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Risk management committee and firm performance: The moderating effect of political connection

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Abstract

Research aims: This study seeks to prove empirical evidence regarding the moderating effect of political connection to risk committee and firm performance relationship.
Design/Methodology/Approach: The method used in this research uses a quantitative approach. The data used is financial companies registered on the Indonesian Stock Exchange (IDX) in the 2019 – 2021 period. The data used and meets the criteria is 129 data.
Research findings: The research results show that the size of the risk management committee has an influence on firm performance. The large number of risk management committee members helps companies assess potential risks early. Political connections weaken the relationship between the risk management committee and firm performance.
Theoretical contribution/ Originality: The originality of this research is based on the moderating results of political connections which provide a weakening effect compared to previous studies.
Practitioner/Policy implications: For practitioners and companies, they can consider it in decision making before having a board of directors join politics
Research limitations/Implications: Limitation of this research is research scope just in financial sector and only risk committee size used in this research.
Keywords: Firm Performance; Political Connection; Risk Committee

Introduction

The financial crisis caused by Enron and WordCom and the COVID-19 pandemic are cases that have affected the company's financial performance. Firm performance is an important thing that companies need to pay attention to for company continuity. The financial sector is an important sector for economic development because it has a wide variety of services offered (Abubakar et al., 2018). Abubakar et al. (2018) adding that a country's financial strength depends on the effectiveness and efficiency of financial firm performance. Poor financial firm performance will have a negative impact on the company. To be able to improve firm performance, good governance mechanisms need to be considered by the company (Aldhamari et al., 2020; Orazalin & Mahmood, 2019).

Companies with good governance will increase company value and be useful in increasing investment from outside (Bhatt & Bhatt, 2017; Pintea et al., 2020). During the COVID-19 period, all company sectors experienced a decrease in performance. The financial sector is one of the sectors affected by the decreasing distribution of funds. One way to achieve good governance is to consider the presence of a risk management committee. The risk management committee can provide useful risk assessments to reduce the level of risk faced by companies, especially in the financial sector (Karim et al., 2022). The presence of a risk management committee will help the company achieve its goals and improve firm performance. However, the existence of a risk management committee under the audit committee means that the performance of this function is not optimal. The breadth of the audit committee's responsibilities, combined with a lack of resources and time, results in the need for a risk management committee to stand alone (Aldhamari et al., 2020).

Kallamu (2015) stated that the presence of a board of directors in the company is an important factor in dealing with the crisis faced by the company. The existence of a risk management committee will help management to plan the company's performance in the long term. Bhuiyan et al. (2021) state that the existence of a risk management committee will provide sufficient relevant information about the risks faced by investors so that it can simultaneously reduce risks that can affect firm performance.

In addition, the role of the risk management committee in a financial firm is not only to deal with risks faced internally but also risks originating from external sources such as regulatory changes or government leaders changes because financial firm regulation is to minimize the potential failure (Iselin, 2020). In an effort to reduce risks originating from external sources, companies need to have political connections when carrying out their operations. The existence of political connections within the company board has an impact on firm performance (Boubakri et al., 2013; Faisal et al., 2021; Shen et al., 2015). Political connections provide opportunities for companies to gain benefits that are useful for improving firm performance. Politically connected companies tend to link their companies to governments or politicians who can provide economic benefits such as government funds, tax reductions, or government subsidies (Aldhamari et al., 2020). Faccio (2006) states that companies that have political connections will provide satisfaction to shareholders. The presence of government officials, such as members of parliament or ministry officials who have political connections with the company, may help the company to prepare regulatory changes and securing a favorable policy. Therefore, companies that have political connections will help the risk management committee in minimizing risks and will improve firm performance.

