

# Effects of politically controlled boards on bank loan performance: an emerging economy perspective

Mohammed Mohi Uddin

*Department of Accounting, Economics, and Finance, University of Illinois Springfield, Springfield, Illinois, USA*

Mohammad Tazul Islam

*Dhaka School of Bank Management, Bangladesh Institute of Bank Management, Dhaka, Bangladesh, and*

Omar Al Farooque

*UNE Business School, University of New England, Armidale, Australia*

## Abstract

**Purpose** – In this study, the authors explore the effects of politically controlled boards on bank loan performance in both state-owned commercial banks (SCBs) and private sector commercial banks (PCBs) in Bangladesh.

**Design/methodology/approach** – The data consist of 409 bank-year observations from 46 sample SCBs and PCBs of Bangladesh for the period 2008–17. The authors apply ordinary least squares pooled regression with year fixed effect for baseline econometric analyses and generalized method of moments regression for robustness tests after addressing the endogeneity issue.

**Findings** – The regression results reveal that the presence of bank “boards controlled by politically affiliated directors” (PA) have significant positive effects on non-performing loans (NPLs). Similarly, the presence of “boards controlled by politically affiliated directors without substantial ownership interests” (PAWOI) show positive association with NPLs. In contrast, the presence of “boards controlled by politically affiliated directors with substantial ownership interests” (PAOI) exhibit an inverse relationship with NPLs. These findings support ‘agency conflict’ arguments and document that both PA and PAWOI are detrimental to bank loan performance in Bangladesh, while PAOI do not have significant effect on increasing NPLs.

**Originality/value** – This study contributes to the existing bank governance literature by providing evidence from an emerging economy perspective, where politically affiliated directors (PADs) exploit their positions for personal and/or political gain at the cost of other stakeholders by taking advantage of relaxed regulatory oversights and investor protections.

**Keywords** Bank governance, Politically controlled/affiliated boards, Ownership interests, Agency theory, Bangladesh

**Paper type** Research paper

## 1. Introduction

Although the effects of political connections within corporate boards on firm performance have received considerable attention worldwide from academics, researchers and policymakers (Ding *et al.*, 2014), relatively few notable studies (e.g. Carretta *et al.*, 2012; Hung *et al.*, 2017; Chen *et al.*, 2018) examine the effects of senior bank executives’ and board of directors’ political ties on bank operations and performance. Despite the above three studies



being closely related to the current research explored the phenomenon, the effects of bank boards controlled by politically affiliated directors (PA) [1] on bank loan performance of commercial banks have not been adequately addressed, let alone in the context of an emerging economy. Our study aims to fulfil this research gap by examining the effect of politically controlled boards on bank loan performance in the Bangladesh banking sector, both in SCBs and PCBs, where directors have no substantial ownership interest in the former type of banks. We also explore whether the status of ownership interests of PADs has any effect on bank loan performance.

The nature of business in the banking sector is fundamentally different from that in other sectors for a number of reasons, including regulations governing bank business, the way bank lending is financed (e.g. relying on depositors for the vast majority of funding) and the way banks do business. Government policies profoundly affect corporate governance and firm performance in emerging economy countries. It has become common practice for corporate entities to develop ties with top government officials and the ruling political party to extract benefits. This is more prevalent in the banking sector, as it is a highly regulated industry. The effect of instability in the banking sector can be severe for the whole economy of a country.

In the Anglo-Saxon corporate governance model, the board of directors plays a central governance role, representing the shareholders. Board members are supposed to monitor the functions of managers (agents) to address any agency conflict (i.e. Type 1 agency problem). They are also responsible for making organisational policies and undertaking fiduciary duties to protect the interests of the firm and its shareholders/stakeholders. Although companies in emerging economy countries such as Bangladesh follow Anglo-Saxon corporate governance models, the institutional environments in which banks in these countries operate are vastly different from those in developed economies. Especially, emerging economies are characterised by “poor financial transparency” (Fan *et al.*, 2007) and “weak rule of law” (La Porta *et al.*, 1999). The enforcement of regulations is also very poor in emerging economies. In the absence of strong regulatory oversights and investor protections, questions may arise as to whether the Anglo-Saxon corporate governance model is effective in an emerging economy context in addressing the ‘agency problems’ (Eisenhardt, 1989).

Again, other key features of emerging economy are high level of corporate political connections and corrupt political culture. Consequently, governance problems in commercial banks can arise when politically influential board members try to maximise their own benefits at the cost of principals, such as shareholders (see, Carretta *et al.*, 2012 [2]). In addition, the dual roles of boards in emerging economies (i.e. decision control [policy making] and decision management [performing routine functions]) can also contribute to increase agency costs. Thus, emerging economies, such as Bangladesh, provide a rich setting to explore the effects of politically controlled boards on bank loan performance.

Three closely related prior studies (Hung *et al.*, 2017; Chen *et al.*, 2018; Carretta *et al.*, 2012) show inconclusive relationships between the political connections of banks and bank performance. It can be noted that Hung *et al.* (2017) and Chen *et al.* (2018) focused on the political connections of Chief Executive Officers (CEOs) of commercial banks in China and Carretta *et al.* (2012) focused on Italian cooperative banks, which may not be generalised to different institutional settings and banks. The motivation for this study is derived from the need to address the research gap that exists in relation to the effects of boards controlled by PADs on bank performance from an emerging economy perspective. This paper aims to address this research gap. Consequently, our research questions are as follows: (i) Do bank boards controlled by PADs negatively affect bank loan performance?; (ii) Do bank boards controlled by PADs without substantial ownership interests (PAWOI) negatively affect bank

loan performance?; and (iii) Do boards controlled by PADs with substantial ownership interests (PAOI) negatively affect bank loan performance?

Our paper contributes to the existing bank governance literature as follows. First, scholars (Maaloul *et al.*, 2018) have recently called for an examination of the effects of political connections on the performance of financial institutions. Our paper is a response to this call by examining whether political control of board members affects loan performance, thus contributing to the fulfilment of this research gap. Second, our findings extend the growing body of literature (e.g. Hung *et al.*, 2017; Chen *et al.*, 2018; Carretta *et al.*, 2012) that examines the effects of the political connection between banks and bank performance [3]. More specifically, our study extends the limited research (e.g. Carretta *et al.*, 2012) that explores the effects of political affiliation on bank performance from a developed country perspective. Our study contributes to bank governance literature from the context of an emerging economy with distinct but ineffective institutional settings and a self-indulgent political culture/practice. Third, we also contribute to existing literature (e.g. Brickley *et al.*, 1988; Lin *et al.*, 2008) that suggests board members' level of ownership interests is a predictor of organisational performance in an emerging economy. Our research aims to extend the bank governance literature in the cases of SCBs and private sector commercial banks. To our knowledge, this is the first study testing the effect of ownership interests of PADs on bank loan performance. Finally, we draw on agency theory arguments to understand the effects of politically controlled boards on loan performance. While there is a plethora of research that used agency theory to explore the board characteristics and organisational performance, to the best of our knowledge, this is the first research from an emerging economy banking sector context where regulatory oversight is weak and board members participate in routine organisational decision-making.

The remainder of this paper is organized as follows: in Section 2, the background of Bangladesh's banking sector governance and research context are discussed. Section 3 briefly describes the theoretical framework, and Section 4 elaborates on empirical literature review and hypotheses development. The methodology, research design and data are described in Section 5, followed by empirical results and discussion in Section 6, and finally, a summary and conclusion in Section 7.

