (2009) provided evidence that state bank credit in India was from 5% to 10% higher in election years than their non-connected peers. Likewise, Cooper et al. (2010) found evidence that the firm's contribution to the U.S. political campaigns positively affected the future returns. Similarly, Faccio et al. (2006) found that po-

litically connected firms are more likely to be rescued in the financial distress time compared to non-connected firms. Moreover, using the 2008 Troubled Asset Relief Program (TARP) as a natural experiment, Blau et al. (2013) found that politically connected banks receive favorable treatment from the government, especially in the crisis time. Similarly, Chavaz and Rose (2019) used a different empirical approach to investigate the value of politically connected banks using the same program (i.e., 2008 TARP). The results suggested gaining government support subject to political power. Despite the stability and integrity of the American institutional and financial structures, the results showed that political power matters. Sapienza (2004) compared the lending behavior of the state-owned banks to other banks. He argued that the lending behavior of the government banks is affected by the election results of the connected party. The more powerful the party is, the lower interest rates the banks charged.

At the macro level, the political connection has distorting effects on financial resource allocation. Niessen and Ruenzi (2010) investigated political connections in German firms in the post-world war II era. They found that politically connected firms outperformed the non-connected firms and were less risky. Bliss and Gul (2012a) found that lenders in Malaysia perceived politically connected firms as risky, and as a result, they charged them higher interest rates. Meanwhile, Correia (2014) found that the political contribution that the firm paid to the powerful politicians was significantly effective in reducing the penalties and probability of enforcement. Song et al. (2015) used dynamic panel data to show that the visible and invisible hand dominate the resources simultaneously. They found that companies with a political connection faced lower financial constraints than those without. Nonetheless, this leads directly to market resources distortion. Fisman (2001) was the first to investigate the value of political connections. In 1997, there was a heated debate about the reasons behind the sudden economic decline in Indonesia. Investigations suggest that the economy was highly dependent on political connections.

To estimate the value of political connection, Fisman (2001) exploited the rumors about former Indonesian President Suharto's health and conducted an event study to estimate the effect of this event on the firms' return. The study found that politically connected firms suffer more than non-connected counterparts. The negative effect of this news on the value of the politically connected firms suggested that political connections added to the firm's value. Similarly, Faccio and Parsley (2009) found that after the sudden death of a politician, the value of the politically connected banks to those politicians declined by 1.7% and followed by decreases in sales growth rate and access to credit. In the U.S. context, Goldman et al. (2009) found a positive abnormal stock return after an announcement of the nomination

of a politically connected individual to the board. Aligned with the work of Faccio (2006) and Goldman et al. (2009), Ferris et al. (2016) explored the effect of political connection on firm acquisition activity and performance. They showed that politically connected bidders acquire more targets and more likely to avoid delay or failure. Also, bids by politically connected firms had a significant positive effect on firm value.

Many researchers have shown that the presence of their political associations could explicate a large percentage of connected firms' value. Agrawal and Knoeber (2001) found substantial differences in the politically connected firms' value, especially in large firms. Akey (2015) used a regression discontinuity design and determined that the returns of the firms that donated to the winning candidates in the off-cycle the U.S. congressional elections were higher by 3% compared to the firms that donated to losing candidates. Meanwhile, Braggion and Moore (2013) investigated the effect of political connection presence on their firm value in the Victorian age in Britain and found evidence that political connections increase the share value by 2.5% after the election. Hill et al. (2013) investigated the political influence of corporate lobbying on the firm value in the USA. They argued that firms contributed through two channels. First, firms contributed through the political action committee campaign to which firm directors and employees can donate up to a maximum of $5,000 for each candidate per election. Second, firms directly contribute from the firm's treasury. They found a significant value associated with both types of contributions and lobbying.

Apart from the politically connected contribution during the election times, Desai et al. (2011) argued that political connections benefits have a price. They described the process by a bargain, as the firm relinquishes some control rights to gain access to government subsidies and protection, especially during crisis times. Lin et al. (2016) argued that political connections and government policy were critical factors that impact the stock prices. These factors could lead to inaccurate disclosure, and investors could misinterpret the stock returns. Moreover, Wang (2015) investigated the stock market reaction of political connections in Chinese firms. The study found that firms with political ties outperformed the non-politically connected peers due to the extra access of government external debt and subsidies. However, politically connected boards of directors increased related-party transactions magnitude with the controlling party in the listed private politically connected firms.

In contrast, having politicians as independent directors does not help add value to listed state-controlled firms, especially firms controlled by the local government, due to the expropriation of minority investors via more related-party transactions and more severe over-investment problems. Drawing upon the moral hazard theory and how firm incentives are affected by government interventions, Kostovetsky (2015)

used cross-sectional variations of political connections in the USA to investigate the effect of the moral hazard. Politically connected boards of director members increase the proportion of market value in toxic assets by 20% and reduce the stock returns by 6%. Moreover, the presence of political connection in the board of directors increases the firm risk. The findings of Fisman (2001) and Kostovetsky (2015) suggested that despite the value that political connections added to the firm, these connections also increased the firm risk.

Bliss and Gul (2012a) investigated a critical question of whether political connection leads to more risk. The study used a large sample of Malaysian firms and explored the relationship between political connection and cost of debt. They found that politically connected firms were perceived as riskier than non-connected counterparts by the market, audit firms, and lenders. Boubakri, Cosset and Saffar (2012) used a multinational sample and found that firms with political ties to strong political power were more valuable and profitable than non-connected firms. Additionally, the effect was higher in countries with a weak legal and institutional environment and a high level of corruption.

Vidal et al. (2012) argued that in the USA, 56% of the net revenue generated by politically connected private firms could be attributed to individuals with work experience in the federal government. Cingano and Pinotti (2013) explored the returns and the social costs of political connection in Italy over the period 1985–1997. The results showed that the average political connection revenue premium was 5.7%, which was obtained through sales and was not related to the firm's productivity. The return was larger (up to 22%) in the highly corrupted areas. In Brazil, Claessens et al. (2008) evidenced the role played by politically connected firms in shaping the government through their contribution to supporting the political parties in the elections. In return, during the election time, these firms had higher stock returns.

### 2.4.2 The Green Cluster: Political Connection, and Finance

The relationship between political connection and finance attracted the attention of academics, practitioners, and policymakers. Whether politically connected and state-owned firms obtain preferential treatment for bank loans is centrally important to a wide array of research agendas in financial studies. Duchin and Sosyura (2012) explored the determinants of capital allocation under the TARP and found a positive association between political connections and the amount of funds that the firm receives. Chen et al. (2014) found that politically connected firms, especially those connected to the party in power, can obtain loans with lower interest rates compared to non-connected counterparts. Khwaja and Mian (2005) investigated the effect of political connection in Pakistan. They found that low-quality politically

connected firms (vs. non-connected firms) had the privilege to borrow from state-owned banks. Additionally, political connections increased the firms' probability to acquire government subsidies. They also found evidence that these privileges were higher in the election years than in non-election years.

Interestingly, Diwan and Schiffbauer (2018) found that in Egypt, the political connection was negatively associated with profitability, suggesting that politically connected firms were less risky. Additionally, they found that most bank loans went to firms with political patronage. Even after the 2011 revolution and the regime collapse, politically connected firms still benefited more than non-connected firms. This is because the privileges they had already received were adequate to make them more attractive to banks. These results suggested that the history of earlier bailout matter. Boubakri et al. (2009) conducted a study in 39 countries to investigate the effect of state-owned ownership on performance in different industries. They found that state ownership negatively impacted profitability, leverage, and efficiency in countries with sound institutional and political environment. Surprisingly, these effects are less pronounced in countries with right-wing governments. Likewise, Fan et al. (2007) found that politically connected firms under performed compared to non-connected peers.

The effect of political connection on performance depends on firm characteristics. For instance, Zhang et al. (2014) showed that the effect of political connections on the ability to obtain government subsidies in the wind energy manufacturing companies was negative. Kim et al. (2012) evidenced that the effect of political ties on financial performance depends on the degree and strength of the political connection and other firm characteristics, such as location and size. For example, the study showed that firms in states aligned with the president had a significantly better performance than those in states aligned with the rivals. The effect was larger among small firms after elections when the party in power won.

You and Du (2012) found evidence that the effect of political connection on future performance was positive when firm profitability was below the industry median. Hence, the value of political connections depends on a firms' performance. The results suggested that political connections benefits outweigh their costs when firms do not meet their profitability targets. Similarly, Elyasiani and Jia (2010) found a significant positive association between firm performance and institutional ownership stability. The results suggested that managers should sustain long-term ties with institutional investors to enhance firm performance and to choose the best stocks according to their investment horizons. Further, Chen et al. (2017) investigated the effect of political connections on firm profitability. They found that political connections negatively and significantly affected the state-owned firms. In contrast, such a relationship turned out to be positive for the other firms. Similarly,

Wu et al. (2012) investigated the political connection of the private and state-owned firms. They found that political connections increased private firms' performance and reduced the effective tax rates. Results suggested that political connections helped private firms in China to obtain tax benefits. Additionally, they found that state-owned firms aggravated the over-investment of free cash flow more than their non-connected counterparts, thus adversely affecting firms' performance.

The relationship between capital market imperfection and investment behaviour has been widely investigated in the literature. Financial discords are deemed to cause a significant hindrance to the efficient allocation of credit for firm investment and therefore economic growth. Cull et al. (2015) used a large sample of Chinese firms and argued that political connection played a vital role in explaining firm investment behaviour and explaining the financing conditions in China. The efficiency of corporate investment is affected by factors related to informational asymmetries and agency problems. Previous studies highlighted the investment cash flow sensitivity after controlling for investment opportunities. Myers and Majluf (1984) pointed out that these investment distortions mainly happened because of the information asymmetry between corporate insiders and the capital market. Jensen (1986) argued that the alignment of managerial and shareholders' interests was the main reason for these distortions.

However, in some counties, politically connected firms enjoyed preferential access to resources by obtaining bank loans and other benefits. Xu et al. (2013) investigated the effect of political connections on investment behaviour and found evidence that political connections reduce investment cash flow sensitivity. Meanwhile, Zhou (2013) investigated the effect of political connections on entrepreneurial investment. They found that in developing countries, entrepreneurial firms always seek political connections that provide them with resources and protection and increase their investments. However, political connections could divert entrepreneurs' energies and attention away from achieving efficiency and productivity. Additionally, Chan et al. (2012) showed that politically connected Chinese firms display no financial constraints.

Connected firms also have easier access to external credit. Drawing on the resource dependence theory, Deng et al. (2018) argued that politically connected firms had a lower outward foreign direct investment. Furthermore, politically connected firms had strong political and market resources and faced exchange pressure, and these tools enabled them to display a high outward foreign direct investment commitment. However, Snyder and Welch (2017) found no evidence that political connections affected investment decisions.

Meanwhile, Butler et al. (2009) and Wu et al. (2013) investigated the effect of political connection on different topics related to finance, such as bond sales and

underwriting, and initial public offering. Butler et al. (2009) argued that corruption and political engagement had significant effects on bond sales and underwriting. Underwriting fees were substantially higher when underwriters used political connections made to win the underwriting business. They suggested that corruption and political connections had a great effect on the financial market outcome. Wu et al. (2013) investigated the effect of political connection on the initial public offering performance in China. The findings showed that political connection increased the firms' ability to raise capital from public markets. This evidence was weak in the market-restricted regions with highly regulated industries. Moreover, Francis et al. (2009) investigated the effect of political connection on share prices in China. They found evidence of a significant positive relationship between political connections and offering price. Li et al. (2019) showed that political connection had a positive impact on the stock price synchronicity. This finding revealed that politically connected firms were more likely to avoid disclosing full financial information, which offered less informative stock price.

### 2.4.3 The Dark Blue Cluster: Political Connection in Banks

Majority of economic literature focuses on banks. Firstly, banks play a vital role in allocating credit. Secondly, unlike other firms, banks exert an influence on the economy and its development. Therefore, banks utilize their political ties to improve their positions in the market and to benefit from the governmental and political support in various aspects. This may happen in countries with weak institutions, and banks' political connections might carry huge social costs. Ang (2013) argued that financial development is widely considered an essential requirement to foster growth because it is an important tool to mobilize the economy's resources, to allocate capital to increase investment, and reduce risks. However, countries with older and deep-state institutions are more likely to have well-established financial systems. Blau et al. (2013) found that banks with political ties were not only more likely to receive government support, but they also received greater amounts of support and received it earlier than the non-politically connected banks. Hung et al. (2017) investigated the effect of political patronage on banks' risk and performance in China. They found that banks with political connections had a higher return on assets, lower default risks, and lower credit risks. Furthermore, the results revealed that these banks had better access to lending and were more likely to be bailed out during a crisis compared with non-connected banks.

Baum et al. (2010) provided empirical evidence that Ukrainian banks with political ties had lower interest margins and a high capital ratio. Correspondingly, in Italy, both Sapienza (2004) and Haque and Brown (2017) identified that state-

owned banks charged lower interest rates compared with private-sector banks, especially lower than the banks with political ties. Additionally, Brown and Dinc (2005) used a sample of large banks in 21 emerging countries and found clear evidence that failing banks were less likely to be taken by the government during the election periods. Government intervention occurs after the electoral cycle in each country. Moreover, Dinc (2005) revealed that government-owned banks increased their lending in election years compared with other banks using cross-country and bank-level data. Jackowicz et al. (2013) provided cross-country evidence that state-owned banks charged small interest rates during the election years. Gropper et al. (2013) demonstrated that the banks politically connected to senators or members of banking committees in the American Congress outperformed non-connected counterparts. In India, Cole (2009) found that state bank credit was 5% 10% higher in election years and state-owned bank loans were less likely to be paid compared with non-connected counterparts.

On the contrary, Micco et al. (2010) argued that, the performance of the state-owned banks worsens during the elections because they are affected by political concerns. Using a large cross-country dataset, Dinc (2005) found similar results regarding the impact of politicians' presence in the boards of directors of banks. During elections, he found that banks with political connections increase their lending compared with other banks. Similarly, Carretta et al. (2012) investigated the effect of politically-connected board of directors on bank performance and on lending and risk. Interestingly, the results revealed that the presence of politicians who held executive roles on the board of directors had a strong negative effect on bank performance. A broad cross-country study by Braun and Raddatz (2010) provided evidence of a significant negative effect of banks' political connections and leverage at the micro-level. Furthermore, at the country level, the study found a considerable negative effect on economic development, especially in the countries with weak institutions and inefficient banking system. La Porta and Lopez-de Silanes (2002) identified that the state-owned banks were the neglected element of financial studies of many countries.

Government banks were large and effective, especially in low-income countries with poor property rights protection and interventionist and inefficient governments. Andrianova et al. (2008) found cross-country evidence that the institutional quality was a crucial factor that moderated the relationship between state-owned banks and financial and economic development. They found that countries with poor institutional quality depend on state banks to boost economic and financial development. These state-owned banks were less efficient and made poor lending decisions, resulting in low profitability and financial fragility (Andrianova et al., 2012).

Gropper et al. (2015) found evidence that the relationship between political con-

nection and bank performance related to the degree of economic freedom. Economic freedom undermines the effect of political connections on bank performance. In the areas where economic freedom is high, the effect of political connection is insignificant. In a similar vein, Khafagy (2017) demonstrated that democracy, political rights, and civil liberties foster financial cooperative development. Furthermore, Baum et al. (2008) investigated the impact of parliamentary election cycles on the Turkish banking system during 1963–2007 and found that banks with political connections were less profitable than foreign and private banks. La Porta and Lopez-de Silanes (2002) indicated a negative association between state-owned banks and growth. In particular, they found that banks with political ties are associated with lower subsequent productivity. This relationship is more pervasive in the less developed countries. Bonin et al. (2005) explored the effect of the state ownership on banks' efficiency in 11 countries during 1996 2000. By exploiting stochastic frontier estimation procedures, they found evidence that state-owned banks were the least efficient service providers in the banking system for all countries.

### 2.4.4 The Yellow Cluster: Debt and Political Connection

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The seminal work of Rajan and Zingales (1995) identified the importance of the institutional effect on capital structure decisions. The board of directors has a significant effect on capital structure decisions of firms (Johnson and Mitton, 2003). The background and political connection of the board of directors provide connected firms with opportunities to obtain benefits that allow them to sustain more debt. Following this, various studies provide supplementary supportive evidence for this viewpoint; for example, (Bliss and Gul, 2012a; Diwan and Schiffbauer, 2018; Faccio et al., 2006; Faccio, 2016; Fraser et al., 2006). Boubakri et al. (2008) found that firms with political ties were highly leveraged. Similarly, Bliss and Gul (2012b) provided direct evidence that firms with political connections had negative equity and higher leverage.

Faccio et al. (2006) investigated the probability of government bailouts of firms with political ties in 35 countries. They found that despite being less profitable than the firms with no political ties, during a crisis, politically-connected firms were more likely to receive support from the government and the International Monetary Fund or the World Bank. In addition, Fraser et al. (2006) examined the impact of political patronage on capital structure in Malaysia. They used three proxies to measure political connections. They found a positive association between the leverage and each of the three measures of political connections, and this positive association is greater when the firm is large and profitable. Faccio (2010) across-country study

found that leverage is higher in firms with political connections compared with firms with no such connections. Moreover, such firms have lower taxation and greater market power. Furthermore, the evidence of such causality is more prominent in crucial times.

Correspondingly, Ebrahim et al. (2014) explored the effect of political connection on capital structure in Malaysia. During a crisis, they found that firms with political connections adjust and reduce their debt faster than firms with no political connections. Diwan and Schiffbauer (2018) found that firms with political ties received greater loans than firms with no such ties. Boubakri, Cosset and Saffar (2012) employed propensity score matching models and found that firms with political connections had a lower cost of capital compared with counterparts with no political connections. Additionally, Tee (2019) provided evidence that firms with political connections in China had a lower cost of debt compared with firms with no political connections. Furthermore, he found that firms with political ties with high ethnic diversity and more female board of directors have a low cost of debt.

Borisova et al. (2015) found that government equity ownership in publicly traded firms had a significant positive effect on the cost of corporate debt in 43 countries during 1991–2010. However, during a crisis, the relationship becomes significantly negative. Their findings suggest that the effect of political connection on firms' debt depends on economic conditions and characteristics of the firm. López Iturriaga (2005) investigated the determinants of debt in 14 developed countries over the period from 1980 to 2000. They found that capital structure decisions were affected by both characteristics of the firm and institutional factors. Boubakri et al. (2009) found that state ownership had a negative impact on leverage, especially in countries with sound institutional and political environments. Recently, Khaki and Akin (2020) examined the effect of government ownership on the capital structure in 329 non-financial firms for the period between 2009 and 2017 in the Gulf Cooperation Council (GCC) and found a negative effect of state ownership on capital structure.

### 2.4.5 The Purple Cluster: Management and Political Connection

The extant literature on the relationship between political connections and management is scarce. Hillman (2005) explored the effect of political connections on market performance. The study revealed that firms in highly regulated industries have more politicians on their boards. These findings reflect the resource dependence theory logic that corporate management boards reflect the environment facing the firm. Highly regulated firms heavily depend on the government, which creates a need for more political ties with the government. Private firms are looking for safeguards

through political connections that allow the owners to retain all the benefits that can be obtained through these connections. Chen et al. (2011) argued that the Chinese government motivates firms to establish political connections. The findings suggested that private firms were more likely to create political connections in regions where the market is less developed with insufficient legal protection and where the government wields more power in allocating economic resources. Additionally, these connections facilitate rent-seeking behavior and ensure that the strategic decisions are in line with government policies.

Some managers seek political connections through executive membership in an industry association. Liu et al. (2016) identified that these memberships help firms in obtaining more trade credit by establishing reputation and trust. Du and Girma (2010) found evidence that political connection enhances firms' growth and survival prospects. Nevertheless, firms without political connections seem to exhibit faster productivity growth. Chen et al. (2010) explored the effect of political forces on the strategic decisions of multinational enterprises (MNEs). They found that financial intermediaries play an important role in reducing the risk of information asymmetry caused by political connections. It is challenging for financial analysts to predict the earnings of firms with political connections compared with their non-politically-connected peers. MNE subsidiaries have often adopted political strategies to achieve both internal and external legitimacy to exert pressure on the parent company and the host country.

### 2.4.6 The Light Blue Cluster: Political Connection and Governance

One of the central questions in governance studies is whether board composition affects the firm's outcome. Several prior empirical studies investigated the effect of politically-connected boards of directors on firms; however, the findings were mixed. For instance, Agrawal and Knoeber (2001) found that firms with political ties enjoyed extra privileges, especially in large firms. Carretta et al. (2012) found that politicians who held executive roles on the board of directors exerted a negative impact on bank performance. Interestingly, the effect was significant only for politicians who held executive positions. Guedhami et al. (2014) found evidence that firms with political connections depended on the Big 4 auditors. Using the Big 4 auditors gives a clear picture that the insiders are keen to improve the transparency and governance in the firm and away from using their connection to achieve any personal benefits.

In countries with weak institutional environment, Big four audits are more valuable and exhibit high levels of transparency, whereas Berger et al. (2009) found that

big four-audited state-owned banks were the least efficient banks, and they have the highest non-performing loans in China from 1994 to 2003. Bliss and Gul (2012b) revealed that banks with political connections were more likely to report losses and be audited by big four audit firms. Additionally, they found a positive association between CEO duality in firms with political connections and the firm's risk. Moreover, the study found that the higher the proportion of independent directors, the lower the interest rates charged by the lenders, which mitigated the perceived risk.

Drawing on agency theory, Pham (2019) argued that political connections moderated the relationship between the cost of equity and political risk. They found that political connections helped firms decrease asymmetric information. This privilege allowed firms with political connections to hedge against uncertainty and government policies. Hence, firms with political connections have a lower cost of income. Bona-Sánchez et al. (2014) found evidence that the presence of politicians on the board had a negative impact on firms' earnings informativeness. They argued that politicians were interested in providing as little information to the market as possible to keep political ties away from public scrutiny and to avoid leakage of information to competitors.

Chizema et al. (2015) used the social comparison theory to examine the impact of political connections on executive compensation. They found a negative association between political connections and executive compensation. In addition, they found that the higher the number of board members with political ties, the lower the gap between executive and average employee compensations.

Lin et al. (2015) explored the relationship between political connections on corporate social responsibility (CSR) and its effect on firm's performance. Firms use CSR to build political ties that increase shareholder wealth. In the long run, they found that political connections lead to misallocation of the resources and have a detrimental effect on social welfare.

The relationship between political connections and firm size is not conclusive. Niessen and Ruenzi (2010) revealed that firms with political connections in Germany were larger and had better accounting performance. Conversely, findings of Boubakri et al. (2008) revealed that firms with political connections exhibit a poor accounting performance compared with banks without political ties. Boubakri, Cosset and Saffar (2012) found that large firms benefited more from political connections. Faccio and Parsley (2009) suggested that large firms were less likely to be harmed if political connections were unexpectedly dismissed.

Furthermore, political connections exert influence on CEO compensation. You and Du (2012) investigated the effect of political connections on CEO turnover. They found that the sensitivity of forced turnover to firm's performance was lower for connected CEOs compared with their non-connected counterparts. The results

suggested that connected CEOs used political connection for their own benefits. However, Yu (2010) used data from Taiwan and found that political connections reduced the proportion of equity-based compensation to CEOs.

## 2.5 Conclusion

This study employs a bibliometric analysis amalgamated with a meta-analysis of a set of 138 articles over the period from 2000 to 2020 to investigate the major aspects of academic research on political connections. The study uses VOSviewer software to analyze literature on political connection using bibliometric citations and the density of citation analysis across countries and over years. The findings suggest that there are six main clusters in literature on political connection. Communities are organized according to a hierarchical clustering algorithm that sorts communities based on similarity. The red cluster connects the value of political connections. Political connections and finance associations are denoted in green. The dark blue cluster links the articles related to political connections in banks, and the yellow cluster reflects the articles that investigate the relationship between debt and political connections. The purple cluster explores the association between management and political connections. Finally, the light blue cluster contains the articles that discuss political connections and governance.

The study concludes that political connections are a double-edged sword. The value of a political connection depends on various factors. First, the quality of the institutions. As a result of the flowering of institutional research in the past three decades and the associated rise of new institutional economics and with developments in related interdisciplinary fields, including the economics of law, there is now considerable agreement among social scientists on the nature of institutions and on their potential to shape economic and social outcomes. Haselmann et al. (2018) findings suggested that the rent-seeking behavior and the negative effects of political connections are not exclusive in the developing or highly corrupted countries with failing institutions. Moreover, these elements occur in developed countries with strong and stable institutions, such as Germany. The difference seems to rely on the rent-seeking channels. For example, banks in Germany do not charge less from the connected firm rather they transfer funds through excessive continuation to firms with political ties that makes this difficult to detect.

Strong institutions have created long-lasting and deep influences on the shape and development of modern financial architecture (Ang, 2013). Andrianova et al. (2008) found that state banks are less efficient than private banks. In particular, countries with poor institutional quality should work on enhancing market regulations and increasing governance disclosure and reducing government ownership in

banking to boost economic and financial growth. This might increase the investment in private banks (the more efficient banks) that will increase the depositors' confidence.

Indeed, by building strong institutions, state banks will die a natural death and disappear, especially after removing any subsidies. Chen et al. (2010) suggested that MNE managers and decision-makers must consider political factors while making strategic decisions and resource-allocation decisions. Brown and Dinc (2005) argued that bank failure is mostly due to political factors and weakness in the banking system.

Acemoglu and Robinson (2012) argued that including elites in establishing extractive institutions was the main barrier in achieving economic prosperity. In the long run, political connections harm the economy because they create misallocation of resources and negatively affect social welfare (Lin et al., 2015). Likewise, Houston et al. (2014) explored the relationship between political connections and the cost of loan contracts in the United States. They found clear evidence that the cost of bank loans was lower in the banks with political ties compared with their peers without political ties. The study did not find evidence that the banks charge lower rates from these firms with political connections; however, they found that banks allocate greater value to connected loans to enhance their relationships with politicians.

Conflicts of interest could steer the influence of bailout programs, even in the low-corrupted countries and politically and financially stable countries, such as the United States (Chavaz and Rose, 2019). In Pakistan, Khwaja and Mian (2005) found that banks with political connections had greater access to 45% larger-sized loans compared with loans from their non-connected counterparts, and these loans had 50% higher rates. The findings suggested that in emerging countries politicians use government banks to extract political rent.

In the long run, political connection is very risky. If the government fails to win an election, it is likely to affect the firm negatively, which will affect the firms' long-run performance ((Leuz and Oberholzer-Gee, 2006)). Ferraz and Finan (2011) explored the relationship between corruption and political connections in Brazil. They found that the corruption was less in cities where the politicians can be re-elected. Thus, the electoral rules play an important role in minimizing the corrupt behavior.

Previous literature argues that state-owned banks have a distortion effect on the economy. Schoenherr (2019) findings suggested that political connections gave state-owned firms control over the allocation of government resources, thus, allowing state-owned firms to direct resources to a private firm with political connections that distorted resource allocation. Some literature suggested that moving banks to privatisation is the solution. However, Berger et al. (2009) suggested that mov-

ing the banking system to privatisation will shift the resources from state-owned banks—especially the Big four banks—to foreign banks would boost the system's profitability and efficiency. Noticeably, Boubakri et al. (2009) found evidence that in 39 countries privatization associated with significant improvements in profitability and efficiency.

However, after privatization, governments maintain at least 20% of the shares in a strategic industry or appoint politicians on the boards of newly privatized firms. Faccio and Parsley (2009) argued that in the long run, misallocation of the capital will have a negative effect on the growth. In addition, Gropper et al. (2015) found evidence that in countries with high freedom, the effect of political connection on bank performance is negligible. These results suggest that economic freedom had a clear positive impact on economic growth, and it might outweigh political connection advantages. Boubakri, Cosset and Saffar (2012) findings suggested that firms with political connections enjoyed a lower cost of equity capital and were perceived less risky than peers without political connections. This relationship is evident in highly corrupted countries, where firms can boost performance without taking the risk. However, it is important, not to draw direct policy conclusions from these findings as political connection is one of the methods that companies use to improve their position. For example, companies might instead strain officials through outright bribes (Braun and Raddatz, 2010).

Second, government enforcement can play a role in mitigating the negative effect of political connections. Liu and Ying (2019) found evidence that China's anti-corruption campaign, which begun in 2012, contributes significantly to reduce the politically-connected stock returns. These results indicated that China's anti-corruption campaign effects were mainly because of losing access to bank credit and government subsidies. Fisman and Wang (2015) results suggested that consolidating regulators' incentives for control could improve the connected firms' safety compliance. Furthermore, Guo (2019) found that politically connected firms obtained preferential treatment and had access to bank loans in China. The value of the politically connected firms was negatively affected by the anti-corruption campaign. Bona-Sánchez et al. (2014) found firms with political ties in Spain were less likely to disclose information. Hence, they suggested that to ensure efficient allocation of resources, the regulators should work to increase transparency in firms where the government takes measurements to improve investor protection and governance policies. Choi and Thum (2009) argued that political connections between the firms and the government are a gift exchange. Firms with political ties enjoy privileges and access to finance and markets and are exempted from extortions. In return, the connected firms, especially, the small firms' credible commitment to support the government and exert efforts in stabilisation. However, this exchange can only hap-

pen if certain institutional conditions are met. Thus, more research into the political economy of institutions for financial development would be highly beneficial.

Third, the effects of political connections are ample during crises and elections. Johnson and Mitton (2003) and Ebrahim et al. (2014) both suggest that d firms with political ties suffer more when an exogenous shock hits that limits the government's ability to offer privileges and support. The exogenous shock increases the systematic risk and affects the government's ability to offer support. Understanding the importance and effect of exogenous shocks is an interesting topic for future research. Finally, the review of the literature concludes that although there is widespread literature about political connections, there are research gaps that need to be filled in this literature. In terms of countries, although the extant literature widely investigated the effect of political connections in the United States and China and some developed and emerging countries, there is a gap in the literature to cover the topic of political connection in other countries and regions with a different institutional environment, such as the GCC and Latin America.

# Chapter 3

# Capital Structure and Political Connections: Evidence from GCC Countries

## 3.1 Introduction

This chapter examines the relationship between capital structure and political connection in Gulf Cooperation (GCC) banks. Beginning with Myers and Majluf (1984) unanswered questions about how to choose the capital structure and the assumptions of capital structure theories that are usually violated, they have developed a heated debate on what determines the capital structure.

In theory, the capital structure depends mainly on three approaches. First, the trade-off theory postulates that decision-makers should strike a balance between the benefits of the debt accomplished from taxes and the bankruptcy risks to achieve the optimal capital structure decision (Kraus and Litzenberger, 1973). Second, Jensen and Meckling (1976) suggested that agency costs like equity issuing and cost of capital play a vital role to explain capital structure decisions. At the beginning of the eighties, asymmetric information theories became involved in this hot debate (Myers and Majluf, 1984). Third, according to the pecking order theory, managers aim to reduce the asymmetry cost to the minimum. The theory asserts that capital structure decisions depend on internal resources and the managers use the external capital as the last resort because of the high cost of the external source (Myers and Majluf, 1984).