Several studies on risk management committees, political connections, and firm performance have been carried out (Abubakar et al., 2018; Aldhamari et al., 2020; Ames et al., 2018; Elamer & Benyazid, 2018; Junus et al., 2022; Malik et al., 2020; Orazalin & Mahmood, 2019; Wati, 2017). The effectiveness of the risk committee has a positive influence on improving firm performance. In times of crisis, the presence of a risk management committee has a positive influence on the company's financial performance (Aldhamari et al., 2020; Ames et al., 2018). Malik et al. (2020) also state that the existence of Risk Committees is more effective in increasing market performance. However, Abubakar et al. (2018) provide the view that the independence of the risk management committee has a negative influence on firm performance. Elamer and Benyazid (2018) also state that the Risk Committee has a negative influence on firm performance. The effectiveness of the Risk Committee will increase pressures and controls on financial institutions. Research has been conducted on political connections to firm performance (Boubakri et al., 2013; Rocca et al., 2022; Sheng et al., 2011; Utamaningsi, 2020; Wati, 2017). Wati (2017) states that political connections have a positive influence on firm performance in Indonesia.

Political connections help to make it easier for companies to achieve their goals. Boubakri et al. (2013) added that political connections positively influence firm performance. Political connections create a choice of risks faced by companies. By being politically connected, such as with regulators, they have access to resources, so they can more easily minimize risks. On the contrary, Rocca et al. (2022) state that political connections negatively influence firm performance. Politically connected companies will reduce their governance. Political connections also have a negative effect on firm performance because even though they benefit from political connections, they cannot improve firm performance because of inefficient management (Cheema et al., 2016). Jackowicz et al. (2014) stated that there is no evidence that companies that are politically connected will have access to profitable government. So, with different results from the prior study, our research investigates the influence of risk management committees on firm performance by adding political connections as a moderating variable. Iselin (2020) explains that financial firms will be subject to government regulation. Political connections may provide firms with more favorable oversight. Thus, this condition will affect how the risk management committee assesses and mitigates risk. This research aims to determine the influence of the risk management committee on firm performance with political connections as a moderating variable. This research focuses on financial sector companies, considering that the financial sector is the driver of a country's economy. Apart from that, a potential financial crisis is something important to pay attention to. Ames et al. (2018) added that focusing on one sector will provide high validity.

Literature Review and Hypotheses Development

Agency Theory

Agency theory provides a view of potential conflicts that arise between agents and principals in agency relationships (Jensen & Meckling, 1979). The principal, in this case, the shareholder, gives authority to agents or management to manage the company. The agent has an interest in developing the company in accordance with the agent's interests without direct supervision by the principal. Agency theory exists to provide alignment of potential conflicts that occur between agents and principals (Karim et al., 2022). Karim et al. (2022) explain that there are two ways in the process of aligning potential conflicts. First, monitoring agent behavior to prevent opportunistic behavior. Second, providing appropriate incentives to agents. By monitoring agent behavior, agency conflicts will be minimized. Because the principal does not have direct supervisory access to the agent, one method that can be used is through a risk management committee. With an effective risk management committee, the potential risks faced by the company can be reduced, thereby potentially improving the company's performance. Firm performance depends on management's ability to provide confidence to principals that they can provide profits for the company without facing high risks (Putri & Endiana, 2020). Under the agency theory, political connection can help to reduce agency conflict. According to Dicko (2017), companies that are politically connected will be more careful about the company’s risks than companies that are not connected. Therefore, political connections will help reduce the risks faced by the company.

Risk Management Committee

The effectiveness of corporate governance is measured not only from the financial aspect but also from how the company is able to manage risk, respond to market changes, and maintain a good reputation. Moreover, good corporate governance also includes social and environmental responsibility, which is increasingly becoming a major concern in the era of broader corporate responsibility.

