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CORPORATE GOVERNANCE AND BANK PROFITABILITY: A FIXED EFFECTS REGRESSION ANALYSIS OF STATE-OWNED BANKS IN UZBEKISTAN

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Abstract: The structural transformation of Uzbekistan's banking sector highlights the need to evaluate the outcomes of corporate governance reforms. This study explores how recent reforms impact the profitability of state-owned banks in Uzbekistan. Utilizing panel data analysis with a Fixed Effects model and Bootstrapping techniques, the research investigates the relationship between governance variables—such as board composition, board size, gender diversity, audit and risk committee size, and government ownership—and profitability indicators, including Return on Assets (ROA) and Return on Equity (ROE). The results indicate that while government ownership enhances financial stability, larger audit committees may reduce efficiency. These findings offer valuable insights for policymakers in emerging markets, emphasizing the importance of aligning governance practices with local economic and institutional conditions

Key Words.
Uzbekistan, Corporate Governance Reforms, Financial Performance, State-Owned Banks.

1. Introduction

Transformation of the Banking Sector has, in fact, started in 2017 when the government allowed the currency to float freely. Later in 2019, law on "Banks and Banking Activities" from 1996 has been revised redefining and modernizing the authority of Central Bank. In addition, Decree of the President of the Republic of Uzbekistan dated January 09, 2018, No.5296 "On measures to radically improve the activities of the central bank of the Republic of Uzbekistan" was adopted. Later, the Uzbek government has launched an ambitious banking sector reform strategy for 2020 – 2025 (Resolution of the President dated May 12, 2020, №UP-5998) aiming at reducing the state's involvement and elevating the proportion of assets owned by private banks from the current 18% to 60% till the end of 2025. In March 18, 2022, another resolution of the President №PP-168 was signed to accelerate the ongoing privatization process.

Studying Central Asia, especially Uzbekistan, is essential for several reasons. First, a country's unique institutional structures offer a largely underexplored environment for analyzing the influence of Corporate Governance on Financial Performance. Additionally, Uzbekistan now is still in transitioning stage from centrally planned economy to a market-oriented system which is bringing about several transformations within the banking sector, particularly concerning state-owned banks that possess assets making up more than 50% of the country's GDP, higher than Kazakhstan or Ukraine (Dubko, 2023). Lastly, Uzbekistan's strategic significance in the area, together with its continuous efforts to attract international investment, renders the enhancement of corporate governance essential for its sustained financial stability and prosperity. Financial institutions, especially state-owned banks, are pivotal to Uzbekistan's economy, possessing a predominant asset share, 65% of total GDP as of 2023 and more worryingly 69% of the bank assets are owned by the government (Dubko, 2023). These banks, historically concentrated on lending to state-owned firms the most, have been in the spotlight of most recent ongoing corporate governance reforms aimed at enhancing efficiency, transparency and profitability (EBRD, 2023)

1.2. Problem Statement and Research Gap

Despite the multiple reformation efforts, State-owned Banks remain plagued by low transparency, inefficiencies and limited profitability. Key initiatives in the government reforms such as privatization, board restructuring and audit committee reforms have yet to produce desired outcomes with initial targets not being fulfilled as planned (EBRD, 2023). As Uzbekistan endeavors to align with international governance norms and attract foreign investments, it is essential to comprehend the effects of corporate governance reforms on the financial performance of state-owned banks. Nonetheless, there is limited empirical research on the success of these reforms resulting in a considerable void in our understanding of how changes in governance can influence financial performance. Existing studies from (Temirov A. 2020. Umarkhojaeva M. 2022) devoted to Corporate Governance in Commercial Banks of Uzbekistan, or from (Mirpulatova L. 2023) have predominantly concentrated on dealing with digital technologies or the privatization process and macroeconomic reforms, however, have not sufficiently addressed the impact of governance changes in state-owned banks towards efficiency and profitability. This gap is essential, considering the current reforms intended to modernize Uzbekistan's banking industry and decrease state ownership.

Objective and Research Questions

This research seeks to assess the impact of key corporate governance variables, stemming from board composition and structure to transparency and disclosure practices, on the profitability of these banks over the past seven years, starting in 2017.

Main Research question will be: How have the changes in governance practices affected financial performance over the past years?

2. Literature Review

Corporate governance reforms have regularly been evaluated through the lens of several different theories, each offering a unique perspectives on the relationship between governance practices and financial performance. In this paper, main frameworks used for understanding corporate governance in government owned banks in Uzbekistan will be Agency Theory and Stewardship Theory as recommended in the literature (Sanda, Mikailu and Garba, 2010).

2.1. Hypothesis Development

- Board Composition and Structure

Adams and Mehran (2012) discovered through empirical study that board size positively affects the financial performance of major banks in the United States, based on a sample of 35 of the largest banks. Their analysis additionally demonstrated that banks with extensive board sizes exhibited a favorable correlation with performance as assessed by Tobin's Q. Conversely, Staikorous et al. (2007) conducted a study involving 58 large European banks from 2002 to 2004, revealing a negative correlation between board size and bank performance. More recent study though conducted in Indonesia showed that the board size does not have a significant impact on financial performance of Banks (Umar, Sudradjat and Etti Ernita Sembiring, 2023).