The empirical support for capital structure is far from conclusive and using one of these approaches depends on the nature of the firm, country or region the study is trying to explore. For instance, Myers and Majluf (1984) pointed out that if the taxes and agency costs are not vital in economics, adopting the pecking order theory

might be a more suitable approach otherwise trade-off theory would be relevant. However, the two approaches are extremely important, as it is hard to identify one approach for a certain country or situation. The exact determinants underlying capital structure differ from those of developed and developing countries and depend upon the nature of each firm and its characteristics. The literature identified the key determinants of capital structure in developed countries, mainly the USA (Frank and Goyal, 2009; Harris and Raviv, 1991; Myers and Majluf, 1984; Titman and Wessels, 1988; Welch, 2004). However, empirically, very little is currently known about the determinants of the capital structure of firms in developing countries. Moreover, most of the previous literature focused on the firm level and has ignored the banks' and financial institutions' capital structure (Antoniou et al., 2008). Some researchers argue that we do not need to investigate the capital structure of the banks because it is identified by the banks' capital requirements. However, Gropp and Heider (2010) review article found that in the USA and other EU countries from 1991 to 2004, there was a huge variation in the capital structure of the biggest twenty banks.

Global Financial Crisis has resulted in extensive criticism of financial institutions and their regulators. Financial institutions have been criticised to have acted interim and irresponsible manner whereas regulators have allowed assets that proved to be of little worth, to be merchandised. Consequently, many of the banks and the financial institutions were bailed out and many of the governments have provided substantial support.

In this study, I introduce a new element to understand the interaction between the financial crisis and the banks' capital structure, by focusing on the influence of directors' political connections on the banks capital structure in the Gulf Cooperation Council (GCC) banking sector. One of the benefits that connected directors convey to the board is preferential access to resources (Pfeffer and Gerald, 1978). Stearns and Mizruchi (1993) claimed that the board of directors in the banks and financial institutions had an effective impact on the institution's capital structure. Faccio (2006) also argued that corruption and agency conflicts may encourage politically connected directors to expropriate resources. However, a lot of effort has been paid after the financial crisis to reduce the excessive risk-taking behaviour in financial institutions. Financial institutions and banks are the most affected by external contingencies, and crisis uncertainties. Hillman (2005) argued that to mitigate the high level of uncertainty, financial institutions are more likely to build external ties (e.g. board directors' political connections). This would protect against major events such as crises through government financial support. The objective of this paper is to explore the impact of political connections on the banks' capital structure in the GCC countries.

The value of political connections to banks is well documented in the litera-

ture. There is a large strand in the literature that investigates the influence of political connections corporate value e.g. (Amore and Bennedsen, 2013; Faccio, 2006; Goldman et al., 2009) Connected directors bring many benefits to the companies. Boubakri, Cosset and Saffar (2012) found that connected firms had a lower cost of equity and preferential support provided by the government. Brown and Dinc (2005) found that, during the election years, the government-owned banks had greater lending portfolios compared to their non-connected counterparts. Claessens et al. (2008) and Faccio et al. (2006) documented that political connection provide accessibility to financial markets and reduce the budget constraints to the connected banks. Moreover, Faccio et al. (2006) and Blau et al. (2013) documented lower cost of borrowing for the connected firms. Goldman et al. (2009) results suggested that the connection add value to the connected stocks following the announcement of the appointment of a connected director in the US.

While there is growing and extensive literature on the determinants of capital structure in developed markets, the literature on the effect of political connections on capital structure is scant. A series of papers found that politically connected firms may have a higher level of debt. Notably, several papers examine the behaviour of Malaysian firms, including Johnson and Mitton (2003) who showed that Malaysian politically connected firms sustain more debt and are riskier than non-connected firms. Fraser et al. (2006) suggested that there was a significantly positive relation between leverage and political connection, while Bliss and Gul (2012b) equally showed that politically connected firms were riskier with higher debt. This study also noted that politically connected firms were more likely to report a loss, to have negative equity or to be audited by a big audit firm compared to non-politically connected firms. In contrast, Khwaja and Mian (2005) and Faccio (2006) argued that political connections make the firm perceived as less risky as it is expected to be rescued by the government or through IMF or World Bank financial assistance.

This paper aims to study the relationship between political connection and capital structure of the Gulf Cooperation Council (GCC) banks for the period from 2005 to 2016. The study employs rigorous tests to mitigate any endogeneity concerns, using the difference in- difference technique.

Our findings show that neither the pecking order theory nor the trade-off theory could conclusively explain capital structure in the GCC banks. The results of our quasi-experiment show that the presence of political connection in the GCC banks results in a leverage reduction. However, our results are opposite the claim that politically connected firms are more likely to sustain debt. The results suggested that GCC countries as rich cash countries are employing risk reduction strategies adopted by regulated industries. More specifically, after controlling the country and year characteristics, the study finds that directors' connections have a negative

and significant, (both statically and economically) impact on the capital structure that politically connected banks reduce leverage ratio by 4.6 points relative to non-connected banks. Interestingly, after the crisis, the study also finds a negative statically significant association between directors' political connection and the leverage ratio. However, the leverage of the politically connected banks is, on average, 1.13 points lower compared with non-connected banks. For all the GCC countries except Qatar, there is strong evidence of a negative relationship between political connection and capital structure. Equally, in the crisis period, there is further evidence of de-levering, especially in Saudi Arabia and UAE. However, Qatar stands in contrast with an increase in debt. There is some evidence, in general, that leverage in non-politically connected firms increases during the crisis.

The paper provides four novel contributions to the literature. Firstly, The GCC countries present an interesting and important area to study the relationship between political connections and capital structure as it represents a mix of newer markets, such as Dubai and Abu Dhabi, against more established markets, such as Saudi Arabia, Kuwait, and Oman, which seek reforms. These new markets, attract investors and foreign capital into the region (Naceur et al., 2008). Secondly, within the GCC countries, a larger role is played by the royal families, who control major aspects of the economies. To the best of our knowledge, the present study is the first to examine the effect of political connection and capital structure in the GCC region in particular for banks. Thirdly, our paper is the first to link board directors' connections with risk-taking behaviour after the financial crisis in the banking sector. Moreover, our paper is the first to investigate this phenomenon in the GCC countries using manually collected primary data.

The remainder of the paper is organised as follows. The next section reviews the GCC context. Section 3 explore relevant literature. Section 4 highlight the capital structure literature review. Section 5 reviews and capital structure literature. Section 6 describes our empirical model. Section 7 describes the data, and the study presents the descriptive analysis in section 9. Then the study explores regression results in section 9. Section 10 concludes the study.

## 3.2 The GCC Context

The Gulf Cooperation Council (GCC), is a regional, intergovernmental political and economic union that consists of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. The GCC has remained a strong union since 1981. The Gulf Cooperation Council was a socioeconomic powerhouse in the region and worked to promote security, stability and build strong ties among the members. For instance, the strength of the Gulf Cooperation Council was a critical factor to

Table 3.1: Global Financial Development for the GCC banks, USA and UK 2017

| Country Name | Bank cost to income ratio (%) | Bank return on assets (%, after tax) | Stock price volatility |
|---|---|---|---|
| **Kuwait** | 35.13 | 1.19 | 9.40 |
| **Oman** | 47.74 | 1.33 | 8.10 |
| **Bahrain** | 44.24 | 1.29 | 7.70 |
| **Qatar** | 31.48 | 1.50 | 16.02 |
| **Saudi Arabia** | 35.09 | 1.98 | 17.91 |
| **UAE** | 35.44 | 1.44 | 14.31 |
| **United State** | 57.41 | 0.96 | 13.39 |
| **United Kingdom** | 68.72 | 0.41 | 11.02 |

Source: The World Bank (2020). Global Financial Development Database 2017.

overcome many challenges such as Iraq's invasion of Kuwait in 1991 and promoting socioeconomic partnerships in the region.

As an example of this strong partnership, in 2001, the GCC members agreed to establish a free movement agreement of goods, services and citizens among the seven countries (Naheem, 2017). The economic stability in the GCC is protected by a safety net of marriage alliances between the rulers, tribal leaders and local merchant families. The nature of the rent-seeking activity in the GCC involves firms using their political capital to secure favoured treatment from the government to increase profits (Krueger, 1974). Hence, the GCC provides a unique regional context for this paper.

The political economy of the GCC region has attracted many researchers. Malik and Awadallah (2013), for example, described the policies that had been followed by oil-rich countries governments in the GCC region with the "original sin", where the discovery of oil helped their governments to preserve power through centralized bureaucratic systems. These systems overlooked important issues of inequality and the importance of redistribution of wealth, in favour of the narrow elites.

In the GCC countries, banks dominate most of the capital by gathering money and finance investments in the region (Naceur and Omran, 2011). One of the most important features of the banking sector in the GCC banks is the nature of the ownership. Banks in the GCC region are domestically owned or dominated by the state (Naceur et al., 2008). The characteristics of the GCC banking system is inherently different from the developed countries. Table 3.1 compares the cost to income ratio and the return on assets ratio in the GCC countries, the USA, and the UK. The table shows that the cost to income ratio in the GCC countries is lower than the cost to income ratio in the USA, and the UK. Moreover, the return on assets is slightly larger in the GCC countries compared to the USA and the UK. The stock price volatility varies between the GCC countries. For example, the volatility rate in Kuwait, Bahrain and Oman are lower than the volatility rate in the UK and the USA, while Qatar and Saudi Arabia are more volatile.

Also, the report of the World Bank Doing Business (2012) pointed out that Saudi Arabia and Kuwait have become the countries with the strongest investor protection

index among the GCC region and scored 7.0 and 6.3 respectively while the UAE had the lowest score of investor protection 4.3.

Gulf Cooperation Council represents an important region in the world. It has 45% of the world's crude oil reserves and 15 percent of the natural gas (IMF, 2018). Natural resources dependency is a preeminent pillar in the dynamic relationship between the state and the private sector in the GCC region.

The GCC countries have witnessed epochal challenges that shaped the region's policies and political system. Beginning with oil discovery 1950, political independence 1971, oil boom 1973, and globalization have contributed to the current GCC political and economic state. The change has been associated with a social cost. The costs imply unequal distribution of wealth, increasing individualism, consuming behaviour, the dependency on foreigners and increasing the power of the ruling families.

The power of the ruling families in GCC countries is one of the rigid pillars that shapes the political system in the gulf region. These ruling families survived tough threats and obstacles and they proved their capability. This power is increasing because of the flourishing standards of living provided to the citizens of these countries. Gause and Gause (1994) pointed out that the power of the ruling families in the Gulf states is not a result of the USA protection as the case in the other Arab countries like Egypt and the ruling families business relationships have a long history and deep roots in the GCC region. The oil boom 1973 was one of the main reasons for the increase of the ruling families' wealth and their active engagement in business activities (Kamrava et al., 2016). Policy makers focused on nation-building and infrastructure, integration to achieve economic growth using the available oil rents, especially in Kuwait, as it was the pioneering country to achieve modernity and development (Power, 2013). Although the far-reaching socio-economic developments, this oil boom strengthened the GCC monarchies (one family regime system) and enhanced the political rigidity. The accumulative wealth of the oil boom weakened demands for political representation "no taxation, no representation" (Power, 2013).

In 2014, the oil prices downfall sharply and intensified a heated debate to find a solution for the social and political challenges. This vision was a reaction to the Arab spring and the uncertainty and instability that accompanied it. This change pushes the ruling families to focus on diversification and sustainability and put a long-run vision to tackle the threats and achieve economic growth (Kamrava et al., 2016). There is no domestic appetite for political reform when prosperity, security and stability are fully guaranteed. In addition, the obedient tribal culture and the good communication between the tribes and the royal families is another reason for the political rigidity and loyalty to the ruling families (Abdulla, 2010). Hertog (2010)

defying the resource curse in the case of GCC state-owned enterprises and giving us a new perspective on rentier states. The study concluded that the rent flows do not necessary leads to institutional stagnation as the resources curse stated. The study results show that the monarchies political system built a large-scale system of efficiency. Hence, the study aims to investigate the effect of political connection on the capital structure in the GCC banks.

## 3.3 Political Connection Literature Review

It is well recognised that Politically connected firms receive a variety of economic benefits all over the world especially in developing countries. However, the recent literature pointed out that the differences vary from one country to another through the political rent channels to connected firms (Amore and Bennedsen, 2013). There are some works in the area about political connection and stock markets based in Egypt. However, this work focuses only on the effect of political connections on the stock market return (Acemoglu et al., 2018; Diwan and Chekir, 2012). This recent body of literature provides mixed results see table 2.2.

Table 3.2: Political Connection Literature Review

| Studies | Years | Firms | Country | PC measure | Methodology | Model &Sign |
|---|---|---|---|---|---|---|
| Abdel-salam & Tortosa-Ausina (2017) | Yearly 2008-2013 | 851 bank-year obs | MENA | Four political connections proxies, (direct, indirect) | Data Envelopment Analysis (DEA) Quantile regression analysis | Efficiency (-) |
| Acemoglu, et al (2018) | Daily 2005-2013 | 177 Firms | Egypt | 1 if connected to the BOD 0 otherwise | Event study Pooled regression OLS | Stock market valuation (+) and driven by the street power (demonstrations), Risk + |

Table 3.2: Political Connection Literature Review

| Studies | Years | Firms | Country | PC measure | Methodology | Model &Sign |
|---|---|---|---|---|---|---|
| Ace-moglu,et al., (2016) | Daily 2008 | 678 Firms | USA | Schedule connections, times that Geithner interacted with execu-tives,Personal connections; personal links that Geithner has with firms,Firm location | Univariate Tests OLS Regression Synthetic Matching | Stock market return (+) |
| Al-Hadi et al (2017) | 2005 to 2013 | 165 firm-year obs | GCC | Royal family, ownership | Panal regression (OLS) | Joint audit and cost of debt (-) moderated by PC |
| Amore and Bennedsen (2013) | 2002 to 2008 | 1946 | Denmark | CEO or a BOD or both Connected by family to CEO or BOD | DID | Profitability (+) |
| Baslandze (2018) | 1993 to 2014 | 1 Million Firms | Italy | 1 if connected to the Network 0 otherwise | Regression discontinuity design | Innovation (+) Productivity growth (-) |
| Baum et al., (2008) | 2003 to 2005 | 1300 bank obs | Ukraine | 1 if connected to the Parliament 0 otherwise | Pooled Fixed effects Cluster-robust standard OLS, Dynamic panel data (DPD) | Interest rate margins (-), Capitaliza-tion (+) |

Table 3.2: Political Connection Literature Review

| Studies | Years | Firms | Country | PC measure | Methodology | Model &Sign |
|---|---|---|---|---|---|---|
| Bertrand, et al., (2018) | 1987 to 2002 | 237958 obs | France | 1 if Connected CEO 0 otherwise | Fixed effects | Tax (-) Profitability (+) |
| Blau, et al., (2013) | 2001 to 2004 | 500 | Malaysia | % government ownership, % institutional investor, Informal ties with the three most powerful politicians in Malaysia in the 1990s | Univariate analysis OLS regression | Leverage (-) |
| Bliss and Gul (2012) | 2001 to 2004 | 500 | Malaysia | 1 if politically connected 0 otherwise | Multiple regression | leverage (+) Reporting a loss (+) Equity (-) Interest rates (+) |
| Bliss and Gul (2012) | 2001 to 2004 | 500 | Malaysia | 1 if politically connected 0 otherwise | Univariate analysis OLS regression | Leverage (-) |
| Boubakri, et al., (2008) | 1980 to 2002 | 245 | 27 developing and 14 developed countries | 1 if politically connected 0 otherwise | Logit regressions,Tobit regressions,Panel regressions, Fixed effects panel, Logit regression | Big cities (+) Leverage (+) Government ownership (+) Foreign ownership (-) Accounting performance (-) |

Table 3.2: Political Connection Literature Review

| Studies | Years | Firms | Country | PC measure | Methodology | Model &Sign |
|---|---|---|---|---|---|---|
| Boubakri, et al., (2012) | 1997 to 2001 | 1248 obs | 26 Countries | 1 if politically connected 0 otherwise | Propensity score matching models | Cost of equity capital (-) Valuable (+) Risk (-) |
| Borisova et al., (2015) | 1991 to 2010 | 2,318 bonds and 249 firms | 43 countries | Government ownership | Cluster two ways regression,Heckman treatment effect two stage model 2SLS | Cost of debt (+) |
| Braun & Raddatz, (2010) | 1996 to 2005 | 4,618 banks | 154 countries | 1 if at least one of the bank's directors has been a politician or bank regulator, and 0 otherwise | DID,Heckman two-step estimator | Size (+) Profit (+) More connection less performance, Corruption (+) Government accountability (-) Country financial development (-) Risk (-) |
| Brown & Dinc (2005) | 1994 to 2000 | 164 private banks | 21 major emerging markets | Electoral cycle | Case studies | Panel regressions, Government interventions delaying the banks failure due to political concerns |

Table 3.2: Political Connection Literature Review

| Studies | Years | Firms | Country | PC measure | Methodology | Model &Sign |
|---|---|---|---|---|---|---|
| Carretta et al., (2012) | 2006 | 123 banks | Italy | % BOD from government (executive or non-executive)% BOD from government (executive) | OLS | Net interest revenues (-) Loan portfolio quality (-) Efficiency (overhead costs) (+) |
| Cooper et al., (2010) | 1979 to 2004 | 1,930 firms | USA | Firm support for PC candidates | Panel regression | Future returns (+) |
| De Nicolo and Loukoianova (2007) | 1993 to 2004 | 10000 banks | 133 countries | Bank ownership | Z-score regression | Risk (+) |
| Diwan and Schiffbauer (2016) | 1996 and 2006 | 469 politically connected firms | Egypt | Entry of connected firms | OLS | Employment Growth (-) Productivity (-) Failure (+) |
| Ebrahim et al (2014) | 1988 to 2009 | 751 firms | Malaysia | 1 if connected to the Network 0 otherwise | DID, GMM | Subsidies (crisis times) (-) Leverage (No relationship) |
| Faccio (2006) | 1997-2002 | 450 firms | 35 Countries | 1 if connected to the Network 0 otherwise | Panel regressions | Bail out (+) Performance (-) |

Table 3.2: Political Connection Literature Review

| Studies | Years | Firms | Country | PC measure | Methodology | Model &Sign |
|---|---|---|---|---|---|---|
| Faccio (2010) | 1997 | 16,191 firm | 47 countries 1 if connected to the Parliament or politician 0 otherwise | Panel regressions | DID | Market share (+) Leverage (+) |

Diwan and Chekir (2012) explored the stock market reaction to crony capitalism and its effect on the firm performance of the politically connected firms and non-connected firms before and after the 2011 revolution. The study compared the politically connected and non-politically connected firms in terms of leverage, market share and tax payments. In additional analyses, the study employed an event study to estimate value in the market. Finally, the study investigated the impact of political connection on the firm profitability and the future advantages such as the growth opportunities and the bailout grantees. The study found that connected firms were less efficient than other non-connected firms. The capital was misallocated, and politically connected firms borrowed more than the non-politically connected firms not because it is more efficient but because of the benefits which make these connected firms more attractive to the banks.

Faccio (2006) looked at the common characteristics of the politically connected firms around the world and their effect on the firm value using data of 20000 firms in 47 countries. Overall, 541 firms were politically connected which representing 8% of the world market capitalization. In the countries with a high level of corruption, connections were solid compared to the low corruption level countries. The study found also that the effect of political connection on the firms' value depended on the political power of the politicians. Faccio (2010) documented in 47 countries around the world that the leverage is higher in the connected firms and they enjoy lower taxation and greater market power. Additionally, connected firms exhibited lower profitability and market valuation.

Faccio (2006) investigated the stock market reaction to the sudden death of a politician. The event study results showed that the prices decreased by 1,93% on average for a sample of 7080 firms and 123 sudden death events around the world. The study results confirmed the importance of the connection especially for family firms

and firms with growth opportunities and in high corrupted environments. Also, Cooper et al. (2010) investigated the stock market reaction to political connection from 1979 to 2004. They developed a new unique firm-level dataset of the firms' contribution to the USA political campaigns. The results showed these expenditures were positively and significantly correlated with future returns. Notably, the impact was much greater when the firm support a higher number of political candidates that hold office in the same state that the firm was based. Acemoglu et al. (2018) investigated 177 firms that were listed in the Egyptian stock exchange and they used Global Data on Events, and Location. (GDELT) database to extract the events data and 318,477 tweets during the period from 2005 to 2013. Moreover, they divided the connected firms into 4 groups: firms that were connected to Mubarak's regime, those connected to the Military, and those connected to the Muslim Brotherhood, and finally those that are not connected to any entity. The results suggested that the street demonstration had a negative effect on the connected firms' ability to extract rent in the future. However, the study found that the effect of the street demonstration on rent holds also when the formal institution and government were stable. Acemoglu et al. (2018) pointed out the explanation of these findings for three reasons: first, the potential future change in regime. Second, de jure institutions (Mubarak's fall). Third, de facto power (street demonstrations). Finally, the study results showed the importance of media role in the Egyptian revolution by investigating the effect of the tweets as a measure of discontent about the government on the demonstration crowding and organization. However, the results did not confirm the effect of Twitter activity on the stock market perception of rents for the different groups of connected firms.

Acemoglu et al. (2016) explored the effect of political connection on firms by investigated the announcement of Timothy Geithner as a nominee for Treasury Secretary in November 2008 on the banks' value. The study consists of all financial firms (678) trading on the NYSE or Nasdaq from the DataStream database. The study found evidence that the political connection of the executive decision-makers has an obvious role in the developed countries with good institutions such as the USA, especially in the crisis time. The announcement of Timothy Geithner as a nominee for Treasury Secretary in November 2008 resulted in producing accumulative abnormal returns. After the first trading day of the event, the return increased by 6% and by 12% after ten days. The results showed that the connected firms reflected higher returns after control for size, profitability, leverage, and prior stock price behaviour. The study showed that the connected firms had negative abnormal returns when the news announced that Geithner's confirmation might be disrupted by taxes. These results hold after controlling for the vulnerability measures in the crisis time. For instance, the effect of the hottest crisis points (September-October

2008); the stock market reaction to the capital injection into banks in October 2008. The study pointed out that in the crisis time the treasury position secretary had unusual power over the financial system. Hence, the study found that in the crisis time when instant action is vital, social connections was one of the most important tools to deal with the crisis.

Amore and Bennedsen (2013) used the difference in difference (DID) and exogenous change in the Danish domestic municipality sizes to investigate political connection and political power (population by elected politician) effect on firms' profitability. Denmark is the least corrupted country in the world and this study argue a long with the previous literature in the developed countries that has a positive effect on the firms' performance. Most of the previous literature depends on the event studies to identify the effect of the political connection while this study used an identification strategy to investigate the effect of political connection on the operating performance. These exogenous changes represented in an administrative reform happened in 2005 and 2001, whereby 238 Danish municipalities merged into 65 new ones while 33 municipalities were left unchanged. The study used two different approaches to avoid the endogeneity problem and exploit the historical variation in the institutional quality, politician, and firm characteristics. The results suggested that the increase in political power enhance firms' performance. Doubling political power doubled the politically connected firms' performance. The study pointed out that the family connection secured more business with the local government. The study argued that the full welfare effect was negative as reduced the overall welfare by transferring the rent from the most productive firms to the least productive firms. Finally, the study contributed to measure corruption as induce benefits that reduce the overall welfare of the country. Overall, the study found evidence that legal corruption presents even in the world's least corrupt country. Akcigit et al. (2018) investigated the association between the firms' political connections dynamics and innovation and creative destruction in Italy using macro and micro data. The study contributed to the literature by using a new dataset covering the period from 1993 to 2014 and merging 5 datasets: firm-level financial data; social security data; European patent office data; the national local politicians; and detailed electoral data in Italy. The study found that the market leader was more likely to be politically connected and less innovative. This phenomenon is called the leadership paradox. Furthermore, the study suggested that firms associated with a high level of survival and growth in employment and revenue by helping to remove the block competition and market frictions such as regulatory barriers or bureaucratic burdens while it had a negative association with productivity at the same time. The politicians enjoyed a significant wage premium relative to the other employees. These results were confirmed after using a regression discontinuity design and firm dynamics model. The

model showed a new interaction between static gains and dynamic losses from rent-seeking in aggregate productivity. As in the macro level, the political connection had a negative impact on entry, allocation, and productivity.

Bertrand et al. (2018) documented the cost of political connection in France by investigating the impact of political connection to support the incumbent politician to stay in power and use the firm resources. On one hand, the results found evidence that allowed the connected firms to benefit from preferential access to government resources. On the other hand, the study results showed that the connected firms were less profitable especially when the connected CEO comes to the power and had lower performance driven by higher labour costs compared to the non-connected firm.

Acemoglu et al. (2018) argued that the relationship between political connection and return is driven by the institution quality, rule of law, regulation and country corruption levels. Blau et al. (2013) analysed the impact of political connection to determine the allocation, timing and magnitude of the 2008 Troubled Asset Relief Program (TARP). The study measured it using two approaches: (1) the lobbying expenditure for each firm in the 5 years prior to TARP and (2) the definition of political connections given by the Centre for Responsive Politics. The probit analysis suggested that the politically connected firms had a 37% and 51% better chance of receiving (TARP) support. Boubakri et al. (2008) estimated the effect of political connection in newly privatised firms in 27 developing and 14 developed countries from 1980 to 2002. The study found that politically connected firms were incorporated in the big cities and highly leveraged compared to non-connected firms. Politically connected firms were also positively associated with government ownership whereas it is negatively correlated with foreign ownership. Finally, the study demonstrated that political connection is negatively associated with accounting performance. More recently, Guo (2019) analysed the effect of the current anti-corruption campaign on the connection between independent directors with political backgrounds (IDPBs) and favoured bank loans of Chinese listed companies. The study found that the IDPBs were positively associated with bank loans. Additionally, the relationship between the IDPBs and bank loans were negatively affected by the anti-corruption campaign.

Abdelsalam et al. (2017) investigated the effect of political connection on the efficiency of 158 banks in the MENA region covering the period from 2007 to 2013. The study highlighted the high concentration in the MENA banking sector. MENA countries have high corruption and a mix of monarchies and authoritarian regimes. The results of the two-stage testing procedure suggested that the four political connections proxies had a significant effect for the highest quantiles (most efficient banks), whereas it is not significant for the lowest quantiles (less efficient banks).

The results demonstrated a negative effect of government ownership on the banks' efficiency.

The present study focuses on the banking sector, as it is the main channel of financial development. Malik (2016) stated that although financial markets serve as its linchpin of the political economy, international research on the political economy has only paid passing attention to finance. Moreover, political patronage might give a bank greater access to the government budget with a low-interest rate. Additionally, politically connected firms are perceived by depositors as less risky banks and these banks might charge higher loan interests. The seminal study by Modigliani and Miller (1963) offered evidence that bank value is enhanced when the level of debt increases. This study encouraged identification of the main channels of capital structure. Nevertheless, academic agreement has not been achieved regarding the drivers of the capital structure.

The effect of political connections on the banking sector has recently been investigated. Braun and Raddatz (2010) seminal work exploited a new dataset of the names of politicians, cabinet members, financial sector supervisors and central bank governors in 154 countries over 10 years from the Country Reports of the Economist Intelligence Unit and Central Bank Publications, extracting the names of bank board members from Bank scope. Braun and Raddatz (2010) highlighted the critical role of central banks' difference from other banks in credit allocation, which affects the economy and welfare. The study revealed evidence in a large number of countries of former high-ranking politicians becoming bank directors. Moreover, the connected banks were more successful in comparison to non-connected counterparts; however, this frequency was associated with multiple important bank features and existing institutions.

Baum et al. (2008) investigated the impact of political connections on banks' performance in Ukraine covering the years from 2003 to 2005. The study argued that banks seek political connections for numerous reasons. A bank that is politically connected with high-ranking officials in the parliament or the executive branch was shown to have the advantage to improve the conditions of doing business and successfully navigate bureaucratic obstacles. Additionally, politically connected investment banks might have a better chance of obtaining a lucrative mandate in privatisation transactions to advise the government. The study examined the bibliographies of 467 members of parliament to measure political connections. The study employed the first difference estimator to investigate the impact of political patronage on the growth of interest rate margins and capitalisation ratios. They used the Generalised Methods of Moments (GMM) to estimate the impact of the level of political activity on banks' behavioural dynamics, finding connected banks to have a significantly lower interest rate margin and higher capitalisation compared

with the non-connected banks. Moreover, the level of activity of affiliated deputies in parliament is positively associated with the banks' capitalisation ratio and negatively associated with the interest rate margin. Related channels were investigated to examine whether politicians serving on banks' boards of directors' influence performance, lending and risk-taking behaviours. Carretta et al. (2012) examined 438 Italian cooperative banks for the year 2016. The study pointed out that the issue is not related to having politically connected members on boards of directors, but the duality of their positions and having executive positions. The results of this investigation indicated that politically connected executive directors appeared to have a negative impact on bank revenue, loan portfolio quality and capital, but exerted a positive impact on banks' efficiency

Similarly, De Nicolò and Loukoianova (2007) investigated the relationship of political connection on banks' risk, ownership and market structure. The results of the study suggested that risk profiles and bank concentration are higher in domestic state-owned banks than in the private banks. Diwan and Schiffbauer (2018) found that politically connected firms received larger loans than non-connected banks, reflecting the exploitation of more opportunities and a greater presence in the market. La Porta and Lopez-de Silanes (2002) examined the impact of government ownership on financial development and economic growth using bank data from 92 countries. The result demonstrated that state-owned banks are associated with deficiencies in financial development and a negative effect on economic growth and productivity. In the same vein, Khwaja and Mian (2005) studied this relationship in earning and providing rents in financial markets in Pakistan with 90,000 loan data points from January 1996 to September 2002. The study investigated loan information for every corporate loan made and the two elections that happened in the study period. The results indicated that politically connected banks had higher access to credit than state-owned banks. Dinc (2005) investigated the role of intervention in failing banks and politicians' incentives. The results showed that politicians used banking regulations to favour partners and discipline opponents.

## 3.4 Capital Structure Literature Review

The theoretical background of capital structure depends on two contradictory theories, pecking order and trade-off. Pecking order theory asserts that there is no optimal capital structure, and each firm aims to maximise its value by choosing the best leverage ratio due to the asymmetry of the information. In contrast, trade-off theory postulates that capital structure decisions represent a trade-off between tax benefits and the costs of bankruptcy to obtain the optimal capital structure. Capital structure research has been largely empirically investigated in the US, among other

developed countries.

However, limited research evidence exists for developing countries. Trade-off theory asserts that there is a positive effect between profitability and leverage because of the low cost of bankruptcy in highly profitable firms and low managerial agency expenditure. Conversely, if debt is the main source of external financing, the relationship between firm leverage and its profitability will be negative. Additionally, if profitability is positively correlated with growth opportunities, this could lead to a negative association between firm profitability and financial leverage. Additionally, size has a positive effect, as large firms are more stable and able to compete. Moreover, risk has a negative impact on firm leverage, as highly volatile firms have high bankruptcy costs.

Artikis et al. (2007) investigated the effect of political connection on the coverage ratio of capital structure finding a significantly negative association. According to pecking order theory, firms should finance their activities. The more debt the company has, the fewer current assets will remain. Rajan and Zingales (1995) asserted that according to the theory, firms with a high market to book ratio have high financial distress costs, which are expected to correlate negatively with the firm leverage. Fama and French (1992) explained that shares of the firms with a high leverage ratio or financial distress may discount at a high rate of interest as a result of the price of distress risk (Al-Najjar and Hussainey, 2011; Frank and Goyal, 2009; Harris and Raviv, 1991; Rajan and Zingales, 1995; Zeitun et al., 2017).

A considerable body of literature has investigated the determinants of corporate capital structure to identify its potential drivers (Al-Najjar and Hussainey, 2011; Al-Hadi et al., 2017; Antoniou et al., 2008; Frank and Goyal, 2009; Harris and Raviv, 1991; Rajan and Zingales, 1995; Titman and Wessels, 1988; Zeitun et al., 2017). Al-Najjar and Hussainey (2011) used UK firm data providing evidence that tangibility, firm size and profitability are the main determinants of capital structure. Their results showed that tangibility is negatively associated with capital structure, and firm size and the capital structure have a positive relationship. Likewise, Rajan and Zingales (1995) investigated what drives the capital structure using a sample from G-7 countries. The results suggested a negative association of market to book ratio with firm leverage. Moreover, profitability was found to have a negative effect on leverage; however, the results indicated that size had a positive impact on capital structure.