The risk management committee works under the audit committee. However, due to recent financial innovations in new products and shifting priorities among traditional financial institutions, there is now a growing requirement to oversee the risks associated with investing in these innovations. An independent risk management committee is comprised of members possessing technical expertise in finance company operations and products (Kallamu, 2015). Apriliani and Dewayanto (2019) state that the number of board members can influence the effectiveness and efficiency of management. The size of the board provides a diversity of opinions, which makes it more effective and powerful in determining potential problems that arise. Musallam (2018) added that the size of the committee causes delays in decision-making. This is because there is much insight from committee members, which leads to the right decision. A large committee size will minimize the potential risks faced more effectively (Abubakar et al., 2018). From this explanation, the first hypothesis that is built is as follows:

***H_1**: Risk Management Committee Size Positively Influences Firm Performance.*

Moderation of political connections on firm performance

Political connections in business contexts have become a significant phenomenon in various economies around the world. The link between politics and firm performance is something that cannot be ignored because politics has a deep impact on the business environment and company strategy. Political connections refer to the relationships and interactions between business actors and policyholders, government officials, and other political institutions, with the aim of influencing decisions and regulations that can affect firm performance (Aldhamari et al., 2020).

In an era of globalization and increasing competition, many companies feel the need to leverage political networks to gain better access to resources, permits, contracts, and critical information (Shahzad et al., 2021). Political connections can provide significant competitive advantages for companies, especially in complex business environments that are often affected by government regulations (Aldhamari et al., 2020). However, the impact of political connections on firm performance is complex and controversial. On the one hand, political connections can help companies overcome bureaucratic obstacles, obtain permits more quickly, and gain easier access to strategic resources (Utamaningsi, 2020). However, on the other hand, too much dependence on political connections can also damage the company's image, trigger negative perceptions from the public and competitors, and create an unfair environment in business competition.

Based on the explanation above, political connections provide the view that directors who are involved in politics support the government, thereby reducing the company's operational risk. Wang et al. (2019) show that political connections reduce the costs of information asymmetry. This suggests that political connections can help risk management committees. However, Ling et al. (2016) show that political connections cause poor corporate governance. Therefore, political connections can moderate the relationship between risk management committees and firm performance, so the second hypothesis is:

***H_2**: Political connections are able to strengthen the relationship between the risk management committee and firm performance*

Based on the ideas, a research model was developed and is depicted in Figure 1:

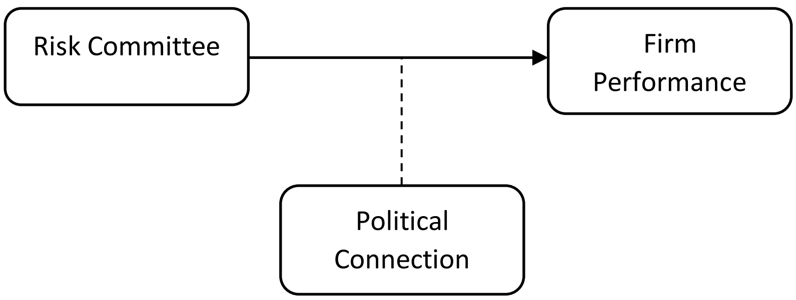

Figure 1 Research Model

Research Method

Data collection used a sample of financial companies listed on the Indonesian Stock Exchange (IDX) from 2019 - 2021. The financial sector was chosen because it is an important sector for economic development, and it offers a wide variety of services. The total number of data observed was 129 data. Data was collected using a purposive sampling method. Table 1 shows the data collection criteria. The data used secondary data taken from financial reports and annual reports on the IDX or the company website. The software used in this research uses Stata 17.

