Are political connections a curse for banks of the MENA region? The moderating effect of ownership structure

Imen Khanchel
Higher School of Commerce of Tunis, University of Manouba, Manouba, Tunisia and
LARIME LR11ES02, ESSECT, University of Tunis, Tunis, Tunisia
Naima Lassoued
Higher School of Commerce of Tunis, University of Manouba, Manouba, Tunisia and
QUARG UR17ES26, ESCT, Manouba University, Manouba, Tunisia, and
Oummema Ferchichi
Higher Commercial Studies of Carthage, Carthage University, Tunis, Tunisia

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Abstract

Purpose – This study examines the effect of political connections on the performance of banks in the MENA region separately and then moderated by family, institutional and state ownership.
Design/methodology/approach – A hierarchical regression method was used for a sample of 111 banks operating in 10 MENA countries observed from 2009 to 2019.
Findings – The results indicate significant negative relationships between political connections and bank performance. Furthermore, institutional and family ownership moderates this relationship; institutional investors and family shareholders attenuate separately the negative impact of political connections on bank performance. Moreover, state ownership positively moderates this relationship; states as shareholders accentuate the negative relationship between political connections and bank performance. Splitting our sample according to bank-specific features (banks in authoritarian regimes versus hybrid regimes, Islamic banks versus conventional banks) confirms our findings. Our results are robust to an alternative measure of bank performance.
Research limitations/implications – Banks operating in the MENA region have to be aware of the consequence of political connections. In addition, they have to take into account the role of ownership structure when they seek to attenuate the harmful effect of political connections.
Originality/value – This paper offers an in-depth understanding of the impact of political connections on bank performance by drawing from two institutional logics: resource dependence logic and agency logic. Some recommendations on the importance of changing the existing ownership structure are highlighted, encouraging some investors to take part in the capital of banks in this region.

Keywords Ownership structure, MENA countries, Political connection, Bank performance
Paper type Research paper

1. Introduction

It has been widely acknowledged in the literature that banks invest substantial resources in building political connections. However, the theoretical and empirical evidence are controversial

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regarding the benefits of political ties to the banking sector (La Porta *et al.*, 2002; Khwaja and Mian, 2005). The first wave of research proved that politically connected banks can extract benefits from their ties such as having access to lower-cost deposits (Chaney *et al.*, 2011). The second wave of research reported that connected CEOs and/or connected directors will align their interests with politicians' interests to smooth their political careers by taking decisions that do not improve bank performance through even granting low-quality loans to insolvent companies (Faccio *et al.*, 2006; Ding *et al.*, 2023).

In addition, previous studies have focused on the impact of political connections in developed markets, especially in the United States (Gropper *et al.*, 2013, 2015), France (Bertrand *et al.*, 2018) or global markets (Faccio, 2006; Faccio *et al.*, 2006). However, few recent studies have been conducted in emerging markets (Sutopo *et al.*, 2017; Damette and Kouki, 2022) and especially in the MENA region (eg. Al-Shboul *et al.*, 2020; Braham *et al.*, 2019; Kassem, 2022), knowing that this context offers an interesting setting to study bank political connections. *First*, MENA countries are still dominated by state-owned banks (Farazi *et al.*, 2013). Recently, state banks lost their important market share through privatization, but they still play a major role in the equilibrium of the banking sector and the economy in general. Then, political connections give the government the opportunities to intervene in bank decisions. *Second*, in 2010, after the subprime crisis, the International Monetary Fund predicted that the rebound of oil prices would lead to a big boom in the MENA region. However, in December 2010, a public revolt against the existing political regimes disrupted recovery and slowed down economic activity. These public protests, known as the "Arab Spring," highlighted the huge impact of politics on the economy and on the banking sector. *Third*, in this high-tense political environment, banks and politicians of this region became instruments of each other due to the poor legal policies implemented that allowed for the emergence of authoritarian regimes and monarchies and gave them the upper hand on the economic resources.

Therefore, the present study aims to contribute to the recent literature by exploring whether political connections in banks of the MENA region enhance bank performance and whether this relationship is moderated by ownership structure.

The present study stands at the crossroads of agency logic and resource dependence logic. Those two competing logics may have different effects on the political connections and bank performance relationship. We draw from institutional logics because they provide a theoretical framework to examine the institutional change taking place in the MENA banking sector. The institutional logics are the socially constructed regulations, practices and assumptions that provide practical guidelines to members of an organizational field (Friedland and Alford, 1991). The wave of liberalization taking place in MENA banks is a transition from a state-based logic to a market-based logic. In this context, the effect of political connections on bank performance integrates resource dependence logic and agency logic. The agency logic draws insights from moral hazard theory and agency theory, whereas resource dependence theory explains resource dependence logic.

Moreover, Ahmed and Hussainy (2023) and Carboni *et al.* (2023) argue that political connections-performance relationship depends on firm characteristics. In this line, Chaney *et al.* (2011) show that firm's agency problems and the quality of its corporate governance are among these characteristics. The premise that distinct corporate governance mechanisms may offer important insights into the link between political connections and bank performance is true because the main agency problems in MENA banks represent the expropriation of minority shareholders by controlling shareholders (the state, institutional investors and families) (Lassoued *et al.*, 2016). This points fingers toward the moderating role of these controlling shareholders in better explaining the effect of political connections on bank performance.

Consequently, we propose to answer the following research questions:

RQ1. Are political connections beneficial for bank performance in the MENA region?

RQ2. Does ownership structure moderate the relationship between political connections and bank performance?