Similarly, Gaud et al. (2005) investigated the dynamics of the capital structure in 104 Swiss companies listed in the Swiss stock exchange covering the period from 1991 to 2000. The results are consistent with both the pecking order and trade-off theories, although the latter theory has more explanatory power regarding Swiss firms' capital structure. The results suggested the positive association of tangible assets

and firm size with firm leverage; however, the results also showed a negative association of growth and profitability related to capital structure. The authors asserted that Swiss firms adjusted toward a target debt ratio, arguing that the adjustment process was much slower than in most other developed countries for institutional reasons. The study suggested that future research should study the institutional role and its effect on capital structure. Denis and Mihov (2003) analysed the determinants 1560 new debt financing choices of 1480 public companies in the US from 1995 to 1996 finding the credit quality of the issuers to be the main determinant of debt choice. In particular, firms with the highest credit quality tended to borrow from public sources. In contrast, medium credit quality firms largely depended on borrowing from banks, whereas firms with the lowest credit quality borrowed from other private sources.

Similarly, Huyghebaert and Van de Gucht (2007) explored the capital structure of 244 entrepreneurial start-ups in the US spread over 97 industries from the year 1988 to the year 1991. They found that entrepreneurial start-ups were risky, and largely carried less bank debt, mainly depending on the other debt sources. In a similar vein, Desai et al. (2004) sought to answer two questions. First, whether corporate borrowing increases as a result of interest expense decreases due to the capital market or the legal system. Second, whether firms use internal capital to cover the costs. This research used unique affiliate-level data from roughly 3700 U.S. multinational companies operating in more than 150 countries with different tax rates and capital markets through 30,000 affiliates in the years 1982, 1989 and 1994 to differentiate the determinants of external borrowing from parent companies. The results suggested that firms largely depended on internal resources, particularly when external capital was costly or when tax arbitrage opportunities were available. The study compared local and multinational firms finding that the internal capital market gave multinational firm advantages over domestic firms in poorly developed credit markets. The results suggested that local firms in countries with low credit borrowing or weak capital markets faced high debt costs from external resources; however, the study also found a weak borrowing credit market. Hence, multinational companies have more access to global capital, presenting an opportunity that is unavailable to local competitors.

Examining the circumstances in Belgium, Dewaelheyns and Van Hulle (2010) exploited 2SLS and Tobit regressions to investigate the effect of business groups on optimising internal and external debt covering the period from 1997 to 2002. The study demonstrated the pecking order of internal debt finding the concentration in subsidiaries' internal debt to be driven by corporations' internal capital market characteristics. Kremp et al. (1999) investigated the determinants of the capital structure in France and Germany using dynamic analysis, highlighting the role of the

institutional framework. The research demonstrated large differences between the two countries in terms of debt trends over time, and firm growth had a positive effect on leverage whereas profitability had a negative impact, supporting the pecking order theory. The results also implied that macroeconomic factors namely 'tax policy and debt economy' were responsible for firms' debt behaviour.

Investigating data from France, Germany and the UK Antoniou et al. (2008) shed the light on the validity of the capital structure determinants of debt maturity using instrumental variables and traditional difference GMM, covering the period starting from 1969, 1983 and 1987 for the UK, France and Germany, respectively and ending in 2000. The results suggested taxes, bankruptcy risk and agency costs had some influence on the debt maturity structure of firms in all three countries.

Additionally, the results suggested that the financial environment and regulations had significant impacts on firms' debt maturity structure. Alonso et al. (2005) examined the factors of debt structure for Spanish firms within a civil-law corporate governance setting. The paper employed fixed effects and GMM finding a positive correlation between firm size and the proportion of bank debt. These results contradicted the findings of previous literature in common-law countries. The results demonstrated a negative association between growth and leverage contradicting previous literature. The study also found that firms with growth opportunities appeared to avoid debt. The study suggested institutional settings and the legal systems as important considerations for future research.

Hooks (2003) explicitly investigated the impact of the firm size on bank debt concentration using US firm-level data, finding evidence that small and medium firms had a high bank debt concentration, whereas large firms only took on high debt when it was difficult for outsiders to observe. These findings agree with Diamond (1991), who determined that as firms grow, they face different debt choices to maintain reputations.

However, the literature exploring the determinants of capital structure in GCC countries is limited. A study examining GCC firms Zeitun et al. (2017) supported the earlier findings of Rajan and Zingales (1995) that profitability has a negative effect on capital structure and firm size has a positive effect on capital structure. They also found that risk to be negatively associated with firm leverage. Conversely, Titman and Wessels (1988) found firm size and profitability had a negative impact on capital structure due to the transaction cost. However, asset tangibility had a positive impact on firms' capital structure. In the same vein, Antoniou et al. (2008) found a positive impact of size on capital structure and a negative relationship between leverage and profitability. Frank and Goyal (2009) identified a negative relationship between leverage and risk and a negative association between leverage and profitability.

## 3.5 Capital Structure and Political Connections

One important unexplored area is the effect of institutions on capital structure decisions. Rajan and Zingales (1995) suggested that it is important to investigate the effect of institutional differences on capital structure in future research. To the best of our knowledge, this is the first research to investigate the effect of political connection on financial firms' capital structure in the GCC countries. Ebrahim et al. (2014), one of the seminal studies to investigate the relationship between political patronage and capital structure using the difference-in-differences (DID) model before and after the Asian crisis from 1998 to 2001 and from 2002 to 2009 to capture the recovery period. The independent variable of the study was leverage, and the political patronage variable equalled 1 if the firm was politically connected and 0 otherwise. The study used GMM estimation, reconciling trade-off and pecking order theories, finding evidence that the theories were complementary. López Iturriaga (2005) investigated the determinants of debt from an institutional perspective for Austria, Germany, Japan, Belgium, France, Italy, Holland, Spain, Portugal, Finland, Sweden and the US using a fixed panel analysis covering the period from 1980 to 2000. The study found capital structure decisions to be affected by both firm characteristics and institutional factors. In particular, firm size, profitability and risk were found to have a significant impact on capital structure decisions. The study also found legal–institutional factors to influence firm leverage regarding protection, disclosure requirements and law enforcement. The study suggested further investigation of new factors for describing the institutional context of each country.

Al-Hadi et al. (2017) explored the association of joint audits and cost of debt capital, investigating whether political connections have a moderating effect on non-financial publicly listed GCC firms. Their results suggested that politically connected firms had a lower cost of capital. Some research has also investigated this relationship in Malaysia(Bliss and Gul, 2012a; Fraser et al., 2006; Johnson and Mitton, 2003). For instance, Johnson and Mitton (2003) argued that political connection gives the politically connected firms' privileges allowing them to sustain more debt, suggesting that the effect was much higher in financial firms compared to non-financial firms. The study demonstrated that firms that had political patronage were riskier than non-politically connected firms.

Similarly, Fraser et al. (2006) investigated the relationship between firm leverage and political connection, determining political patronage to have a significant positive impact on leverage for three different measures of political patronage. In additional analyses, the results suggested clear differences in capital structure between market-based capitalism (e.g. US or G-7 countries) and 'relationship based' economics. This could be explained by institutional factors and the nature of bank-

ing sectors. Boubakri, Cosset and Saffar (2012) investigated the cost of equity and the factors that affect investors' perceptions of political connection examining a cross country sample of 35 countries spanning from 1997 to 2001 with propensity score matching models. The study found that politically connected firms exhibited a lower capital cost than non-connected counterparts. Furthermore, the effect of political connections on firm value was positively associated with the political power of the connections. The study also confirmed the relationship between countries' institutional quality and the effect of firms' capital cost, noting the influence of firm characteristics as well. Overall, the study results suggested that politically connected firms are less risky compared to non-connected firms.

In the same vein, Borisova et al. (2015) used a cross-country analysis of 43 nations to investigate the effect of governmental ownership on the debt expenditure of publicly traded firms. The study used fixed effects and 2SLS regressions covering the period from 1991 to 2010, finding government ownership to have a significant positive effect on firm debt. Likewise, Bliss and Gul (2012a) confirmed politically connected firms to have a higher leverage ratio. Intrinsic to this idea is the notion of connected firms' riskiness. The study argued that politically connected firms were more likely to report a loss, have negative equity or to be audited by a large audit firm than non-politically connected firms.

## 3.6 Econometric Model

According to pecking order theory, leverage ratio depends on the historical financing decisions, which are triggered by the minimisation of adverse selection costs wherein firms adjust towards a target leverage ratio. The time to reach this target is referred to as the speed of adjustment (Fitzgerald and Ryan, 2019). The adjustment process, as in Equation 3.2 and Equation 3.3 depend on time passage reflected on the difference between the optimal capital structure and the previous year's actual capital structure. According to dynamic partial adjustment, the bank targets an optimal leverage ratio each period, as in Equation 3.1, where $Y_{it}^{*}$ is the target leverage ratio, $Y_{it}$ is the actual leverage ratio of the bank and $\lambda$ is the fraction of the required change in the actual leverage ratio achieved.

$$Y_{it} - Y_{it-1} = \lambda(Y_{it}^{*} - Y_{it-1}) \tag{3.1}$$

The original static trade-off model assumed the leverage ratio as optimum; therefore, the change in the leverage ratio equals the required change $\lambda = 1$. However, when a bank seeks to achieve target leverage and faces adjustment costs, in this case, the actual change will be a fraction of the required change, and $\lambda$ will be between

0 and 1. Hence, $\lambda$ reflects the speed adjustment to the target and the magnitude of this speed depends on the relative costs of deviating from and adjusting to target leverage as in equation 3.2.

$$Y_{it} = (1 - \lambda)Y_{it-1} + \lambda Y_{it}^{*} \tag{3.2}$$

To estimate the determinants of capital structure, this study considers the following model to obtain target leverage ratio.

$$Y_{it}^{*} = \alpha + \sum_{j} \beta_j x_{jit} + \zeta_i + \alpha_t + \epsilon_{it} \tag{3.3}$$

The optimal capital structure captured by leverage ratio $Y_{it}^{*}$ for the $i$ bank at time $t$ was represented in the previous three equations.

Where: $i$ represents banks ranging from 1 to N; $t$ denotes year, $x$ captures $(J)$ bank-specific and time varying characteristics and $\zeta_i$ represent unobserved fixed bank-specific and $\alpha_t$ represents time-specific effects; $\epsilon_{it}$ represents an error term. A wide range of previous literature (Antoniou et al., 2008; Frank and Goyal, 2009; Rajan and Zingales, 1995; Öztekin, 2015) pointed out the significant effect of the institutional factors on the capital structure decision. The approach used in this study considers the lagged dependent variable, which controls for persistence in the leverage ratio as the study expects capital structure decisions to adjust to changes with factors such as firms' size and profitability etc. Because firms do not adjust instantaneously towards optimal leverage. Equation 3.4 represents the removal of the unobserved optimal leverage $Y_{it}^{*}$ as follow:

$$Y_{it} = (1 - \lambda)Y_{it-1} + \lambda(\alpha + \sum_{j} \beta_j x_{jit} + \zeta_i + \alpha_t + \epsilon_{it}) \tag{3.4}$$

$$Y_{it} = \varphi + \theta Y_{it-1} + \sum_{j} \theta_j x_{jit} + \eta_i + \eta_t + \xi_{it} \tag{3.5}$$

Where:

$\varphi = \lambda\alpha$

$\theta = (1 - \lambda)$

$\theta_j = \lambda\beta_j$

$\eta_i = \lambda\zeta_i$

$\eta_t = \lambda\alpha_t$

$\xi_{it} = \lambda\epsilon_{it}$

Following Arellano and Bond (1991) and Arellano and Bover (1995), to eliminate the time-invariant fixed effect, the study will use the difference GMM estimator assuming that the errors in Equation 3.5 are serially uncorrelated and the levels of endogenous variables are valid instruments for first-difference variables.

As an alternative approach, Blundell and Bond (1998) introduce the system GMM estimator. The system GMM estimator uses the lagged differences of each variable and combines them with a levels regression as an instrument. In this paper, the study will use the system GMM to estimate the partial adjustment model and control for endogeneity, which could accompany dynamic capital structure models. In equation 3.5, the study adds the dummy variable to control for year effect (Antoniou et al., 2008; Ebrahim et al., 2014). To check the validity of the instrument the study uses the Sargan test and Hansan tests for over-identification restriction and Arellano and Bond's test for the absence of second-order serial correlation (Arellano and Bond, 1991). After reviewing the prior literature about the determinants of capital structure, the dependent variable is capital structure is measured by total debt to total assets ratio.

The study uses the model in Equation 3.5 to investigate the determinants of capital structure for all the banks from 2005 to 2016. The results are generated by GMM using Xtbond2 command for unbalanced data using Stata Software. In the analysis, the study includes the year dummies to capture unobserved time-specific banks invariant effect of banks' target leverage ratio. To choose the best model the study run the pooled; fixed; one-step difference GMM; two-step difference GMM; one step system GMM and two-step system GMM. According to Bond et al. (2001) if the difference GMM estimate is close to or below the fixed effect estimate. This gives us an indication of downward biases and the system GMM estimator is preferred. Additionally, the autoregressive model was estimated by pooled OLS as an upper bound. In our model, the coefficient of the GMM difference models is lower than the fixed effect results suggesting biases in the results. Applying Bond et al. (2001) rules in our model suggested that System GMM is appropriate in our model.

Additionally, Flannery and Hankins (2013) compared between panel models in finance and investigated the differences between the effectiveness of the different models to estimate the adjustment speeds (measures the fraction of the gap between last period's leverage and this period's target that firms close each period). Their results were in favour of using the System GMM estimator.

A substantial literature has determinant the core factors that affect the capital structure decision as follows.

*Size:* calculated as the natural logarithm of the market capitalization. Size is a proxy for the capital market (Fama and French, 2002) and (Fama and Jensen, 1983). Trading off theory stated that there is a positive relationship between leverage and size. The pecking order theory claimed that larger firms with good reputations could issue equity easier than small firms.

*Growth* equals the stock price to the book value per share and it is a company investment proxy. On one hand, the trading off theory contended a negative associ-

Table 3.3: Variables Definitions

| Variable | Variable Definition |
|---|---|
| **CS** | denoted for capital structure<br>measures by Total debt to total assets ratio. |
| **Size** | The natural logarithm of the<br>market capitalization (total current market value of all a company's<br>outstanding shares stated in the pricing currency). |
| **Growth** | Ratio of the stock price to the<br>book value per share. Calculated as:<br>Price to Book Ratio = Last Price / Book Value per Share. |
| **PC** | PC refers to political connection and it is a dummy variable<br>equal to 1 if the bank is politically connected, 0 otherwise. |
| **ROA** | Indicator of how profitable a company is relative to its total assets,in percentage.<br><br>Calculated as: (Trailing 12M Net Income / Average Total Assets) * 100. |
| **COV** | Defines the coverage ratio, which is a measure of a company's ability to<br>cover debt obligations with its assets after all liabilities have been satisfied.<br>Calculated as: [(Book Value of Total Assets - Total Intangible Assets) -<br>(Current Liabilities - Short Term Borrowings)]<br>/ Total Debt Outstanding |
| **VOL** | Measure of the risk of price moves for a security calculated from the standard<br>deviation of day-to-day logarithmic historical price changes |

ation between growth and leverage because growing firms face an under-investment problem. On the other hand, pecking order theory argued that growing firms accumulate debt over time providing profitability is constant. This reflects a positive association between growth and leverage.

*Profitability:* ROA is an indicator of how profitable the company is. It reflects the efficiency of the management in using its assets to generate earnings. Static trading off theory predicted that profitable firms hold more debt. Agency theory argued that profitable firms hold debt as a mechanism to overlook managers (Jensen, 1986). However, pecking order theory asserted that profitable firms depending more on cash-flows and their internal fund resources other than debt or the external resources (Myers and Majluf, 1984).

*Coverage Ratio:* is a measure of the company's ability to cover debt obligations with its assets after all liabilities have been satisfied. Calculated as: [(Book Value of Total Assets - Total Intangible Assets) - (Current Liabilities - Short Term Borrowings)] / Total Debt Outstanding.

*Volatility* is a measure of the risk of price moves for security calculated from the standard deviation of day-to-day logarithmic historical price changes and it is controlled for the firm risk (Frank and Goyal, 2009). Under the trade-off theory, a higher level of volatility reflects a lower level of profitability, which is associated, with low levels of debt while the pecking order theory implies a positive correlation between volatility and leverage (Ebrahim et al., 2014). All the variable definitions are available in table 3.3.

## 3.7 Data

The primary objective of this paper is to examine the impact of political connection on capital structure in GCC banks. I collected information and affiliation manually about the royal families and parliament members from governments and trusted media websites and used the Orbis database to obtain the required information about the board of directors in the GCC banks. Additionally, political connections were traced by examining whether the board of the director members is a member in a royal family or currently a parliament member and if the director's family member is a current parliament member while our financial data are taken from the Bloomberg dataset. The dataset includes 183 banks (with 46 banks in Bahrain, 20 banks in Saudi, 38 banks in Kuwait, 25 banks in Oman, 13 banks in Qatar, and 41 banks in the UAE). The banks in the sample countries are periodically listed from 2005 to 2016.

Table 3.4: Sample Composition by Country

| Country/Year | 2005 | 2006 | .... | 2016 | Total |
|---|---|---|---|---|---|
| Bahrain | 20 | 20 | ... | 20 | 240 |
| Kuwait | 22 | 22 | ... | 22 | 264 |
| Oman | 22 | 22 | ... | 22 | 264 |
| Qatar | 10 | 10 | ... | 10 | 120 |
| Saudia | 14 | 14 | ... | 14 | 168 |
| UAE | 29 | 29 | ... | 29 | 348 |
| Total | 117 | 117 | ... | 117 | 1,404 |

After matching the politically connected banks with the Bloomberg database companies' tickers from which researchers gathered financial information such as earnings per share, asset growth, and monthly stock prices, researchers dropped from the sample the banks that did not have any financial information in Bloomberg. Moreover, bank-year observations with missing data were excluded. However, I collect the financial data for the missing banks from the annual reports. The final sample includes 117 banks and 1404 bank-year observations as showed in table 3.4. After merging the two data sets, researchers obtained the following data summarized by country and year.

Table 3.5 illustrates the sample composition for each country. In Qatar where royal families' members are in control of the banking sector since the late 1980s, the data shows that from 13 banks, there are only 2 banks not politically connected, which means that approximately 84% of the banking sector is politically connected. In the same vein, Oman from the mid-2000s royal family members and parliament members entered the business sector; Mustahil al Ma'aahani (Sultan Qaboos's maternal uncle) has chaired Dhofar International Development and Muscat

bank Kamrava et al. (2016).

Table 3.5: Sample Composition by Bank Status

| Country | Connected Banks | Not Connected Banks |
|---|---|---|
| Qatar | 11 | 2 |
| Oman | 20 | 3 |
| Bahrain | 25 | 19 |
| Kuwait | 26 | 11 |
| Saudi Arabia | 9 | 11 |
| UAE | 24 | 16 |
| Total | 115 | 62 |

In the banking sector, 86% of the banks are politically connected with 20 banks from 23 banks in total. In the case of Bahrain, 56.8% of the banks are politically connected with 19 out of 44 banks. Regarding the Kuwaiti banking sector, the children of the current ruler involvement have become clear. Among the most prominent royal member, the former emir's daughter Hussa bint Saad (chair of the Arab Business women's Council and a board member of Ithamar Bank) (Kamrava et al 2016). For the banking sector in Saudi Arabia and the United Arab of Emirates, the numbers of politically connected firms are relatively low compared with the other countries with 45% and 60%, respectively with 9 connected banks out of 20 banks in Saudi Arabia and 24 connected banks out of 40 banks in the UAE.

I have collected detailed data about the type of connection for the banks (see table 3.6). The number of politically connected chair members from the royal families and the parliaments' members for Qatari banks are 43 members in 13 banks. Twenty-six of them come from the royal family and 7 are currently parliament members while there are 10 indirectly politically connected (have the same last name of the current parliament member). The royal families' connections are 60% of the total connection. In Oman, the presence of political connections in the board of directors in 20 banks was notable with 60 members. Only 1 % of the connected members are from the ruling family, and the other 1% are directly connected with the Parliament members, while 48 people which approximately 80% are indirectly connected with the parliament's members. In Saudi Arabia, although the extent of the ruling families' involvement in the business sector is evident from the 1990s, the number of politically connected members in the 20 Saudi banks is only 6.6% while there is no one is currently a parliament member. Also, over 90% of the connections are indirectly politically connected with the parliament members. In Bahrain, royal families' appearance is conspicuous; almost 33% of the connection is connected to ruling family members while only 8% are directly connected with the parliament's members and 58% of the connections are indirectly connected with the parliament's members. Similarly, in Kuwait 19 board of directors from 37 banks in total are

Table 3.6: Political Connection Type

| **Country** | **Royal Family** | **PC PM direct** | **PC PM indirect** |
|---|---|---|---|
| Qatar | 26 | 7 | 10 |
| Oman | 6 | 6 | 48 |
| Bahrain | 12 | 3 | 21 |
| Kuwait | 19 | 6 | 28 |
| Saudi Arabia | 1 | 0 | 14 |
| UAE | 37 | 3 | 21 |
| Total | 101 | 25 | 142 |

ruling family members. On the other hand, only 6 members are directly connected with the parliament's members while 28 respectively are indirectly connected with the parliament's members. In contrast, In the UAE the number of politically connected banks members are the highest in the total and from the royal family with 37 politically connected members from 40 banks and only 3 members are directly connected and 21 are indirectly connected with parliament members.

## 3.8 Descriptive statistics For All Banks

Table 3.7: Descriptive Statistics

| **Variables** | ***Mean*** | **Sd** | ***Min*** | **Max** |
|---|---|---|---|---|
| CS | 6.08 | 3.35 | 1.00 | 23.39 |
| Size | 9,655 | 20,782 | 1.960 | 243,450 |
| Growth | 1.81 | 1.64 | 0.03 | 21.12 |
| PC | 0.70 | 0.45 | 0 | 1 |
| ROA | 2.71 | 5.84 | -46.31 | 35.60 |
| COV | 141.7 | 1,373 | 0.754 | 21,185 |
| VOL | 37.08 | 26.05 | 0 | 311.5 |

This table provides descriptive information on the variables. CS: denoted for capital structure measures by total debt to total assets ratio of bank $i$ in year $t$. Size: Total current market value of all companies outstanding shares stated in the pricing currency. Growth: is the ratio of the stock price to the book value per share. Calculated as: Price to Book Ratio = Last Price / Book Value per Share. PC: As defined is the political connection variable which is a dummy variable 1 if the bank is politically connected, 0 otherwise. ROA: is an indicator of how profitable the company is relative to its total assets (in percentage). COV: is a coverage ratio, which is a measure of a company's ability to cover debt obligations with its assets after all liabilities have been satisfied. Calculated as: [(Book Value of Total Assets - Total Intangible Assets) - (Current Liabilities - Short Term Borrowings)] / Total Debt Outstanding. VOL: measure the risk of price moves for security calculated from the standard deviation of day-to-day logarithmic historical price changes.

Table 3.7 reports the summary statistics for the determinants of the capital structure defined above. Political connection is a dummy variable equal to 1 if the bank is politically connected and 0 otherwise. The numbers represent time-series averages of the annually cross-sectional mean, standard deviation, minimum

and maximum value for each variable. Almost 70% of the banks exhibit political connection. The numbers represent time-series averages of the annual cross-sectional mean, standard deviation, minimum and maximum value for each variable. The table shows that mean of the capital structure measure is 6.08% and ranges from 1% to 23.39%. The mean of ROA, as a measurement of profitability, is 2.7% with a standard deviation of 5.8% and a range between 35.60% to -46.31%. The mean market capitalization (size, in m's dollars) of the sampled firms is 9,655 with a maximum of 243,450 and a minimum of only 1.96. The average volatility is 37.1 with a maximum of 311.5 and a minimum of 0. However, the volatility factor has the largest standard deviation in sample 26.05. The mean of the market to book ratio is 1.816% with a maximum of 21.12 % and a minimum of 0.03 %. The mean of the asset's coverage ratio is 141.7%.

Table 3.8: Descriptive Statistics for Connected and Non-Connected Banks

| **VARIABLES** | **N** | **Mean** | **Sd** | **min** | **max** |
|---|---|---|---|---|---|
| **Politically Connected Banks** | | | | | |
| CS | 703 | 6.26 | 3.14 | 1.03 | 23.39 |
| Size | 709 | 9,905 | 22,187 | 1.960 | 243,450 |
| Growth | 705 | 1.85 | 1.65 | 0.13 | 21.12 |
| ROA | 674 | 2.26 | 5.36 | -46.31 | 27.27 |
| COV | 692 | 177.3 | 1,621 | 0.75 | 21,185 |
| VOL | 593 | 35.00 | 23.94 | 0 | 298.1 |
| **Non-politically Connected Banks** | | | | | |
| CS | 284 | 5.62 | 3.77 | 1.000 | 18.47 |
| Size | 290 | 9,043 | 16,881 | 3.26 | 116,700 |
| *Growth* | 285 | 1.73 | 1.63 | 0.034 | 17.72 |
| ROA | 273 | 3.83 | 6.76 | -18.20 | 35.60 |
| COV | 280 | 53.87 | 202.8 | 1.30 | 2,030 |
| VOL | 252 | 40.14 | 22.76 | 2.96 | 127.5 |

This table provides descriptive information on the variables: CS: denoted for capital structure measures by total debt to total assets ratio of bank $i$ in year $t$. Size: Total current market value of all companies outstanding shares stated in the pricing currency. Growth: is the ratio of the stock price to the book value per share. Calculated as: Price to Book Ratio = Last Price / Book Value per Share. PC: As defined is the political connection variable which is a dummy variable 1 if the bank is politically connected, 0 otherwise. ROA: is an indicator of how profitable the company is relative to its total assets (in percentage). COV: is a coverage ratio, which is a measure of a company's ability to cover debt obligations with its assets after all liabilities have been satisfied. Calculated as: [(Book Value of Total Assets - Total Intangible Assets) - (Current Liabilities - Short Term Borrowings)] / Total Debt Outstanding. VOL: measure the risk of price moves for security calculated from the standard deviation of day-to-day logarithmic historical price changes.

Table 3.8 separates the summary statistics between politically connected and non-connected banks. On average politically connected banks are slightly larger than non-politically connected banks. The average level of leverage in connected banks (6.26) is higher than for non-connected banks (5.63). This could be evidence of informal support for higher leverage in politically connected banks (Ebrahim et al.,

Table 3.9: Correlation Matrix

| | **CS** | **VOL** | **Size** | **Growth** | **ROA** | **COV** | **PC** |
|---|---|---|---|---|---|---|---|
| **CS** | 1 | | | | | | |
| ***VOL*** | -0.114** | 1 | | | | | |
| ***Size*** | 0.175*** | -0.0605 | 1 | | | | |
| ***Growth*** | 0.103** | -0.0641 | 0.446*** | 1 | | | |
| ***ROA*** | -0.276*** | -0.0915* | 0.0335 | 0.199*** | 1 | | |
| ***COV*** | -0.0522 | -0.0257 | -0.0135 | 0.0195 | 0.0128 | 1 | |
| ***PC*** | 0.102** | -0.0441 | 0.0186 | 0.0333 | -0.124*** | 0.0328 | 1 |

$^{***}p < 0.01$, $^{**}p < 0.05$, $^{*}p < 0.1$

CS: denoted for capital structure measures by total debt to total assets ratio of bank $i$ in year $t$. Size: Total current market value of all companies outstanding shares stated in the pricing currency. Growth: is the ratio of the stock price to the book value per share. Calculated as: Price to Book Ratio = Last Price / Book Value per Share. PC: As defined is the political connection variable which is a dummy variable 1 if the bank is politically connected, 0 otherwise. ROA: is an indicator of how profitable the company is relative to its total assets (in percentage). COV: is a coverage ratio, which is a measure of a company's ability to cover debt obligations with its assets after all liabilities have been satisfied. Calculated as: [(Book Value of Total Assets - Total Intangible Assets) - (Current Liabilities - Short Term Borrowings)] / Total Debt Outstanding. VOL: measure the risk of price moves for security calculated from the standard deviation of day-to-day logarithmic historical price changes.

2014; Diwan and Chekir, 2012). Equally connected banks have a substantially higher coverage ratio (177.3) compared to non-connected banks (53.87) in order to support the higher debt. Similarly, the growth ratio is higher in politically connected banks. Conversely, profitability is higher in non-politically connected banks (3.83 compared to 2.26 for connected banks), which is in line with the findings of (Faccio, 2010).

Table 3.9 presents the correlation coefficients between the leverage and the bank-specific variables. The correlations between leverage and size, growth and political connection variables are positive and significant, while the correlation with volatility and profit is negative and significant (the correlation with coverage is negative but not significant). Again, this supports the view that leverage is higher in connected banks. Notably, within the explanatory variables, we see a significant positive correlation between size, growth and profit and a significant negative correlation between profit and volatility. Similarly, we find a negative correlation between profit and political connection.

## 3.9 Results

### 3.9.1 Determinants of Capital Structure Results

Table 3.10 presents the empirical results of pooled regression, fixed regression and the GMM dynamic capital structure model. In the table 3.10, the first column

shows the pooled regression results of the determinants of the capital structure for the whole sample. The results suggested that neither the pecking order theory nor the trade-off theory conclusively predict capital structure.

The results of the Hansen test and bond test for zero-auto-correlation indicate that the null hypotheses are not accepted, confirming that the model neither over-identified nor was there a residual affected by the second-order serial correlation. The lagged dependent variable is significant at the 1% level. For the one-step GMM results, the coefficient 0.568 shows that the GCC banks adjust leverage towards the optimal leverage with a speed of adjustment equal to 43% per annum. The results demonstrated a positive relationship between bank size and capital structure congruent with trade-off theory. Large banks in the GCC countries carry more debt, suggesting that these banks face lower related agency problems (Fama and Jensen, 1983). The results are in the line with (Al-Hassan et al., 2010; Ebrahim et al., 2014; Rajan and Zingales, 1995; Titman and Wessels, 1988) among others, consistent with transaction cost theory, which posited that large firms tend to diversify activities and have access to debt.

The results demonstrate that profitability has a strong negative effect on capital structure in the case of all GCC countries, supporting pecking order theory, which asserted that profitable banks largely depend on internal fund resources and less on debt (Myers and Majluf, 1984). These results are congruent with (Rajan and Zingales, 1995; Titman and Wessels, 1988), who found a significant negative relationship between capital structure and profitability due to the transaction cost.

The results indicate a significant negative association between capital structure decisions and volatility as a measurement of risk. These results are consistent with Frank and Goyal (2009), who explain the negative relationship through bankruptcy costs. Firms with a high leverage ratio are more prone to bankruptcy than banks with less debt. Because banks that have high volatility can have high bankruptcy costs compared with other banks, they prefer to control the dependency on debt; however some firms are able to safely use more debt and leverage than others.

Finally, the results elicit a positive association between growth and bank leverage. The positive sign implies that GCC banks with a higher growth rate are highly unlikely to experience under-investment problems and accumulate debt holding to maintain profitability levels (Ebrahim et al., 2014).

The second column reproduces the analysis using more robust fixed-effect models.