Table 1 Sampling Criteria

No	Criteria	Total
1.	Financial companies listed on the IDX in 2019-2021	90
2.	Companies that do not present complete financial reports	(4)
3.	Companies that do not present complete annual reports	(6)
4.	Incomplete Company Data (no information about the number of RMC and Politically Connected BoD)	(47)
	Number of Samples	43
	Number of Observations (3 years)	129

The first stage of data analysis is carrying out the Chow test to determine the regression model. The Chow test is carried out with the condition that if the Prob value is > 0.05, then use the Common Effect Model (CEM). If the prob value is <0.05, then use the Fixed Effect Model (FEM) (Dwi Sihono & Agus Djoko, 2020). Then, proceed with the Hausman test. If the prob value is > 0.05, then use the Random Effect Model (REM). If the prob value < 0.05, then use the Fixed Effect Model (FEM). Based on the research conducted, the following regression model was obtained.

$$FPERFORM = \alpha + \beta_1 RC + \beta_2 RC * PC + e$$

Where FPerform is firm performance, α as constant, RC is risk committee management, PC is political connection.

Operational Definition Variable

Firm Performance

This research in measuring firm performance follows the existing literature by Junus et al. (2022) to see how the company can manage the company with the company's existing resources as proxied by Return on Assets (ROA). ROA is used to see the company's accounting performance. ROA is defined as net profit before tax divided by total assets (Eissa & Eliwa, 2021). ROA is chosen because it can show a company's efficiency in using its assets to make a profit, and it reflects the firm performance (Junus et al., 2022).

Risk Management Committee

Having a risk management committee indicates high strength in risk management (Aebi et al., 2012). Tao and Hutchinson (2013) add that a large number of committees will impact the company's deep knowledge and ability to assess risks. The size of the risk management committee is related to the level of risk assessment faced by the company. The large RMC will bring diversity with various backgrounds and lead to a more comprehensive assessment of potential risk. Therefore, in this study, the risk management committee is measured by looking at the number of risk management committees in the company (Ghazieh & Chebana, 2021; Tao & Hutchinson, 2013).

Political Connection

The political connections used in this research are of several types. Political connections within a company can be in the form of directors holding government offices or government share ownership (Eissa & Eliwa, 2021). Political connections are measured using a dummy variable where a value of 1 is given if there is a board of directors who has a position or share ownership in the government and otherwise (Cheema et al., 2016; Faccio, 2006; Fan et al., 2007).

Result and Discussion

Table 2 shows the results of the descriptive statistics of the data used in the research. The amount of data observed after data reduction was carried out according to the criteria was 129 data. The data characteristics presented in the following table are related to the minimum, maximum, average, mean, and number of samples.

Table 2 Descriptive Statistics

Variable	Observations	Minimum	Maximum	Mean	Std. Dev
Risk Committee	129	2	10	4,542	1.820
ROA	129	0.000	0.090	0.018	0.018
PolCon	129	0	1	0.705	0.457

Table 2 shows the descriptive statistical results of the variables studied. The results show that the risk management committee projected using committee size has a minimum value of 2 and a maximum value of 10. The average value of the risk management committee is 4.54. Firm performance projected by ROA has a minimum value of 0.000151 and a maximum value of 0.090. The average ROA value is 0.018. The political connection variable is projected using a dummy variable to have a minimum value of 0 and a maximum value of 1 with an average value of 0.705. From the table, it can be seen that the data has low variation because the standard deviation is below the average.

The data in this study was processed using STATA software. The data analysis stage begins with testing the best estimation model. The first stage is carrying out the Chow test. Chow test was used to estimate the best model between the Common Effect Model and the Fixed Effect Model. If the prob value < 0.05, the Fixed Effect Model is selected and goes to the second test, which is named the Hausman test. Based on the results of the Chow test carried out in Table 3, the data shows a prob value = 0.000. This indicates that the estimation model used is the Fixed Effect Model (FEM) (Dwi Sihono & Agus Djoko, 2020). Then, after the Chow test, the Hausman test is carried out to ensure that the estimated model is appropriate. Based on the Hausman test results, the Prob value > Chi2 = 0.003. This shows that if the prob value is <0.05, the best estimation model is still to use the Fixed Effect Model (FEM).