## 2. Institutional framework for bank governance in Bangladesh

There are 9 SCBs [4] and 43 PCBs in Bangladesh. In SCBs, board members are directly appointed by the government. These board members do not have any substantial ownership [5] interests in the banks (see, Agrani Bank Limited Annual Report, 2019 [6]). Conversely, board members in PCBs are nominated by the respective banks and must be approved by Bangladesh Bank (BB [7]). These board members [8] generally have substantial ownership interests in the banks. Most of the independent board members in PCBs are also nominated by shareholders/directors and have no substantial ownership interest in the banks.

In developing countries like Bangladesh, the role of board members is substantially different. Board members of both SCBs and PCBs in Bangladesh not only formulate lending and repayment policies and monitor the functions of bank managers on behalf of owners, but they also perform certain routine banking functions, such as approving large loans and rescheduling outstanding loans. When board members engage in routine lending decision-making, the role of the board deviates from typical corporate governance practice. We argue that such direct involvement of the board in major lending and loan recovery decisions in emerging economies such as Bangladesh creates another type of agency problem between board members and shareholders. Therefore, in the context of this different, albeit weak, governance practice and regulatory regime in Bangladesh, conducting the current research is justified and would contribute new knowledge to the literature.

In recent years, the government appointed a substantial number of board members mostly based on their political loyalty rather than their banking expertise (*The Daily Star*, 2009; *The Daily Prothom-Alo*, 2020). Recent newspaper reports show that PADs were responsible for making lending decisions involving huge numbers of bad loans through corrupt practices [9] and misused their board positions for personal benefits (*The Daily Star*, 2017; *The Dhaka Tribune*, 2020a; *The New Age*, 2020). These practices raise serious conflicts of interest on the part of board members. The situation becomes worse in the case of SCBs, as the central bank [10] cannot remove the corrupt board members appointed by the government (Bank Companies Act–1991). All of these appear to have contributed to the soaring percentage of non-performing loans (NPLs) in SCBs at around 23.85% (BB, 2019). The rate of NPLs has been increasing in the PCBs as well.

In addition to the above issues, a substantial number of board members in PCBs are also affiliated with political parties. In Bangladesh, some PCBs are controlled by family boards [11] in which most of the members come from the same family. Although the political connection of businessmen is not a new issue in some countries, the level of such connections is extraordinarily high in Bangladesh. For example, 59% of the elected representatives in the national parliament were businessmen during the ninth (2009–2013) parliamentary tenure (Chowdhury, 2009). Recent newspaper reports indicate that politically affiliated boards are accused of being involved with loan scams [12], and actions taken by BB confirm that some of the PADs have been accused of making fraudulent or personally beneficial loans to politically connected firms and their family businesses. These politically affiliated influential board members often enjoy some types of immunity against prosecutions for wrongdoing in which law enforcement is selective in the cases of political activists of the ruling party (Muttakin *et al.*, 2015). Political party members often utilize or influence law enforcement agencies for their own business or political purposes (see, *The Daily Star*, 2014). Even the central bank cannot perform its regulatory duties properly due to political interventions (*The Daily Star*, 2022). A World Bank report states, “weak internal controls, poor corporate governance, and slackening of credit standards resulted in irregularities in loan approvals” (World Bank, 2013). The contexts discussed above warrant attention because of the extraordinary level of influence of PADs in board functions.

### 3. Theoretical framework

As mentioned earlier, in this paper we have drawn on agency theory literature. The theory assumes that agents are self-interested individuals (Jensen and Meckling, 1976; Eisenhardt, 1989) and that there is goal divergence, which may lead to a conflict of interest on the part of the agents (Miller-Millesen, 2003). The presence of a conflict of interest and ‘information asymmetry’ can create ‘agency problems’ (Eisenhardt, 1989), whereby agents try to maximise their benefits at the expense of owners. But as fiduciary duty-holders (DeMott, 2017), agents are not allowed to benefit from their role without the informed consent of principals. The theory also posits that in the absence of proper monitoring of agents’ actions and the lack of incentive for agents to maximise owners’ interests, short-term-oriented agents (Olson, 2000) can try to maximise their benefits (Fama, 1980). As a remedy, shareholders appoint board members to monitor the actions of agents (i.e. managers) on their behalf. The directors often receive remunerations and/or allowances as an incentive to control agency problems. In the absence of adequate incentives, directors have little incentive to reduce the agency costs of a firm (Jensen and Meckling, 1976).

As agents of owners, directors are supposed to monitor the activities of company executives (i.e. decision control), rather than performing the functions of the executives (i.e. decision management). According to Fama and Jensen (1983), decision control and decision management have to be separated for effective governance. Having the same person in

charge of decision control and decision management (duality) can create governance problems in the case of public companies. Because of the overlapping functions, there can be collusions or conflicts between the two 'upper tier' agents – influential board members and managers (Tirole, 1986). The level of conflict of interests intensifies if regulatory oversight is weak (Miller-Millesen, 2003). If politically influential board members are involved in managing routine functions in addition to monitoring executives' activities, some conflicts between the parties may arise that can compromise boards' monitoring functions and create a 'hierarchical' agency problem (Cyert *et al.*, 2002; Certo *et al.*, 2008). The dual role of boards – policymaking and performing routine functions – can contribute to increasing agency costs (Fama and Jensen, 1983) to shareholders.

#### 4. Empirical literature review and hypothesis development

##### 4.1 Political affiliations of board members and politically controlled boards

The concept of political affiliation [13] (firms or boards) varies in the literature. According to Faccio (2006), politically affiliated firms (PAFs) are those whose large shareholder or senior official is a member of parliament, minister, head of state, or has close connection with politicians. Dao (2013) used the terms 'hard connection' and 'soft connection' to define two different types of political connections. A hard connection exists when firms or banks are state-owned, whereas a soft connection arises with the presence of politicians on boards. Furthermore, Bianchi *et al.* (2013) categorised political connections in two ways: direct and indirect. A direct political connection exists when present or past senior officials or investors are connected with politicians, whereas indirect political connection means a contribution to political parties for lobbying. According to prior research (Perez *et al.*, 2015; Boubakri *et al.*, 2008), political connection of a board is characterised as the presence of at least one bureaucrat [14], former bureaucrat, parliament member, political party member, or former parliament member. Carretta *et al.* (2012) defined political connection as the presence of politicians in executive roles on a bank's board. While prior research focused on political connection or affiliation of banks and bank performance, in this research we examined the effect of politically controlled boards on bank loan performance. We consider a board to be politically controlled [15] if 20% or more directors are politically affiliated. While earlier research (Perez *et al.*, 2015; Boubakri *et al.*, 2008) defines the political connection of a bank with even one director or a senior official with a political link, we note that 20% or more PADs in Bangladesh can exert 'significant influence' [16] on a board's decision-making.