Therefore, our study examines 111 banks operating in the MENA region observed during the 2009–2019 period, using hierarchical regressions.

Our study attempts to contribute to bank performance-related research in different ways. *First*, this study contributes to the ownership literature on the effect of state, institutional and family ownership on the bank performance-political connections relationship. In fact, although recent research has examined ownership structure as a determinant of bank performance (Kobeissi and Sun, 2010; Farazi *et al.*, 2013), to our knowledge, our study is the first to explore the moderating role of these three types of shareholders in the relationship between political ties and bank performance. *Second*, this study is among the first studies to test the impact of political connections on bank performance in the MENA region. Indeed, few recent studies have examined the consequences of political connections in the MENA region (e.g., Al-Shboul *et al.*, 2020; Braham *et al.*, 2019; Kassem, 2022). Our study goes beyond these studies in at least three ways: (1) by considering a larger sample of banks operating in ten countries, (2) by focusing on the political ties of each bank and (3) by testing two competing logics.

The rest of the paper is structured as follows. In the next section, we develop our theoretical framework and hypotheses. The third section describes our data, defines our variables and presents our econometric approach. In the fourth section, we discuss our results, and the final section concludes the paper.

2. Theoretical framework and hypotheses development

2.1 The impact of political ties on bank performance

Institutional logics, the set of cultural beliefs and rules in a broad sense that guide decision-making and action in a field (Lounsbury, 2007), serve to focus the attention of institutional parties and guide their actions and decisions. Since they belong to different institutional levels (e.g. family, state), individuals face several logics. These logics provide actors with alternative knowledge to make decisions. Through these actions and interactions, institutions can be sustained, modified or conceived (Thornton *et al.*, 2012). The stability of institutional structures on the one hand, and institutional change on the other, can be explained by these logics. Taking this idea further, we suggest that the tensions between agency logic and the resource dependence logic can contribute to the development of more coherent institutional practices and explain the relationship between political connections and bank performance.

2.1.1 The resource dependence logic. According to this logic, political connections increase bank performance. Resource dependence theory explains this logic. The resource dependence theory, which reports the link between resources and energy, assumes that superior growth requires external help (Pfeffer and Salancik, 1978). Providing external funds is the role of managers, and so they need to expand their networks. Accordingly, the main aim of the board of directors is to provide resources. Moreover, directors can provide other sources to their firms like policymakers, supplier social groups and market information (Najaf and Najaf, 2021). Board political ties improve a firm's performance because they bring less taxation and regulations (Lassoued *et al.*, 2023). Then, firms with board political connections are easier to finance and have better performance (Khwaja and Mian, 2005). The political connection enhances firm's market performance (Ben Cheick and Loukil, 2023; Lassoued and Ben Rejeb-Attia, 2014). In addition, companies with politically connected CEOs are protected by politicians or political parties, and they eliminate the risk of being penalized for low-quality accounting information (Chaney *et al.*, 2011). Many empirical studies confirm the resource dependence logic. Political connections give banks the opportunity to extract benefits like minimizing taxes and deposit costs, less strict regulations and preferential treatment

(Disli *et al.*, 2013), and advantages of government subsidies and tax discounts (De Soto, 1989). These banks will have an advantage compared to other banks, resulting in an increase in performance (Faccio, 2006).

2.1.2 The agency logic. The agency logic assumes that political connections decrease bank performance. This logic draws insights from moral hazard theory and agency theory.

First, much attention has to be devoted to "moral hazard" theory (Pauly, 1968) to explain the political connections and bank performance relationship. With information asymmetries due to hidden actions (where the effort of the politically connected member is overestimated) and hidden information (where a politically connected member obtains private information through their ties), politically connected CEOs or directors put their own interests first. Thus, drawing on the moral hazard theory, politicians use banks, especially government-owned banks, to achieve their own political goals. These banks tend to use moral hazard, which will lead to less performance. Then, CEOs with political ties will align their policies with those of politicians to promote their political careers. The most important scope of the moral hazard argument is that of "crony capitalism," where personal connections and political patronages are the main determinants of getting access to credits and other resources (Tee and Chee-Wooi Hooy, 2023), leading to a decrease in bank performance. Moreover, to gain political influence, CEOs lend to low-quality borrowers. This increases default rates, and then performance will be poor. In addition, lending decisions are not optimal as they are affected by the political background of lenders (Saibal Ghosh, 2023). In many cases, politicians easily pursue their own individual goals (for example providing assistance, power, resources, jobs and authority to their supporters, friends and family) in government-linked banks. Furthermore, bank deposits are commonly guaranteed by governments because of the importance of bank liabilities in the domestic payments system (McKinnon and Pill, 1998). When CEOs or directors are politically connected, such guarantees create moral hazard, which then leads to misconceived or speculative projects resulting in a decrease in bank performance. Finally, we argue that political ties generate moral hazard, and the inefficiencies arising from such moral hazard cannot be offset by the gains from the skills and benefits that they allow.

Second, according to agency theory, the principal hires the agent to perform a service efficiently (Jensen and Meckling, 1976). However, the agent can invest in non-profitable projects with a long maturity just to guarantee their position. Thus, politically connected firms perform better than non-connected ones because they are less financially constrained (Ben Cheikh and Loukil, 2023). Specifically, there is a monitoring of the firm's operations from the political allies who provide external financial resources and lower interest rates (Lassoued and Ben Rejeb-Attia, 2014; Li *et al.*, 2008). However, conflicts between the controlling and monitoring shareholders result from a lack of internal and external oversight. Many empirical studies approve the agency logic, arguing that political ties can be used with government-linked banks, which leads to favorable loans even if their financial performance is low (Faccio *et al.*, 2006). In addition, CEOs with political ties are protected by politicians or political parties, which eliminates the risk of being penalized for low-quality accounting information (Chaney *et al.*, 2011).