The findings in column (5) are consistent with Flannery and Hankins (2013) which showed firms acted to close the leverage gap at a rate higher than 30% per year. In each case, the effect of the lag-leverage on the leverage ratio is significantly positive and this relationship is propagated through time. Regarding column (6) in Table 3.10, the results of the adjustment speed of the Lag-leverage in the two-step

Table 3.10: Dynamic Capital Structure for GCC Banks

| VARIABLES | Pooled | Fixed | GMM_Diff_1 | GMM_Diff_2 | GMM_Sys_1 | GMM_Sys_2 |
|---|---|---|---|---|---|---|
| **Lag-Leverage** | 0.779*** | 0.343*** | 0.271*** | 0.276** | 0.568*** | 0.746*** |
| | (0.049) | (0.061) | (0.090) | (0.138) | (0.153) | (0.250) |
| **ROA** | -0.083*** | -0.032* | -0.020* | -0.018 | -0.157*** | -0.102* |
| | (0.019) | (0.017) | (0.012) | (0.015) | (0.045) | (0.052) |
| **Growth** | 0.141** | 0.191** | 0.320** | 0.336* | -0.568** | -0.190 |
| | (0.064) | (0.078) | (0.123) | (0.171) | (0.276) | (0.267) |
| **VOL** | -0.008* | 0.002 | 0.002 | 0.003 | -0.002 | -0.003 |
| | (0.004) | (0.002) | (0.002) | (0.002) | (0.006) | (0.007) |
| **CVRG Ratio** | -3.210 | -4.770 | -1.440 | -9.600 | -0.000* | -7.080 |
| | (4.730) | (3.690) | (1.210) | (1.100) | (8.870) | (9.520) |
| **Size** | 0.139*** | 0.0469 | -0.543* | -0.426 | 1.255*** | 0.726* |
| | (0.0432) | (0.236) | (0.280) | (0.337) | (0.354) | (0.381) |
| **2005** | | -0.930** | -2.220*** | -2.165*** | 1.347 | -0.250 |
| | | (0.434) | (0.674) | (0.790) | (1.246) | (1.130) |
| **2006** | 0.510 | -0.682** | -1.294*** | -1.197** | 0.476 | 0.106 |
| | (0.614) | (0.282) | (0.430) | (0.498) | (0.565) | (0.524) |
| **2007** | 1.124* | -0.225 | -0.578 | -0.665 | 1.243** | 0.801 |
| | (0.580) | (0.355) | (0.406) | (0.435) | (0.568) | (0.545) |
| **2008** | 1.334** | -0.140 | -0.367 | -0.303 | 0.378 | 0.530 |
| | (0.629) | (0.313) | (0.341) | (0.392) | (0.470) | (0.520) |
| **2009** | 0.496 | -0.406 | -0.576** | -0.582* | -0.517* | -0.251 |
| | (0.600) | (0.263) | (0.271) | (0.300) | (0.289) | (0.320) |
| **2010** | 0.438 | -0.367 | -0.563** | -0.558** | -0.384 | -0.512* |
| | (0.601) | (0.267) | (0.263) | (0.274) | (0.304) | (0.286) |
| **2011** | 0.555 | -0.284 | -0.481* | -0.458* | -0.635** | -0.300 |
| | (0.604) | (0.284) | (0.243) | (0.255) | (0.292) | (0.283) |
| **2012** | 0.549 | -0.0379 | -0.229 | -0.212 | -0.0225 | -0.169 |
| | (0.624) | (0.276) | (0.215) | (0.209) | (0.273) | (0.259) |
| **2013** | 0.721 | 0.109 | 0.111 | 0.151 | | |
| | (0.603) | (0.282) | (0.148) | (0.130) | | |
| **2014** | 0.824 | 0.098 | | | -0.292 | -0.077 |
| | (0.623) | (0.305) | | | (0.318) | (0.332) |
| **2015** | 0.926 | 0.270 | -0.093 | 0.122 | -0.222 | -0.087 |
| | (0.616) | (0.284) | (0.224) | (0.185) | (0.350) | (0.321) |
| **2016** | 0.400 | | -0.446 | -0.071 | -1.068** | -0.538* |
| | (0.625) | | (0.423) | (0.227) | (0.440) | (0.309) |
| **Constant** | 0.0412 | 3.730** | | | -4.883*** | -2.955 |
| | (0.641) | (1.631) | | | (1.783) | (1.845) |
| **Observations** | 783 | 783 | 577 | 577 | 783 | 783 |
| **R-squared** | 0.772 | 0.250 | | | | |
| **Arellano-Bond test for AR1** | | | 0.153 | 0.230 | 0.003 | 0.019 |
| **Arellano-Bond test for AR2** | | | 0.151 | 0.132 | 0.345 | 0.218 |
| **Sargan test chi2 =** | | | 0.000 | 0.000 | 0.011 | 0.011 |
| **Hansen test chi2 =** | | | 0.393 | 0.393 | 0.331 | 0.331 |
| **Number of IDC** | | 108 | 96 | 96 | 108 | 108 |

$^{***}p < 0.01$, $^{**}p < 0.05$, $^{*}p < 0.1$

GMM is 25%, broadly consistent with previous literature: (Ebrahim et al. (2014) (28%), Frank and Goyal (2009) (27%) and Lemmon et al. (2008) (25%). In table 3.11, the speed of adjustment is higher compared to the original sample (57%) and the results of the other variables are similar to all banks. [1]

### 3.9.2 Effect of Political Connection

To investigate the effect of political connection on banks' leverage, this research employs the natural experimental approach. Natural experiments are used to identify causal effect(s); however, it is difficult for social science researchers to design experiments. The difference-in-differences (DID) approach has been used in previous research to estimate causal effect. The empirical strategy of DID is subject to the time trends for the two groups. The first group is the treatment group which is exposed to the treatment at two different times (before and after the event). The second group is the control group this group is not exposed to the treatment both before and after the event. Obenauer (1915) was the first study that used DID to investigate the determinants of the minimum wage in the USA. Using DID in this study enables us to find the causal effect of political connections on the capital structure.

The study uses panel data for six countries. Gomez et al. (1999) argued that the relationship between firms and politicians is based on connections. In the same vein, Johnson and Mitton (2003) argued that associations between firms and politicians exist prior to connections, and it is difficult to believe that unobserved firm characteristics influence political patronage. The study seeks to identify the fundamental effect of switching political connection from zero to one on banks' capital structure decisions. Using the parallel trend assumption enables us to reveal the effect of political connection prior to and following the financial crisis.

#### Difference-in-Differences Method Identification

Difference-in-differences (DID) has become one of the most popular research designs used to estimate the causal effects of policy interventions. DID was used to calculate the means of treated and controlled groups after the treatment and deducted from the difference between the two groups prior to the treatment. The first assumption, the Stable Unit Treatment Value Assumption (SUTVA) implies that the treatments are completely represented.

The second assumption, Exogeneity (EXOG), concerns the conditioning variables X. The treatment variable in our case is a dummy variable and variables that cannot

[1] In table3.10 To avoid the dummy trap, 2005 was used as a base year for the regression chosen by the Stata program.

Table 3.11: Dynamic Capital Structure for Politically Connected GCC Banks

| VARIABLES | Pooled | Fixed | Diff-1GMM | Diff-2GMM | Sys-1GMM | Sys-2 GMM |
|---|---|---|---|---|---|---|
| **Lag-Leverage** | 0.743*** | 0.292*** | 0.195*** | 0.181* | 0.400** | 0.429* |
| | (0.062) | (0.068) | (0.065) | (0.102) | (0.158) | (0.226) |
| **ROA** | -0.071*** | -0.030 | -0.012 | -0.010 | -0.143*** | -0.112** |
| | (0.025) | (0.022) | (0.014) | (0.016) | (0.044) | (0.049) |
| **Growth** | 0.159* | 0.173* | 0.432*** | 0.416** | -0.593** | -0.275 |
| | (0.088) | (0.103) | (0.142) | (0.203) | (0.291) | (0.339) |
| **VOL** | -0.009* | 0.002 | 0.004 | 0.005 | -0.005 | -0.008 |
| | (0.005) | (0.003) | (0.003) | (0.003) | (0.007) | (0.009) |
| **CVRG Ratio** | -4.920 | -4.690 | -1.610 | -7.810 | -0.000*** | -0.000** |
| | (4.650) | (3.890) | (1.590) | (1.200) | (8.650) | (9.430) |
| **Size** | 0.164*** | 0.288 | -0.778*** | -0.650* | 1.326*** | 1.020*** |
| | (0.051) | (0.319) | (0.280) | (0.358) | (0.291) | (0.322) |
| **2005** | -0.298 | -1.167** | -2.803*** | -2.877*** | 1.651 | -0.0703 |
| | (0.790) | (0.545) | (0.875) | (0.976) | (1.588) | (1.701) |
| **2006** | -0.119 | -1.097*** | -1.720*** | -1.931*** | 0.573 | 0.008 |
| | (0.390) | (0.328) | (0.585) | (0.582) | (0.694) | (0.797) |
| **2007** | 0.291 | -0.788** | -1.115* | -1.370** | 0.982 | 0.429 |
| | (0.304) | (0.344) | (0.581) | (0.562) | (0.651) | (0.745) |
| **2008** | 0.698* | -0.574* | -0.916* | -1.117** | 0.450 | 0.458 |
| | (0.391) | (0.336) | (0.498) | (0.496) | (0.501) | (0.557) |
| **2009** | -0.076 | -0.805*** | -0.913** | -1.147*** | -0.461 | -0.284 |
| | (0.269) | (0.261) | (0.449) | (0.405) | (0.434) | (0.397) |
| **2010** | 0.020 | -0.632** | -0.685 | -0.893** | -0.207 | -0.321 |
| | (0.245) | (0.272) | (0.450) | (0.379) | (0.398) | (0.400) |
| **2011** | | -0.570** | -0.511 | -0.742* | -0.487 | -0.331 |
| | | (0.285) | (0.447) | (0.372) | (0.457) | (0.409) |
| **2012** | 0.010 | -0.333 | -0.152 | -0.399 | 0.354 | -0.023 |
| | (0.300) | (0.268) | (0.419) | (0.335) | (0.433) | (0.444) |
| **2013** | 0.099 | -0.226 | 0.198 | 0.001 | -0.038 | -0.154 |
| | (0.258) | (0.242) | (0.339) | (0.229) | (0.450) | (0.351) |
| **2014** | 0.303 | -0.180 | 0.098 | -0.189 | 0.026 | 0.150 |
| | (0.330) | (0.258) | (0.299) | (0.248) | (0.382) | (0.394) |
| **2015** | 0.323 | -0.015 | | | | |
| | (0.291) | (0.232) | | | | |
| **2016** | 0.074 | | -0.030 | -0.133 | -0.669* | -0.465 |
| | (0.274) | | (0.180) | (0.176) | (0.352) | (0.280) |
| **Constant** | 0.696** | 2.805 | | | -4.054** | -2.421 |
| | (0.329) | (2.140) | | | (1.571) | (1.698) |
| **Observations** | 555 | 555 | 407 | 407 | 555 | 555 |
| **Arellano-Bond test for AR1** | | | 0.307 | 0.362 | 0.014 | 0.067 |
| **Arellano-Bond test for AR2** | | | 0.916 | 0.861 | 0.935 | 0.499 |
| **Sargan test chi2 =** | | | 0.023 | 0.023 | 0.244 | 0.244 |
| **Hansen test chi2 =** | | | 0.454 | 0.454 | 0.403 | 0.403 |
| **R-squared** | 0.745 | 0.289 | | | | |
| **Number of IDC** | | 78 | 69 | 69 | 78 | 78 |

$^{***}p < 0.01$, $^{**}p < 0.05$, $^{*}p < 0.1$

change over time are exogenous by construction (Lechner et al., 2011). Finally, the assumption is that in the pre-treatment period, the treatment did not affect the pre-treatment population (NEPT), implying that if the treated group had not been subjected to the treatment, the treatment and the control group $D = 1$ and $D = 0$ would have experienced the same time trends conditional on X. Any differences in the outcomes of the treated group would then be directly attributable to the treatment effect and not any other differences in characteristics (Lechner et al., 2011).

$$CS_{it} = \beta_0 + \beta_1 * F_t + \beta_2 * PC_i + \beta_3 * F_t * PC_i + \beta_k * V + \epsilon_{it} \tag{3.6}$$

Where $CS_{it}$ is the dependent variable as a measure of banks' Leverage ratio and $i$ donates a bank and $t$ represents time. $F_t$ is the event time (Financial crisis). $PC_i$ is the intervention or the treatment (Political connection). $V$ is a vector of independent variables. $\epsilon_{it}$ is an error term assumed to be independently identical and normally distributed with zero mean and constant variance. $\beta_1$ refers to the crisis year (Financial crisis) and $\beta_2*$ is the treatment (political connections), and $\beta_3$ express the DID coefficient which shows the interaction between the time and the intervention.

The study used the whole banking sample of the GCC countries, either the connected or the non-connected banks. Additionally, the treatment is exogenous and does not change over time. To make sure if DID methodology is suitable for our model and to ensure the internal validity of DID models. To investigate if both groups have the same trend over time before the treatment, the study runs parallel trends assumption regression.

Table 3.12 shows the present the parallel trends assumption comparing trends in leverage for politically connected and non-connected banks in short and long run accounting for year and country effects, identifying both the reaction of leverage to the cross-time change in banks' behaviour immediately after the shock and over the long run. The first column presents the interaction between the treatment and the time dummy one year before and one year after the financial crisis. The results demonstrate that the coefficient before the financial crisis is insignificant and became significant following the financial crisis. Additionally, applying the parallel trends assumption for the long run, taking three years after and three years before, reveals that the interaction between the year dummies and the treatment is mostly insignificant in the first year before the crisis and insignificant in the second and third year. However, the results show the interaction between the treatment and the year dummies are substantially significant in the three years following the financial crisis. Hence, we can assert that all the leverage ratios of political and non-political banks were moving in the same direction before the financial crisis.

Table 3.12: Parallel Trends Assumption for GCC banks In Short and Long Run

| **VARIABLES** | **PTA_Short** | **PTA_Long** |
|---|---|---|
| **PC_b1** | -1.485 | -2.013* |
| | (0.911) | (1.032) |
| **PC_b2** | | -1.056 |
| | | (0.955) |
| **PC_b3** | | -1.782 |
| | | (1.303) |
| **PC_a1** | -2.232*** | -2.658*** |
| | (0.588) | (0.625) |
| **PC_a2** | | -1.222** |
| | | (0.591) |
| **PC_a3** | | -2.343*** |
| | | (0.668) |
| **Size*PC** | 0.507*** | 0.545*** |
| | (0.096) | (0.097) |
| **Cov*PC** | -0.000*** | -0.000*** |
| | (6.890) | (6.900) |
| **ROA*PC** | -0.175*** | -0.169*** |
| | (0.049) | (0.049) |
| **VOL*PC** | -0.047*** | -0.047*** |
| | (0.009) | (0.009) |
| **Growth*PC** | 0.040 | 0.106 |
| | (0.134) | (0.162) |
| **2005** | - | - |
| **2006** | -0.390 | -0.663 |
| | (0.468) | (0.618) |
| **2007** | 0.743 | 0.097 |
| | (0.944) | (1.042) |
| **2008** | 1.522** | 0.550 |
| | (0.663) | (0.901) |
| **2009** | 1.102 | 0.479 |
| | (0.830) | (1.037) |
| **2010** | -0.885 | -0.957 |
| | (0.680) | (1.035) |

*Continued on next page*

Table 3.12 – *Continued from previous page*

| VARIABLES | PTA_Short | PTA_Long |
|---|---|---|
| **2011** | -0.631 | 0.197 |
| | (0.718) | (1.067) |
| **2012** | -0.592 | -1.498 |
| | (0.665) | (0.920) |
| **2013** | -0.681 | -1.615* |
| | (0.668) | (0.970) |
| **2014** | 0.467 | -0.472 |
| | (0.663) | (0.926) |
| **2015** | 0.193 | -0.720 |
| | (0.716) | (0.939) |
| **2016** | -0.089 | -0.993 |
| | (0.690) | (0.899) |
| **Bahrain** | - | - |
| **Kuwait** | -0.532 | -0.532 |
| | (1.070) | (1.059) |
| **Oman** | -1.425 | -1.329 |
| | (1.103) | (1.103) |
| **Qatar** | -2.935*** | -3.073*** |
| | (1.101) | (1.100) |
| **Saudi Arabia** | -1.893 | -2.034* |
| | (1.187) | (1.186) |
| **UAE** | -1.700 | -1.771 |
| | (1.120) | (1.117) |
| **Constant** | 6.783*** | 7.471*** |
| | (1.240) | (1.373) |
| **Observations** | 777 | 777 |
| **R-squared** | 0.213 | 0.223 |

$^{***}p < 0.01$, $^{**}p < 0.05$, $^{*}p < 0.1$

This study is the first to investigate the effect of political connection on capital structure decisions. The study applies a DID model to assess panel data from six countries, examining the effect on the banks' capital structure and controlling for bank, country and time characteristics to derive precise results. The study assumes that politically connected banks' leverage differed from non-politically connected banks following the exogenous shock. The shock period equals 1 if the year is 2007,

2008, 2009 and 0 otherwise.

Additionally, the study links the bank covariates with year and countries' dummies to estimate the effect of the financial crisis on the determinants of capital structure decisions.

Eq 3.7 presents the model:

$$CS_{it} = \alpha_t + \beta_1 PC_i + \beta_2 F_t + \beta_3 PC_i F_t + \sum_{j=q}^{q} \beta_j X_{it} * PC_i + \sum_{k=q}^{q} \beta_k X_{it} PC_i F_t + \epsilon_{it} \quad (3.7)$$

Where $CS_{it}$ is the dependent variable and the banks' leverage ratio; $PC_i$ is a political connection indicator that is equal to one if a bank $i$ is connected and zero otherwise, $F_t$ is equal to unity for 2007,2008,2009 (financial crisis years) and zero otherwise. $X_{it}$ is a vector of observed characteristics. $\epsilon_{it}$ is an error term assumed to be independently identified and normally distributed with zero mean and constant variance. The coefficient $\beta_1$ measures the difference in the leverage ratio of politically connected and non-connected banks, $\beta_2$ captures the banks' leverage response to the financial crisis. At the same time, $\beta_3$ is the DID Coefficient which reflects the interaction between the financial crisis and political connection dummy variable measuring the effect of the exogenous shock on politically connected banks' capital structure. $\beta_j$ captures the interaction between the bank covariates and the political connection variable to investigate the effect of the core factors on the capital structure in politically connected banks and non-politically connected banks. $\beta_k$ captures the interaction between each bank core factor and the political connection variable to investigate the effect of the core factors on the capital structure in the politically connected banks and non-politically connected bans during the Qatar financial crisis. Throughout this paper, I cluster the standers errors at the bank level to mitigate concerns about heteroscedasticity and serial correlation of error term (Petersen, 2009).

Table 3.13: The effect of Crisis and the Relationship Between the Capital Structure and Political Connection in the GCC Banks

| **Variables** | | **Year Controls** | **Country & year control** |
|---|---|---|---|
| **PC** | -1.356 | -1.040 | -4.608** |
| | (1.259) | (1.298) | (1.765) |
| **Crisis** | 0.664 | | |
| | (0.489) | | |
| **PC*Crisis** | -0.543** | -1.198* | -1.137* |
| | (0.222) | (0.616) | (0.594) |

*Continued on next page*

Table 3.13 – *Continued from previous page*

| **Variables** | | **Year Controls** | **Country & year control** |
|---|---|---|---|
| **Cov*PC** | -0.001*** | -0.002*** | -0.001*** |
| | (4.100) | (4.790) | (6.960) |
| **Size*PC** | 0.441*** | 0.425*** | 0.920*** |
| | (0.110) | (0.112) | (0.190) |
| **ROA*PC** | -0.137*** | -0.136*** | -0.140*** |
| | (0.045) | (0.048) | (0.042) |
| **VOL*PC** | -0.026*** | -0.030*** | -0.028*** |
| | (0.008) | (0.009) | (0.008) |
| **Growth*PC** | 0.099 | 0.138 | 0.034 |
| | (0.112) | (0.151) | (0.145) |
| **Size*PC*Crisis** | -0.033 | -0.022 | 0.021 |
| | (0.153) | (0.152) | (0.137) |
| **Cov*PC*Crisis** | -0.003 | -0.003 | -0.002 |
| | (0.004) | (0.004) | (0.004) |
| **ROA*PC*Crisis** | -0.159** | -0.162* | -0.133* |
| | (0.079) | (0.082) | (0.067) |
| **VOL*PC*Crisis** | 0.021 | 0.023 | 0.019 |
| | (0.013) | (0.014) | (0.013) |
| **Growth*PC*Crisis** | 0.661 | 0.591 | 0.360 |
| | (0.417) | (0.429) | (0.414) |
| **2005** | | - | - |
| **2006** | | -0.006 | -0.205 |
| | | (0.469) | (0.476) |
| **2007** | | 1.028 | 0.696 |
| | | (0.800) | (0.781) |
| **2008** | | 0.965 | 0.862 |
| | | (0.802) | (0.740) |
| **2009** | | 0.784 | 0.708 |
| | | (0.858) | (0.857) |
| **2010** | | -0.283 | -0.407 |
| | | (0.725) | (0.724) |
| **2011** | | 0.011 | -0.033 |
| | | (0.748) | (0.752) |

*Continued on next page*

Table 3.13 – *Continued from previous page*

| **Variables** | | **Year Controls** | **Country & year control** |
|---|---|---|---|
| **2012** | | 0.0176 | -0.0159 |
| | | (0.717) | (0.701) |
| **2013** | | -0.014 | -0.221 |
| | | (0.718) | (0.716) |
| **2014** | | 0.893 | 0.640 |
| | | (0.718) | (0.708) |
| **2015** | | 0.787 | 0.600 |
| | | (0.783) | (0.760) |
| **2016** | | 0.491 | 0.325 |
| | | (0.762) | (0.738) |
| **Bahrain** | | | - |
| **Kuwait** | | | -0.386 |
| | | | (1.007) |
| **Oman** | | | -0.429 |
| | | | (1.120) |
| **Qatar** | | | -3.924*** |
| | | | (1.224) |
| **Saudi Arabia** | | | -2.940** |
| | | | (1.360) |
| **UAE** | | | -2.506** |
| | | | (1.202) |
| **Constant** | 5.889*** | 5.484*** | 7.365*** |
| | (0.723) | (0.959) | (1.361) |
| ***Observations*** | 777 | 777 | 777 |
| ***R-squared*** | 0.154 | 0.167 | 0.257 |

$^{***}p < 0.01$, $^{**}p < 0.05$, $^{*}p < 0.1$

Table 3.13 presents the results of three models. In all the models, standard errors are robust and clustered at the bank level to control for serial correlation in the dependent variable. The first model reports the results of the model represented in equation 3.7. Model (2) augments model (1) by including dummies for years, whereas model (3) includes dummies for years and countries.

In model (1), the results reject the claim that politically connected banks hold significantly higher levels of debt showing that $\beta_1$ is insignificant, but the results

indicate that politically connected banks reduce gearing to a greater extent in crisis compared to non-connected banks. In model (2), after controlling for the time effect, the results show similar results to model (1).

To obtain more robust results, in model (3), the study controls for time and country characteristics, showing that political connection explains differences in leverage.

In GCC countries, politically connected banks depend less on debt compared to non-connected banks. Additionally, in the crisis period, the results demonstrate that GCC banks decreased leverage compared to non-connected banks, with an economically meaningful result at the 10% significance level.

All models demonstrate that larger politically connected banks held higher debt. For politically connected banks, debt is negatively associated with coverage ratio, profitability, and volatility relative to non-connected banks. However, the study elicits no evidence of differences in the relationship between growth opportunities and leverage for politically connected banks. The results emphasise the importance of profitability and debt association in crises, indicating that profitable politically connected banks depend less on debt compared to non-politically connected banks.

As a further robustness check, we consider the DID for each country. Table 3.14 shows strong evidence of a negative relationship between political connections and capital structure for all GCC countries, except Qatar, as reported above. Equally, in the crisis period, there is further evidence of de-leveraging, particularly in Saudi Arabia and the UAE. Again, Qatar is an outlier with an increase in debt. There is some evidence, in general, that leverage increased in non-politically connected banks during the crisis.

## 3.10 Conclusion

The effect of political connection on firms is a hot topic in contemporary literature. While a plethora of studies on this nexus are available, this paper appears to be the first to investigate the relationship of political connection and capital structure in the GCC banks from two perspectives. First, the paper examined whether GCC banks target optimal leverage. Second, the paper empirically tested the effect of political connections on banks' capital structure. This study uses two types of data; political connection data is primary data and was collected manually from the Orbis database, annual reports and governmental websites. The financial data was collected from Bloomberg and merged with the first dataset. The panel data covers the period from 2005 to 2016. The use of GMM to estimate a dynamic partial adjustment model enables to analyse the determinants of the capital structure in the GCC banks. Consistent with other empirical studies (see for example (Antoniou et al., 2008; Frank and Goyal, 2009; Ebrahim et al., 2014)), the study found evidence that

Table 3.14: The Effect of Crisis and the relationship between Capital Structure and Political Connection in the GCC banks for each country using DID

| Variables | Bahrain | Kuwait | Oman | Qatar | S Arabia | UAE |
|---|---|---|---|---|---|---|
| **PC** | -7.801*** | -7.813*** | -2.750*** | 0.114 | -10.340*** | -11.140*** |
| | (2.063) | (1.734) | (0.821) | (2.164) | (1.750) | (2.008) |
| **Crisis** | 1.518* | 1.238 | 0.811 | 0.106 | 0.522 | 0.654 |
| | (0.907) | (1.810) | (1.384) | (0.088) | (1.647) | (1.706) |
| **PC*Crisis** | 2.132 | -1.405 | 1.094 | 58.290*** | -6.676*** | -23.060*** |
| | (2.063) | (15.961) | (3.709) | (19.340) | (2.365) | (4.647) |
| **Size*PC** | 1.500*** | 1.639*** | 1.468*** | 0.570*** | 0.977*** | 1.727*** |
| | (0.422) | (0.218) | (0.140) | (0.216) | (0.149) | (0.199) |
| **Cov*PC** | 0.000 | -0.058 | 0.017 | -0.000 | -0.001*** | -0.000** |
| | (0.012) | (0.064) | (0.017) | (0.000) | (0.000) | (7.060) |
| **ROA*PC** | -0.181 | -0.252*** | -0.035 | -1.337*** | -0.286** | -0.213* |
| | (0.114) | (0.048) | (0.027) | (0.118) | (0.119) | (0.121) |
| **VOL*PC** | -0.032*** | -0.002 | 0.002 | 0.034*** | 0.030 | -0.027 |
| | (0.008) | (0.027) | (0.015) | (0.010) | (0.024) | (0.017) |
| **Growth *PC** | -0.480 | -0.320 | -0.355 | 1.162*** | -0.014 | 0.315** |
| | (0.662) | (0.225) | (0.380) | (0.186) | (0.063) | (0.157) |
| **Size*PC Crisis** | -0.380 | -0.070 | -0.046 | -4.167*** | -0.470*** | 2.172*** |
| | (0.422) | (1.353) | (0.311) | (1.502) | (0.149) | (0.366) |
| **Cov*PC Crisis** | -0.623*** | -0.751 | 0.012 | -0.005 | -0.054*** | -0.087** |
| | (0.012) | (0.869) | (0.017) | (0.005) | (0.000) | (0.039) |
| **ROA*PC Crisis** | 0.140 | -0.092 | -0.411** | 0.729*** | -2.120*** | 0.145 |
| | (0.114) | (0.589) | (0.158) | (0.200) | (0.119) | (0.186) |
| **VOL*PC Crisis** | -0.040*** | 0.035 | -0.060 | -0.269*** | 0.116*** | 0.097*** |
| | (0.008) | (0.116) | (0.039) | (0.102) | (0.024) | (0.021) |
| **Growth *PC*Crisis** | 3.231*** | 1.019 | 2.260** | -0.751 | 3.358*** | -1.789* |
| | (0.662) | (1.681) | (0.868) | (2.833) | (0.063) | (1.057) |
| **Constant** | 8.103*** | 6.749*** | 2.357*** | 1.678*** | 6.922*** | 4.425*** |
| | (0.907) | (0.566) | (0.258) | (0.088) | (0.423) | (0.400) |
| **Observations** | 117 | 146 | 118 | 99 | 133 | 164 |
| **R-squared** | 0.264 | 0.399 | 0.583 | 0.811 | 0.199 | 0.472 |

$^{***}p < 0.01$, $^{**}p < 0.05$, $^{*}p < 0.1$

the trade-off theory and the pecking order theory are complementary. To investigate the determinants of the capital structure in the GCC banks the study applied subsequent robustness checks demonstrating the determinants to be generally con-

sistent over time. The results reveal the importance of some factors over time, such as profitability, size and growth.

Additionally, the DID empirical results reveal a negative association between political connections and banks' leverage. Politically connected banks depend less on external resources, which changed slightly during the financial crisis, as the banks increased leverage, but not as much as non-connected banks. These results are consistent with Ebrahim et al. (2014), who found politically connected firms to depend less on debt in times of financial distress in Malaysia. One explanation is that the banking sector is large and dominates a considerable portion of the Gulf economy, with connections to royal families or governments, banks are safer and less willing to assume further debt when the price is high. Furthermore, the study documents a direct negative association between politically connected banks' leverage and volatility. Similarly, the results demonstrate a negative relationship between politically connected banks' leverage, profitability and risks during the financial crisis relative to non-connected banks.

Finally, the study uses DID to investigate the relationship between political connection and capital structure in each country, showing clear evidence of a negative relationship between political connections and capital structure in all GCC countries, except Qatar, as well as further evidence of de-leveraging during the crisis period, particularly in Saudi Arabia and the UAE and Qatar increasing debt. There is some evidence, in general, that leverage increased in non-politically connected firms during the crisis.

The findings offer several important policy implications for policymakers, investors and regulators in GCC countries. The study suggests a degree of caution with respect to governments regarding the amount of support provided to avoid sending an erroneous signal to both investors and markets, which may negatively affect economic growth in the long run. Indeed, as the Covid-19 pandemic continues (at the time of writing), the results here suggest that banks may receive a different level of support as other calls as made of each country's finances.

# Chapter 4

# Political Patronage, and Banks' Profitability in Bahrain

## 4.1 Introduction

The issue of how political connections affect firms' behavior and profitability has been garnering a great deal of attention. Prior research has explored the impact of political connections on critical strategic issues, such as preferential access to finance from governments e.g., (Claessens et al., 2008; Khwaja and Mian, 2005), as well as the link between political connections and firm value (Fisman, 2001; Johnson and Mitton, 2003; Goldman et al., 2009). Despite the growing body of literature on political connections and performance(Fan et al., 2007; Fisman, 2001), most previous studies focus on politically well-connected firms, viewing political connections as a resource that provides firms with preferential access to entities whose decisions can affect those firms. Additionally, most studies that investigate the effects of political connections focus on firms that are borrowers of capital; however, there is little research on the impact of political connections in the banking sector (Abdelsalam et al., 2017; Carretta et al., 2012; Hung et al., 2017).

There is little understanding of the effect of political connections on lenders (Hung et al., 2017), and to the best of our knowledge this study is the first to investigate the effect of political connections in the banking sector in Bahrain. Thus, we are attempting to bridge a gap in the literature by investigating the effects of political connections on Bahraini banks before and after the Qatar blockade, and to present insights that extend the body of research on the financial sector in emerging countries.

In June 2017, Saudi Arabia, the United Arab Emirates, Egypt, and Bahrain formed a coalition that resulted in a rift between Qatar and its Gulf neighbors. The alliance decided to blockade Qatar and cut diplomatic and economic ties with the

country over its alleged support for terrorism, specifying a list of demands that Qatar would have to meet to end the crisis. Qatar remained defiant, denying the charge and accusing its neighbors of seeking to interfere with and curtail its sovereignty.