##### 4.2 Prior research and hypothesis development

Prior research has shown that PADs play a political role on boards (Perez *et al.*, 2015) and serve as instruments that endorse systematic favourable exchanges between politicians and business elites (Chaney *et al.*, 2011). Board members' political connections can negatively affect firm performance by incurring higher employee costs (see, Du and Girma, 2010; Wu *et al.*, 2012), using the firms' assets for political purposes (Bertrand *et al.*, 2007) and losing control of the board (You and Du, 2012). Prior research has found that PAFs have experienced decreasing firm profitability (Jackowicz *et al.*, 2014; Faccio, 2006), underperformance (Mathur and Singh, 2011; Faccio, 2006) and lower earnings quality (Chaney *et al.*, 2011). Saeed *et al.* (2016) have argued that PAFs' profits are negatively affected when they pursue social and political objectives. Carretta *et al.* (2012) have found that politicians on bank boards with executive roles significantly reduced bank profit in Italian cooperative banks. Chen *et al.* (2018) have shown that sample Chinese banks run by politically connected CEOs performed worse because of poor lending decisions based on political influence. Conversely, Hung *et al.* (2017) examined the effects of Chinese bank CEOs' political connections on bank performance

and found that politically connected banks perform better because of more lending opportunities to firms through their political connections. Prior research also argued that politicians used resources to benefit political supporters (Shleifer and Vishny, 1998) and achieve political goals (La Porta *et al.*, 2002). Politically appointed directors with loan allocating decision power can assist in the process of transferring resources to these supporters by approving poor-quality loans. Khwaja and Mian (2005) have shown that SCBs in Pakistan advance more loans to politically affiliated firms although the default rate is 50% higher than other loans.

Appointments of board members through political connections are common in developing countries (Islam and Siddique, 2010), particularly in government banks (Chen *et al.*, 2018). In Bangladesh, board members are appointed to the SCBs based on their political connections. Some of the appointees are active members or leaders of the ruling party. We note that in the absence of adequate monitoring of 'agents' (i.e. PADs) and because of the poor regulatory regime and lack of sanctions (e.g. removal from boards) in Bangladesh, agency problems (Eisenhardt, 1989) will likely intensify when PADs benefit personally or politically (Bertrand *et al.*, 2007) by approving large loans to their poorly performing family-controlled firms, or firms owned by other political allies (see, Chen *et al.*, 2018), or by other means. These kinds of undue practices can happen due to collusions between these two 'upper tier' agents (Tirole, 1986). A significant portion of these types of loans in SCBs become bad loans, also called NPLs and negatively affect bank performance (see, Jackowicz *et al.*, 2014; Chaney *et al.*, 2011; Carretta *et al.*, 2012). SCBs in Bangladesh account for 23.85% of NPLs, whereas the rate is 5.78% for the PCBs (BB, 2019). Under these circumstances, we predict that the significant presence of PADs will contribute to increasing amount of NPLs and negatively affect loan performance. Hence, our [first hypothesis](#) is as follows:

- H1. Boards controlled by politically affiliated directors (PA) in both state-owned and private commercial banks negatively affect bank loan performance.

Oswald and Jahera (1991, p. 311) note that "*the notion is that the greater the degree of ownership or financial attachment by those with decision-making authority, the better is likely to be the performance of the organization*". Scholars have found that board members' ownership interests help explain improved financial performance (Brickley *et al.*, 1988; Lin *et al.*, 2008). Similarly, Booth *et al.* (2002) explained that board members' significant holdings in a company's stock affect their decisions making. This is not necessarily the case for SCB board members. In Bangladesh, board members of SCBs have no significant ownership interests; rather, they represent taxpayers, who do not demand accountability directly from boards, unlike the private owners. Eisenhardt (1989) argued that agents are more likely to work for the benefit of principals if the 'contract' is based on 'outcomes'. This is also not necessarily the case for SCB board members. Board members of banks in Bangladesh receive negligible financial benefits, and their allowances are not related to bank performance. The government rarely holds these board members to account in the case of bad performance. So, there is little incentive for these PADs to control agency problems (Jensen and Meckling, 1976). When the government routinely bails out SCBs in the case of financial distress, and in the case of relaxed enforcement of laws and regulations, corrupt PADs in these banks can feel entitled to use their positions as board members to benefit personally or politically without facing serious consequences. For example, the amount of NPLs in SCBs in Bangladesh is substantially higher than in PCBs (BB, 2019). Loan scams, fund diversions, and disbursement of loans to their affiliated firms are more acute in SCBs. The worst loan scams in the history of the country occurred in SCBs (*The Daily Star*, 2013, 2016, 2018; *The New Nation*, 2018; *The Daily Prothom-Alo*, 2020; *The Dhaka Tribune*, 2020b). PADs' self-serving actions can create huge agency problems and negatively affect the performance of SCBs. Hence, our [second hypothesis](#) is as follows:

H2. Boards controlled by politically affiliated directors in state-owned commercial banks without substantial ownership interest (PAWOI) negatively affect bank loan performance.

Generally, owner–directors in PCBs have substantial ownership interests or represent shareholders with substantial ownership interests in the bank. There is an expectation that these directors will work to improve bank performance because they will benefit from it.

The main sources of funding in banking companies come from depositors, not from the owners. [John et al. \(2016\)](#) note that the governance mechanisms and ownership structures in banks are different from those of manufacturing companies. In Bangladesh, approximately 75% of a banking company’s operating capital comes from depositors, whereas only 5.9% comes from shareholders’ equity and 19.1% from other sources ([BB, 2021](#)). This example shows how a bank board directly or indirectly controls a huge amount of deposits with relatively negligible shareholding. In the absence of adequate insurance protection [[17](#)], any conflict of interest and self-dealing among bank board members can create risks for the depositors. This risk is particularly high in South Asia because the boards of directors’ involvement in fund diversions or loan scams is widespread. A few notable examples of these loan scams took place at Andhra Bank in India ([The Business Standard, 2018](#)), Sindh Bank and Summit Bank in Pakistan ([The News, 2020](#)) and Farmers Bank (currently Padma Bank) and the National Bank in Bangladesh.

Task complexity ([Kirsh, 1996](#)) in banking companies is higher because of the nature of the business these companies are involved with. Ordinary shareholders in PCBs may not know how a bank is run. By utilizing this ‘information asymmetry’ between shareholders and ‘agents’ and with the help of managers ([Tirole, 1986](#)), influential PADs in PCBs can siphon off huge amounts of depositors’ money (see, [The Daily Star, 2019](#)).

We argue that in the absence of adequate regulatory oversights and sanctions for wrongdoing, PADs with significant ownership interests in PCBs can unduly benefit substantially by abusing their positions. In that case, they will have to forgo only part of a reduced dividend and capital gains because of the possible negative effects on bank profitability. Hence, our [third hypothesis](#) is as follows:

H3. Boards controlled by politically affiliated directors in private commercial banks with substantial ownership interests (PAOI) negatively affect loan performance.

## 5. Research design

### 5.1 Data and sample selection

There are 61 approved commercial banks in Bangladesh. We excluded foreign-owned commercial banks, because their corporate management, nature of governance and ownership structure are different from those of local commercial banks operating in Bangladesh. Of the 52 local banks, we excluded 4 banks incorporated after 2017, 1 joint-venture bank with foreign owners, and 1 bank for which relevant data were not available. These exclusions leave us a final sample of 46 banks, including 8 SCBs and 38 PCBs. [Table 1](#) exhibits the sample selection procedures.