Although little research is conducted in the MENA region, given the presence of minority and controlling shareholder conflicts that is common in the region, we assume that political connections will likely decrease the checks and balances that can lead to a more deliberate decision-making process, and therefore will decrease bank performance. Therefore, the agency logic is more suitable for MENA banks. Thus, we hypothesize:

H1. Political connections have a negative effect on bank performance.

2.2 The impact of state ownership on the relationship between political connections and bank performance

State ownership accentuates the agent-principal problem because there is a disagreement between the principals (citizens as co-owners of state banks) and the controlling managers (as

agents), and the latter may prefer to make decisions that satisfy their own interests rather than satisfy the interest of the principals. This will deteriorate the firm performance (Khanchel and Bentaleb, 2022). The lending behavior of state-owned banks is affected by the electoral results of the party affiliated with the bank. The stronger the political party in the area where the firm is borrowing, the lower the interest rates. State-owned banks tend to lend more to firms with politically connected directors (Khwaja and Mian, 2005). Moreover, government intervention distorts investment behavior and impairs the operational efficiency of state-owned banks of the MENA region through the channel of state ownership and the appointment of managers with political backgrounds (Ben Rejeb-Attia *et al.*, 2018).

Therefore, bearing on agency theory, the effect of political ties on bank performance could depend on the degree of state influence. Generally, this influence is associated with state ownership, notably when the state is a shareholder of a bank. In addition, state-owned banks are inefficient because they pursue strategies that satisfy political objectives rather than efficiency maximization.

The moderating role of state ownership in the relationship between political ties and bank performance is lit by the following arguments. *First*, in state-owned banks, citizens are co-owners. However, in MENA countries, citizens do not have any influence on the management of banks owned by the state (Lassoued *et al.*, 2018). As a result, governments with multiple conflicting goals became the one and only deciders, which emphasizes the free-rider problem. *Second*, according to La Porta *et al.* (2002), under a social welfare view, in some cases, government-linked banks prefer financing state-owned enterprises (SOE's) rather than private enterprises even if the loan quality of the latter is better than the former, because they look for socioeconomic development goals and have to adopt strategies that maximize social welfare (Lassoued *et al.*, 2018; Ben Rejeb-Attia *et al.*, 2018). *Third*, in state banks, directors with government ties find themselves forced to choose projects that go well with the government's strategies, which is widely observed in MENA countries. Therefore, they just do not consider loan quality and solvency as a priority. *Fourth*, CEOs of state banks have no primary goal to maximize profits or minimize costs, and they look more to government considerations.

Thus, we formulate our second hypothesis:

H2. State ownership intensifies the negative effect of political ties on bank performance.

2.3 The impact of institutional ownership on the relationship between political connections and bank performance

The market reacts to political connections (Carboni *et al.*, 2023). Therefore, institutional ownership is another factor that can affect the relationship between political ties and bank performance. *First*, institutional ownership is a good instrument to mitigate agency problems (Khanchel, 2007b, 2011; Williams and Nguyen, 2005; Berger *et al.*, 2005; Lassoued and ElMir, 2012). *Second*, institutional ownership represents a good monitor for managers to act efficiently and to carefully take decisions (Bhojraj and Sengupta, 2003). Therefore, institutional investors protect banks from political intervention because they monitor the allocation of resources and as a result prevent political lobbying in banks (Chen *et al.*, 2018). *Third*, banks with institutional ownership suffer less from the negative effects of political connections because institutional investors attenuate the impact of the political tie and reduces agency conflicts (Chen *et al.*, 2018). *Fourth*, there is a relationship between higher credit ratings and lower bond yields in firms with high institutional ownership (Bhojraj and Sengupta, 2003). *Fifth*, institutional ownership is a solution for CEO with poor performance and who takes bad managerial decisions. *Sixth,* as institutional ownership highly relates to governance quality (Khanchel, 2007a), institutional investors implement efficient governance mechanisms, reducing political ties' negative effect.

Thus, we formulate our third hypothesis:

H3. Institutional ownership attenuates the negative impact of political connections on bank performance.

2.4 The impact of family ownership on the relationship between political connections and bank performance

Family ownership as a governance mechanism affects banking behavior and outcomes. Family shareholders are likely to establish political ties because of their unique cultural and social capital (Chung and Zhu, 2021). Therefore, family ownership moderates the relationship between political connections and bank performance. According to agency theory, agency costs are low when there is family ownership because the family controls the distribution of resources, the flow of important market information and cost structure (Khanchel, 2007b). When facing political ties, family shareholders can judge the market because they can integrate internal information and are less likely to blindly approve of CEOs' or directors' decisions. Family shareholders' goal is to avoid losses of the family' wealth and control that may compromise profit maximization (Miller *et al.*, 2010), leading to principal–principal conflicts between controlling family owners and other minority shareholders. Such conflicts are true in MENA countries where the weak regulatory institutions give families more leeway to pursue private goals (e.g. family control and social status) and even expropriate minority shareholders (Ben Rejeb-Attia *et al.*, 2019). To protect themselves from potential legal prosecutions, family owners build political ties and use endowed power. In addition, banks with family shareholders are confident and loyal, which enables them to form ties with external stakeholders effectively (Lassoued *et al.*, 2018). Such attributes and long-term orientation make banks with a high presence of family shareholders credible and thereby preferred partners, which enhances bank performance. Finally, ruling families are largely dominant in the Gulf Cooperation Council countries (GCC) (Lassoued *et al.*, 2018; Almarhabi *et al.*, 2023). Ruling family members exert significant power on the board because of their status as major shareholders, and because of their political connections. Thus, ruling family directors are likely to have power that leads to enhanced bank performance.