The IMF report (2018) states that Qatar was able to withstand the crisis due to governmental measures that mitigated the impact by relying on the country's extensive economic resources. However, the crisis added further complications to a region that was already dealing with concurrent civil wars, growing tensions between Iran and Saudi Arabia, and several Arab Spring uprisings occur from about 2010-2014, long before the Qatar blockade – indeed, the entire region was negatively affected, although significant progress has recently been made toward thawing the rift between Qatar and its neighbors.

Exploiting the unique natural experiment of the 2017 Qatar blockade crisis, this study employs a simple testing strategy to quantify the effect of political connections on banks' profitability.

Using primary data collected manually from annual reports and official websites, this study is the first to exploit the Difference in Difference (DID) methodology to investigate the effect of political connections on banks' profitability in one of the boycotting countries before and after the blockade crisis, focusing on the period from 2015 to 2019. Bahrain offers a suitable context to test the effects of political connections on bank performance because Bahrain is an important financial capital in the region. Banking sector assets in the country stood at over US$192 billion, more than five times Bahrain's annual GDP and accounting for over 85% of the country's total financial assets. Within the Gulf Cooperation Council (GCC), the banking sector is mainly domestically owned. Furthermore, all of the GCC countries except Bahrain impose limits on foreign ownership. Bahrain's domestic banking system has sizable joint ventures with foreign investors, mostly with GCC members. Hence, the study investigates the effect of the Qatar blockade on banks' profitability by focusing on Bahrain.

Our paper offers four novel contributions to political connection literature as follows:

This study offers four novel contributions to the literature on political connections as follows: Firstly, the study fills in an important gap in the literature as it is the first attempt to quantify the impact of political connections on bank performance in Bahrain. To the best of our knowledge, the role of political factors in Bahrain has not been studied in relation to the banking system. Secondly, the study depends on primary data about political connections collected manually from various sources. Thirdly, this is the first study to investigate the effect of the Qatar blockade on the banking sector. Finally, our evidence suggests that politically connected banks are more profitable than banks that lack political connections. However, the Qatar

blockade crisis resulted in a sharp decrease in bank profitability, suggesting that the crisis significantly harmed the banking sector in Bahrain.

Investors can enhance their hedging and investment decisions by exploiting knowledge of how political connections affected bank profitability during the Qatar diplomatic crisis, and how that effect can be transmitted from one market to another. In addition, regulators could use insights about the association between political connections and profitability in Bahrain to undertake strategies to increase banks' profitability and mitigate the transmission effect of a crisis by ensuring adequate regulation and supervision.

Our main finding is that political connections have a positive effect on bank profitability in Bahrain. These results are similar to the findings in (Faccio et al., 2006; Hung et al., 2017; Boubakri, Cosset and Saffar, 2012) for banks in other countries. Faccio et al. (2006) found that politically connected firms are more profitable than non-connected firms, and they are more likely to obtain support from the government. The Qatar blockade crisis has had a notable effect on the banking system throughout the region, including both the boycotting countries as well as Qatar. In the banking sector, politically connected banks tend to exploit their connections to maximize profits and shareholder value. However, during the Qatar blockade crisis politically connected banks suffered more than their non-connected counterparts, which is consistent with findings in previous research (Fisman, 2001; Faccio and Parsley, 2009).

These results are in line with Francis et al. (2009), who found that after the sudden death of a politician, politically connected firms' profitability decreased dramatically compared to the profitability of non-connected firms. Hence, although there is evidence of thawing in the relationships among the countries in the region, politically connected banks may want to reduce their dependency on external support and political connections and aid further diversification in the GCC region to improve profitability and reduce the likelihood of financial stress in future crises.

Hence, the politician-bank network should be carefully considered by regulators and market participants to support accountability and transparency. Investors should be cautious when they invest in politically connected banks, especially during times of crisis. The results of this study also suggest that regulators should monitor politically connected banks to promote their competitiveness and efficiency.

The rest of this chapter proceeds as follows. Section 2 reviews the literature on political connection. Section 3 explores the Qatar blockade crisis. Section 4 present the data. Section 5 explains the research design and the descriptive statistics are shown in section 6. Section 7 presents the empirical results. The conclusion of the analysis is in section 8.

## 4.2 Political Connection Literature Review

Politics plays a vital role in finance. Capital is a limited commodity and political connections are considered a form of capital for firms that need external resources. Political capital is less fungible than financial capital in transactions that are based on market competition. However, political capital can vary across distinct institutional domains. Gomez et al. (1999) defines political connection as a privilege given to a firm that is connected to a government or politicians that allows it to capture rents in exchange for economic and political support. There is an increasing body of economic literature on the impact of political connections on firms. Prior research provides evidence that political connections afford benefits and are valuable to politically connected firms in various countries (Amore and Bennedsen, 2013; Faccio, 2006; Faccio and Parsley, 2009; Claessens et al., 2008; Goldman et al., 2009; Khwaja and Mian, 2005). A growing body of literature explores the benefits of political connections in establishing relevant regulations (Agrawal and Knoeber, 2001; Mian et al., 2010). Claessens et al. (2008) and Faccio (2006) argue that political connections have a positive effect on stock market valuations. Prior research also investigates the probability of politically connected firms receiving bailouts (Faccio, 2006), accessing the capital markets and other financial resources under more advantageous conditions (Boubakri et al., 2009; Claessens et al., 2008; Fan et al., 2007; Fraser et al., 2006; Gomez et al., 1999), and competing for government contracts and subsidies over their non-connected counterparts e.g., (Goldman et al., 2013), the cost of equity (Boubakri, Guedhami, Mishra and Saffar, 2012).

Recent empirical research on transition economies suggests there is no simple answer regarding the overall economic value of political connections at the firm level. Patronage can take various forms and produce different outcomes for firm performance. The evidence relating to the effect of political connections on firm performance is also inconclusive. Previous studies document both a positive and negative influence.

On one hand, there are some indications that political capital may have a positive effect on firm profits (Amore and Bennedsen, 2013; Boubakri et al., 2008; Boubakri, Cosset and Saffar, 2012; Hillman, 2005; Niessen and Ruenzi, 2010). Boubakri et al. (2008) shows that politically connected firms exhibited low profitability in the three years following privatization. In emerging countries where the state tightly controls markets, firms with high levels of political capital are more likely to secure preferential treatment. Hillman (2005) compares the boards of two groups of firms and finds that the number of directors with political connections on a board is statistically associated with performance, and the relationship is more pronounced in heavily regulated industries. Amore and Bennedsen (2013) finds that Danish enterprises with

political connections exhibit a higher return on equity than their counterparts that lack such connections. Boubakri, Cosset and Saffar (2012) shows that political connections increase a firm's return on assets and improve performance. This suggests that politically connected firms can secure positional advantages over non-connected firms.

Similarly, Niessen and Ruenzi (2010) provides evidence that political connections through Bundestag members helped German enterprises to secure contracts with local governments and improve performance.

On the other hand, Faccio (2010) shows that politically connected firms record a lower return on assets than their non-connected competitors. Bertrand et al. (2007) found that due to higher labor costs, politically connected French enterprises are characterized by decreasing profitability. Furthermore, Faccio and Parsley (2009)found that after the sudden death of a politician, profitability of firms with connections to that individual significantly declined.

Despite the growing literature on the role of political connections on firm performance, relatively little is known about how political connections affect connected banks. Acemoglu et al. (2016) show that US banks were impacted by the announcement of a Treasury secretary nominee, with higher abnormal returns following a favorable announcement. Khwaja and Mian (2005)'s results suggest that state-owned banks tend to lend more to politically connected firms. Similarly, Dinc (2005) found that state-owned banks decrease their lending compared to privately owned banks in the year before an election; however, in election years state-owned banks increase their lending. Blau et al. (2013) show that politically connected firms had a higher probability of receiving Troubled Asset Relief Program funding from the US government following the global financial crisis. Sapienza (2004) use data on individual loan contracts to investigate the effect of political connection measured by bank ownership on the loans' interest rates. They found that the lending behavior of state-owned banks is affected by the election results for the party affiliated with the bank.

The stronger the political influence in the region where a firm is seeking to borrow from a bank, the lower the interest rates charged. Micco et al. (2010) find state-owned banks, which are driven by political considerations, are less profitable than their private counterparts argues that for banks in Italy, political connections have a negative impact on revenue and the quality of the loan portfolio and a positive effect on efficiency. La Porta and Lopez-de Silanes (2002) documents that government ownership of banks is pervasive worldwide and that politicians' involvement has a negative effect on bank efficiency, as politicians are only interested in pursuing their personal objectives.

On the other hand, Molyneux and Thornton (1992) provides evidence from a

sample of European banks during the period from 1986 to 1989, that state bank ownership has a positive effect on bank profitability. Altunbas et al. (2001) in the line with,Blau et al. (2013) also emphasises that state-owned banks have a significant positive effect on profitability in Germany. Generally, we expect that the probability of receiving privileged treatment is greater for profitable banks, making the impact of their political connections more noticeable.

## 4.3 Bahrain Context

Banks play an important role in boosting economic development and are the main stimuli of economic growth. The GCC's financial sector is dominated by banks. According the report of the Central Bank of Bahrain in 2018, Bahrain has the most extensive banking sector in the region with assets of over US$192 billion, more than five times the country's annual GDP, accounting for over 85% of total financial assets. The first modern bank in Bahrain was established in 1920 as a result of an agreement between the United Kingdom and Bahrain. This provided a base for an expansion of banking in the country. In the GCC, bank shareholders are primarily domestic. Bahrain differentiates itself from its neighbors by focusing on developing its banking sector to help provide a decent standard of living and facilitate business success through an innovative regulatory environment that attracts diversified pools of foreign investors. Bahrain involves foreign investors, mostly from the GCC, in substantial joint projects in its domestic banking sector(Al-Hassan et al., 2010). However, Lopez et al. (2020) argues that the Bahraini economy is strongly connected to the economy of the GCC region. Bahrain's economic transition depends on the GCC countries' ability to shift their economies away from a dependence on oil, and its investments and growth depend on foreign investments, mainly from the GCC countries.

Bahrain has a well-developed financial sector. Its banks comprise a lively mix of local, regional and international institutions that compete for business within the kingdom and beyond. This includes 29 retail banks (including seven Islamic retail banks) and 76 wholesale banks (including 19 Islamic wholesale banks). Of the retail banks, 14 are locally incorporated while 15 are branches of foreign banks. With 26 Islamic banks (both retail and wholesale), Bahrain, has the largest concentration of Islamic bank operations among the countries that operate dual banking systems.

According to the Central Bank of Bahrain in 2019, the total aggregated banking assets were at $192.7bn in 2018, up from $187.4bn at the end of 2017 and $186.1bn in 2016. Domestic assets were worth $59.8bn and foreign assets $135.8bn. As of August 2018, total assets of retail banks stood at BD31.9bn ($84.5bn) including 18.3bn ($48.5bn) of domestic assets. Assets of wholesale banks stood at $107.4bn of

the wholesale assets, $11.1bn were domestic assets, and $96.4bn were foreign assets.

There are a number of reasons to focus on Bahrain in analyzing the effect of political connections in the context of the Qatar blockade on the banking sector. Bahrain, among other Gulf countries, enjoys political stability, as the Gulf monarchies are, powerful, stable and have broad connections throughout business sector. In particular, the geographic diversity seen on the balance sheets of Bahrain's banks has allowed them to perform well even during the most challenging periods.

The connections between Qatar's and Bahrain's economies are strong. For example, in 2010 Bahrain, Qatar and Kuwait took a step toward building a Gulf central bank, or "Monetary council." Previously, the state of Qatar had been under the rule of the Kingdom of Bahrain. Signing the oil agreement with the British authorities paved the way to Qatar's independence and sovereignty, which can be seen as an additional reason to investigate the effect of the blockade on the Bahraini economy. The main problem that the blockade caused for Qatar arose from its dependent on food imports from Saudi Arabia, and since Qatar was able to find alternative food sources it managed to defeat the blockade. However, according to the World Bank, in 2018 both Bahrain and Oman were in a highly vulnerable condition.

In 2017, the economy in Bahrain was experiencing a record-breaking year according to the 2018 IMF report. During this crisis, international investors were 'spooked' and started to question the efficacy of their investment strategies, particularly because there was no sign that the diplomatic row between Qatar and its neighbors would soon be mended. This is an additional reason to explore the effects of the Qatar blockade on Bharani banks. Finally, to the best of our knowledge, no study to date has empirically investigated the effect of the Qatar blockade crisis on banking sector profitability in Bahrain.

## 4.4 The Qatar Blockade

The GCC, which comprises the six Gulf nations of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the UAE, has remained a strong union since 1981. The GCC is a socioeconomic powerhouse in the region that works to promote security and stability, and build strong ties among its members. The strength of the GCC has been a critical factor in overcoming many challenges, such as Iraq's invasion of Kuwait in 1991, and promoting strategic partnerships.

The GCC countries have witnessed epochal challenges that have shaped the region's policies and political systems. The discovery of oil in the 1950s, followed by political independence in 1971, the oil boom in 1973, and globalization, have all contributed to the current GCC political and economic status quo. These changes have been associated with social costs, including unequal distribution of wealth,

increasing individualism, consumption, and a dependency on foreign workers.

Change in the region has specific goals; the GCC countries seek modernization while preserving the fundamentals of their political and cultural systems. These fundamentals are deeply rooted in Arabic culture and history such as values, institutions, and relations. The GCC countries, which pride themselves on being the cradle of Arabism, recognize that these factors have socio-political consequences. For example, traditionalism governs political relationships and favoritism, which determine social structures. These factors affect the natural resistance to change, and are expected to persist for years to come.

Ruling families, one of the firm pillars of the Gulf political system, have survived formidable threats and obstacles, and proved their ability to tackle a crisis. Their power is increasing due to the region's growth, prosperity, and socio-economics achievements. Gause and Gause (1994) points out that the power of the ruling families in the Gulf States is not a result of US protection, as is the case in other Arab countries such as Egypt. Political connections and business relationships have a long history in the GCC countries. The inclusiveness of the GCC patronage system has undoubtedly contributed to its longevity. Economic stability in several GCC countries exists as a result of links – mostly through marriage alliances – among the rulers, tribal leaders and local merchant families who are primarily engaged in trade and pearl hunting. Rent-seeking activities involve firms that use their political capital to secure favored treatment from the government to increase profits (Krueger, 1974). The merchant families help to meet the ruling families' needs in exchange for political influence and protection (Kamrava et al., 2016).

To investigate the causal effect of political connections on banks' value and performance, prior research has explored exogenous shocks to firms' political connections. Fisman (2001) shows that politically connected firms' stock prices dropped sharply compared to non-politically connected firms after bad news about President Suharto's health was released. Similarly, Acemoglu et al. (2016) analysed the stock market's reaction to various political parties in Egypt using different flows of demonstrations. Results reveal that political protests are associated with different stock market returns for the three connected group in the study. Faccio and Parsley (2009) examined the value of geographic ties with respect to the unexpected deaths of politicians, and their results suggest that firms headquartered in the politicians' hometowns experience adverse market reactions.

On June 5, 2017, Saudi Arabia, the UAE, Bahrain and Egypt cut political, diplomatic, trade links and economic ties with Qatar. They also closed Qatar's only land border, with Saudi Arabia, and its airspace to Qatar accusing it of backing terrorism. However, Qatar refused to comply with the demands and consider them as unacceptable restrictions on Qatari sovereignty. The boycotting nations Saudi

Arabia, the UAE, Bahrain and Egypt issued 13 demands for Qatar to end the crisis and Qatar rejected these demands. Kuwait and the United States have tried to mediate the rift supported intermittently by the Trump administration.

A prolonged crisis poses a threat to social, economic and regional stability, and the Qatar blockade seriously weakened the region. It affected the flow of goods and services and caused a massive withdrawal of funds from GCC banks, which triggered widespread damage among companies in the area. Clearly, the rift escalated fears regarding the consequences of the blockade on banks, firms, and economic stability. Given this background, the Qatar blockade provides a useful setting to examine the linkage between political connections and bank profitability in Bahrain for the following reasons.

The 2018 IMF report stated that Qatar was able to manage the crisis by governmental measures that relied on the country's extensive economic resources. However, the crisis added further complications to a region that was already dealing with concurrent civil wars, growing regional tensions between Iran and Saudi Arabia, and several Arab Spring uprisings. The entire region was negatively affected by the crisis, and the effects of the blockade on Qatar and the boycotting countries threatened the region's social, economic, and political stability. The blockade negatively affected the flow of goods and services and triggered a massive withdrawal of funds from banks. The IMF stated that medium-term growth in all of the GCC economies could decline if the rift was protracted: "The diplomatic rift between Qatar and several other countries is expected to have a limited impact on growth in the region at this stage... although a protracted rift could weaken medium-term growth" (IMF, 2017).

## 4.5 Banking Structure in Bahrain

Figure 4.1 show the change of the return of average equity (ROAE) in the last five years. Nonetheless, there has been little research on how political connections affect the banking sector.

Molyneux and Thornton (1992) provides evidence that banks with strong financial performance can support a country's stability, especially in times of crisis. This study investigates how banks' profitability is affected by an exogenous shock to political connections using Bahrain as a prime example. Given the connections between the economies of the Gulf countries, it is useful to investigate the effect of an event such as the Qatar blockade using Bahrain as the main focus, as the country is home to the main banking sector in the region and participated in the blockade. Thus, the study offers insights into the economic consequences of such a decision on the banking sector, fills a gap in the literature regarding the impact of

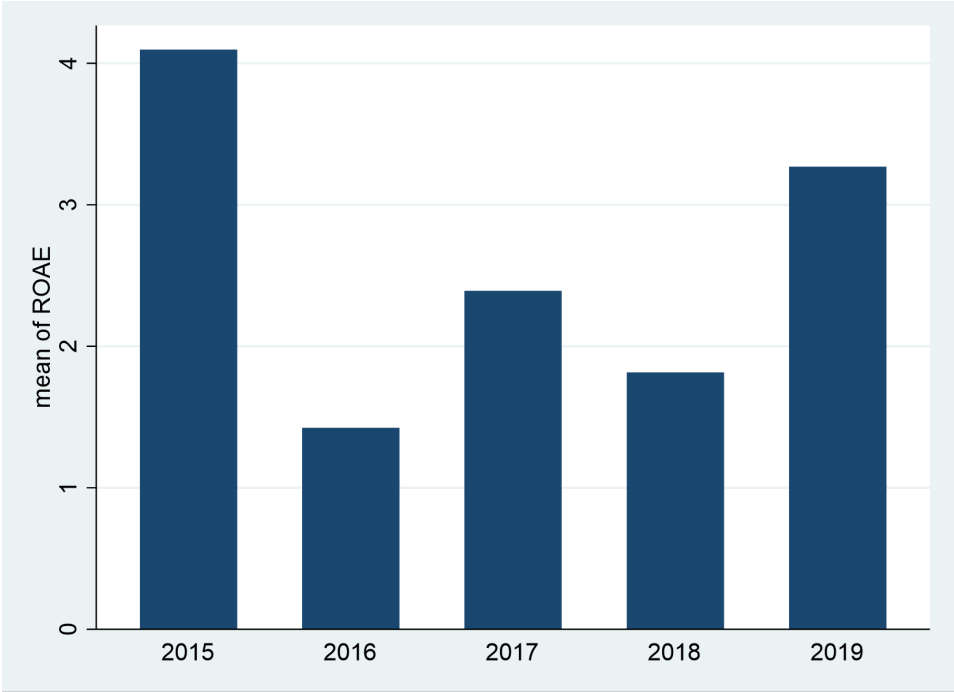


Figure 4.1: Profitability Ratio in Bahraini Banks
Source: SNL Financial S&P Global Market Intelligence Database (2019)

political connections on profitability in the banking sector which, to the best of our knowledge, no studies have investigated, and suggests policy recommendations to policymakers.

## 4.6 Data

To identify whether politically connected banks secure advantages by relying on political capital, our analysis examines political connections among Bahrain's banks that could substantially improve their profitability, focusing on the effect of the Qatar blockade crisis. In particular, the study examines the impact of the Qatar blockade crisis on the profitability of politically connected banks and non-politically connected banks over the period 2015 to 2019. The banks level covariets are included to control for the basic banks characteristics that could have some effect on the association between political connection and banks profitability.

A common practice in the political connection literature is to not add any control variables (see, e.g., (Fisman, 2001; Fisman et al., 2012)), although Johnson and Mitton (2003) control for firm size and leverage and Acemoglu et al. (2016) control for firm size, deposits, and profitability.

The study uses ROAE (Return on average equity) to measure the bank profitability, calculated as net profit as a percentage of equity.

*Political Connection* (PC) variable is a dummy that takes a value of one if the

bank Board of Directors (BOD) is politically connected with a royal family or a parliament member and zero otherwise.

The study uses control variables all of which have been shown to have significant influences on bank performance in past studies namely:

Size, total deposits, cost to income ratio, capital ratio, and a series of corporate governance variables: BOD size, BOD independence (Abs), and BOD Independence (Share), Ownership and Big4.

*SIZE* is calculated as the natural logarithm of all assets owned by the bank and controls for economies of scale (also called the size effect in the literature), such as larger banks having lower unitary costs and greater diversification than smaller banks: the first factor would lead to a positive association between bank size and profitability, while the second factor could have a negative association if increased diversification leads to lower risk which in turn decreases the overall returns(Athanasoglou et al., 2014).

*Total Deposits* are the total amount of deposits from customers. Previous studies showed evidence that banks with a high level of deposits are more likely to provide loan competitively and increase profitability (Naceur and Omran, 2011).

*Cost to Income Ratio* is a managerial efficiency measure, for which the study uses operating expenses as a percentage of operating income as a proxy, reflecting that the cost of income has been found to have a negative effect on banks' performance (Goddard et al., 2011).

*Capital Ratio* (bank equity as a percentage of total assets) are included since prior studies have shown that better-capitalised banks are correlated with better performance.

(Athanasoglou et al., 2014; Berger and Bouwman, 2013; Molyneux and Thornton, 1992). The study also includes corporate governance variables, namely:

*Board of Directors' Numbers* (BOD Number), to account for the propensity of larger boards to be more diverse, which in turn may have a positive impact on the bank profitability (Estélyi and Nisar, 2016).

*BOD Independence* is the number of the non-executive board of directors. A wide body of literature argues that the independence of the board is an essential factor in ensuring effective management performance. Studies by (Provan, 1980; Zald, 1967) found a positive effect in firm performance when non-executive directors dominate the boards of directors.

*BOD Independence* (share) is calculated as the number of the non-executive (also called independent) board of directors divided by the number of the board of directors. The literature suggested that independent directors are more likely to opt more to monitor efficiently, leading to better performance (Estélyi and Nisar, 2016).

*Ownership* (number of principal shareholders), manually collected from the an-

nual reports. Various studies suggested that the number of shareholders has a negative effect on firms' profitability. Ang et al. (2000) found that agency costs increase with the number of shareholders. In particular, they found that the large-block shareholders or institutional investors have a positive impact on firm performance.

*Big 4* is a dummy variable that identifies if the bank's external auditor is one of the big four companies (Price water house Coopers (PwC), Deloitte & Touche (D&T), Ernst & Young (E&Y), and KPMG).

Since the global financial crisis of 2008, much attention has been paid to auditors because of the belief that a clean audit opinion means that a firm's accounting practices meet financial disclosure requirements(Sikka, 2009). Wallace et al. (1994) pointed out that companies that are audited by one of the Big 4 audit firms are more likely to provide more information because they are influenced by those auditors, and that influence is reflected in their performance.

Our sample is comprised of all the banks in Bahrain over the period 2015 to 2019. The main objective in choosing this particular sample period and their respective data is to utilise the most recent financial data that cover the Gulf crisis that is available. Our dependent variable ROAE and all the financial data has been collected from SNL Financial S& P Global Market Intelligence Database (2019). The data is a yearly data which is published at the end of the financial year. The study manually collected the annual reports of Bahraini banks in the mentioned years.

Political connection information and affiliation were manually collected from different sources. Royal families and parliament members have been identified from governments and trusted media websites and supplemented these sources with numerous documents that are available on the Internet. The study uses the official documents and the publications of both the national parliament, information provided by local governments, and reports prepared by ministries. Additionally, the study collects the annual reports to extract the board of directors' names. Finally, the study matches the last names of the board of directors and the royal families and parliament members' last names. Our data collection began with an initial list of 46 domestic and private banks. Ten banks were lost because of the lack of annual reports availability. Our final sample goes from 169 bank year observation and 107. Our sample is hand-gathered from the annual reports published on the banks' websites.

## 4.7 Methodology

The study implements a difference in difference (DID) design to test the impact of political connection on bank performance before and after the Qatar blockade. DID is widely used in the recent economics literature to measure the policies development

impact [1]. On June 5, 2017, three Gulf countries (Saudi Arabia, the UAE, and Bahrain) together with Egypt cut political, commercial links with Qatar. They also closed Qatar's only land border, with Saudi Arabia, and their territory to Qatar condemning Qatar for supporting terrorism. The DID research designed to compare the change in the outcome in two groups before and after an event. This study compares the performance of a sample of treated banks (politically connected banks) to the control banks (non-politically connected banks) before and after the Qatar blockade. Following Bertrand et al. the study will run two-period DID where temporal information is collapsed into two periods.

The DID design offers the best method to capture the causal inference for different reasons: Firstly, the intuition behind the DID is to calculate the pre-treatment differences between the comparison group and treatment group. It is to reflect the selection bias, while the changes between the pre-period and post-period in the outcomes within the control group capture time trend. Secondly, since the blockade crisis as an exogenous shock crushed the political network and all the economics of the GCC countries, the study expects that politically connected banks experienced significant performance deterioration after the crisis. Thirdly, Gomez et al. (1999) pointed out that the relation between firms and politicians is triggered mainly from individual personal ties. Similarly, Johnson and Mitton (2003) argued that the relationship between the banks and politicians occurs before the connections. Hence, it is difficult to claim that unobserved banks characteristics influence the political patronage of banks. The broad gauge the DID is based on the following:

$$ROAE_{it} = \alpha + \beta_1 * B_t + \beta_2 * PC_i + \beta_3 * B_t * PC_i + \beta_k * V + \epsilon_{it} \qquad (4.1)$$

Where ROAE is the dependent variable as a measure of banks' profitability and $i$ donates a bank and $t$ represents time. $B_t$ is the event time (Qatar Blocade, 2017). $PC_i$ is the intervention or the treatment (Political connection). $V$ is a vector of independent variables. $\epsilon_{it}$ is an error term assumed to be independently identified and normally distributed with zero mean and constant variance. $\beta_1$ refers to the crisis year (Qatar blockade) and $\beta_2*$ is the treatment (political connections), and $\beta_3$ express the DID coefficient which shows the interaction between the time and the intervention. A possible concern about the method is to prove the parallel trend assumption, which means that the change in y for the treated group would not have been different from the change in y for the untreated observations. To investigate whether the results are driven by differential trends before the blockade crisis the average of the treated and non-treated groups would have been the same absent

[1]The study of Obenauer (1915) was the first to employ the DID approach in economics to examine the determinants of the minimum wage in the USA.

treatment, the study uses parallel trend assumption regressions in table 2.

The study expects that politically connected banks' profitability differs from the non-politically connected banks following the exogenous shock. The shock period =1 if the year is 2017 and 0 otherwise. The study employs difference-in-differences for all the banks in Bahrain (34 banks) to examine the effect of political connection on the banks' profitability and control for the bank, and time characteristics to derive precise results. Additionally, the study interacts with the bank covariates with year dummies and countries dummies to estimate the effect of political connection and the Qatar blockade crisis on the banks' profitability. With the aim of accurate drive evaluation of the Qatar blockade crisis effect on profitability, the study interacts the crisis dummy with the banks' covariates.

$$ROAE_{it} = \alpha + \beta_1 PC_i + \beta_2 B_t + \beta_3 PC_i B_t + \sum_{j=q}^{q} \beta_j X_{it} * PC_i + \sum_{k=q}^{q} \beta_k X_{it} PC_i B_t + \epsilon_{it} \quad (4.2)$$

Where $ROAE_{it}$ is the dependent variable and the banks' profitability measurement; $PC_i$ is a political connection indicator that is equal to one if a bank $i$ is connected and zero otherwise, $B_t$ is equal to unity for 2017 (the blockade year) and zero otherwise. $X_{it}$ is a vector of observed characteristics. $\epsilon_{it}$ is an error term assumed to be independently identical and normally distributed with zero mean and constant variance. The coefficient $\beta_1$ measures the difference in the profitability of politically connected and non-connected banks, $\beta_2$ captures the banks' profitability response to the blockade crisis. At the same time, $\beta_3$ is the interaction between the blockade crisis and political connection dummy variable measuring the effect of the exogenous shock on politically connected banks' profitability. $\beta_j$ captures the interaction between the bank covariates and the political connection variable to investigate the effect of the core factors on the politically connected banks and non-politically connected banks' profitability. $\beta_k$ captures the interaction between the bank covariates and the political connection variable to investigate the effect of the core factors on the politically connected banks and non-politically connected banks profitability during the Qatar Blockade crisis. Throughout this paper, I cluster the standers errors at the bank level to mitigate concerns about heteroscedasticity and serial correlation of error term (Petersen, 2009).

## 4.8 Summary statistics

Table 4.1 reports the summary statistics for our variables as described above. Table 4.1 presents the statistics for our full sample, politically connected banks and non-politically connected banks. The numbers represent time-series averages of the annual cross-sectional mean, standard deviation, minimum and maximum value for

Table 4.1: Summary Statistics for All, Connected and Non-Connected Banks

| VARIABLES | Mean | Standard Deviation | Min | Max |
|---|---|---|---|---|
| **All banks** | | | | |
| ROAE% | 2.59 | 10.96 | −41.14 | 25.04 |
| Pc* Blockade | 0.05 | 0.23 | 0 | 1 |
| Total Assets | 3959.14 | 8373.88 | 13.28 | 38 638.62 |
| Total Deposits | 2300.74 | 5515.15 | 0 | 24 547.97 |
| Total Equity To Assets% | 30.84 | 34.95 | −259.40 | 98.83 |
| Cost to Income% | 55.24 | 26.63 | 0.40 | 156.50 |
| BOD Number | 9.19 | 2.61 | 3 | 22 |
| BOD Non-Executive | 5.39 | 2.77 | 0 | 15 |
| BOD Composition | 0.57 | 0.22 | 0 | 1 |
| Ownership | 5.56 | 7.74 | 1 | 45 |
| Big4 | 0.77 | 0.41 | 0 | 1 |
| **Connected banks** | | | | |
| ROAE | 6.50 | 7.83 | −15.54 | 25.04 |
| Total Assets | 9.11 | 1.18 | 112.76 | 3.86 |
| Total Deposits | 5.58 | 7.71 | 1.13 | 2.45 |
| Total Equity to Assets% | 20.98 | 16.11 | 0.43 | 59.76 |
| Cost to Income% | 55.14 | 29.84 | 0.40 | 113.30 |
| BOD Number | 10.38 | 2.38 | 7 | 17 |
| BOD Non-Executive | 6.88 | 3.06 | 1 | 15 |
| BOD Composition | 0.66 | 0.24 | 0.09 | 1.09 |
| Ownership | 5.12 | 2.05 | 2 | 8 |
| Big4 | 0.65 | 0.48 | 0 | 1 |
| **Non-Connected banks** | | | | |
| ROAE% | 0.95 | 11.67 | −41.14 | 17.48 |
| Total Assets | 1.80 | 5.12 | 13.28 | 2.95 |
| *Total Deposits* | 934.22 | 3.51 | 0 | 2.03 |
| Total Equity to Assets% | 34.95 | 39.63 | −259.40 | 98.83 |
| Cost to Income% | 55.29 | 25.21 | 15.69 | 156.50 |
| BOD Number | 8.70 | 2.55 | 3 | 22 |
| BOD Non-Executive | 4.76 | 2.39 | 0 | 11 |
| BOD Composition | 0.53 | 0.22 | 0 | 1 |
| Ownership | 5.71 | 8.92 | 1 | 45 |
| Big4 | 0.82 | 0.38 | 0 | 1 |

each variable. The table shows that the mean of the profitability measure ROAE is 2.6% and ranges from -41% to 25%. Politically connected banks have higher profitability compared to non-connected banks. This is also supported by Blau et al. (2013) who suggested that due to better access to governmental funding, over the period, politically connected firms' customers' deposits and total assets are higher than the non-politically connected firms. Larger banks are more likely to have a close connection with the royal family and politicians. Johnson and Mitton (2003) found that large companies are more likely to be politically connected. The cost to income of the politically connected banks and the non-connected banks are sim-

ilar. Interestingly, the average of the total equity to total assets ratio is 30% in all banks. Although the capital ratio for the non-politically connected banks is almost the same 34%, the total equity to total assets ratio for politically connected banks is 20%, which suggested that politically connected banks are more efficient, compared to the non-politically connected banks.