Table 3 Data Panel Regression

Variable	Observations	Coeff	Std. Error	t	P>|t|
Risk Committee	129	0.006	0.001	3.040	0.003
RC*PC	129	-0.002	0.001	-2.010	0.040
Constant		-0.007	0.008	-0.840	0.402
R-Swuare		0.130			
Prob > F		0.000			
Prob > Chi2		0.003			

Based on Table 3, the risk management committee variable has a P value <|t| of 0.03. This indicates that H1 is accepted where the risk management committee has a significant value below 0.05. The coefficient value of 0.006 indicates that a risk management committee has a positive direction. The risk management committee, based on data from Figure 3, has a positive effect on firm performance (Ames et al., 2018; Ghazieh & Chebana, 2021; Kallamu, 2015). Table 3 also shows that the significance value of the political connection moderating variable shows a value of P>|t| of 0.048. This value is still below 0.05, which indicates that political connections are significant, with a coefficient value of – 0.002. This value indicates that political connections weaken the relationship between the risk management committee and firm performance.

Risk Committee Management to Firm Performance

Based on the data above, the risk management committee variable has a significant positive influence on firm performance. The presence of a large risk management committee has a positive impact on improving firm performance, and the risk management committee plays an important role in management effectiveness (Ghazieh & Chebana, 2021). Company risks can be detected earlier by the risk management committee. In line with Musallam (2018), the risk management committee will provide various insights that will help the company reduce the potential risks it faces. Management will be more careful in making company decisions. This concerns the level of shareholder trust in the company. In line with Ames et al. (2018), the presence of a risk management committee reduces the company's potential risks, which has an impact on increasing firm performance, thereby minimizing agency conflicts. In addition, a large risk management committee provides better monitoring of the company's business (Kallamu, 2015).

Risk Committee Management to Firm Performance with Moderating Political Connection

Based on the results of data analysis, the risk committee management variable moderated by political connections has a significant effect on the financial performance. Table 3 shows that the coefficient value is – 0.002, and the significance is 0.04 < 0.05. This shows that political connections have a negative influence on firm performance. Political connections weaken the relationship between the risk management committee and firm performance. Companies with a large risk management committee size will improve their performance, but when management has political connections, this will weaken the relationship between the risk management committee and firm performance. Under the agency theory political connections create agency conflicts which force management to participate in actions that prioritize personal interests and defend the interests of politicians. This will weaken the risk management committee, affect shareholder trust, and increase risks for the firm. Potential conflicts of interest will also occur between individuals with political connections and companies. Management will take detrimental actions through their political connections in the company so that the involvement of management with political connections will influence business decision-making and reduce firm performance (Boubakri et al., 2013; Ha & Frömmel, 2020; Islam et al., 2023). The financial sector, as an important sector in economic development, should be separated from political connections. Being involved in political connections will reduce management's awareness of the company's situation because politically connected management has access to information related to government policy. This then has the potential to increase the company's risk (Saeed et al., 2019).

Conclusion

Based on the results of the above research conducted on risk management committees on firm performance with the political connection variable as a moderating variable, the size of the risk management committee has a positive influence on firm performance. The size of a large risk management committee provides a lot of insight so that decisions taken to minimize risks are more accurate. In addition, the large number of risk management committees increases management awareness, so management is more careful when making decisions. However, on the other hand, the presence of politics within the company actually weakens the relationship between the risk management committee and firm performance. Our findings theoretically provide evidence that politically connected firms actually have the potential to increase the risk due to the conflict of interest of politicians. Political connections create decisions taken by management that are potentially based on personal interests, which will create risks for the company and reduce shareholder confidence. Therefore, financial companies need to consider political connections in the future. Because financial companies are important for a country's economic sector, they need to be aware of political interests that have the potential to influence management decision-making. This research has limitations that do not include all of the board risk management committees and are just limited to financial sector firms. For further research, the researchers can investigate other sectors and use all board committee risk management indicators. Even though the financial sector is an important sector of the country's economy, other sectors still need to be studied further regarding the presence of political connections within them.

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Conflicts of Interest

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