Thus, we formulate our fourth hypothesis:

H4. Family ownership attenuates the negative impact of political connections on bank performance.

3. Empirical analysis

3.1 Sample and data sources

The original sample covers MENA emerging markets, observed over the 2009–2019 period. We applied some filtering rules to ensure data availability and sample homogeneity. We excluded countries that might be affected by internal conflicts or war during the study period (e.g. Yemen, Syria, Libya, Algeria and Iran), which might bias our research findings.

As our study is based on accounting data, we choose countries using the same accounting standards to ensure comparability of our results. Thus, as the difference between IFRS and domestic GAAP affects operating income and expenses, we excluded Tunisia and Egypt, applying accounting standards other than IFRS (Kamal Hassan, 2008; Ozkan *et al.*, 2021). In this line, the conformity score between IFRS and domestic GAAP in these two countries was not high (almost 59.45%) (Ding *et al.*, 2009). Additionally, the major divergence between the two accounting standards was almost 20% (6.3%) in Egypt (Tunisia) (Ding *et al.*, 2009). In this line, many previous studies have excluded these two countries because they do not adopt IFRS standards (Tunyi *et al.*, 2020).

For consistency purposes, we excluded subsidiaries from our samples.

Finally, we deleted banks that do not publish information about their top managers and board of directors or do not disclose their corporate annual reports. After these series of sample-filtering, the final sample consists of 1,183 bank-year observations from 111 banks operating in 10 MENA countries: Bahrain, Jordon, Kuwait, Lebanon, Morocco, Oman, Qatar, Saudi Arabia, Turkey and the United Arab Emirates (UAE).

Financial and ownership data were extracted from Thomson Reuters Eikon. Macroeconomic data used in this study were taken from the World Bank website. Political data are hand-collected from bank websites, annual reports and Bureau and Thomson Reuters. Table 1 presents our sample by country.

3.2 Variables and measures

3.2.1 Dependent variable. We consider the net interest margin (NIM) as the difference between the income that a bank earns from its lending activities and the interest it pays to depositors.

$$\text{NIM} = (\text{Interest received} - \text{Interest paid to depositors}) / \text{Total Assets}$$

3.2.2 Independent variables. We consider that a bank is politically connected if one of the top directors or board members is a member of parliament, a minister, a head of state, members of the royal families or closely related to a politician (Faccio, 2006; Abdelsalam *et al.*, 2017). Close relationships indicate friendship, with former heads of state or prime ministers as well as former directorships held by current politicians, foreign politicians and well-known relationships with political parties.

We hand-collected the names of board members and top directors from the annual reports of each bank for all the periods. Then, we collected the biographies of each member from their CVs published in different sources (bank websites, annual reports, Bureau and Thomson Reuters).

Political connection is a dummy variable that takes 1 if the CEO and/or board members are politically connected, and 0 otherwise.

3.2.3 Moderating variables. We employ the ownership data available in the Thomson Reuters database. We consider the direct owner to identify the different categories that directly exert control [1]. We consider the percentage of shares held by a given shareholder when it exceeds the 5% threshold. Following previous studies (Holderness, 2009; Munisi *et al.*, 2014), we have retained a threshold of 5%, as several banks do not disclose the shareholders who hold a proportion below this threshold. Then, we sum up the percentage of owned shares

Country	No. of banks	No. of political connected observations	No. of non-Political connected observations	Total of observations
Bahrain	15	72	83	155
Jordan	12	63	62	125
Kuwait	10	41	65	106
Lebanon	7	11	66	77
Morocco	6	49	17	66
Oman	8	31	53	84
Qatar	11	62	53	115
Saudi Arabia	11	62	55	117
Turkey	11	54	67	121
UAE	20	74	143	217
	111	*519*	*664*	*1,183*

Source(s): Authors' own creation

Table 1.
Sample distribution

by shareholders categories. Therefore, the ownership variables will be equal to 0 if no shareholder holds a proportion higher than 5%, and will vary from 5% to 100% otherwise.

Specifically, the first variable (STATE) refers to the direct percentage of the bank's shares held by the state. The second variable (INST) is the sum of direct percentage of the bank's shares held by institutions (financial institutions or any other institutions). The third variable (FAM) is the sum of the direct percentage of the bank's shares held by families.

3.2.4 Control variables. We included several variables that control for bank characteristics and country macroeconomic characteristics.

Our review of the bank performance literature suggests that there are six factors that are most likely to affect bank performance. The following factors are used in our study. The first is bank liquidity (LTD) measured by the loan to deposit ratio and assesses the extent to which customer deposits finance customer loans (Bhunia, 2010). The second is the bank asset quality. We include loan loss provisions (LLP) approximated by "the ratio of loan loss provisions to total assets" (Ben Rejeb-Attia *et al.*, 2013). The third is credit risk. We use non-performing loans (NPL) as "the ratio of nonperforming loans to gross loans" (Lassoued, 2022). The fourth is the bank solvency measured by the capital asset ratio (CAR) (Velliscig *et al.*, 2022). The fifth is size (SIZE) measured as the natural logarithm of the bank's total assets (Aebi *et al.*, 2012). The sixth variable (AUD) indicates the modification of audit opinion. It is a dummy variable that takes 1 if the opinion is modified, ad 0 otherwise (Bamber and Stratton, 1997).