Table 4.2: Correlation Matrix

| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) | (10) | (11) | (12) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| (1) | 1 | | | | | | | | | | | |
| (2) | 0 | 1 | | | | | | | | | | |
| (3) | 0.232* | −0.009 | 1 | | | | | | | | | |
| (4) | 0.399* | −0.006 | 0.182* | 1 | | | | | | | | |
| (5) | 0.385* | −0.002 | 0.197* | 0.189* | 1 | | | | | | | |
| (6) | −0.183* | 0.027 | −0.398* | −0.223* | −0.234* | 1 | | | | | | |
| (7) | −0.003 | −0.019 | −0.429* | −0.078 | −0.095 | 0.195* | 1 | | | | | |
| (8) | 0.295* | −0.015 | −0.004 | 0.078 | 0.065 | −0.149 | 0.084 | 1 | | | | |
| (9) | 0.349* | −0.007 | 0.029 | −0.126 | −0.132 | −0.126 | 0.044 | 0.599* | 1 | | | |
| (10) | −0.034 | −0.001 | −0.381* | −0.076 | −0.072 | 0.275* | 0.325* | 0.166* | 0.179* | 1 | | |
| (11) | −0.190* | 0.016 | −0.083 | 0.107 | 0.103 | 0.269* | −0.281* | −0.130 | −0.159* | 0.022 | 1 | |
| (12) | 0.246* | 0.005 | 0.020 | −0.170* | −0.157 | −0.091 | 0.025 | 0.169* | 0.863* | 0.144 | −0.129 | 1 |

Table 4.2 shows the correlation matrix among the main variables for the study sample. Notably, the results show a negative correlation between ROAE and cost to income ratio and a relatively high positive correlation between the board of directors' numbers and the board of directors' non-executive. The variables of interest are PC, Blockade, ROAE, Total Assets, Total Deposits, Total Equity to Assets, Cost to Income, BOD Numbers, BOD Non-Executive, Ownership, Big4, BOD Composition, taking the value from 1 to 12 respectively. All significant correlations coefficients among the independent variable are below the threshold of 8, which implies excluding multi-collinearity in the estimation.

## 4.9 Empirical results

The effect of political connections on banks' profitability is shown in Table 4.3. First, we examine the effect of political connection on bank performance.

Table 4.3 reports the OLS baseline estimation results. The results from such regressions could be confounded, however, by the differential effects of political connection on banks with different characteristics.

Column one in Table 4.3 shows the impact of political connections and other core factors on profitability. Corporate governance control variables were added in columns 2, 3, 4, and 5. There might be other variables causing correlation of error term across banks. Unadjusted OLS regression could be biased. Hence, we estimate

Table 4.3: Political connection effect: Baseline results with clustered stander errors

| Variables | (1) | (2) | (3) | (4) | (5) |
|---|---|---|---|---|---|
| PC | 6.195*** | 5.920*** | 5.842*** | 5.924*** | 7.933*** |
| | (1.443) | (1.696) | (1.611) | (1.711) | (1.987) |
| Log Total Assets | -1.147 | -1.087 | -1.027 | -1.059 | -2.047 |
| | (0.931) | (0.995) | (1.028) | (1.054) | (1.308) |
| Log Total Deposits | 0.173 | 0.190 | 0.168 | 0.173 | 0.235 |
| | (0.534) | (0.524) | (0.531) | (0.544) | (0.557) |
| Total Equity to Assets | -0.163** | -0.156** | -0.151** | -0.155** | -0.227** |
| | (0.0622) | (0.075) | (0.068) | (0.076) | (0.091) |
| Cost to Income | -0.158*** | -0.158*** | -0.160*** | -0.159*** | -0.172*** |
| | (0.038) | (0.039) | (0.037) | (0.038) | (0.040) |
| BOD Number | | -0.160 | | -0.034 | 0.079 |
| | | (0.286) | | (0.534) | (0.537) |
| BOD Non-Executive | | 0.229 | | -0.015 | -0.837 |
| | | (0.223) | | (0.951) | (1.051) |
| BOD Composition | | | 2.318 | 2.448 | 10.35 |
| | | | (2.463) | (10.34) | (11.45) |
| Ownership | | | | | -0.034 |
| | | | | | (0.307) |
| Big4 | | | | | 1.050 |
| | | | | | (2.506) |
| Constant | 28.84** | 27.93** | 25.80* | 26.55 | 40.13** |
| | (11.48) | (14.01) | (14.24) | (17.09) | (19.98) |
| | | | | | |
| Observations | 118 | 118 | 118 | 118 | 107 |
| R-squared | 0.394 | 0.398 | 0.398 | 0.398 | 0.462 |

The table shows the effect of political connection on the bank profitability for the Bahraini banks in the period of 2015 to 2019. All variable defined in table A1 in the appendix. Robust and clustered standard errors in parentheses. ***, **, * stands for statistical significance levels of 1%, 5%, 10% respectively.

adjusted standard error that account for potential cross banks correlations. The adjusted standard errors are reported below coefficients in parentheses.

The regression results in Table 4.3 show that the coefficient for the political connections variable is strongly significantly positive across all five columns. In column 1 the coefficient on political connection is 6.195, which indicated that politically connected banks are 6 times more profitable on average relative to non-connected banks, and it is statically significant at 1%. After controlling for all banks characteristics and corporate governance variable, the coefficient for column 5 is significant at 1% level and indicate that politically connected banks approximately 8 times more profitable on average compared to non-connected banks.

This suggests that the impact on bank performance of having a board of directors that is politically connected to the royal families is economically large. In particular, the political connection coefficient indicates that Return on Average Equity for po-

litically connected banks is substantially higher compared to non-connected banks. These findings are consistent with (Altunbas et al., 2001; Molyneux and Thornton, 1992; Sapienza, 2004) who show that politically connected banks, which are driven by the political network, are more profitable compared to their counterparts.

The increase in profitability by 1% decrease cost to income ratio in column 4 and 5 by 15% and 17% respectively. The coefficients on the capital ratio are significantly negative at 1% in all the models. Unsurprisingly, cost-efficient banks are more profitable than their less efficient counterparts. This result is consistent with Berger and Bouwman (2013)'s argument that a decline in a bank's cost-to-income ratio, resulting from managerial efficiency, is likely to increase profitability.

Regarding the variables for equity to assets ratio, the coefficient of equity to assets ratio in column 1 and 4 is decreasing by 16% and 22% and it is statically significant at 5%. Equity to assets is negatively correlated with banks profitability, therein lies the key to the equity-to-asset ratio, which is to alter what percentage of a Banks' assets are owned by investors and not leveraged and therefore could come under the control of debt holders in the crisis time.

In column 2, adding variables for the board of directors, BOD number, and number of non-executives on the board contributes no additional insights. The coefficients for board composition in columns 3, 4, and 5, though positive, are insignificant. This indicates that diversity on a Bahraini bank's board of directors does not affect the banks' profitability. The ownership variable, measured by the number of shareholders, which is added to the model in column five, is also insignificant. The results also suggest that although 77% of Bahraini banks are audited by one of the Big 4 audit firm, the effect on bank performance is not significant.Column 2,3,4 and 5 show that controlling for this variables in our regressions does not change the main findings. The effect of the political connection remains statically significant at 1% and the coefficients are not much affected.

To address endogeneity concerns, we test for a Parallel Trend Assumption as follows:

$$ROAE_{it} = \alpha + \beta_1 Before * PC_i + \beta_2 After * PC_i + \beta_3 PC_i * X_{it} + \epsilon_{it} \qquad (4.3)$$

Where $ROAE_{it}$ is the profitability measure ROAE for the bank $i$ at time $t$. The study estimates the effect of political connection on bank's profitability one year before and after the crisis by establishing two dummies for the year 2016 and 2018. The regression estimates the trend of the connected and non-connected bank's profitability before and after the crisis. In particular, the coefficient estimates of $\beta_2$ are of particular interests as their magnitude, and statistical significance indicates whether treatment and control groups follow the same trend (in banks' profitability) following the Qatar Blockade after controlling the main variables $X_{it}$ in the base

Table 4.4: DID identification (Parallel Trend Assumption)

| Variables | (1) | (2) |
|---|---|---|
| PC* 2016 | 1.732 | 5.169 |
| | (3.892) | (3.379) |
| PC* 2018 | 5.297** | 4.928*** |
| | (2.083) | (1.505) |
| Log Total Assets | | -1.014 |
| | | (1.295) |
| Log Total Deposits | | 0.606 |
| | | (0.833) |
| Equity To Assets% | | -0.124 |
| | | (0.0767) |
| Cost to Income% | | -0.160*** |
| | | (0.0472) |
| Constant | 2.159 | 22.15 |
| | (1.495) | (15.45) |
| Observations | 169 | 118 |
| R-squared | 0.014 | 0.342 |

$^{***}p < 0.01$, $^{**}p < 0.05$, $^{*}p < 0.1$

regression. The results are clustered the standers errors at the bank level to mitigate concerns about heteroscedasticity and serial correlation of error term (Petersen, 2009).

Table4.4 shows the result of the Parallel Trend Assumption test. Column 1 shows the effect of the interaction between the treatment before and after the crisis. The results show that $\beta_1$ is insignificant, suggesting that there are no systematic differences in pre-trends with respect to banks' profitability between politically connected and non-connected banks before the Qatar blockade crisis. However, $\beta_2$ is statistically positively significant at the 5% level, which means that after the crisis the trend changed between politically connected and non-connected banks, providing sufficient evidence to satisfy the Parallel Trend Assumption, which is the key assumption of the DID model used in this study. In column 2, we rerun the regression, controlling for the main variable. The results are confirmed and the significance of $\beta_2$ increases to the 1% level.

Table 4.5 and table 4.6 report the results for the DID regressions on the effect of political connections on bank profitability.

The results show that coefficient on political connections are significantly positive across different models and slightly less in the magnitude than the coefficient in our baseline results.

Table 4.5 presents the results for four models. We first measure the effect of each core factor on profitability for all Bahraini banks; then we investigate the effect of each factor on the subset of politically connected banks. In addition, we estimate

Table 4.5: Political connection effect on Profitability

| Variables | (1) | (2) | (3) | (4) |
|---|---|---|---|---|
| PC | 3.099* | 3.001* | 4.825** | 6.050** |
| | (1.629) | (1.532) | (2.011) | (2.459) |
| Blockade | -0.149 | -0.105 | -0.348 | -0.452 |
| | (2.439) | (2.461) | (2.792) | (2.829) |
| PC*Blockade | -33.04** | -32.35** | -34.50** | -33.87** |
| | (15.16) | (15.25) | (14.36) | (13.85) |
| Log Total Assets | -1.466 | -1.426 | -1.863 | -2.367 |
| | (1.289) | (1.284) | (1.483) | (1.554) |
| Log Total Deposits | -0.011 | -0.037 | -0.053 | -0.022 |
| | (0.732) | (0.732) | (0.669) | (0.693) |
| Equity To Assets% | -0.183** | -0.178** | -0.219*** | -0.244*** |
| | (0.077) | (0.071) | (0.076) | (0.089) |
| Cost to Income% | -0.127*** | -0.129*** | -0.138*** | -0.136*** |
| | (0.047) | (0.046) | (0.050) | (0.050) |
| Log Total Assets *PC | -0.703 | -0.663 | 0.894 | 0.432 |
| | (2.279) | (2.284) | (2.204) | (2.205) |
| Log Total Deposits*PC | 1.169 | 1.14 | 1.262 | 0.861 |
| | (2.265) | (2.27) | (2.181) | (2.17) |
| Equity To Assets% *PC | 0.109 | 0.102 | 0.103 | 0.030 |
| | (0.186) | (0.185) | (0.199) | (0.216) |
| Cost to Income%*PC | -0.051** | -0.050** | -0.047* | -0.042* |
| | (0.023) | (0.023) | (0.024) | (0.022) |
| Log Total Assets *PC*Blockade | -9.020*** | -8.833*** | -8.536*** | -9.638*** |
| | (2.392) | (2.243) | (2.125) | (2.392) |
| Log Total Deposits*PC*Blockade | 10.90*** | 10.68*** | 10.50*** | 11.52*** |
| | (2.078) | (1.907) | (1.84) | (2.067) |
| Equity To Assets% *PC*Blockade | 0.569*** | 0.552*** | 0.551*** | 0.628*** |
| | (0.174) | (0.167) | (0.165) | (0.175) |
| Cost to Income%*PC*Blockade | -0.054 | -0.055 | -0.050 | -0.048 |
| | (0.035) | (0.034) | (0.037) | (0.037) |
| BOD Number | -0.189 | | | 0.051 |
| | (0.24) | | | (0.572) |
| BOD Non-Executive | 0.261 | | | -0.662 |
| | -0.238 | | | -1.134 |
| BOD Composition | | 2.525 | 2.425 | 8.499 |
| | | (2.532) | (2.455) | (11.7) |
| Ownership | | | (0.0574) | (0.035) |
| | | | (0.057) | (0.035) |
| Big 4 | | | 0.939 | 1.43 |
| | | | (1.85) | (1.95) |
| Constant | 34.35** | 32.28** | 40.27** | 46.50** |
| | (16.49) | (16.08) | (18.81) | (21.58) |
| Observations | 118 | 118 | 107 | 107 |
| R-squared | 0.484 | 0.484 | 0.522 | 0.527 |

$^{***}p < 0.01$, $^{**}p < 0.05$, $^{*}p < 0.1$

the effect of each core factor on politically connected banks during the crisis by computing interaction terms between those factors and the Politically Connected and blockade variables. Column 1 reports the results for Model 1, which controls for the size of the board of directors and number of non-executive board members. Model 2 in column 2 controls for board composition. Model 3 in column 3 augments Model 2 by including two more corporate governance variables, namely Ownership and Big 4. Finally, Model 3 in column 4 includes all of the corporate governance variables across all of the previous models. The DID results reveal some interesting patterns.

In column 4 we control for the corporate governance variables and the coefficient of the political connection is significantly positive at 5%. We find evidence that politically connected banks are 6 times on average more profitable compared to non connected counterparts. This confirms previous findings (Altunbas et al., 2001; Molyneux and Thornton, 1992; Sapienza, 2004) that politically connected banks are more profitable than those that lack such connections, and that the effect of political connections is economically large.

The political connections variable has a positive effect on banks' profitability, suggesting that banks with politically connected boards of directors have better management and follow practices that control costs to achieve greater profitability. These results are consistent with the view that political connections significantly and positively affect banks' profitability (Amore and Bennedsen, 2013; Carretta et al., 2012; Dinc, 2005; Faccio, 2010, 2016; Ferguson and Voth, 2008; Khwaja and Mian, 2005; Micco et al., 2010; Sapienza, 2004). Amore and Bennedsen (2013) find evidence that political connections have a significant positive effect on profitability for banks in Denmark. Khanna (2000) also find evidence that political connections have a positive effect on firm performance. Our results suggest that political connections boost welfare-enhancing functions and increase profitability in Bahraini banks. Because of the connection between the royal families and the business sector in the GCC, managers aim to sustain long-term ties with politically connected boards of director to enhance bank performance. Agrawal and Knoeber (2001) argued that politically connected boards of directors could assist in a bank's political dealings by using its connections to predict or influence government actions.

Interestingly, the results show that the interaction between the Qatar blockade crisis and the political connection variable has a significantly negative and economically meaningful effect on banks' profitability across all models. The study find that politically connected banks are 33 times less profitable during the blockade crisis time. In other words, politically connected banks are less profitable than non-connected banks during the blockade crisis. The results is consist with Johnson et al. (2000) claims that politically connected firms suffer more during the crisis time as

Table 4.6: Political Connection and Profitability (Year Control)

| Variables | (1) | (2) | (3) | (4) |
|---|---|---|---|---|
| PC | 3.031 | 2.897 | 4.503* | 5.816* |
| | (2.141) | (1.987) | (2.487) | (2.988) |
| Blockade | 0.653 | 0.680 | 0.551 | 0.440 |
| | (2.569) | (2.595) | (2.868) | (2.923) |
| PC*Blockade | -33.81** | -32.94** | -35.04** | -34.49** |
| | (14.53) | (14.31) | (13.82) | (12.81) |
| Log Total Assets | -1.509 | -1.440 | -1.831 | -2.383 |
| | (1.645) | (1.591) | (1.619) | (1.731) |
| Log Total Deposits | -0.027 | -0.057 | -0.104 | -0.069 |
| | (1.033) | (1.017) | (0.873) | (0.893) |
| Equity To Assets% | -0.186* | -0.178* | -0.220** | -0.247** |
| | (0.107) | (0.094) | (0.095) | (0.113) |
| Cost to Income% | -0.127*** | -0.129*** | -0.138*** | -0.136*** |
| | (0.056) | (0.055) | (0.060) | (0.060) |
| Log Total Assets *PC | -0.739 | -0.733 | -1.005 | -0.507 |
| | (2.292) | (2.250) | (2.258) | (2.312) |
| Log Total Deposits*PC | 1.225 | 1.227 | 1.409 | 0.977 |
| | (2.292) | (2.250) | (2.258) | (2.312) |
| Equity To Assets% *PC | 0.110 | 0.107 | 0.111 | 0.033 |
| | (0.208) | (0.200) | (0.216) | (0.254) |
| Cost to Income%*PC | -0.053 | -0.052 | -0.049 | -0.044 |
| | (0.031) | (0.031) | (0.032) | (0.032) |
| Log Total Assets *PC*Blockade | -9.009*** | -8.724*** | -8.388*** | -9.604*** |
| | (2.444) | (2.143) | (2.094) | (2.540) |
| Log Total Deposits*PC*Blockade | 10.92*** | 10.60*** | 10.38*** | 11.51*** |
| | (2.242) | (1.800) | (1.820) | (2.259) |
| Equity To Assets% *PC*Blockade | 0.575** | 0.549*** | 0.546*** | 0.633*** |
| | (0.214) | (0.178) | (0.188) | (0.212) |
| Cost to Income%*PC*Blockade | -0.052 | -0.053 | -0.048 | -0.046 |
| | (0.042) | (0.041) | (0.045) | (0.044) |
| BOD Number | -0.217 | | | 0.031 |
| | (0.265) | | | (0.601) |
| BOD Non-Executive | 0.260 | | | -0.686 |
| | (0.293) | | | (1.227) |
| BOD Composition | | 2.517 | 2.320 | 8.595 |
| | | (2.877) | (2.592) | (12.28) |
| Ownership | | | -0.056 | -0.033 |
| | | | (0.309) | (0.298) |
| Big 4 | | | 0.869 | 1.403 |
| | | | (1.783) | (1.692) |
| 2016 | 1.132 | 1.110 | 1.103 | 0.991 |
| | (2.057) | (2.065) | (2.292) | (2.348) |
| 2018 | 0.124 | 0.084 | 0.250 | 0.268 |
| | (1.739) | (1.739) | (1.849) | (1.925) |
| 2019 | 2.202 | 2.131 | 2.486 | 2.635 |
| | (1.684) | (1.703) | (1.568) | (1.621) |
| Constant | 34.58* | 31.94* | 39.59** | 46.62** |
| | (19.98) | (18.23) | (18.25) | (21.68) |
| Observations | 118 | 118 | 107 | 107 |
| R-squared | 0.493 | 0.492 | 0.531 | 0.536 |

it limit's the government ability to provide privileges and subsidies.

Bahrain is a small country, with a population of only 1.6 million. Despite having a diversified economy and the world's 34th largest GDP per capita, it is struggling economically and financially. Manama, the capital of Bahrain, was bailed out by fellow GCC countries in 2018 and its socioeconomic underdevelopment significantly threatens its internal stability.

In line with our baseline regression results, capital ratio has a negative and significant effect on bank profitability in all models. In column 1 and 4 the increase in the cost to income ratio by 1% decrease the profitability by 12.7% and 13.6% respectively and it is statically significant at 1%

Unsurprisingly, cost-efficient banks are more profitable than their less efficient counterparts. This result is consistent with Berger and Bouwman (2013)'s argument that a decline in a bank's cost-to-income ratio, resulting from managerial efficiency, is likely to increase profitability.

Equity to assets ratio in column 1 and 4 negatively associated with profitability, the 1% increase in the Equity to assets ration decrease the profitability by 18% and 24% respectively at 1% in all the models.

However, the coefficient of the interaction term between political connection and the capital ratio shows that the capital ratio (Total equity to total assets) and profitability ratio are both insignificant for politically connected banks.

We run triple DiD and we find evidence that size and total deposits impact on profitability in Bahrain is substantial. The results also show that the coefficient of total assets, as a measure of the size of politically connected banks during the crisis, is strongly negative. The study finds that large politically connected banks is 9 times less profitable on average compared to non connected banks during the blockade crisis. This findings suggest that largest Bahraini banks, most of which are controlled by the government and are therefore politically connected, suffered more during the crisis.

However, politically connected banks with high total deposits is 10 times more profitable on average compared to non connected banks during the blockade crisis. Banks with a high level of deposits are able to provide loans at competitive rates, which can increase profitability Naceur and Goaied (2001).These results suggest that the log of total deposits ratio of politically connected Bahraini banks corresponds to a significantly higher levels of profitability compared to non-connected banks during the crisis.

During the crisis period, the significant positive sign suggests better-capitalized banks are more profitable during the Qatar blockade crisis. This result emphasizes the economic importance of capital on bank profitability in a time of crisis. Qatar blockade's exogenous shock increased risk, which caused governments to rethink

their support for politically connected banks. The results in Table 4.6 support the previous results in Table 4.5 after controlling for year effects across all models.

## 4.10 Conclusion

This study examines the effect of political connections in Bahrain with two goals. First, we investigate the effect of political connections on Bahraini banks' profitability and our results are generally consistent with previous empirical studies. Second, we examine the effect of political connections on the banking sector in Bahrain before and after the Qatar blockade, for the period from 2015 to 2019. The blockade event has had a substantial negative effect on the region, but with a greater impact on the boycotting countries than on the Qatari economy. Few studies have explored the effect of political connections on the banking sector. This study uses hand-collected data on the boards of directors from banks' annual reports to identify whether or not the boards are politically connected. We then identify the effect of political connections on banks' performance in Bahrain after controlling for corporate governance variables and bank characteristics, exploiting the DID method to test for the causal effect of an exogenous shock. The results argue that the blockade crisis created a new Gulf with no winners. The change in the direction of relationships before and after the crisis is that politically connected banks are safer bets as they depend mainly on government support and are not willing to mitigate the crisis through self-dealing measures. An alternative explanation is in line with Ebrahim et al. (2014) who argues that exogenous shocks increase risk and decrease the government's ability to provide sufficient support to politically connected banks. Moreover, our findings suggest that politically connected banks outperform non-connected banks. However, the results show that the Qatar blockade crisis triggered a sharp decline in politically connected banks' performance relative to the performance of politically non-connected banks.

Certainly, assessments of political connections during periods of rising uncertainty can be perceived as an effective way to predict the profitability of financial markets and the economy, and can help policymakers to design policies to support banks' performance. Collectively, these findings help us to better understand the effect of political connections on the banking sector in Bahrain.

The GCC region is an emerging economy characterized by the dominance of royal families and ruling regimes, weak rule of law, widespread corruption, and poor investment protections policies. Therefore, policy makers must be cautious with respect to the amount of support they provide to the region's banks to avoid sending erroneous signals to the markets and investors, especially in the time of a crisis. The rift between Qatar and the other GCC countries took investors by

surprise and disrupted business activity, thereby adding to investors' perceptions of political risks for the Gulf as a whole.

Political capital can affect banks' competitiveness, which in turn can have negative consequences for the economy in times of distress. Investors need to account for political support and its potentially negative effect during a crisis. Our findings are important to GCC policymakers who need to carefully consider the impact of the GCC blockade on the region's banking sector before taking future actions against any of its member countries, as the effect of the blockade on the banking sector in Bahrain, one of the boycotting countries, was clearly negative. The blockade crisis has had a significant effect on the banking sector and inflicted losses not only on Qatar but also on the boycotting countries (in other words, it is a lose-lose scenario).

Regulations should emphasize methods to mitigate risk during a crisis to avoid its negative impact on profitability and avoid future instability in the financial sector.

Investors can enhance their hedging and investment decisions by exploiting their knowledge with respect to the way the political connection is associated to banks profitability over the Qatar diplomatic crisis can be transmitted from one market to another.

Additionally, the current study provides explanation regarding the association between political connection and profitability in Bahrain which should allow regulators undertake strategies to increase banks profitability and mitigate the transmission effect of the crisis by ensuring adequate regulation and supervision (Cafaggi and Miller, 2013).

This study contributes to an understanding of the effect of the Qatar blockade crisis as an exogenous shock on the financial sector in the region, and how political connections influence bank profitability. The results suggest that political connections have a negative causal impact on banks' profitability during a crisis. The results provide support for the political rent-seeking literature about GCC banks. This study has some limitations. The results could be improved through the use of larger datasets. The analysis performed here was limited to banks in Bahrain, and could be expanded to include banks in other GCC countries.

Research that investigates the effect of political connections on the banking sector, particularly in the Middle East and GCC countries, is scarce. In this regard, it is important to direct future research to produce studies that investigate this topic from various angles to better understand how political factors affect financial sector development. Future research could also analyze the effect of the political network on the banking sector and on banks' lending behavior. Panel data could be useful to investigate the effect of the GCC crisis on the banking sector across the entire GCC region.

# Chapter 5

# Game of Thrones: Political Connections, Foreign Dictatorship and Qatar Blockade Crisis, Effect on Bahraini Banks' risk

## 5.1 Introduction

The board of directors is a critical element in achieving high performance and decreasing the firms' risks. The managers have two roles: to monitor, and to advise the managers about the provision of resources and decision-making. The success of the company and shareholder value creation mainly depends on how effectively the board of directors performs these two functions. This study focuses on two unique characteristics that influence the banks' risk. Specifically, I examine the political connection effect and foreign directorship on banks in Bahrain.

Growing literature documents various benefits to firms with political patronage. For instance, Fisman (2001), and Faccio (2006) provided direct evidence that the benefits on average outweigh the costs of establishing political connections to specific firms. Their findings showed that political connection increases the value of the companies specifically in crisis time. Moreover, Mian et al. (2010) and Faccio (2006) argued that politically connected firms are perceived as less risky than their counterparts as governments is expected to be rescued them during the crisis. However, Altunbas et al. (2001) found that state-owned banks as a measure of political connection were less profitable than their private counterparts.

Foreign directorship could also deliver valuable international skills and expertise to the corporations Carter et al. (2003). However, some researchers argued that foreign directorship tends to be less effective and increases conflicts and weakens the

boards' role which could negatively the companies' performance. Consistent with this view, Lehman and DuFrene (2008) contended that the presence of foreign board members on the board of directors may cause miscommunication and increase the likelihood of cross-cultural and interpersonal conflicts.

This study examines the political connection of the board of directors of the Bahraini banks on risk from 2015 to 2019. The paper tries answering the following questions by exploiting the Qatar blockade crisis as an exogenous shock: Does political connection have a positive or negative impact on banks' risk? Does the foreign directorship increase or decrease banks' risk in Bahrain?

The study makes several contributions to the political economy and corporate governance literature. Firstly, this study improves our understanding of banks' political connection in Bahrain and contributes to political connection literature. Scarce attention has been given to diversity and political connection topics, especially in the Gulf countries. Fisman (2001) suggested the importance of investigating the effect of the institutional factor on performance. The impact of political connection on performance depends upon country-level laws, regulations and, corruption levels (Acemoglu et al., 2018). Secondly, the study uses Bahrain a developing country with different economic, legal and cultural environments that need to be investigated. Moreover, it focuses on the political connection on the board of directors and its effect on banks' risk. Further, this study extends the literature by providing evidence of the effect of foreign directorship on banks' risk. Additionally, Bahrain a boycotting country and investigating the effect of the blockade on it is interesting. Moreover, the banking sector in the GCC countries is connected and all members of the board of directors have a large number of foreign directors especially from the GCC countries. Hence, the effect of foreign directorship on banks' risk must be investigated. The use of unique dataset of manually collected data about political connection in all Bahraini banks from 2015 to 2019 is an additional contribution.

The results show strong evidence of a significant positive relationship between banks' risks and political connection. The result is consistent with the moral hazard theory and how firm incentives are affected by government interventions. Previous studies(Bliss and Gul, 2012a; Boubakri, Guedhami, Mishra and Saffar, 2012; Kostovetsky, 2015) obtained evidence of the positive a positive association between political connection and banks' risks. Kostovetsky (2015) in the USA investigated the effect of the moral hazard and found evidence that politically connected members of the board of directors increased the proportion of market value in toxic assets, reduced stock returns and increased firms' risk. Leuz and Oberholzer-Gee (2006) also determined that in the long run, political connection investment is perilous, especially, if the government fails to win an election. More importantly, our results reveal that the effect of political connection is extensive and increased dramatically

after the crisis. Even if Bahrain was a boycotting country, the effect of the crisis on risk, especially for politically connected banks, was vast. Additionally, the regression results show evidence for a negative relationship between foreign directorship and banks' risk. Hence, foreign directors increase the efficiency of the board of directors. Furthermore, national cultural diversity increases banking stability but decreases the risk.

The remainder of the paper is organized as follows. Section 2 Literature review. Section three describes the procedures for sample construction and identification of political connections and presents summary statistics of our sample. Section 3 presents the results from banks' risk regressions. Section 6 summarizes the findings and conclusions.

## 5.2 Literature Review

According to the agency theory, the board of directors' incentives will result in a board improvement in monitoring activities. However, resource dependence theory identified the board of directors as a board capital that affects the provision of resources and firms' risk and performance. Hillman and Dalziel (2003) argued that the board of directors' role is integrating between monitoring and the provision of resources. Moreover, the board's duty is to identify the possible threats and opportunities for shaping long-term plans. Additionally, they work to build external relations to strengthen the company. Firms try to increase capital every so often by inviting important customers and/or suppliers, foreigners or politician to be embodied on their board and thus increase the profitability and decrease firms' risk.

Board diversity has attracted the interest of researchers from various disciplines. Previous research determined a positive link between board diversity and firm performance (Carter et al., 2003; Dalton et al., 1998; Mak and Yuanto, 2003; Yermack, 1996). A growing number of studies have also investigated the relationship between board diversity and corporate governance in developed countries (Adams and Ferreira, 2009),and innovation in banks (Bantel and Jackson, 1989). However, the effect of political connection and foreign directorship on banks' risk in developing counties is not sufficiently addressed. The study uses the difference-in- difference (DID) method to investigate the causal effect of political connection on the banks' risk in Bahrain exploiting the recent crisis in the region. The study covers the period from 2015 to 2019.