Data were manually collected from the annual reports of the respective banks from 2008 to 2017 by the 2nd author. The sample of the study consists of 409 bank-year observations for the variables used [[18](#)] (see [Table 3](#) Panel-A). Further, the 2nd author collected information on boards’ political affiliations by analysing board members’ internet domicile biographies, which were cross-checked with a list of members of parliament (MPs) or members of any committee of the political parties. A total of 5,607 board members’ biographies were analysed and simultaneously cross-checked with the list of 3,500 MPs ([www.parliament.gov.bd](http://www.parliament.gov.bd)) in

Bangladesh from 2008 to 2017. Following the earlier literature (Faccio, 2006; Aburime, 2009; Braun and Raddatz, 2010; Carretta *et al.*, 2012; Sutopo *et al.*, 2017; Haris *et al.*, 2019), we used a step-by-step method to measure a board's political connections in sample banks. First, we listed the names of the directors of the sample bank boards, then analysed their biographies. Second, if at any time a bank director had a political position in the country, ran for parliament membership under a political banner, or participated in other (local government) political positions, then we considered that the director had a political affiliation. Third, any director who is appointed by the government of Bangladesh is considered politically affiliated. Fourth, if the number of directors in any of the above categories was 20% or more, then the board is considered to be a politically controlled board (PA).

Description	Total banks	SOCBs	PCBs	Foreign banks
Population of all banks	61	9	43	9
Exclude foreign banks	(9)	–	–	(9)
Exclude banks incorporated after 2017	(4)	(1)	(3)	–
Exclude joint-venture banks with foreign owners	(1)	–	(1)	–
Exclude banks with incomplete data	(1)	–	(1)	–
Total sample of banks	46	8	38	0

Source(s): Bangladesh Bank (2022)

**Table 1.**  
Sample selection  
procedures

Variable name	Acronym	Explanation
<i>Dependent variable: bank performance</i>		
Non-performing loans	NPLs	Ratio of total classified loans to total loans and advances
<i>Political connection: independent variables</i>		
Board controlled by politically affiliated directors	PA	A dummy variable
Boards controlled by PADs without substantial ownership interests	PAWOI	A dummy variable
Boards controlled by PADs with substantial ownership interests	PAOI	A dummy variable
<i>Control variables</i>		
Profitability	ROA	Return on assets: ratio of net income to total assets
Total assets	LnSIZE	Natural logarithm of total assets
Leverage	LEVERAGE	The ratio of Tier 1 capital to a bank's exposure measures
Equity to total assets	EtoTA	Ratio of equity to total assets
Cost-to-income ratio	CIR	Ratio of total cost to total income
Total loans and advances to total assets	TLATA	Ratio of total loans and advances to total assets
Interest income to total loans and advances	IntTLA	Ratio of total interest income to total loans and advances
Age	AGE	Age of the bank from the year of commencement of business
<i>Effect variables</i>		
Year fixed effect	YearDum	Year effect from 2008 to 2017

**Table 2.**  
Variable names,  
acronyms and  
explanations



Panel-A: Descriptive information					
Variables	Observations	Mean	Std. Dev.	Minimum	Maximum
NPLs	398	8.65	11.20	0	68.88
PA	409	0.59	0.49	0	1
PAWOI	292	0.30	0.46	0	1
PAOI	321	0.48	0.50	0	1
Profitability (ROA)	405	1.04	1.45	-14.05	6.46
LnSIZE (Total Assets)	405	11.60	1.08	6.41	14.03
LEVERAGE	405	0.06	0.09	-0.27	0.81
EtoTA	405	0.11	0.12	-0.24	0.81
CIR	398	0.77	1.20	0.04	17.55
TLATA	405	0.68	0.44	0.02	7.46
IntTLA	405	0.17	1.2	0	25.34
AGE	409	20.19	11.48	1	45

Variables	NPLs		Political affiliation of bank boards*	
	Highest	Lowest	Highest	Lowest
NPLs	-	-	16.75	3.77
Board size	12	20	19	9
Number of PADs	11	5	18	2
Ratio of number of PADs	0.92	0.25	-	-
Profitability (ROA)	0.48	1.18	0.19	1.09
LEVERAGE	0.039	0.110	0.060	0.048
EtoTA	0.114	0.133	0.055	0.015
CIR	0.489	0.560	0.623	0.549
TLATA	0.531	0.630	0.497	0.637
IntTLA	0.084	0.124	0.120	0.132
AGE	38	2	41	30

**Note(s):** Here, NPLs = non-performing loans; PA = boards controlled by PADs; PAWOI = board controlled by PADs without significant ownership interest; PAOI = board controlled by PADs with significant ownership interests; profitability = return on assets (ROA); leverage = Tier-1 capital/total balance sheet exposure; EtoTA = equity to total assets; CIR = cost to total income ratio; TLATA = total loans and advances to total assets; IntTLA = interest income to total loans and advances; AGE = age of the bank from the year of commencement of business

\* Political affiliation in the board is determined by the ratio of the total number of PADs to the total number of directors on the board

Year	NPLs (in % Of		Written of bad		Total number of directors*	Total number of PADs*	Ratio of PADs to total directors*
	Billion BDT)	NPLs to total loans	loans (in Billion BDT)	ROA			
2008	224.8	10.8	130.5	1.20	441	110	0.249
2009	224.8	9.2	153.0	1.40	469	115	0.245
2010	227.1	7.3	174.0	1.80	491	131	0.267
2011	226.5	6.1	193.9	1.50	493	132	0.268
2012	427.4	10.0	164.9	0.64	477	133	0.279
2013	405.8	8.9	253.2	0.90	620	155	0.250
2014	501.6	9.7	321.1	0.64	647	160	0.247
2015	594.0	8.8	376.5	0.77	644	162	0.252
2016	621.8	9.2	422.6	0.68	643	159	0.247
2017	743.1	9.3	455.3	0.74	644	159	0.247

**Table 3.**

Descriptive statistics

**Note(s):** \* Indicates the figure within our sample

## 5.2 Variables

**5.2.1 Dependent variable.** There are various accounting measures used to quantify performance, such as ROA (net income divided by average total assets), ROIAA (return on operating income by average assets), etc. (Saeed *et al.*, 2016). We use NPLs as an accounting measure, as suggested in prior research (Musaya, 2009; Cucinelli, 2015; Hung *et al.*, 2017) to assess a bank's loan performance. NPLs are measured by the ratio of total classified [19] loans to total loans and advances. Compared to ROA or ROIAA, NPL is more relevant for assessing a bank's loan performance, as the former may include other operating items not directly linked to bank lending.

**5.2.2 Independent variables.** To assess the effects of boards controlled by PADs, we defined PA as a dummy variable. If a bank board meets the criteria of a PA in a year, mentioned in sub-section 4.2, we assigned it a value of 1; otherwise, we assigned a value of 0. This classification is consistent with earlier studies (see, Faccio, 2006; Boubakri *et al.*, 2012; Perez *et al.*, 2015; Hung *et al.*, 2017). For example, one of the board members and chairman of a private bank (i.e. IFIC Bank Ltd.) is an MP and advisor to the Prime Minister. We classified this board member as a PAD. Again, in any sample year, if more than 20% of the bank board was composed of PADs, we assigned it a code of 1.

Furthermore, within the cluster of boards controlled by PADs, there are directors who have no significant ownership interest in the bank. All of the board members in the SCBs are appointed by the government of Bangladesh, and these directors own only one share. We considered this category of the board to be a board controlled by PADs without significant ownership interests (PAWOI). We treated PAWOI as a dummy variable and assign the boards of SCBs a value of 1 and all others a value of 0.

All of the board members in the PCBs in Bangladesh are appointed by the shareholders (principals), and these board members usually have significant ownership interests in the bank, while independent directors without any shareholdings are closely related to other board members with ownership interests. In some of the PCBs, there are PADs, as defined in the previous section. If 20% or more of any of the boards of these banks had PADs, we classified the board as controlled by PADs with significant ownership interests (PAOI). We treat PAOI as a dummy variable and assigned PCB boards controlled by PADs with substantial ownership interests a value of 1; otherwise, the boards are assigned a value of 0.