Moreover, country-level variables are also controlled for. We take into account the country governance index (GOV) based on the governance index of Kaufmann *et al.* (2010). We include GDP growth (GDPG) measured as "the real GDP growth rate of each country" (Angkinand and Wihlborg, 2010). We also introduce the inflation rate (INF_RATE) measured by the growth of the consumer price index.

3.3 Econometric models

A hierarchical regression analysis was used in line with a moderation analysis procedure. First, in model (1), the main independent variable (political connections) was introduced together with the control variables along with year dummies. Next, we include political connections in the regression analysis along with the moderating variables and the control variables (model 2). More specifically, we investigate the impact of the interaction between political connections and the moderating variables (respectively state ownership, institutional ownership and family ownership) on bank performance in the presence of control variables. Definitions of variables are reported in Appendix.

$$NIM_{it} = PC_{it} + NIM_{it-1} + Control\ variables + years + \varepsilon_{it} \quad (1)$$

$$NIM_{it} = PC_{it} + Moderating\ variable_{it} + PC_{it} \times Moderating\ variable_{it} + NIM_{it-1} + Control\ variables + years + \varepsilon_{it} \quad (2)$$

Previous empirical studies generally admit the dynamic nature of bank performance (Kumar *et al.*, 2020; Delis and Kouretas, 2011). To capture persistence, we use the lagged dependent variable coefficient. Furthermore, bank performance is also potentially endogenous in case of omitted variables or causality between exogenous and endogenous variables. Profitable banks can increase easier their size, tangible assets and advertising activities, which, in turn, might make them more profitable. Consequently, the OLS estimator is not adequate (Nickell, 1981). Therefore, to deal with endogeneity problems, we test our model using two-step dynamic generalized moments method (GMM) from Arellano and Bover (1995) and Blundell and Bond (1998), following Arellano and Bond (1991). A two-step system GMM is more

efficient than one-step system GMM (Roodman, 2009). This approach with Windmeijer-corrected standard errors takes into account the unobservable heterogeneity transforming the original variables into first differences and the endogeneity of the independent variables using instruments. The two-step GMM model allows treating the independent variables as endogenous by orthogonally using their past values as instruments. This technique implies that we consider bank characteristics, ownership, country variables and the one-year lag of the dependent variable as endogenous covariates.

4. Empirical findings

4.1 Descriptive statistics

Table 2 presents the summary statistics.

We notice that the minimum value of the net interest income is −0.014, the maximum value is 0.769 and the mean is 0.0531. For the political connection variable, more than 43% of banks are politically connected (panel B of Table 2). For ownership structure, as the three variables represent ,respectively, the proportion of shares owned by the state, institutions and families, the minimum for these three variables is zero. For state ownership, the maximum is almost 100%, which means that our sample includes banks totally owned by the state. The mean for state ownership is 10.11%, while family ownership is on average 6.55%. For institutional ownership, the maximum is 99.12%, and the mean is 23.42%.

4.2 Main results

We tested the stationarity of all variables. At level, the unreported result shows the absence of unit root for most variables. However, some variables (INF_RATE, GDP_GR) were not stationary

Panel A: Continuous variables (N = 1,183)

Variables	Mean	Std. dev	Min	Max
NIM	0.0531	0.094	−0.014	0.769
STATE	10.11	0.175	0	99.93
INST	23.42	0.246	0	99.12
FAM	6.55	0.128	0	82.31
LTD	1.185	1.152	0	11.85
LLP	0.0962	0.582	−0.09	0.1381
NPL	6.909	7.312	0.091	38.355
CAR	0.135	0.141	−0.185	0.674
SIZE	9.264	0.812	5.944	15.473
GOV	0.1362	0.206	0	0.990
GDPG%	9.618	0.957	7.692	11.351
INF_RATE%	1.803	1.799	−2.406	5.39

Panel B: Dummy variables (N = 1,183)

Variables	Frequency	Percent	Cum
PC			
0	664	56.13%	56.13%
1	519	43.87%	100%
AUD			
0	201	16.99%	16.99%
1	982	83.01%	100%

Source(s): Authors' own creation

Table 2.
Summary statistics

at the level which indicates the presence of unit root. We corrected the non-stationarity of these variables by using their first differences. Hence, other variables are used at levels.

Table 3 presents the empirical results of the regressions estimated by the GMM system estimator. The Wald test, indicating the joint significance of the variables, is reported and does not reject our model specification. Furthermore, there is no evidence of overidentifying restrictions as indicated by Sargan and Hansen test results. Furthermore, the absence of second-order autocorrelation implies that the estimates are consistent.

The first column displays the effect of political connections and the control variables on bank performance. As shown, a negative significant coefficient of the political connection variable ($\beta = -0.043, p < 0.01$) suggests a negative relationship between political connections and bank performance, giving, thereby, no evidence to reject our hypothesis H1. Then, political connections deteriorate bank performance. Our results do not give support to the resource dependence resource logic. Politically connected CEOs or directors are not considered a valuable resource for banks in the MENA region as they do not take advantage of political connections in the form of benefits like minimization of taxes and deposit costs, profitable regulations and so forth.