## 5.3 Political Connection

Despite many years of research, political connection literature has not reached a consensus on whether the effect of political connection is positive or negative. The political connection between the firms and the government is a "gift exchange". In particular, politically connected firms gain benefits, government subsidies, abnormal returns, and access to finance and markets. They are also exempted from the extortions. In return, these connected firms support the government and exert effort to achieve economic growth (Choi and Thum, 2009). In a similar vein, Desai et al. (2011) argued that political connection privileges come with a price. They described the process by a bargain as the firm relinquishes some control rights access to government subsidies and protection, especially during crisis. Hence, the effect of the political connection of banks as the main source of financial development must be investigated. Ang and Kumar (2014) argued that financial development is broadly viewed as a crucial necessity for promoting growth because it helps the economy to mobilise resources, allocate capital to increase investment and reduce risks. However, countries with older and deep state institutions tend to have more well-settled financial systems. Meanwhile, political connection bargains do not always succeed in all countries due to the varying institutional environments. Li et al. (2012) found a strong positive relationship between corporate diversification and political connection in China. They argued that the institutional context moderates the relationship between political connection and firms' performance. Indeed, the political connection is more likely to be ineffective when the institutional environment is mature.

Efficient markets decrease the formal transaction costs and increase the firms' growth. Similarly, Andrianova et al. (2008) obtained cross-country evidence of the moderating role of institutional quality in the relationship between state-owned banks and financial and economic development. They found that countries with low levels of institutional quality depend on state owned banks to uplift the economics and financial development. These state-owned banks are less efficient and make bad lending decisions following low profitability and financial fragility (Andrianova et al., 2012).

The empirical results of the effect of political connection on firms are controversial. Wang (2015) found that firms with political ties in China outpace the nonpolitically connected peers due to the extra-governmental subsidies and support. In the USA, Vidal et al. (2012) found that political connections increase the net revenue by 56% compared to non-connected firms. Goldman et al. (2009) also in the USA found a positive abnormal stock return after an announcement of the nomination of a politically connected individual to the board. Gropper et al. (2013) showed that the political connection of the senators had a positive impact on the bank

performance. Furthermore, Agrawal and Knoeber (2001) argued that a politically connected board of directors could assist in the political dealings of a firm by using skills to predict or affect government actions. These skills might come from prior work experience in or friendship ties with politician and decision-makers.

This effect is clearer during the crisis time. For example, Liu et al. (2016) used the global financial crisis as a natural experiment to investigate the effect of managers' professional connections on trade credit. They found that political connection positively affects the trade credit during the financial crisis. Moreover, the findings of Faccio et al. (2006) suggested that political connection plays an important role in capital allocation and financial assistance, especially in distress time. Gropper et al. (2013) proposed that political connections matter, and it pays to have political connections especially in the banking sector during crisis time. In contrast, Acemoglu and Johnson (2005) and Fan et al. (2007) argued that in countries with fragile property rights and low investment rates, the political connection has a strong negative effect on the performance of firms and governance quality. Fisman (2001) exploited the rumours about former Indonesian President Suharto's health as an exogenous shock and conducted an event study to estimate the effect of this event on the firms' return. The study found that politically connected firms suffer more than non-connected counterparts.

## 5.4 Political connection and Risk

Related to our work several studies have investigated the effect of political connections on firm and bank risk. For instance, Boubakri, Cosset and Saffar (2012) utilised data from 26 countries covering the period from 1997 to 2001 and found a negative association between political patronage and risk. Similarly, Braun and Raddatz (2010) examined the effect of political connection on 4,618 banks in 154 countries using DID. The study found a negative impact of political connection on banks' risk. More closely related to our topic, Iannotta et al. (2013) used a large sample of Western European banks to investigate the effect of political connections on banks' risk. They found that the state-owned banks have a lower risk compared to non-connected banks. Their result suggests that connected banks benefit from government protection in the form of implied guarantees. For example, after the 2008 financial crisis, many European banks were bailed out by their government using government underwriting of debt instruments at favourable conditions and government guarantees of uninsured debt with equity capital injections. Meanwhile, Hung et al. (2017) explored the effect of political patronage on banks' risk and performance in China. They found that politically connected banks had a higher return on assets, and lower risk. Also, the results showed that politically connected

banks had better access to lending and were more likely to be bailed out during crisis than non-connected banks. Niessen and Ruenzi (2010) investigated political connection in Germany during the post-World War II era. They found that politically connected firms are less risky than non-connected firms. Lastly, the finding of Boubakri, Cosset and Saffar (2012) suggested that the benefits from the political connection outweighed the costs and encouraged the investors to choose politically connected firms which enjoy a lower rate of return and risk.

However, Bliss and Gul (2012b) investigated an important question about whether political connections lead to more risk. The study used a large sample of Malaysian firms and explored the relationship between political connection and cost of debt. They found that politically connected firms were perceived as riskier than non-connected counterparts by the market, audit firms, and lenders. Boubakri, Cosset and Saffar (2012) used a multinational sample and found that firms with political ties to strong political power were more valuable. Additionally, the effect was higher in countries with a weak legal and institutional environment and a high level of corruption. Moreover, De Nicolò and Loukoianova (2007) determined a positive relationship between banks patronage and risk in 10,000 banks covering 133 countries. Likewise, Carretta et al. (2012) investigated the politically connected board of directors' effect on banks' performance, lending, and risk. Noticeably, the results showed that the presence of a politician who holds executive roles on the board had a strong negative effect on banks' performance. Leuz and Oberholzer-Gee (2006) argued that political connection investment is perilous in the long run. If the government fails to win an election, the firm can be affected negatively, which in turn will negatively affect the firms' long-run performance.

The study used the loan loss provision (LLP) as a measurement for risk. Notably, banks have become more prone to bankruptcy risk due to the huge amounts of money provided to customers through loans, which may pose a threat toward the banks' stability and growth . Previous literature has highlighted solutions to reduce such risks by setting aside some amount of reserved known as loan loss provision. Therefore, loan loss provision is deemed an important tool employed to measure risk. The connected bank's role in keeping the stability of financial markets during the global financial crisis is clear (Laeven and Valencia, 2013). However, the effect of political connection on banks' risk during the crisis is not the same for all countries. Chen et al. (2010) argued that politically connected banks tend to have more low-quality loans that can affect their performance negatively, especially during financial crises. Notably, these connected banks most probably do not get penalized for high loan default rates, and they are more likely to lend money to low-quality borrowers to gain political influence. LLP measures credit risk as a proxy for banks' risk-taking behavior towards profits and sustainability, especially after the occurrence

of a global financial crisis. LLP is significant in assessing financial system stability. Beatty and Liao (2009) argued that LLP has a great impact on banks' performance. In other words, loan-loss reserves directly affect the earnings during upturns in the economic cycle, as banks predict future shortfalls on the loan portfolio when the economy hits a downturn. When the economy faces any exogenous crisis, provisions should cover the whole spectrum of potential loan defaults, and then, the banks need to cover the excess loss from its capital. The European economy has suffered one of the deepest recessions of the post-war period. The impact of this crisis on the banking sector was crucial. For instance, bad loans piled up, thus reducing revenues and increasing LLP. This has made LLP behaviour a key issue that needs to be investigated (Caporale et al., 2018).

Drawing upon the moral hazard theory and how government intervention affect firm incentives, Kostovetsky (2015) used cross-sectional variations in political connections in the USA to investigate the effect of the moral hazard. The politically connected member of the board of directors increased the proportion of market value in toxic assets by 20% and reduced the stock returns by 6%. Moreover, the political connection present on the board of director also increased the firms' risk. Johnson and Mitton (2003) and Ebrahim et al. (2014) both suggested that politically connected firms suffer more when an exogenous shock happens, which limits the government's ability to offer privileges and support. The exogenous shock increases the systematic risk and affects the government's ability to offer support. Bliss and Gul (2012b) finding suggested that the lender perceive politically connected firms as riskier than nonpolitically connected firms. Moreover, the results of Faccio and Parsley (2009) suggested that political patronage is critical especially for family firms and firms directly under politician control. However, the misallocation of capital will harm growth in the long run.

Based on the previous empirical studies of the effect of political connection and risk, the first hypothesis is stated as follows:

H1: A positive exists between political connection and banks' risk.

## 5.5 Foreign Directorship

On the one hand, Hillman et al. (2000), argued that the diverse boards contribute to divergence, unique views and distinct backgrounds in firms. Additionally, varied groups also enhance in producing a broader selection of ideas and solutions because they contain a diverse type of knowledge. Additionally, foreign dictatorship is a source of Knowledge and expertise aiding banking stability and decreasing risk Carter et al. (2003). Additionally, Oxelheim and Randøy (2003) pointed out that nationality diversity in the board is a competitive advantage to a firm as it is a source

of the foreign network. Klein (1998) argued that the board with foreign directors' benefit from the diversity of skills and knowledge.

On the other hand, there is also literature that found a negative relationship whereby board diversity weakens banks' stability, posing challenges since personal differences and cultures might lead to conflicts within the organization and increase risk. Lehman and DuFrene (2008) argued that nationality diversity may increase the likelihood of cross-cultural and interpersonal conflicts. Moreover, communication is more difficult with both foreign and non-foreign boards of directors.

The effect of foreign diversity in the board in developing countries is scarcely addressed. It is interesting to note the effect of foreign directorship in emerging countries since most of the capital inflows are from other countries and firms with a high level of foreign shareholders are more likely to have foreign directorship (Choi et al., 2007). Carter et al. (2003) investigated the relationship between the board diversity and the firm value for a sample of approximately 1000 firms. They found a significant positive relationship between board diversity and firm value. Erhardt et al. (2003) reported similar results in their study on board diversity. By using data from 127 large US companies, their findings suggested that board diversity was associated with positive effects on financial performance. Choi et al. (2007) study in Korea, showed a positive impact of foreign directorship on firm performance. Similarly, Oxelheim and Randøy (2003) investigated the relation between foreign board members and firm performance for the USA. The empirical results demonstrated that independent and foreign directors enhance firm performance.

However, Masulis et al. (2012) found a significant negative association between foreign directorship and firm performance. Moreover, Choi and Hasan (2005) examined the presence of foreign investors on banks' risk. Their results provided evidence of a negative association between foreign ownership and banks' risk. Based on the previous empirical studies on the effect of foreign nationals in the boardrooms, we proposed second hypothesis:

H2: A negative relationship exists between foreign directorship and banks' risk.

## 5.6 Bahrain Context

The Arab Gulf states consist of six small oil-rich countries: Bahrain, Saudi Arabia, Qatar, Kuwait, Oman, and the United Arab Emirates. These states individually and collectively wield immense power, mostly soft power, to move to the forefront of international finance. However, even if Bahrain, among the other gulf countries, has elevated living standards. and generous investment in human capital and economic and financial development, it is not utterly without challenges and shortcomings. The gulf region is highly susceptible to regional tensions. Additionally, the rapid

socio-economic transformation over the last three decades has produced massive capital misallocation and disorientation. The rapid change, regional tensions, political reforms, foreign interventions, and equality of wealth distribution are firmly the interconnected forces shaping policies and development. Previous literature has widely investigated the oil effect on the GCC countries which sadly prevent scholars from deepening and broadening their investigation to include other important topics that affect the region. The study attempts to investigate the effect of the blockade on the Bahrain banking sector as it is the main financial development channel. Bahrain is considered a regional financial center. It has a well-developed financial sector, including 29 retail banks (including 7 Islamic retail banks) and 76 wholesale banks (including 19 Islamic wholesale banks). Fourteen retail banks are locally incorporated, whereas 15 are branches of foreign banks. With 26 Islamic banks (both retail and wholesale), Bahrain has the largest concentration of Islamic bank operations among the countries that operate dual banking systems. According to the Central Bank of Bahrain (2019), total aggregated banking assets were at $192.7 bn as of the third quarter of 2018, an increase from $187.4 bn at the end of 2017 and $186.1 bn in 2016. Domestic assets were worth $59.8 bn and foreign assets $135.8 bn. As of August 2018, total assets of retail banks stood at BD31.9 bn ($84.5 bn) including BD18.3 bn ($48.5 bn) of domestic assets. Assets of wholesale banks stood at $107.4 bn of wholesale assets, $11.1 bn were domestic assets, and $96.4 bn were foreign assets.

The banking sector in Bahrain faces substantial macroeconomic challenges. For example, in August 2018, sovereign credit ratings agency Moody's downgraded main 4 domestic banks, highlighting the government's reduced capacity to support banks was one of the main reasons for this downgrading. The credit ratings agency. However, The credit rating agency also pointed out that the sector appeared to remain resilient, thanks in part to solid profitability and healthy liquidity buffers.

Among the other Gulf countries, Bahrain enjoys political stability that makes it tempted to investigate the effect of political connections on its banks. Secondly, unlike all GCC countries, Bahrain has no limits on foreign ownership. The geographic diversity seen on Bahrain's banks' balance sheets has enabled them show strong performance during even the most challenging periods. In July 2016, Bahrain introduced further liberalised additional business activities, allowing most companies to have 100% foreign ownership in various sectors(Central bank of Bahrain report 2017).

The gulf monarchies are very powerful and stable. The Alkhalifa family in Bahrain established their rule in the late eighteenth century. Gause and Gause (1994) (146) state that "it would be a serious mistake to underestimate their staying power or to assume that the only power for their rule is the protection of the

US". The interconnection between Qatari and Bharani economies is strong. For example, in 2010, Bahrain , Qatar and Kuwait set up a step to the build a Gulf central bank, a "monetary council". Previously, the state of Qatar was under the rule of the Kingdom of Bahrain. Signing the oil agreement with the British authorities paved the way for Qatar's independence and sovereignty that can be an additional reason to investigate the effect of the blockade on the Bahraini economy. The main setback for Qatar that the blockade caused was its dependent on food imports from Saudi Arabia mainly and Qatar find alternative solutions and managed to fail the blockade. However, according to the World Bank Report 2018,Bahrain and Oman are in most vulnerable condition.

Finally, to the best of our knowledge, no study to date has empirically investigated the effect of the Qatar blockade crisis on the banking sector risk in Bahrain. According to the Milken Institute report 2019, non-performing loan (NPL) reached as high as 6.5% by the end of 2017 as asset quality was visibly affected by the economic slowdown arising from low oil prices and the gulf blockade crisis.

## 5.7 Methodology

The aim of this study is to explore whether banks populated by the politically connected board of directors before the Qatar blockade witnessed larger increases in risk after 2017. To explore the differential effect of the recent crisis, and to throw light on the empirical validity of the political connection hypothesis, I set up a difference in difference (DID). Before proceeding, the study presents a brief background about the Qatar blockade and specify the identification strategy in more detail.

### 5.7.1 The Qatar Blockade

In June 2017, Saudi Arabia, the United Arab Emirates, Egypt, and Bahrain decided to break off diplomatic and economic ties with Qatar. They imposed air, land, and sea blockade. In 1981 the six gulf nations established a political-economic alliance called the gulf corporation council GCC. The connection between the countries not only economic or political but also social. The people in these countries come from tribes from royal families and many of them intermarried. People from these tribes live in different gulf countries and they have a foot in each other's royal courts. In 1995, Sheikh Hamad Bin Khalifa Al Thani announced that he is taking power over his father. Since then, Qatar started to follow different foreign relationship policy. Qatar also launched the Al Jazeera platform which was supporting the Arab Spring when Saudi Arabia and the other Gulf countries were supporting the ruling regimes

in these countries. In 2017, GCC leaders broke off diplomatic relationship with Qatar. Saudi Arabia, Bahrain, the UAE, and Egypt decided to cut diplomatic and economic ties and presented a list of demands for Qatar to end the crisis.

Qatar found these demands as unacceptable interference and affected Qatari sovereignty. For example, the boycotting countries asked Qatar to downgrade diplomatic ties with Iran and shut down Al Jazeera. Qatar in return denied the charge and accuses its neighbours of seeking to interfere and curtail its sovereignty. Although the impact of the blockade on Qatar was clear, Qatar was able to shore up its banks, increase trade between Iran and Turkey and manage the crisis effectively IMF (2018). The effect of the blockade in Qatar and the boycotting countries was clear and posed threats on social, economic, and political permanence. The blockade negatively affects the flow of goods and services and triggered a massive money withdrawal from the banks. Against this backdrop, the Qatar blockade can be treated as an exogenous shock. it is also sensible to believe that political connections had little if any, role in driving the crisis. The ties between the banks in the GCC countries are interwoven. The board of directors in the banks in Bahrain has a lot of foreign directors from the GCC countries. Hence, I believe that this event has tremendous consequences on the banking sector in Bahrain.

### 5.7.2 Identification

I set up the difference in difference (DID) framework to identify the causal effect of political connections in Bahraini banks. The study is interested in exploiting the Qatar blockade crisis concerning political connection to explore its effect on banks' risk. Our study covers the period 2015-2019. Setting our cut-off year as 2017 when the Qatar blockade crisis happened, the study defines the pre- period as including the years from 2015 and 2016, while post period 2018 and 2019. Our basic model specification of the DID is as following:

$$LLP_{it} = \alpha + \beta_1 * B_t + \beta_2 * PC_i + \beta_3 * B_t * PC + \beta_k * cov + \epsilon_{it} \tag{5.1}$$

Where the dependent variable is the banks' risk $LLP_{it}$ which is the loan provision as a percentage of the average loan at amortized cost. $i$ donate a bank and $t$ represent time. $\epsilon_{it}$ is an error term assumed to be independently identical and normally distributed with zero mean and constant variance. $\beta_1$ refer to the crisis year (Qatar blockade). Our main variable of interest is PC which is $\beta_2$ defined as a dummy variable equal to one if the bank is politically connected with a royal family or a parliament member and zero otherwise. $\beta_3$ expresses the DID coefficient which shows the interaction between the crisis year and the treatment.

To use the DID analysis, we must meet its assumptions. Random assignment

rests a perennial disquiet. The validity of our analysis methodology depends on the assumption that the treatment of politically connected banks should be exogenous to the banks' risk behaviour. The Qatar blockade creates an exogenous shock which in return created a natural experiment setting as the effect of the crisis on banks was unexpected. The study uses the Difference- in- Difference methodology to compare the risk of the politically and non-politically connected banks in Bahrain before and during the blockade crisis. Politically connected banks are the treatment group and non-politically connected banks are the control group. Defining the control group is an additional task in conducting DID analysis, which can be tackled by ensuring that the treatment and the control group both do not exhibit opposing trends before the event. This is called the parallel trend assumption. I will provide formal empirical tests of the parallel trend assumption in our result section (table 5.4). To address the endogeneity problem for the study tests for the Parallel Trend Assumption as follows:

$$LLP_{it} = \alpha + \beta_1 Before * PC_i + \beta_2 After * PC_i + \beta_3 PC_i * X_{it} + \epsilon_{it} \tag{5.2}$$

Where $LLP_{it}$ is the risk measurement for the bank $i$ at time $t$. The study estimates the effect of political connection on bank's risk one year before and after the crisis by establishing two dummies variable for the year 2016 and 2018. The regression estimates the trend of the connected and non-connected bank's risk before and after the crisis. In particular, the coefficient estimates of $\beta_2$ are of interests as their magnitude, and statistical significance indicates whether treatment and control group follow the same trend (in banks' risk) following the Qatar Blockade after controlling the main variables $X_{it}$ in the base regression. The results are clustered standard errors at the bank level to mitigate concerns about heteroscedasticity and serial correlation of error term (Petersen, 2009).

## 5.8 Data

To measure the effect of political patronage on banks' risk in Bahrain, I use novel data on politically connected board directors in Bahraini banks. The dataset was compiled as follows. Firstly, the study delineated a potential connection if the board of director connected to the royal family or parliament. Secondly, I extracted the board of directors' information for the banks from the Orbis database. Thirdly, I assessed the degree to which the board of directors of the banks were politically connected by matching the last names of the board of directors together with the royal family and the parliaments' members names.

Our main political connection variable (PC) is a dummy variable equal to 1 if the banks politically banks are connected and o otherwise. Information on bank risk

is taken from SNL (Financial S&P Global Market Intelligence Database (2019)). The data is yearly data at the end of the financial year. Additionally, I collected the annual reports to extract the board of directors' control variables. Our data is unbalanced data covering the period 2015 to 2019. The choice of our sample period is driven by our aim to exploit the Qatar blockade exogenous shock 2017. I wanted to employ an event study to investigate the causal effect of political connection on banks' risk before and after the event. Our data collection began with an initial list of 46 domestic and private banks.

Twelve banks were lost because of the lack of annual reports availability. Our final sample extends from 169 bank year observation and 107. Our corporate governance data is hand-gathered from the annual reports published on the banks' websites. Our dependent variable is a risk measurement (LLP) which is the loan provision as a percentage of the average loan at amortized cost. LLP measures the fragility of banks' assets, whereby an increase in this ratio implies an estimated rise in the non-performing loans (NPLs). Banks maintain loan loss provision in order to deal with the occurrence of loan impairment. The higher the amount of bad loan that banks have the higher the value of LLP.

## 5.9 Banking structure in Bahrain

Many studies have stressed the importance of financial structure and market structure factors in studying the banking sector risk (Naceur and Goaied, 2001). Athanasoglou et al. (2014) included bank size as a determinant of banks' risk. Influence of financial structure indicators such as capital ratio and bank cost to income ratio of banking sector have also been examined (Goddard et al., 2011; Hughes et al., 2001). Regarding the control variables, I use data from SNL. The study controls important bank characteristics namely: size, cost to income ratio, total deposits, and capital ratio. Size and total deposits exhibit a considerable degree of skewness and are therefore log-transformed. Size is calculated as the natural logarithm of all assets owned by the bank and controls for economies of scale (also called the size effect in the literature). Big firms are more complex and require integration in the board of director to tackle the challenges and decrease risks (Dalton et al., 1998).

Additionally, Athanasoglou et al. (2014) argued that large banks enjoy lower unitary costs and bigger diversification than small banks which improves banks' performance and decrease the risk. Faccio and Parsley (2009) also found that large firms are less likely to be harmed if the political connection is unexpectedly dismissed. Following Naceur and Goaied (2001), I further use the total deposits, that is total amount of deposits from customers. Previous studies showed evidence that banks with a high level of deposits are more likely to provide loans competitively

and increase profitability (Naceur and Goaied, 2001). However, deposit coverage generates a moral hazard for banks excessive risk-taking. Keeley (1990) suggested that excessive deposit base of the bank lead to an increase in risk propensity. Diamond and Dybvig (1983) showed that banks' deposit may cause bank funding liquidity risk, which is the driver of bank runs. Hence, deposit in the model must be controlled.

Further, the study uses bank equity to total assets (capital ratio), as our model builds on the literature on bank performance which shows that better diversified and capitalised banks are associated with greater risk reduction see for example (Berger and Bouwman, 2013; Chan-Lau et al., 2015). Previous research also showed that the bank cost to income ratio reflects the managerial efficiency reflected the bank's running costs, and is positively associated with banks' risk (Goddard et al., 2011). Hughes et al. (2001) showed that economies of scale reduces the marginal cost of risk management, which in turn decreases the bank risk appetite.

Additionally, the study controls a few corporate governance variables namely: BOD size, BOD composition and Big4. BOD Size refers to the board of directors' number. Banks with larger board members tend to be more diverse which decrease the banks risk (Estélyi and Nisar, 2016). BOD Composition refers to the number of non-executive directors. Prior research demonstrates that the independence of the board is an essential factor in ensuring effective management performance. (Provan, 1980), and (Zald, 1967) argued that non-executive directors are positively associated with better firm performance and less risk. BOD Composition is the number of non-executive (also called independent) board of directors divided by the number of the board of directors. The literature suggested that independent directors are more efficient (Estélyi and Nisar, 2016). Big 4 is a dummy variable that identifies if the bank's external auditor is one of the Big 4 companies (Price water house Coopers (PwC), Deloitte & Touche (D&T), Ernst & Young (E&Y), and KPMG).

Using the Big 4 auditor gives a clear picture that the insiders are keen to improve transparency and governance in the firm and stay away from using their connections to achieve any personal benefits. In countries with weak institutional environments Big 4 audits are more valuable and exhibit high levels of transparency Bliss and Gul, 2012a; Guedhami et al., 2014; Wallace et al., 1994. Piotroski et al. (2015) page 3 explained that: "transparency will limit the ability of politicians and managers to consume their private benefits of control by exposing poor governance".

The study reports in Table 5.1 some summary statistics about all banks from 2015 to 2019. The numbers represent time-series averages of the annual cross-sectional mean, standard deviation, minimum and maximum value for each variable. In our sample, around 30% of the banks are politically connected. The loan loss provision for the politically connected banks is substantially higher than their non-

Table 5.1: Summary Statistics

| Variables | Mean | Standard Deviation | Min | Max |
|---|---|---|---|---|
| **All banks** | | | | |
| Pc | .294 | .457 | 0 | 1 |
| LLP | 18.52 | 36.23 | -62.11 | 191.9 |
| Total Assets | 39,591 | 83,739 | 13,284 | 386,386 |
| Total Deposits | 23,007 | 55,152 | 0 | 245,480 |
| Total Equity to Assets% | 30.84 | 34.95 | -259.40 | 98.83 |
| Cost to Income% | 55.24 | 26.63 | 0.40 | 156.5 |
| BOD Number | 9.19 | 2.61 | 3 | 22 |
| BOD Foreign | 5.39 | 2.77 | 0 | 15 |
| BOD Composition | 0.57 | 0.23 | 0 | 1.09 |
| Big4 | 0.77 | 0.41 | 0 | 1 |
| **Connected banks** | | | | |
| LLP | 36.25 | 51.65 | -62.11 | 191.9 |
| Total Assets | 91,194 | 118,170 | 112,767 | 386,386 |
| Total Deposits | 55,804 | 77,131 | 1,138 | 245,480 |
| Total Equity to Assets% | 20.98 | 16.11 | 0.43 | 59.76 |
| Cost to Income% | 55.14 | 29.84 | 0.40 | 113.30 |
| BOD Number | 10.38 | 2.38 | 7 | 17 |
| BOD Foreign | 3.14 | 3.27 | 1 | 10 |
| BOD Composition | 0.65 | 0.23 | 0.09 | 1 |
| Big4 | 0.65 | 0.48 | 0 | 1 |
| **Non-Connected banks** | | | | |
| LLP | 11.14 | 24.05 | -21.73 | 108.2 |
| Total Assets | 18,090 | 51,220 | 132.80 | 295,875 |
| Total Deposits | 9,342 | 35,124 | 0 | 203,488 |
| Total Equity to Assets% | 34.95 | 39.63 | -259.40 | 98.83 |
| Cost to Income% | 55.29 | 25.21 | 15.69 | 156.5 |
| BOD Number | 8.69 | 2.55 | 3 | 22 |
| BOD Foreign | 4.71 | 3.16 | 0 | 17 |
| BOD Composition | 0.53 | 0.22 | 0 | 1 |
| Big4 | 0.82 | 0.38 | 0 | 1 |

politically peers 36.25 for treated banks vs 11.14 for the controlled group which suggest that political connection might be riskier than non-politically connected banks.

There are two features though for which the two sub-samples differ. The first one is size, as measured by total assets for which treated banks appear to outsize the controlled banks. The second one is the total deposits, politically connected banks total deposits are drastically higher compared to non-connected peers 55804 million and 18090 million, on average, respectively. Noticeably, the average of the total equity to total assets ratio is 30% in all banks which is quite low. Although the capital ratio for the non-politically connected firms is the same at almost 34%, the total equity to total assets ratio for politically connected banks is 20%, which suggested that politically connected banks are riskier, compared to the non-politically connected banks as they depend heavily on debt. Furthermore, the cost to income ratio for sample, politically connected and non-politically connected is 55% which is quite high as well. Indeed, governance variables for the treated and control banks look very much alike. For instance, the BOD Size is 10 for treated banks vs. 8 for control banks.

In politically connected banks the board of director numbers is higher compared to non-connected banks. Board number reflects a high level of diversity and less risk (Estélyi and Nisar, 2016). BOD foreign is 3 for treated banks vs. 4 for control banks. Moreover, BOD composition is 66% of the treated banks while is 53% for the control banks. Finally, interestingly, 65% of the treated firms were audited by the big 4 companies vs 82% of the control banks. Piotroski et al. (2015) Big 4 companies help companies to increase transparency, however, transparency limits the ability of politicians and managers to achieve their benefits.

Table 5.2: Correlation Matrix

| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) | (10) | (11) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| (1) | 1 | | | | | | | | | | |
| (2) | 0 | 1 | | | | | | | | | |
| (3) | 0.317* | −0.023 | 1 | | | | | | | | |
| (4) | 0.399* | −0.006 | −0.061 | 1 | | | | | | | |
| (5) | 0.385* | −0.002 | −0.074 | 0.189* | 1 | | | | | | |
| (6) | −0.183* | 0.027 | −0.198* | −0.223* | −0.234* | 1 | | | | | |
| (7) | −0.003 | −0.019 | −0.069 | −0.078 | −0.095 | 0.195* | 1 | | | | |
| (8) | 0.220* | −0.013 | 0.068 | 0.077 | 0.065 | −0.152 | −0.083* | 1 | | | |
| (9) | −0.220* | 0.007 | −0.202* | 0.026 | −0.041 | −0.094 | −0.018* | 0.352* | 1 | | |
| (10) | −0.190* | 0.016 | 0.010 | 0.107 | 0.103 | −0.083 | −0.281* | −0.125 | 0.292* | 1 | |
| (11) | 0.236* | 0.003 | 0.359* | −0.172* | −0.160* | −0.089 | 0.026 | 0.178* | −0.221* | −0.134 | 1 |

Table 5.2 shows the correlation analysis. it shows a small correlation between the dependent variables and independent variables Additionally, the table shows

no collinearity between the independent variables. The variables of interest are (1) PC, (2) Blockade, (3) LLP, (4) Total Assets, (5) Total Deposits, (6) Total Equity to Assets, (7) Cost to Income, (8) BOD Numbers, (9) BOD Foreign, (10) Big4, (11) BOD Composition, taking the value from 1 to 11 in the correlation table, respectively.

Liu et al. (2014) argued that a correlation coefficient of 0.8 or higher (in absolute value) may be a sign of multicollinearity problem. Since there is no correlation with the absolute value of more than 0.7, the issue of multi-collinearity does not exist in our sample. The correlation analysis reveals that political connection correlates positively and significantly with Loan loss provision, total assets and total deposits. However, total equity to total assets ratio, big 4 and foreign board of directors negatively associated with political connection. In general, the results of the correlation matrix suggest that political connection have a significant impact on various banks variables.