**5.2.3 Control variables.** We included SIZE, which is measured by the natural logarithm of total assets, to control the effect of other variables (Cooper *et al.*, 2010; Islam, 2013; Perez *et al.*, 2015; Hung *et al.*, 2017; Islam *et al.*, 2021). It is argued that a larger SIZE increases the likelihood that firms will establish a political connection (Faccio, 2006; Faccio *et al.*, 2006; Cooper *et al.*, 2010). Moreover, we controlled the banks' listing AGE (Cochran and Wood, 1984; Islam, 2013; Islam *et al.*, 2021), which can increase the likelihood of establishing political connections. We controlled the intervening variable AGE in the empirical tests as suggested by other scholars. Again, Khwaja and Mian (2005), Cooper *et al.* (2010) and Boubakri *et al.* (2012) documented that politically connected firms had higher leverage. Leverage in the banking sector should be measured differently than in other sectors (Islam *et al.*, 2021). The ratio of total debt to total assets is the measurement criterion of leverage in manufacturing companies (Perez *et al.*, 2015), whereas leverage [20] in banks is the measured relation between a bank's Tier 1 capital and total exposure. Leverage represents the strength and soundness of the bank and a lower leverage ratio may affect a bank's performance by increasing NPLs (Islam *et al.*, 2021). We used LEVERAGE to control the absorption of losses during financial stress. Additionally, we included bank equity to total assets (EtoTA) as a capital ratio, cost-to-income ratio (CIR), interest income to total loans and advances (IntTLA) (Chan-Lau *et al.*, 2015; Hung *et al.*, 2017; Goddard *et al.*, 2010) to control managerial efficiency and total loans and advances to total assets (TLATA) (see, Hung *et al.*, 2017) to loan portfolio orientation. Finally, we used dummy variables to control the possible industry and time effects on the likelihood that a bank establishes a political connection (Table 2).

### 5.3 Regression models

The regression model for measuring the effect of boards controlled by PADs on bank loan performance is as follows:

$$\begin{aligned} \text{NPLS}_{it} = & \alpha + \beta_1 \text{PA}_{it} + \beta_2 \text{ROA}_{it} + \beta_3 \text{LnSIZE}_{it} + \beta_4 \text{LEVERAGE}_{it} + \beta_5 \text{EtoTA}_{it} \\ & + \beta_6 \text{CIR}_{it} + \beta_7 \text{TLATA}_{it} + \beta_8 \text{IntTLA}_{it} + \beta_9 \text{AGE}_{it} + \text{YearDum} + \varepsilon_{it} \end{aligned} \quad (1)$$

In the above model (equation i), the dependent variable,  $\text{NPLS}_{it}$ , is the performance variable of  $i$ th bank for the year ' $t$ '. The independent variable for the above model is  $\text{PA}_{it}$ , which represents boards controlled by PADs for the year ' $t$ ' of  $i$ th bank.  $\text{PAWOI}_{it}$  is an independent variable that indicates boards controlled by PADs without significant ownership interests (in SCBs) for the year ' $t$ ' of  $i$ th bank (equation ii). Similarly,  $\text{PAOI}$  is an independent variable that indicates boards controlled by PADs with significant ownership interests (in PCBs) for the year ' $t$ ' of  $i$ th bank (equation iii). The variable  $\text{YearDum}$  estimates the year fixed effect, which has been measured through a dummy variable.  $\varepsilon_{it}$  indicates error terms of  $i$ th bank for the year ' $t$ '.

$$\begin{aligned} \text{NPLS}_{it} = & \alpha + \beta_1 \text{PAWOI}_{it} + \beta_2 \text{ROA}_{it} + \beta_3 \text{LnSIZE}_{it} + \beta_4 \text{LEVERAGE}_{it} + \beta_5 \text{EtoTA}_{it} \\ & + \beta_6 \text{CIR}_{it} + \beta_7 \text{TLATA}_{it} + \beta_8 \text{IntTLA}_{it} + \beta_9 \text{AGE}_{it} + \text{YearDum} + \varepsilon_{it} \end{aligned} \quad (2)$$

$$\begin{aligned} \text{NPLS}_{it} = & \alpha + \beta_1 \text{PAOI}_{it} + \beta_2 \text{ROA}_{it} + \beta_3 \text{LnSIZE}_{it} + \beta_4 \text{LEVERAGE}_{it} + \beta_5 \text{EtoTA}_{it} \\ & + \beta_6 \text{CIR}_{it} + \beta_7 \text{TLATA}_{it} + \beta_8 \text{IntTLA}_{it} + \beta_9 \text{AGE}_{it} + \text{YearDum} + \varepsilon_{it} \end{aligned} \quad (3)$$

**5.3.1 Fitness tests for the regression models.** We proceeded as follows while selecting an appropriate regression method for panel data. First, we used the Hausman test to determine the preferred method (Gujarati and Porter, 2009). The Hausman test result explains that models fitted on these data fail to meet the asymptotic assumption of the Hausman test ( $\text{Chi}^2 > 0$ ;  $\text{Chi}^2(8) = -6.42$ ). Hence, neither Fixed Effect nor Random Effect could be used in this study. So, we used the pooled ordinary least squares regression method (OLS) with year fixed effect to explain the regression relations. Second, we tested for serial correlation as suggested by Drukker (2003). We also tested VCE ROBUST to adjust the standard errors in the regression results for better prediction.

**5.3.2 Endogeneity test.** Testing the effects of political affiliation on firm performance might have an endogeneity problem (Perez *et al.*, 2015). To address endogeneity in the regression model we followed the lead-lag method. We tested the generalized method of moments (GMM) regression for the endogeneity of the baseline regression result. Our findings on the relationship between the bank loan performance (NPLs variable) and political control of bank boards (PA) might be biased and can have an endogeneity problem. To address this concern, we used Blundell and Bond's (1998) systematic GMM regression with lagged bank loan performance (NPLs) variable.

## 6. Empirical results and discussion

### 6.1 Descriptive statistics

Table 3 of Panel-A, Panel-B and Panel-C explain the descriptive information of the variables: NPLs and political affiliation in the board; and year-wise politically affiliated board ratio, NPLs and ROA, respectively. In Panel-A, the averages for sample banks' PA, PAWOI and PAOI are 0.59, 0.30 and 0.48, respectively, indicating that nearly 60% of bank boards are controlled by PADs in Bangladesh. Among them, about 30% of PADs have no substantial ownership interest in the bank (i.e. in SCBs), while 48% of PADs have substantial ownership interests (i.e. in PCBs). The mean NPL – a measure of loan performance – is 8.65, with a maximum of 68.88, showing a relatively high level of NPL out of the total loan portfolio of

sample banks. These percentages of the main variables of interest are significantly high compared to developed economies. Regarding control variables, the mean ROA – a measure of profitability – is 1.04, with a maximum of 6.46 and a minimum of –14.05. The average leverage (Tier-1) is 6%, equity to the total asset (EtoTA) is 11% and total loans to total assets (TLATA) is 68%, while the average bank size (lnSIZE) is 11.6 in terms of total assets and bank age (AGE) is 20 years. The mean cost to total income ratio (CIR) is 77% and interest income to total loans (IntTLA) is 17%. Overall, this descriptive information indicates low levels of profitability and loan interest income compared to loan portfolio, but high levels of costs associated with loans in the Bangladesh banking sector.