Our results are rather in line with the agency logic and support the agency theory and the moral hazard theory. On the one hand, our results confirm the conclusion of agency theory, suggesting that the presence of political ties is explained by high agency conflicts. On the other hand, and with reference to moral hazard theory, the harmful effects of political connections on bank performance are explained by moral hazard in banks. Our findings support those of previous studies (Faccio *et al.*, 2006). Three main reasons explain why political ties make MENA banks less performant. *First*, banks inefficiently cater to politicians' wishes such as the pursuit of individual goals or the transfer of financial resources to their supporters (Boubakri *et al.*, 2012; Yeh *et al.*, 2013). Politically connected CEOs are more concerned about their political career than their managerial career. *Second,* the presence of CEOs or directors with political connections makes the bank less careful about loan quality and lending decisions (Abdelsalam *et al.*, 2017). More specifically, politically connected banks do not care when they choose the projects to finance because, in case of default, they will have support from "friends" in high positions. This confirms "crony capitalism" mechanism in MENA banks (Tee and Chee-Wooi Hooy, 2023). Consequently, party membership has a dominant impact on MENA banks' risk-taking behavior (Braham *et al.*, 2019). *Third*, politically connected banks operate in a hostile environment, and such ties are particularly important for them as they seek to secure resources.

In column (2) of Table 3, STATE has a negative coefficient leading us to conclude that the state as a shareholder harms bank performance. However, in columns (4) and (6) of Table 3, INST and FAM have a positive effect on bank performance, showing that institutional and family investors enhance the quality of control and therefore boost bank performance.

We now examine the moderating role of state ownership (column 3). The coefficient of the interaction variable (PC × STATE) is negative and significant ($\beta = -0.031, p < 0.01$). Thus, politically connected banks with a high state ownership have 0.031 fewer NIM than their peers, with a low impact of the state on decision-making. Hence, we have no evidence to reject H2. Our results corroborate the assumptions of agency theory. Many arguments explain our results. *First*, firms use their political ties, especially with state-owned banks or banks dominated by the state, allowing them to gain preferential loans even if their financial situation does not allow them to access credit (Almarhabi *et al.*, 2023) which decreases bank performance (Faccio *et al.*, 2006). *Second*, agency problems in government-linked banks are much more important than in non-government-linked banks (Huibers, 2005). *Third*, the presence of the state as bank shareholders is inefficient because they pursue strategies that satisfy political objectives rather than performance maximization (Boycko *et al.*, 1996). *Fourth*, state banks in the MENA region still play a major role in the equilibrium of the

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
PC	−0.043***	−0.045***	−0.047***	−0.018***	−0.019***	−0.038***	−0.037***
	(−4.69)	(−4.54)	(−4.54)	(−4.79)	(−4.75)	(−4.37)	(−4.26)
STATE		−0.006**	−0.022**				
		(−2.47)	(−2.48)				
PC × STATE			−0.031***				
			(−2.89)				
INST				0.021***	0.028***		
				(4.35)	(3.68)		
PC × INST					0.039***		
					(5.23)		
FAM						0.014***	0.017***
						(3.23)	(3.26)
PC × FAM							0.024**
							(2.24)
LTD	0.001	−0.003	−0.003	0.003	0.001	0.001	0.001
	(0.31)	(−1.39)	(−1.42)	(0.11)	(0.55)	(0.41)	(0.41)
LLP	−0.001**	−0.001**	−0.001**	−0.002	−0.001	−0.001**	−0.001**
	(−2.56)	(−2.43)	(−2.46)	(−0.52)	(−0.87)	(−2.37)	(−2.13)
NPL	−0.003**	−0.001**	−0.001**	−0.005**	−0.002**	−0.005***	−0.005***
	(−2.63)	(−2.19)	(−2.21)	(−2.08)	(−2.34)	(−2.93)	(−2.95)
CAR	−0.014	−0.002	−0.004	−0.006	−0.006	−0.023	−0.019
	(−0.41)	(−0.04)	(−0.08)	(−0.20)	(−0.20)	(−0.43)	(−0.35)
SIZE	−0.001***	−0.002***	−0.003***	−0.001***	−0.002***	−0.001***	−0.002***
	(−3.77)	(−3.15)	(−3.44)	(−2.91)	(−3.06)	(−3.39)	(−3.34)
AUD	0.1	0.116	0.118	0.002	0.01	−0.11	−0.109
	(0.44)	(1.33)	(1.32)	(0.48)	(0.43)	(−0.05)	(−0.02)
GOV	−0.031	−0.034	−0.023	0.004	0.004	−0.041	−0.041
	(−0.92)	(−0.74)	(−0.45)	(0.68)	(0.60)	(−1.04)	(−1.02)
GDPG	−0.001	0.001	0.001	0.001	0.001	−0.001	−0.001
	(−0.81)	(0.34)	(0.49)	(1.10)	(0.99)	(−0.68)	(−0.71)
INF_RATE	0.674**	0.982***	0.005	0.251***	0.244***	0.622**	0.607**
	(2.52)	(2.92)	(2.92)***	(2.91)	(2.86)	(2.11)	(1.99)
L.NIM	0.003***	0.014***	0.015***	0.004***	0.004***	0.001***	0.001***
	(3.44)	(4.33)	(4.32)	(3.48)	(3.43)	(3.05)	(3.02)

(*continued*)

Table 3.
Hierarchical regression analysis

Table 3.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Year dummies	*Yes*	*Yes*	*Yes*	*Yes*	*Yes*	*Yes*	*Yes*
Number of banks	111	111	111	111	111	111	111
Number of observations	1,183	1,183	1,183	1,183	1,183	1,183	1,183
Number of instruments	37	37	37	37	37	37	37
Wald χ^2	563.23***	525.36***	525.88***	573.21***	562.15***	551.68***	542.12***
AR(2) (p-value)	0.322	0.658	0.236	0.695	0.623	0.352	0.362
Sargan test (p-value)	0.127	0.425	0.331	0.188	0.195	0.269	0.287
Hansen test (p-value)	0.222	0.365	0.712	0.234	0.954	0.768	0.873

Source(s): Authors' own creation

banking sector and the economy in general (Farazi *et al.*, 2013). Then, all these arguments lead us to conclude that state ownership intensifies the negative impact of political connections on bank performance in the MENA region.