## 5.10 Empirical Analysis

Our empirical models explore whether the presence of political ties in the banks' board of directors is systematically associated with higher banks' risk. To answer this question, I exploit Qatar blockade exogenous shock to measure the effect of political connection on banks risk following the crisis. The study applies a difference-in-differences model to examine the effect of political connection on banks' risk. Additionally, the study interact the political connection variable with the bank covariates with year dummies and countries dummies to estimate the effect of political connection on banks' risk. With the aim of accurate drive evaluation of the Qatar blockade crisis effect on banks' risk, the study interacts the crisis dummy with the banks' covariates. Following Bertrand et al. (2004) I will run two periods DID where temporal information is collapsed into two periods.

$$LLP_{it} = \alpha + \beta_1 PC_i + \beta_2 B_t + \beta_3 PC_i B_t + \sum_{j=q}^{q} \beta_j X_{it} * PC_i + \sum_{k=q}^{q} \beta_k X_{it} PC_i B_t + \epsilon_{it} \quad (5.3)$$

Where $LLP_{it}$ is the indicator for bank risk, $i$ donates the bank and $t$ donates the year; $PC_i$ is a political connection indicator that is equal to one if a bank $i$ is connected and zero otherwise. $\epsilon_{it}$ is an error term assumed to be independently identical and normally distributed with zero mean and constant variance. $B_t$ is equal to unity for 2017 (the blockade year) and zero otherwise. $x_{it}$ is a vector of observed characteristics. The coefficient $\beta_1$ measures the difference in the profitability of politically connected and non-connected banks, $\beta_2$ captures the banks' risk response to the blockade crisis. At the same time, $\beta_3$ is the interaction between the blockade

crisis and political connection dummy variable measuring the effect of the exogenous shock on politically connected banks' risk. $\beta_j$ capture the interaction between the bank covariates and the political connection variable to investigate the effect of the core factors on the connected banks and non-politically connected banks' risk. $\beta_k$ capture the interaction between the bank covariates and the political connection variable to investigate the effect of the core factors on the politically connected banks and non-politically connected banks' risk during the Qatar Blockade crisis. Throughout this paper, I cluster the standard errors at the bank level to mitigate concerns about heteroscedasticity and serial correlation of error term (Petersen, 2009).

## 5.11 Results

Table 5.3 presents the results for DID regressions. These models show that politically connected boards have a positive and significant impact on banks' risk. Interestingly, in coloumn (1) the coefficient magnitude of the political connection variable is extensive. Politically connected banks LLP is 64 times higher than non-connected banks. In column (3) the number holds high, 52, when we controlled for corporate governance variables. The results show that politically connected banks in Bahrain are extremely riskier than non connected banks and suggesting that these banks carry more debt and have less reliable LLP non connected banks. Several studies found evidence that politically connected banks are more likely to receive support from the government in times of crisis (Blau et al., 2013; Borisov et al., 2016); thus these banks are more likely to drawn in risk taking activities Kostovetsky (2015).

These findings support Hypothesis 1 and agree with previous studies investigating the impact of political connection on risk, especially in emerging countries e.g., (Bliss and Gul, 2012a; Boubakri, Cosset and Saffar, 2012; Carretta et al., 2012; De Nicolò and Loukoianova, 2007; Leuz and Oberholzer-Gee, 2006). The results suggest that these connected banks enjoy lower capital cost (Boubakri, Cosset and Saffar, 2012) and are more likely to receive favorable terms for loans (Houston et al., 2014).

The coefficient of interest is the double interaction term of the political connection and blockade that shows politically connected banks is 485 times riskier than the unconnected banks in Bahrain during the blockade crisis.

The result shows that during the crisis, politically connected banks tend to be extremely riskier than non-connected counterparts. During the Qatar blockade, international investors and portfolio managers were worried about the efficiency of their investment in the banking sector in Bahrain which affected the economy badly. The main variable of interest, the DID variable shows that during the blockade

crisis, politically connected banks was extremely risky. The coefficients on bank's risk during the blockade crisis in columns 1, 2 and 3 are 485.1, 382.5 and 298.4. In column 3 when we control for all the corporate governance variables, the results indicate that politically connected banks are 298.4 times on average riskier that no connected banks, and it is statically significant at 5%. This number is extensive and very worrying.

During the crisis most of the banks especially, politically connected banks borrow money, and there is the risk that loans may not be repaid or may be repaid later than the expiry date of the loan, the banks would have to increase loan loss provisions due to change in loan quality. Politically connected banks can write off the loans with the expectation that the ruling family in Bahrain will support the bank. However, the connected banks have already set-aside some loan loss provisions to mitigate this risk since banks are aware that it is not guaranteed that the royal family will pay their debt, demanding banks to keep higher provisions.

The Bahraini economy has witnessed a record-breaking year for the whole country in 2017. After the blockade borrowing interest rate of inter-banks in the wholesale banking market increased from 1.6% in January 2017 to reach 2.7% by December (Central bank of Bahrain 2018). This increase reflects a mild liquidity decline due to a contraction in deposit growth as the government has drawn down reserves and corporate growth has slowed down. This is in line with the findings (Acemoglu and Johnson, 2005) and (Fan et al., 2007) identifying the misalignment between the political connection and firms' performance in countries with fragile property rights and low investment rates. Results also reveal that connected banks suffer more when an exogenous shock happens, which limits the government's ability to offer privileges and support. The exogenous shock increases the systematic risk and affects the government's ability to offer support (Fisman, 2001) , Johnson and Mitton (2003) and (Ebrahim et al., 2014). In 2018 and after the Qatar blockade crisis Bahrain has introduced bankruptcy law that includes insolvency legislation, which enables companies that face financial challenges to restructure under court supervision and allow business greater access to credit.

Besides our main variable of interest, we also tackle our control variables. Starting with column (1), the study finds a positive and statistically significant coefficient of our main variable of interest, which is political connection. A central question in the governance studies is whether the board characteristics have many effects on the firms' outcome. Many prior empirical studies with mixed findings investigated the effect of politically connected board of directors on firms. The results continue to hold in column (2) and (3) when the study controls a variety of governance variables including BOD number, BOD Foreign, BOD Composition and Big 4.

Notably, the study finds evidence that larger banks are riskier compared to small

banks. In column 2 and 3, the coefficient on bank's size is -21.50 and -18.26 which indicated that larger banks are 21% to 18% less risky on average relative to small banks, and it is statically significant at 10%. These results consist the previous finding of (Athanasoglou et al., 2014) and Faccio and Parsley (2009), who argued that large banks enjoy lower unitary costs and bigger diversification than small banks which improves banks' performance and decrease the risk.

Our analysis goes one step further and includes interactions between the main variables and the political connection variable. The results show that the total equity to total assets ratio negatively and significantly affects politically connected banks' risk. The coefficients on the capital ratio are significantly negative at 1% in model 1 and 5% in module 2 and 3. The coefficients of equity to assets ratio for politically connected banks relative to non-connected banks in column 1, 2 and 3 are 2.3, 3.3, 3.09 respectively, indicating that politically connected banks are better diversified and capitalised banks.

Finally, we interacted with the main variables with the political connection dummy variable and the blockade crisis dummy. The relationship between equity to assets ratio and risk for politically connected banks relative to non-connected banks holds, indicating that politically connected banks are better diversified and capitalised banks during the crisis, however, after controlling of the corporate governance variables the coefficient turns to be insignificant.

In addition, the study finds that the proportion of the foreign board of directors negatively associated with banks' risk. This seems to imply that foreign board members are more likely to be motivated to face strategic challenges that lead to less risk. In column 2 and 3 the coefficient of foreign directorship indicates banks with foreign directors on the board are 4.1and 3.3 times less risky respectively and it is statically significant at 5%. The results are consistent with (Carter et al., 2003) findings that revealed that national cultural diversity increases banking stability and decreases risk and (Oxelheim and Randøy, 2003) who argued that foreign directorship is a source of the foreign network. Our analysis documents the following new findings. Firstly, consistent evidence reveals that highly diversified banks are less risky than their highly focused counterparts. These results support our hypothesis and prior research that foreign directorship decrease banks' risk. A negative relationship between the foreign directorship and risk suggests that foreign directors' benefits the board of directors and increase the diversity of skills and knowledge.

The results also show that Big 4 significantly and positively affect the banks' risk. (Guedhami et al., 2014) argued that Big 4 auditor improves the transparency and the governance in the firm and more likely to report loss. This suggests that firms with big 4 auditors are risky as they are more likely to report bad news and loss. We also find a positive association between board composition and risk. The

results contradict the previous literature (Provan, 1980), and (Zald, 1967) that non-executive directors positively combined with less risk. This result indicates that the Bahraini banks different from other banks in developed countries and independent board of directors' increase conflicts and the risk in the bank.

We next run the regression controlling for years' effect to further enrich our identification for the causal effect of political connection and banks' risk in table 5 The effect of political connection on risk continues to be significant at 5% before and after controlling for corporate governance variables and year effect. The DID coefficient hold significant and substantial as well at 1% and 5% in column (1) and (2), (3) respectively.

In sum, the study finds strong evidence that politically connected banks in Bahrain increase the risk in banks and the effect is large and substantial during the crisis. Finally, the results confirm the negative association between the foreign directorship and banks' risk.

Collectively, these results support our hypothesis and prior research that politically connected banks are riskier than non-connected banks. This suggests that the value of having a politically connected board of directors to the royal families or parliament members on banks' risk is economically extensive.

Table 5.4 shows the parallel trend assumption formal test. By regress the interaction of political connection variable with the year before the crisis and one year after the crisis on the banks risk measurement, column 1 shows that the effect of political connection before the Qatar blockade crisis. The effect of political connection is insignificant in the years before the crisis. However, it is significant in the year after the crisis. Reassuringly, the result suggests a similar trajectory of the two groups before the crisis. In column (2) results are consistent with what is reported in column (1) as the coefficient estimates for political connection interaction with the year before crisis dummy is insignificant, meanwhile, coefficient estimates for the interaction of political connection and the year after the crisis are bigger and more significant. This suggests that politically connected banks and non-politically connected banks follow the same trend pre the blockade crisis in terms of risk-taking. Therefore, the key assumption of the difference-in-difference model used in the paper is satisfied.

## 5.12 Conclusion

This study investigate the effect of political connection on banks' risk in Bahrain. The study exploits Qatar blockade exogenous shock to reveal the causal effect of political connection on risk using DID. The study depends on primary political connection data manually collected from annual reports and other official websites.

Table 5.3: Political Connection Effect on Banks' Risk

| Variables | (1) | (2) | (3) |
|---|---|---|---|
| PC | 64.29** | 55.72** | 52.73** |
| | (30.08) | (24.99) | (23.34) |
| Blockade | -5.539 | -2.685 | -1.497 |
| | (4.004) | (4.881) | (4.882) |
| PC*Blockade | 485.1*** | 382.5** | 298.4** |
| | (156.0) | (142.0) | (109.2) |
| Log Total Assets | -8.237 | -21.50** | -18.26* |
| | (8.344) | (9.973) | (9.691) |
| Log Total Deposits | 3.450 | 9.036* | 7.656 |
| | (4.805) | (4.848) | (5.606) |
| Total Equity to Assets | 0.0557 | -0.0124 | -0.0321 |
| | (0.126) | (0.142) | (0.124) |
| Cost to Income | -0.288 | -0.207 | -0.148 |
| | (0.210) | (0.157) | (0.168) |
| Log Total Deposits*PC | -11.60 | -18.03 | -17.92 |
| | (8.232) | (12.69) | (11.59) |
| Total Equity to Assets*PC | -2.396*** | -3.261** | -3.098** |
| | (0.838) | (1.270) | (1.163) |
| Cost to Income*PC | 0.252 | 0.262 | 0.196 |
| | (0.219) | (0.217) | (0.206) |
| Log Total Assets*PC | 10.39 | 18.96 | 18.77 |
| | (8.026) | (12.22) | (11.13) |
| Log Total Deposits*PC*Blockade | -4.290 | -28.83 | -21.33 |
| | (18.59) | (21.36) | (18.70) |
| Total Equity to Assets*PC*Blockade | -2.731** | -3.204** | -2.194 |
| | (1.118) | (1.545) | (1.301) |
| Cost to Income*PC*Blockade | -0.286 | 0.050 | 0.076 |
| | (0.180) | (0.190) | (0.178) |
| Log Total Assets*PC*Blockade | -22.28 | 7.206 | 3.885 |
| | (23.85) | (24.79) | (21.99) |
| BOD Number | | -1.082 | -1.700 |
| | | (1.883) | (1.803) |
| BOD Foreign | | -4.102** | -3.373** |
| | | (1.601) | (1.364) |
| Big 4 | | 37.18** | 34.45** |
| | | (14.94) | (12.37) |
| BOD Composition | | | 40.26** |
| | | | (17.38) |
| Constant | 109.7 | 219.9** | 171.0* |
| | (77.21) | (97.43) | (91.18) |
| Observations | 119 | 113 | 113 |
| R-squared | 0.334 | 0.484 | 0.536 |

$^{***}p < 0.01$, $^{**}p < 0.05$, $^{*}p < 0.1$

Table 5.4: DID identification (Parallel Trend Assumption)

| **Variables** | **(1)** | **(2)** |
|---|---|---|
| PC* 2016 | 7.762<br>(9.291) | 5.866<br>(10.09) |
| PC* 2018 | 20.48*<br>(10.57) | 20.32**<br>(9.367) |
| Log Total Assets | | -9.746<br>(9.350) |
| Log Total Deposits | | 5.622<br>(6.195) |
| Equity to Assets% | | 0.0551<br>(0.129) |
| Cost to Income% | | -0.286<br>(0.0472) |
| PC*Log Total Deposits | | -7.496<br>(9.667) |
| PC*Equity to Assets% | | -1.611*<br>(0.892) |
| PC*Cost to Income% | | 0.246<br>(0.253) |
| PC*Log Total Assets | | 8.355<br>(9.437) |
| PC*Log Total Deposits*Blockade | | -19.46**<br>(8.976) |
| PC*Equity to Assets%*Blockade | | -0.942<br>(0.651) |
| PC*Cost to Income%*Blockade | | 0.0392<br>(0.0786) |
| PC*Log Total Assets*Blockade | | 20.20**<br>(9.086) |
| Year | | -1.857<br>(1.879) |
| Constant | 16.77***<br>(5.725) | 3,854<br>(3,788) |
| Observations | 170 | 119 |
| R-squared | 0.020 | 0.143 |

$^{***}p < 0.01$, $^{**}p < 0.05$, $^{*}p < 0.1$

Table 5.5: Political connection effect on banks' Risk (Year Control)

| **Variables** | **(1)** | **(2)** | **(3)** |
|---|---|---|---|
| PC | 65.28** | 56.05** | 53.05** |
| | (29.49) | (24.12) | (22.45) |
| Blockade | -5.501 | -2.567 | -1.381 |
| | (3.987) | (4.826) | (4.853) |
| PC*Blockade | 487.1*** | 379.4** | 295.4** |
| | (157.4) | (144.9) | (111.3) |
| Log Total Assets | -8.020 | -21.53** | -18.29* |
| | (8.292) | (9.924) | (9.553) |
| Log Total Deposits | 3.266 | 8.917* | 7.537 |
| | (4.748) | (4.804) | (5.550) |
| Total Equity to Assets | 0.0416 | -0.0262 | -0.0457 |
| | (0.125) | (0.141) | (0.121) |
| Cost to Income | -0.289 | -0.207 | -0.149 |
| | (0.214) | (0.161) | (0.172) |
| Log Total Deposits*PC | -10.86 | -17.32 | -17.22 |
| | (8.341) | (13.02) | (11.92) |
| Total Equity to Assets*PC | -2.342** | -3.214** | -3.051** |
| | (0.841) | (1.283) | (1.176) |
| Cost to Income*PC | 0.245 | 0.256 | 0.190 |
| | (0.220) | (0.221) | (0.209) |
| Log Total Assets*PC | 9.604 | 18.23 | 18.05 |
| | (8.172) | (12.56) | (11.50) |
| Log Total Deposits*PC*Blockade | -4.700 | -30.64 | -23.14 |
| | (18.99) | (22.12) | (19.22) |
| Total Equity to Assets*PC*Blockade | -2.779** | -3.306* | -2.297 |
| | (1.172) | (1.602) | (1.341) |
| Cost to Income*PC*Blockade | -0.279 | 0.0610 | 0.0870 |
| | (0.181) | (0.199) | (0.186) |
| Log Total Assets*PC*Blockade | -21.99 | 9.238 | 5.907 |
| | (24.13) | (25.62) | (22.57) |
| BOD Number | | -0.914 | -1.533 |
| | | (1.944) | (1.848) |
| BOD Foreign | | -4.245** | -3.516** |
| | | (1.662) | (1.410) |
| Big 4 | | 38.01** | 35.28** |
| | | (15.24) | (12.65) |
| BOD Composition | | | 40.24** |
| | | | (17.14) |
| Year | -2.304 | -2.335 | -2.322 |
| | (1.572) | (2.082) | (2.100) |
| Constant | 4,756 | 4,930 | 4,855 |
| | (3,176) | ((4,204) | (4,243) |
| Observations | 119 | 113 | 113 |
| R-squared | .34 | .49 | .542 |

$^{***}p < 0.01$, $^{**}p < 0.05$, $^{*}p < 0.1$

The dataset covered all the banks in Bahrain for the period from 2015 to 2019.

To investigate the factors that may affect banks risk I collected financial data from SNL and corporate governance data from the banks' annual reports including: Size, Cost to income ratio, Total deposits, Capital ratio,BOD size, and BOD Composition and Big4. The results show that politically connected banks are riskier than non-connected banks and it became extremely risky in the crisis time compared to non-connected counterparts. The finding is consist with the claim that politically connected banks suffer more during the crisis times as crisis weakens the government's ability to provide subsidies and support the firms. Also, connected banks do not have enough precautions for the crisis as they depends on their political connection and their expectations to be rescued by the governments during the crisis. Bahrain Economic Development Board (EDB) generated inward investment to Bahrain doubled over the year to US$ 733 million, supporting robust non-oil sector expansion and creating greater than 2,831 jobs in the wider economy.

The Bahraini government has introduced new policies and key initiatives have been introduced by the Bahrani government after the crisis. In October 2017, the Central Bank of Bahrain (CBB) established a resolute FinTech Unit to support the financial services sector in developing new technologies and innovation in the field. Bahrain is the hub of digitization as it is the first country in the region to introduce an onshore FinTech regulatory sandbox, and more traditional banks to innovate in the financial services industry. Competition Law Bahrain launched a new Competition Law to promote fairness and combat any anticompetitive practices (Central Bank of Bahrain report 2019). Additionally, the government introduced a Bankruptcy Law Bahrain will that strengthen the insolvency framework procedures to avoid of preferential transactions. Finally, in early 2018 the government is also planning to introduce a value-added tax (VAT). According to the IMF report 2018, VAT could give Bahrain a fiscal boost of around 2% of GDP – equivalent to approximately one year of current economic output.

Additionally, the study finds a negative association between the proportion of the foreign board of directors and banks' risk. This seems to imply that foreign board members are likely to be motivated to face new challenges and strategic challenges that lead to less risk.

Understanding the effect of political connection on banks risk in Bahrain which is dominant by royal families, has some important policy implications and may allow banks, investors, and GCC policy makers to take precautionary actions to mitigate the risk ,especially during the crisis times. The rift took investors by surprise, and disrupted business activity; it has thereby added to investors' perceptions of political risks for the Gulf as a whole. For instance, politically connected banks risk increased dramatically during the crisis. Hence, banks should find ways to

improve their performance without relaying on the government support to avoid being exposed to higher risks during the crisis. The results help us to understand better the effect of political connections and board diversification in the GCC region.

The study can give the bank directors an idea of banking development in Bahrain by having politically connected members on the board . To achieve sustainability, firms must acquire a balance between risk and profit to avoid risk-taking excessively due to non-alignment of bank strategy, as conventional risk portfolio destroys the ability to deliver market competitiveness.

Investors can benefit from this paper by considering the risks associated with politically connected banks during the blockade crisis when they take their investment decisions that can be transmitted from one market to another in this connected region.

Additionally, policy makers in the GCC must be careful when they take any political decision, as its effect most probably will affect the economy of the entire region. Additionally, providing evidence of the political patronage relevance when considering risk-taking behaviour, the results are of importance to the investors and financial inter-mediators to understand the factors that affect the banks' risk. In particular, for the banking sector, politically connected banks gravitate toward overwork their connection to maximise their profits by engaging in riskier activities consistent with the moral hazard theory.

Thus, the political connection in banks is an important factor that regulators and market participants should carefully consider ensuring their competitiveness and efficiency.

Milken Institute report points to recent policy that Bahrain's government has been introduced has a fruitful impact to increase transparency, protect investors, align with international standards, and modernize access to Bahrain's capital markets.

This study is subject to some limitations, which are expected to be overcome by future studies. First, this study uses the banks is Bahrain to investigate the effect of political connection and foreign directorship on banks' risk. Hence, future studies should address the effects of firm performance in the GCC countries. Secondly, the study could examine the effect of political connection on the corporate governance quality and disclosure before and after the crisis.

Furthermore, even when banks do not increase their loans during the crisis, banks will still increase general provisions in response to the blockade crisis uncertainties that may affect the loan portfolio of banks in the banking sector.

The mission of the BIS is to promote monetary and financial stability in the financial system of member countries. Sufficient provisioning can act as a cushion to absorb some unexpected losses in abnormal periods, thereby contributing to financial

stability.

# Chapter 6

# Conclusion

Political connections in the Middle East in general, and the GCC countries specifically, are not only safety nets that firms employ to improve their performance, in accordance with resource dependence theory, but they are also deeply rooted in the socio-economic and cultural systems of the GCC region. This thesis offers an extensive analysis to understand the dynamics of political connection by conducting four studies which provide crucial signposts to address some of the central arguments within the GCC banking sector.

The first study moves beyond a simple transitory measurement of the impact of political connection: it analyses the political connection literature over a period of 20 years. Moreover, it presents a catalogue of the influential aspects resulting from a bibliometric meta-analysis of political connection literature; metrics considered include countries, authors, articles, and topics, supported with advanced visualisation techniques. The second study investigates the relationship between political connection and capital structure in the GCC banks by using a unique political connection dataset which has been manually collected from various databases. The third study fills in an important gap in the literature because it constitutes the first attempt to measure the impact of political connections on the performance of banks in the case of Bahrain, also highlighting the role of sport in thawing conflicts and exploring the effect of the Qatar blockade. Finally, the fourth study considered the relationship between the political connections of board of directors of the Bahraini banks and their risk profiles, with a focus on the Qatar blockade crisis and foreign directorship. While there are limitations to all four of these studies, each of them significantly adds to the existing political connection literature.

The main findings indicate that; political connections are a 'double-edged sword'. The value of the political connection depends on several factors. A significant factor is the quality of the institutions. The burgeoning of institutional research in the past three decades, the rise of new institutional economics and developments in related interdisciplinary fields has resulted in considerable agreement among social

scientists on the potential of institutions to shape economic and social outcomes. Furthermore, the results of our quasi-experiment show that the presence of political connection in the GCC banks results in a leverage reduction. However, our results oppose the claim that politically connected firms are more likely to sustain debt.

The findings suggest that GCC countries (as cash rich countries) are employing risk reduction strategies adopted by regulated industries. Furthermore, after the 2008 crisis, the study finds a statically significant negative association between directors' political connection and the leverage ratio. Additionally, of particular of interest, and one of the primary findings of our thesis is that of political connection positively affecting banks' profitability in Bahrain. Despite the appreciable effect of the Qatar blockade crisis 2017, and its impact on the entire banking system in the region (including boycotting and boycotted countries), the study finds evidence that the profitability of politically connected banks is significantly negatively impacted during the crisis. There is also evidence of a thawing of the rift in the relationship between certain countries in the region. It also shown that there is a strong evidence of a significant positive relationship between bank risk and political connection. The results are consistent with moral hazard theory in respect of how government interventions incentivise organisations. More importantly, our results find evidence that the effect of political connection is substantial and increased dramatically post crisis. Even allowing for Bahrain being one of the boycotting countries, the effect of the crisis on risk, especially for politically connected banks, was extreme. In addition, the regression results provide evidence for a negative relationship between foreign directorship and banks' risk: the presence of foreign directors would appear to enhance the overall competence of the board of directors. Lastly, but of particular interest, national cultural diversity increases banking stability and decreases risk.

The findings of the first study, which comprises a bibliometric meta-analysis review, indicates that there are six main clusters in political connection literature. Communities are organized according to a hierarchical clustering algorithm that sorts communities based on similarity. The clusters are as follows: (i) the value of the political connection, (ii) the association between political connection and finance, (iii) political connection in banks, (iv) the relationship between debt and political connection, and (v) the association between management and political connection, and (vi) the correspondence between political connection and governance. The study concludes that political connections are "mixed blessings". The value of political connection depends on several factors. Firstly, the quality of the institutions. Secondly, government enforcement can play a role to mitigate the negative effect of political connections. Thirdly, the effect of political connection is magnified during times of crisis and elections.

There are several practical and policy implications that may be drawn from these

findings. This study unlocks fruitful avenues of research in political connection by offering a comprehensive analysis of the current literature. An implication of the findings of this study is that the institutional environment and the state-of-crisis (if any) should both be considered when investigating the effect of political connection on firms. Another important practical implication, which became apparent during the literature review process, is that a sole dependence on citations from Google Scholar might be misleading because it could result in non-academic research being included. A reasonable approach to tackle this issue is to depend more on academic databases, such as Web of Science or ProQuest, to gain more credible academic information. This study should also encourage researchers to use visualization software to conduct bibliometric analysis instead of the more traditional techniques. Using visualization techniques in developing the literature analysis provides more information about the topics in an intuitive and appealing format which could help policymakers to better understand the magnitude of certain problem scenarios. It could also facilitate research co-ordination amongst disparate fields, assisting the subsequent development of strong research ideas.

Abundant scope exists for further progress in understanding the political connection literature. The review of the literature concludes that, although there exists widespread literature concerning political connection, many research gaps remain. In terms of countries, even though the effect of political connection has been widely investigated in the USA, China and some developing counties, there is a deficit of literature covering the political connection topic in other countries and regions with different institutional environments (such as the GCC and Latin America). The present study encourages future researchers to focus on these regions.

The main findings of the second study using the GMM model show that political connection is, indeed, one of the determinants of the capital structure in the GCC banks. Additionally, the DID empirical results reveal a negative association between political connections and banks' leverage. Politically connected banks depend less on external resources and this changes slightly during the financial crisis as these banks increase their leverage but not to as great an extent as the non-connected banks. Finally, for each country, the findings show that for all the GCC countries, except Qatar, there is clear evidence of a negative relationship between political connection and capital structure. Additionally, in the crisis period there is further evidence of de-leveraging, especially in Saudi Arabia and the UAE. Again, we see Qatar standing in contrast with an increase in debt. There is some evidence, in general, that leverage in non-politically connected firms increases during the crisis.

These findings suggest several courses of action for both policymakers and other financial stakeholders. The study sheds light on the importance of political connection in capital structure decisions. The GCC region is characterised by the domi-

nance of royal families and permanent ruling regimes, weak rule of law, widespread corruption, and poor investor protection. It provides evidence of the relevance of political connection when considering capital structure decisions. The managers of banks should not rely entirely on their political connections when taking capital structure decisions and investors should be aware that the level of political connection is a primary factor affecting investment decisions made on their behalf. The negative relationship between political connection and capital structure could have increased the confidence of investors in politically connected banks because they did not depend heavily on debt during the time of the blockade crisis. In this time, UAE deleverage heavily while Saudi Arabia's politically connected banks marginally increase their debt. Qatari banks choose to greatly rely upon debt during this time. The study suggests a degree of caution exercised by governments regarding the level of support provided in order to avoid sending an erroneous signal to both investors and markets, which may negatively affect economic growth in the long term. This is especially so in the case of Qatar. The results here suggest that banks may receive differing levels of support as other calls are made upon a country's finances.

Notwithstanding the informative nature of the present research, further development is possible. This research considered only the core factors that affect capital structure decisions, and a snapshot of the relationship between political connection and capital structure from 2005 to 2016. This research could be expanded to consider more recent data. In addition, the institutional environment and corporate governance structure was not considered, which could lead to incomplete conclusions; this should be considered in future research. The findings of the third study suggest that political connection has a positive impact on banks' profitability. These results provide evidence of the influential role of political connection on banks' profitability in Bahrain. However, the Qatar blockade crisis resulted in a sharp decrease on banks' profitability. Although Bahrain was one of the boycotting countries, this finding suggests that the Qatar blockade crisis caused significant harm to the banking sector within the country. In the banking sector, politically connected banks tend to exploit their connections to maximise their profits and value. However, it is found that, during a time of crisis, politically connected banks suffer more than their non-connected counterparts; this is consistent with prior literature (Fisman,2001 and Faccio & Parsley, 2009). Hence, the network of politicians and banks should be carefully considered by regulators and market participants. Investors should exercise greater caution when they consider investing in politically connected banks, especially during times of crisis. The result of this study also suggests that regulators should monitor these banks closely to ensure their competitiveness and efficiency.

There is scope to further this research through the use of larger datasets: the analysis performed for the present research was limited to banks in Bahrain. An-

other limitation concerns the role of sport for economic development: this study did not measure the effect of FIFA 2022. However, if data becomes available, a profitable avenue of research would be the effect of the event on banks' performance. More generally, a comparison between the output of banks before and after different sporting events would be beneficial. This could be extended even further to include the effect of what may be deemed to be the effect of positive and negative events on banks' output, possibly using DID.

The final empirical study explored the relationship between the political connections of banks' board of directors and banks' risk in Bahrain through the lens of the recent Gulf crisis, and the effect of foreign directorship on banks' risk in Bahrain. The results demonstrate that strong evidence exists of a positive significant relationship between bank risk and political connection. The risk associated with politically connected banks during the Qatar Blockade crisis was especially high when compared to non-connected counterparts. The result is consistent with moral hazard theory and how government interventions incentivise particular behaviours. The study highlights that policy makers in GCC countries should exercise caution when making political decisions, because it is most likely that these decisions will affect the economy of the entire region. This finding is consistent with the claim that politically connected banks suffer more during times of crisis because crisis weakens government's ability to provide subsidies and generally support organisations. Also, connected banks are less likely to adopt precautionary crisis-management measures because they largely depend upon their political connections and have an expectation that government will "come to the rescue" during times of adversity.

The implications of these results are vitally important. Firstly, in order to avoid being exposed to higher risks during times of crisis, the managers of banks should find means to improve their performance and decrease their risk profile without relying upon governmental support or political ties. Secondly, the present research provides evidence of the relevance of political patronage when considering risk-taking behaviour; the results are of importance to investors and financial intermediaries in order to understand the factors that affect the banks' risk. In particular, for the banking sector, politically connected banks gravitate toward overworking their connections to maximise their profits by engaging in riskier activities, consistent with moral hazard theory. Thus, political connection in banks is an important factor that regulators should carefully consider to ensure competitiveness and efficiency in the sector. This also has implications for market participants. Finally, the results help researchers to better understand the effect of political connections and board diversification: a negative relationship between foreign directorship and risk suggests that the increased skillset and knowledge that foreign directors bring has a measurable impact upon banks' performance.

The present study is subject to a number of limitations, which can be addressed through future research efforts. Firstly, this study uses Bahraini banks as a vehicle to investigate the effect of political connection and foreign directorship on banks' risk. Future studies could investigate these effects on firm performance in other or all GCC countries. Secondly, future research could examine the effect of political connection on corporate governance quality and disclosure before and after the crisis. Bahrain is one of the boycotting countries and it would be beneficial to investigate the effect of the blockade on all the GCC countries and to perform inter-comparisons. Moreover, the banking sector in the GCC countries is highly connected and most of the boards of directors have a large number of foreign directorships, especially from other GCC countries. Hence, it is pertinent to investigate the effect of foreign directorship on banks' risk in all GCC banks. Another consideration resulting from this research is the identification of the countries of origin of foreign directors. Using this information, DID methodology could be employed to compare between banks that have a director from Qatar and those that have directors from any other country in the GCC, both pre and post Qatar blockade.

In conclusion, the four studies comprising the present research greatly enhance the political connection literature, yielding several new findings that not only expand the current literature, but also unlock further avenues for research. Similarly, the policy implications of this research are expansive, with several ramifications identified for bank managers, investors and regulatory authorities, together with proposals for potential solutions to enhance banks' performance. Moreover, with the march of time, an ever-increasing volume of data becomes available for future research efforts in international comparisons. Indeed, one, if not more, of these studies may comprise the seed for new and far-reaching directions of research into the relationship between political connection and the output of banks in the entire GCC region.

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