Again, in Panel-B, we find that banks with the highest NPLs have more PADs and less ROA, compared to banks with the lowest NPLs. Further, in Panel-C, yearly data reveals that PADs in the sample banks range between 24.7 and 27.9%, while NPL varies between 6.1 and 10.8%.

### 6.2 Correlations and multicollinearity

We tested multicollinearity as suggested in prior research (Belkaoui and Karpik, 1989). Table 4 explains the correlation matrix among the variables. Further, for data multicollinearity, we tested variance inflation factors (VIFs) (Wooldridge, 2013). According to Wooldridge (2013), a multicollinearity problem exists when the VIF is more than 10. We found the mean VIFs for NPLs with PA, PAWOI and PAOI variables to be 1.65, 2.08 and 1.65, respectively. Furthermore, we found the maximum VIF to be 3.49 for EtoTA to explain NPLs for all PA, PAWOI and PAOI variables, which are thus less than 10 (Table 4 Panel-A). Hence, the data are free from the multicollinearity problem. Further, Table 4 Panel B depicts the Pearson's correlations among the variables. The results show that PAWOI has a high positive correlation with NPLs (0.767), while TLATA has the lowest negative correction with NPLs (–0.092). Among the independent variables, a high correlation is found between EtoTA and LEVERAGE only. However, there is no multicollinearity between these control variables, as the correlation figures are lower than the benchmark multicollinearity point of 0.80 (Gujarati, 1995).

### 6.3 Interpretation of the results

Model 2 and Model 3 explain the regression results without vce (robust) and with vce (robust), respectively, for boards controlled by PADs (Table 5). Time (year) fixed effect has been controlled in both models. Regression Model 2 with NPLs (at 1% as Prob > F = 0.000;  $R^2 = 0.425$ ) is statistically significant. The PA variable is statistically positively significant ( $\beta_1 = 3.904$  and  $p < 0.01$ ) with NPLs, meaning that bank boards that are controlled by PADs contribute to increasing NPLs. The PA variable indicates that politically controlled boards approve loans to politically affiliated or family-owned firms and are reluctant to recover those disbursed loans, hence the increased number of NPLs in these banks. Thus, we cannot reject H1, which projects that boards controlled by PADs negatively affect loan performance. This finding supports the results from prior similar research (Chen *et al.*, 2018; Carretta *et al.*, 2012). Our finding also supports the arguments put forward by researchers (e.g. Khan *et al.*, 2020; Ghosh *et al.*, 2020; Zheng *et al.*, 2020) that the banking sector in developing economies is hampered by the substantial growth of NPLs. Khan *et al.* (2020) explained that among others, the predominant factor for the growth of NPLs is political interference in the banking system of a country.

This study's findings are also consistent with agency theory arguments. In the absence of adequate regulatory oversight, board members' conflicts of interest cannot be addressed effectively. The situation is worse in Bangladesh, where PADs appointed to SCBs enjoy a level of impunity against sanctions because the banking regulator, BB, cannot remove

**Table 4.**  
Variance inflation factor (VIF) and correlations

Panel A: Variance inflation factor (VIF)									
Variables	VIF with PA				VIF with PAWOI				VIF with PAOI
PA	1.28				—				—
PAWOI	—	1.82			—	1.12			—
PAOI	—	—	1.30		—	1.56	1.09		1.12
Profitability (ROA)	1.89	1.99	1.89		1.99	1.99	1.99		1.09
LnSIZE (Total Assets)	2.18	2.77	2.18		2.77	2.77	2.77		2.72
LEVERAGE	2.44	3.49	2.44		3.49	3.49	3.49		1.74
EtoTA	1.13	1.20	1.13		1.20	1.20	1.20		2.38
CIR	1.17	1.67	1.17		1.67	1.67	1.67		1.10
TLATA	1.25	1.62	1.25		1.62	1.62	1.62		1.28
IntTLA	2.17	2.61	2.17		2.61	2.61	2.61		1.34
AGE	1.65	2.08	1.65		2.08	2.08	2.08		2.03
Mean VIF									1.65

  

Panel B: Pearson's correlations of the variables												
	NPLs	PA	PAWOI	PAOI	Profitability	LnSIZE	LEVERAGE	EtoTA	CIR	TLATA	IntTLA	AGE
NPLs	1.000											
PA	0.368***	1.000										
PAWOI	0.767***	0.435***	1.000									
PAOI	-0.276***	0.629***	-0.396***	1.000								
Profitability	-0.410***	-0.156***	-0.432***	0.212***	1.000							
LnSIZE	-0.050	-0.059	0.025	-0.105***	-0.124**	1.000						
LEVERAGE	-0.297***	-0.121**	-0.267***	0.104**	0.324***	-0.349***	1.000					
EtoTA	-0.086*	-0.036	-0.156***	0.074	0.234***	-0.472***	0.665***	1.000				
CIR	0.255***	0.077	0.217***	-0.089**	-0.334***	0.040	-0.142***	-0.076	1.000			
TLATA	-0.092*	0.025	-0.118**	0.129***	0.002	-0.058	-0.045	0.190***	-0.019	1.000		
IntTLA	-0.044	0.040	-0.034	0.072	-0.006	-0.254***	-0.029	0.241***	-0.005	-0.077	1.000	
AGE	0.343***	0.316***	0.486***	-0.119**	-0.320***	0.600***	-0.448***	-0.447***	0.128**	-0.030	-0.102**	1.000

Note(s): \*, \*\* and \*\*\* indicate 10, 5 and 1% levels of significance, respectively

Variables	Dependent variable = NPLs					
	Equation (1)		Equation (2)			
	(Without vce robust) Model-1	(With vce robust) Model-2	(Without vce robust) Model-3	(With vce robust) Model-4	(Without vce robust) Model-5	(With vce robust) Model-6
PA	8.361*** (7.83)	3.904*** (3.81)	3.904*** (3.51)	20.676*** (16.28)	16.535*** (10.36)	16.535*** (6.75)
PAWOL	-	-	-	-	-0.459 (-1.05)	-0.459 (-1.05)
Profitability (ROA)	-	-1.727*** (-4.51)	-1.727*** (-2.42)	-	-2.892*** (-3.95)	-2.892*** (-2.15)
LnSIZE	-	-3.394*** (-5.39)	-3.394*** (-2.82)	-	-2.892*** (-3.95)	-2.892*** (-2.15)
LEVERAGE	-	-48.820*** (-6.01)	-48.820*** (-2.74)	-	-66.775*** (-5.55)	-66.775*** (-2.68)
EtoTA	-	27.988*** (4.76)	27.988* (1.80)	-	48.942*** (5.76)	48.942*** (2.29)
CIR	-	0.950** (2.39)	0.950** (1.99)	-	0.902*** (2.03)	0.902*** (3.23)
TLATA	-	-4.984*** (-4.63)	-4.984*** (-2.80)	-	-5.634*** (-4.51)	-5.634*** (-2.62)
IntTLA	-	-1.723*** (-4.39)	-1.723*** (-3.43)	-	-2.141*** (-4.98)	-2.141*** (-3.19)
AGE	-	0.339*** (5.70)	0.339*** (4.04)	-	0.700 (0.95)	0.700 (0.62)
Constant	3.484* (1.87)	42.286*** (6.17)	42.286*** (3.23)	4.014* (1.92)	38.730*** (4.93)	38.730*** (2.69)
Year fixed effect	Yes	Yes	Yes	Yes	Yes	Yes
Number of observations	398	386	386	231	219	219
R <sup>2</sup>	0.141	0.425	0.425	0.550	0.665	0.665
Adjusted R <sup>2</sup>	0.119	0.396	0.396	0.530	0.634	0.634
Prob > F	0.000	0.000	0.000	0.000	0.000	0.000

**Note(s):** Value indicates coefficient of the variables, whereas the value in parentheses indicates 't' value  
\*\*\* Significant at 1% level; \*\* Significant at 5% level; \* Significant at 10% level

**Table 5.**  
Regression results (PA  
and PAWOL)

corrupt directors from SCBs. There is little evidence to suggest that the government takes meaningful measures to hold those corrupt PADs to account. The influence of politically controlled boards in approving low quality loans and relaxed loan recovery policies are possible explanations for these findings.