For the moderating effect of institutional investors, the interaction variables (PC × INST) in column (5) show a positive and a significant coefficient ($\beta = 0.039, p < 0.01$), suggesting that a one standard deviation increase in institutional investors' ownership, in politically connected banks, is associated with 0.039 fewer NIM. Thus, institutional investors attenuate the negative effect of political connections on bank performance. Therefore, there is no evidence to reject hypothesis H3. Our result is in line with agency theory and suggests that institutional investors are effective at taking actions that increase the performance of banks with political ties. Accordingly, our results support the activism hypothesis; institutional investors have large access to information, better risk assessment and expertise, leading to high level of implication in governance and broadly in the management of MENA banks. In addition, as institutional investors keep their relationships with banks and have some ties with their CEOs and board members, they win independence and develop the ability to oversee managers and therefore weaken the effect of political ties on bank performance. Therefore, institutional investors in MENA banks play an effective role. Thus, institutional ownership attenuates the negative effect of political connections on bank performance by mitigating conflicts and making board members and/or CEOs focus more on bank profitability than their political careers (Williams and Nguyen, 2005; Berger *et al.*, 2005).

For the moderating effect of family ownership, our results show that the coefficient of PC × FAM in column (7) is significantly positive ($\beta = 0.024, p < 0.05$). The results indicate that a one standard deviation increase in family ownership, in politically connected banks, is associated with 0.024 more NIM. Therefore, there is no evidence to reject hypothesis H4. Family shareholders and ruling family members (in the GCC economy) play an important role in MENA banks (Almarhabi *et al.*, 2023). In most cases, family shareholders keep their shareholdings for long-term (Villalonga and Amit, 2006), have better access to information and exercise closer monitoring of management. Our results confirm those of previous studies carried out in the MENA region, showing that family ownership exercises tight monitoring and control (Arayssi and Jizi, 2019). Consequently, family ownership leads to an attenuation of the negative effect of political connections on bank performance.

4.3 Additional evidence

4.3.1 Banks in the authoritarian regimes versus hybrid regimes. Gaining political outcomes is an entire political process in which political power matters (Ulziisukh and Wei, 2022). As power is central to the resource dependence rationale, the effectiveness of political connections depends on the political regime. Moreover, the political regime has an effect on bank performance (Asutay and Mohd Sidek, 2021). Therefore, we propose to test whether the effect of political connections on bank performance differs across political regimes.

More specifically, we split our sample according to the Democracy Index gathered by the Economist Intelligence Unit. Democracy is measured by 5 indicators rated on a scale of 0–10 (Karataş, 2021). Countries with authoritarian regimes in our sample are Bahrain, Jordan, Kuwait, Oman, Qatar Saudi Arabi and UAE, while countries with hybrid regimes are Lebanon, Morocco and Turkey. Our results [2] show that in the authoritarian sub-sample, political connections are harmful to bank performance and that only family ownership moderates this effect positively. Our results are explained by the high proportion of royal family members in these banks. Royal family members are more cohesive and powerful than other segments of society. Then, ruling family directors are likely to have the power to obtain private benefits, leading to enhance bank performance. Estimations of the sub-sample of

banks in hybrid regimes shows that political connections decrease bank performance. Moreover, the moderating effect of the state and institutional investors is significant.

4.3.2 Islamic banks versus conventional banks. The growing momentum of Islamic banks is mainly concentrated in the MENA region (Khanchel and Mghaieth, 2017). Islamic banks are restricted to follow the rules of Islamic Shariah. In the MENA region, Islamic banking has a different risk profile than conventional banks, which can affect their performance (Abrar *et al.*, 2022). Political connections are considered a primary concern for policymakers while developing policies for promoting Islamic banking (Abrar *et al.*, 2022). We split our sample into Islamic banks and conventional banks. Our results [2] show that political connections decrease the performance of conventional as well as Islamic banks. For the moderating effect of the three ownership variables, our estimations show almost the same result in the two-sub samples. However, when we compare the coefficients of the political connection for the two kinds of banks, we show that the coefficient of PC in the case of conventional banks is higher in absolute value than in the case of Islamic banks. This result implies that the negative effect of the policy connection is more pronounced in the case of conventional banks. This result is also verified by introducing the moderator variable STATE. The moderating effects of institutional investors and family ownership are positive and more important in conventional banks. Thus, the performance of conventional banks is more sensitive to political connections than Islamic banks.

4.4 Robustness checks

To ensure the robustness of the results, we use an alternative proxy of banking performance: return on assets (ROA) [2]. The coefficient of political connections in the basic model is negative and statistically significant. This finding supports our earlier evidence. For the moderating effect, our results show, on the one hand, the alleviating effect of institutional investors and family shareholders, and the exacerbating effect of state on the other hand.