Furthermore, Model 5 and Model 6 (Table 5) explain the regression results without vce (robust) and with vce (robust), respectively, for boards controlled by PAWOIs. The regression result is statistically significant (Prob > F = 0.000; R<sup>2</sup> = 0.665; Model 5). The PAWOI variable is positively significant ( $\beta_1 = 16.535$  and  $p < 0.01$ ) with NPLs, which indicates that a bank whose board is controlled by PADs with no significant ownership interest is significantly associated with increased NPLs. We cannot reject H2, meaning that a PAWOI negatively affects banks' loan performance by increasing NPLs. This implies that in the absence of proper regulatory oversights, PADs without ownership interests may feel a sense of impunity regarding financial crimes, leading them to try to benefit substantially by misusing their positions. Anecdotal evidence also shows that some of the board members benefit personally by scamming loans or disbursing loans to affiliated firms using forged documents which makes a loan unrealizable. For example, local newspapers report that huge amounts of loan money were siphoned off from two SCBs through forgery with the help of PADs (see, *The Daily Star*, 2016; *The Dhaka Tribune*, 2017). An earlier study (Chen et al., 2018) documented similar findings in the case of the political affiliation of CEOs and bank performance. As discussed earlier, the directors in SCBs in Bangladesh are generally appointed based on political considerations, and these directors have no significant ownership interest (only one share for BDT 10) in the banks. Consequently, these PADs have little incentive to maximise the benefits of owners (taxpayers) (Olson, 2000). In the absence of accountability, PADs work in their own self-interest rather than in the interest of the owners (see, Bonazzi and Islam, 2006; Fernando, 2012). This situation can be explained by the 'agency conflict' concept of the agency theory argument.

Further, Model 8 and Model 9 (Table 6) explain the regression results without vce (robust) and with vce (robust), respectively, for boards controlled by PAOI. The model explained by

Variables	Equation- 3 Dependent variable = NPLs		
	(Without vce robust) Model-7	Model-8	(With vce robust) Model-9
PAOI	-0.454 (-0.94)	-1.270*** (-2.95)	-1.270*** (-2.70)
Profitability (ROA)	-	-1.552*** (-4.66)	-1.552*** (-3.76)
LnSIZE	-	-3.086*** (-8.08)	-3.086*** (-3.37)
LEVERAGE	-	-17.877*** (-4.61)	-17.877** (-2.45)
EtoTA	-	-7.412*** (-2.61)	-7.412* (-1.72)
CIR	-	-0.183 (-0.66)	-0.183 (-0.68)
TLATA	-	0.174 (0.38)	0.174 (0.32)
IntTLA	-	-0.514*** (-3.16)	-0.514*** (-2.63)
AGE	-	0.262*** (7.77)	0.262*** (5.27)
Constant	4.861*** (5.89)	38.571*** (9.56)	38.571*** (3.68)
Year fixed effect	Yes	Yes	Yes
Number of observations	322	311	311
R <sup>2</sup>	0.034	0.352	0.352
Adjusted R <sup>2</sup>	0.002	0.312	-
Prob > F	0.000	0.000	0.000

**Table 6.**  
Regression  
results (PAOI)

**Note(s):** Value indicates coefficient of the variables, whereas the values in the parenthesis indicate 't' value  
\*\*\* Significant at 1% level; \*\* Significant at 5% level; \* Significant at 10% level

the data set is statistically significant ( $\text{Prob} > F = 0.000$ ;  $R^2 = 0.352$ ; Model 8). The PAOI variable is negatively significant with NPLs ( $\beta_1 = -1.270$  and  $p < 0.01$ ) (Model-9 with vce robust). Therefore, we cannot accept H3, meaning that PADs with significant ownership interests in the sample PCBs do not have a significant negative effect on loan performance. In other words, in PCBs, PADs with substantial ownership interests naturally align their interests with those of other non-controlling shareholders to ensure the long-term survival, success and performance of the banks. A substantial number of PAs are also family-controlled. These family-controlled boards have considerable wealth invested in their banks, thus they have an incentive to govern the banks in ways that improve the financial performance of the banks and protect the family reputation (Farooque *et al.*, 2019). Our evidence shows that the number of politically controlled boards in PCBs have been increasing in recent years. Although the NPLs in politically controlled boards in PCBs have been increasing, it is not sufficient to affect the loan performance significantly.

#### 6.4 Robustness and additional test

The GMM regression results depicted in Table 7 indicate that our baseline regression results have not been affected by the endogeneity problem. We also performed a Sargan over identification test and found insignificant results, indicating that the instrumental variable ensures the over identification validity. Arellano-Bond autocorrelation first (AR1) order and second-order (AR2) indicate that the findings are free from serial correlation. Hence, the baseline results are consistent and unbiased.

We have also conducted several tests to ensure the robustness of our baseline findings. First, Table 5 (Models 3 and 6) depicts an additional sensitivity analysis of the variables – PA and PAWOI – without vce (robust). Models 1 and 4 also explain the regression results without the control variables (Table 5). Similarly, for the variable PAOI, Table 6 (Model 7) explains the regression results without the control variables and Model 9 without vce (robust). Second, we tested endogeneity using Blundell and Bond’s (1998) systematic GMM regression with the lagged loan performance (NPLs) variable. Third, we performed a Sargan over identification

	Dependent variable = NPLs		
	Model-10	Model-11	Model-12
PA	9.580** (2.14)	–	–
PAWOI	–	10.792*** (2.61)	–
PAOI	–	–	–6.061*** (–3.93)
Profitability (ROA)	–0.555*** (–3.11)	–0.539** (–2.30)	–0.687*** (–3.17)
LnSIZE	0.872 (1.14)	0.532 (0.47)	–1.259** (–2.27)
LEVERAGE	–28.358*** (–3.18)	–36.386*** (–3.01)	–29.486*** (–3.62)
EtoTA	8.876* (1.94)	18.809** (2.36)	3.765 (1.63)
CIR	0.306* (1.68)	0.314 (1.33)	0.123 (0.50)
TLATA	–0.741 (–1.01)	–1.460 (–1.26)	–0.808** (–2.18)
IntTLA	9.200** (2.24)	10.932** (2.07)	16.269*** (8.24)
AGE	–0.197* (–1.71)	–0.269* (–1.69)	0.325** (3.25)
NPL (Lag 1)	0.798*** (14.76)	0.689*** (9.09)	0.610*** (10.58)
Constant	–8.935 (–1.03)	0.293 (0.02)	14.498** (2.50)
Observations	342	194	274
Arellano-Bond AR (1) Test ( $Z$ )	–1.934*	–1.859*	–1.802*
Arellano-Bond AR (2) Test ( $Z$ )	0.980	1.067	1.035
Sargan over identification test ( $\chi^2$ )	25.851	15.022	24.093

**Note(s):** Value indicates the coefficient of the variables, whereas the values in the parenthesis indicate  $Z$  score  
\*\*\* Significant at 1% level; \*\* Significant at 5% level; \* Significant at 10% level

**Table-7.**  
GMM regression of  
board political  
affiliation (PA, PAWOI  
and PAOI variables)



test and also tested AR1 and AR2. Table 7 (Models 10, 11 and 12) describes the GMM regression results, which are congruent with our baseline regression results in Tables 5 and 6. Therefore, we reconfirm our acceptance of H1 and H2 and rejection of H3, suggesting that our main variables of interest – PA and PAWOI – are detrimental to bank loan performance, while the other variable of interest – PAOI – is not significantly detrimental to bank loan performance.