5. Conclusion

This paper studied the impact of political connections on bank performance of a sample of MENA banks observed from 2009 to 2019. Specifically, this paper examined the relationship between political connections and bank performance as moderated by state, institutional and family shareholders. We considered two common institutional logics: the agency logic and the resource dependence logic. Our analysis is informed by theoretical insights drawn from agency theory, hazard moral theory and resource dependence theory.

The results show that political ties have a negative and significant effect on bank performance. For the moderating variables, state ownership strengthens the negative relationship between political connections and bank performance. Meanwhile, institutional investors and family shareholders weaken this relationship. Additional evidence has been put out by taking into account many features of MENA banks such as banks in authoritarian versus hybrid regimes, and Islamic banks versus conventional banks. Finally, through a robustness check, our results are the same when we consider alternative proxy of banking performance.

Our evidence does not negate the value of political connections in the MENA region but suggests the need for better corporate governance mechanisms to reduce its potential negative effects. Theoretically, the results support agency theory and moral hazard theory and highlight conflicts of interests using political influence as a balance of power along with the substantial control of politically connected members. Ownership structure, mainly institutional and family ownership, effectively reduces the negative effect of political ties on bank performance.

This study has many managerial and economic implications and delivers new insights to banks, investors, regulators, policymakers, CEOs and directors. Practically, our findings imply that banks have to take into account another determinant of performance, that is, political ties. Banks in the MENA region have to be more cautious when they hire or appoint politically connected CEOs or directors. As one of politicians' goals is rent-seeking and politically connected banks can be harmed, these latter have to minimize those rent-seeking transactions and make their decisions more efficient through the implementation of more objective and non-political criteria when appointing CEOs and directors. Our study further suggests that both institutional investors and family shareholders attenuate the negative effect of political connections on bank performance. Following this study, banks have to encourage these two types of investors. Moreover, we found that state ownership is not helpful for MENA banks, as it can have an acute negative impact on the political ties-bank performance relationship. Then, to increase performance, we encourage the implementation of new rules for the banking sector and the promotion of disclosure policies to counterbalance the effect of state shareholders. In this regard, it is recommended to improve the control of the banking sector in the MENA region by reviewing their financial regulations through a more pronounced involvement of the financial authorities. Moreover, we suggest for policymakers and regulators, first, to monitor and oversee the strategies and conditions of appointing politically connected CEOs and/or directors in banks of the MENA region, and, second, to create more effective mechanisms for politically connected banks with low performance to protect minority shareholders' interests. Finally, CEOs and directors of banks have to review the disadvantages of their political connections through the analysis of their effect on their human capital and career in the banking sector in the long term.

For the limitation and future studies, although this study examined a large sample of banks operating in the MENA region and considered the significant role of the most important shareholders in the political connections-bank performance relationship, it has some limitations. *First*, a composite measure of political connections is considered in the current study. Future research can carry out interesting extensions by separating the political connection of CEOs from the political connection of directors on the one hand, and distinguishing direct from indirect political connections on the other. As each political connection type has its own logic and incentives, such analysis is helpful and leads to test which type of political connections affects more bank performance *Second*, to deepen our analysis and test if the relationship between political ties and bank performance is different for high-performing and low-performing banks, quantile regression can be used. This estimation method offers a new insight to determine the effect of political ties on bank performance at different quantiles. The idea behind using quantile regression to extend this study is that banks with low performance do not have enough support from stakeholders and are subject to acute control. They are more likely to have political connections to help bail them out of financial problems and protect them against prudential and regulation penalties. *Third*, our study has been carried out during a non-turbulent period. Nevertheless, the MENA region had faced several crises. Therefore, it will be interesting to replicate this study during an uncertain period. *Finally*, our study shows that ownership structure moderates the relationship between political connections and bank performance, and it will be interesting to extend our analysis to the moderating effect of other corporate governance mechanisms such as board characteristics (board size, the presence of independent directors, board diversity, etc.).

Notes

1. We do not consider the ultimate owners because Thomson Reuters does not provide information on such owners.
2. The results are not reported for brevity reasons and available upon request from the corresponding author.

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Appendix

Variables	Label	Description
Bank performance	NIM	(Interest received–Interest paid to depositors)/Total Assets
Political connections	PC	A dummy variable that takes 1 if the CEO and/or board members are politically connected, and 0 otherwise
State ownership	STATE	The sum of the direct percentage of the bank's shares held by the state
Institutional ownership	INST	The sum of the direct percentage of the bank's shares held by intuitional investors
Family ownership	FAM	The sum of the direct percentage of the bank's shares held by families
Bank liquidity	LTD	The loan-to-deposit ratio
Asset quality	LLP	The ratio of loan loss provisions to total assets
Credit risk	NPL	The ratio of nonperforming loans to gross loans
Bank solvency	CAR	Capital to asset ratio
Bank size	SIZE	The natural logarithm of the bank's total assets
Audit opinion	AUD	A dummy variable that takes 1 if the audit opinion is modified, and 0 otherwise
Country governance index	GOV	The index is the sum of the following sub-indices: voice and accountability, political instability and violence, government efficiency, regulatory quality, rule of law and corruption control
Economic growth	GDPG	The growth rate of gross domestic product on an annual basis
inflation rate	INF_RATE	The growth rate of the consumer price index

Source(s): Authors' own creation

Table A1.
This table describes in detail all the variables used in empirical models

Corresponding author
Naima Lassoued can be contacted at: naima.lassoued@sesame.com.tn