## 7. Summary and conclusion

In this study, we first investigated whether bank boards controlled by PADs affect bank loan performance. We concluded that the PA variable has significant positive effects on NPLs, which indicates that politically controlled boards contribute to an increase in NPLs. This result validates a key finding from previous research (Carretta *et al.*, 2012) carried out on cooperative banks in Italy. Prior research suggests PADs on a board play a political role, that is, they primarily serve as instruments to promote the systematic exchange of favours between politicians and business elites (Chaney *et al.*, 2011). Contextual information shows that the situation is even worse in Bangladesh. Some PADs in Bangladesh garner undue advantages by misusing their board positions, which is tantamount to a conflict of interest. The types of misuse include undue influence in approving poor-quality or fraudulent loans to businesses in exchange for personal or political benefits. The absence of adequate regulatory oversights, perceived impunity from legal consequences among some PADs, and the undue influence of PADs in approving loans and formulating relaxed recovery policies in the banking sector explain the aforementioned findings of this research.

We further investigated whether the status of ownership interests of these PADs has any significant association with bank loan performance. Our findings show that boards controlled by PADs who have no significant ownership interests (PADs in SCBs) contribute to increased NPLs. We note that PADs in SCBs are appointed for short terms and receive negligible financial benefits, which may dissuade them from working in the owners' (principals') best interest. Moreover, BB cannot remove the directors of SCBs, even if they commit fraud or engage in activities that conflict with their positions, and the government appears unwilling to sanction these directors. These factors explain why board members in SCBs pursue personal benefits more aggressively and affect bank loan performance negatively.

Finally, we investigated whether boards controlled by PADs with substantial ownership interests (i.e. PADs in PCBs) negatively affect loan performance. Our results suggest that PADs with ownership interests do not contribute significantly towards increasing NPLs. One possible explanation for this finding is that PADs in PCBs have longer-term financial interest in the bank because of their ownership interests, which might dissuade them from aggressively pursuing undue personal interests. Another possible reason is that it may be too early to see a significant effect on bank loan performance, as a substantial increase in the number of boards that were controlled by PADs in PCBs occurred only during the early and mid-2010s.

This study contributes to the existing bank governance literature by giving evidence from Bangladesh's perspective where some PADs exploit their positions for personal or political gains by taking advantage of weak regulatory oversights. By comparing results from SCBs and PCBs, we provide evidence that the ownership interests of PADs is a predictor of bank loan performance. While prior research explored the relationship between ownership interests of directors and firm performance in the non-banking sector, to the best of our knowledge, this is the first study to test the effects of ownership interests of PADs on bank loan performance. Theoretically, this study applies agency theory arguments in a setting where 'hierarchical' agency problems increase agency costs, and indicates that weak

regulatory oversights and sanctions regimes and lack of incentive for board directors (i.e. without significant ownership interest) can be detrimental to bank loan performance.

The findings of this study have several implications that benefit policymakers, regulators, banks, investors and other stakeholders. Since banks are highly leveraged, increases in NPLs in the banking industry can increase insolvency and liquidation risk which can ultimately affect the whole economy. Regulators should address the weakness in the regulatory oversights of bank governance and implement stringent monitoring mechanisms. In the absence of strict regulations on bank governance, PADs' conflict of interest can jeopardize the interests of owners, depositors and taxpayers. Again, this study also questions the applicability of the Anglo-Saxon corporate governance model in the emerging economy banking sector where undue political interventions are so high. In order to improve the effectiveness of the existing governance model, the government of Bangladesh should abandon politically motivated appointments of bank directors in SCBs, which could deter undue political influence in the banking sector. Further, the results of this research illustrate that directors' substantial ownership interests is positively associated with good loan performance. Thus, policymakers should consider de-nationalising SCBs. Such policy can lead to achieving the best value from the banking sector and ultimately to the sustainable development of the economy.

This study has some limitations. We used data from one emerging country only. Future researchers can use a more robust data set from multiple emerging economies in order to generalize findings in other settings. In this paper, we only used arguments from agency theory. Future research can combine multiple theories to generate hypotheses while studying the political affiliation of board members and bank performance. Finally, we used NPLs as a dependent variable to test the effect of political affiliation of board members on bank loan performance. Future research can use multiple variables to test other factors affecting bank performance.

## Notes

1. In this paper, PA refers to boards (controlled by politically affiliated directors–PADs). It is a key variable in interest.
2. Albeit in a different setting.
3. Non-performing loans are one of the key variables in measuring bank performance.
4. The state-owned commercial banks are fully or majorly owned by the government of Bangladesh.
5. Each board member holds only one share worth BDT 10 as nominal capital. We classify these types of board members as directors without ownership interest.'
6. Agrani Bank Limited is a 100% government-owned bank (Annual Report, 2019).
7. Bangladesh Bank is the central bank of Bangladesh. It regulates banking companies in Bangladesh.
8. Except for independent board members
9. See ([The Daily Prothom-Alo, 20 October 2020](#))
10. The banking sector regulator
11. Most of the family boards are also connected to political parties.
12. See, ([The Dhaka Tribune, 2020](#); [The Daily Prothom-Alo, 20 October 2020](#)).
13. We used the terms 'political connection, and 'political affiliation, interchangeably.
14. Often bureaucrats in developing counties are closely related to ruling parties. In Bangladesh, some bureaucrats in Bangladesh openly support the ruling party's political agenda even though they are supposed to play politically neutral roles. Some of them join political parties just after retiring from their jobs.

15. Given the political culture and the influence of politicians, it is justified to assume that 20% or more PADs can control major decision-making in bank boards in Bangladesh. A substantial number of PADs also come from the same family. It makes it even easier for these PADs to control the boards' decisions.
16. We borrow the definition of 'significant influence' from IAS (International Accounting Standard) 28.
17. Depositors in Bangladesh have only BDT 100,000 (USD 1,163) covered by deposit insurance protection.
18. There are some missing observations for some variables
19. When recovery of a loan is doubtful, we treat it as 'classified'.
20. Leverage is the ratio of Tier-1 capital (capital measures) to a bank's exposure measures (the sum of on-balance sheet exposures, derivative exposures, security financing transaction [SFT] exposures and off-balance sheet [OBS] exposures). The higher the leverage ratio, the higher the likelihood the bank will withstand negative shocks to its balance sheet (BIS, 2014).

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**Corresponding author**

Mohammed Mohi Uddin can be contacted at: [muddi2@uis.edu](mailto:muddi2@uis.edu)

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