Agency theory suggests that corporate boards manage managerial activities to mitigate the self-serving actions of agents (Miller, 2002). The primary motivation for appointing sovereign members to the boards of publicly traded organizations is to mitigate potential wrongdoing by mainstream members and to augment the value of the boards, particularly in the dissemination of information that safeguards stakeholder interests (Rashid & Hossain, 2022). However, some argue that while non-executive directors enhance a company's board, an excessive number may exacerbate information asymmetry between the board and management, thereby compromising the board's monitoring effectiveness (Musah et al. 2019). When it comes to profitability, the findings are inconclusive (Maniruzzaman et al., 2024).

Lastly, Gender diversity has attracted significant attention from government entities, academics, and practitioners, sparking vigorous debate on its good or bad effects on organizational dynamics and performance (Khan et al. (2020). He argued that the inclusion of female directors in Islamic banks may better reflect the inclusive attitude of these institutions. Meanwhile, a year earlier Musah et al. (2019) had discovered no significant correlation between gender diversity and the performance of commercial banks in Ghana. However, most recent study by Umar in Indonesia, Sudradjat and Etti Ernita Sembiring in 2023 also supported the results. Based on the empirical findings presented and in accordance with agency theory, the study hypothesizes that:

H1: There is positive correlation between board sizes of the state-owned banks in Uzbekistan and their financial performance

H2: The proportion of non-executive directors in state-owned banks in Uzbekistan is positively correlated with bank performance

H3: The Diversity of the board has a positive influence on financial performance of the state-owned banks of Uzbekistan

- Government Ownership

Studies on the share of state on firms and their profitability have provided mixed results, especially in emerging markets. Most recently, Boshnak (2023) examined this dynamic within Saudi Arabia and discovered that government ownership favorably influences both accounting-based and market-based performance indicators. Similarly, Government ownership may promote optimal governance practices and thus improve performance due to direct enforcement and efficient monitoring (Al-Janadi et al., 2016). However, there are some evidences of negative relationships coming from researchers such as Al-Malkawi and Pillai (2018) and Iwasaki et al. (2022) .

H4: There is a positive link between Government ownership and financial performance of state-owned banks in Uzbekistan

- Board Committees

Research investigating the presence and size of a board-level risk committee is scarce due to data constraints and challenges in identification (Jiang and Ji, 2023). Regardless, agency theory predicts that a larger committee can cause free-rider problems with the presence of additional members showing complacency which may lead to agency problems between the committees and management (Subramaniam et al., 2009). More recently, Musallam (2018) also confirmed this by stating that bigger size committees will cause focus lost and possibly negative effect in performance. Research in Malaysian nonfinancial firms in 2024, the researchers found that the size of the Risk committee is negatively and significantly linked with ROA (Karim et al., 2024). On the other hand, Pearce and Zahra (1992) believe resource dependence theory supports the idea of size because the larger the committee, the more probable that it has more resources to be deployed in addressing difficulties and problems in the monitoring process.

Numerous modern regulations, corporate practices, and rigorous legal frameworks have been instituted to revitalize the Audit Committee (AC) so far (Abhisheck Kumar Singhania and Nagari Mohan Panda, 2023). Various studies showed that Audit committee size has a significant positive effect on firm performance (Musallam, 2020). Most recent study using meta-analysis by Altin (2024) confirmed the positive and strong relationship. However, there have been a few warnings too by DeZoort et al., 2002 stating that if the audit committee becomes excessively large, it may experience a diffusion of responsibility.

H5: Having more risk committee members in state-owned banks can positively impact the profitability

H6: Existence of larger audit committee in state-owned banks can lead to increased firm value

3. Methodology

3.1. Research Design

The study uses Panel data regression model to evaluate the impact of corporate governance changes on financial performance of state-owned banks in Uzbekistan.

Because of the lack of available data the researcher had to deal with limited sample size (3 banks over 7-year period, before and after the main banking sector reform strategy 2020-2025). To make the most out of the data, I used Fixed Effects regression model with bootstrapping (for robustness check) to accommodate for the limited sample size.

Data Collection

Three banks – NBU (National Bank of Uzbekistan), SQB and Asaka banks were selected for this study as their assets combined represented 60% or more of the total share of state-owned banks in Uzbekistan. Therefore, the results coming from those chosen banks could be generalized to all state-owned banks in Uzbekistan and possible the whole Banking Sector in the territory. Also, last seven years (2017-2023) were selected because this allowed the researcher to see the changes of corporate governance variables in the light of the governance reforms. Main sources of the data were Annual Reports and Financial Statements of the selected banks obtained from their respective websites in Investor relations section and openinfo.uz platform. Government ownership related proportions were obtained from CERR report

Model Specification and Justification

$$\mathbf{ROA} = \alpha + \beta_1 * \mathbf{BoardIndependence} + \beta_2 * \mathbf{BoardSize} + \beta_3 * \mathbf{GenderDiversity} + \beta_4 * \mathbf{AuditCommitteeSize} + \beta_5 * \mathbf{RiskCommitteeSize} + \beta_6 * \mathbf{GovernmentOwnership} + \gamma_1 * \mathbf{Bank\ Size} + \gamma_2 * \mathbf{LTD} + u_i + \epsilon$$

3.2. Descriptive Statistics

Corporate Governance variables: Board independence averaged at 18.9% with the range of 11% and 27% which meant that the number of independent board members varied a lot across banks. Board size though had relative consistency with banks staying at an average of 16.7 members. Moving to gender diversity, the percentage of woman in the board was low, with an average 10% of total members and a range of 6%-17%. Audit and Risk committees, meanwhile, reflected almost consistent committee structures with average 3.24 and 2.6 members respectively. As expected, government ownership indicated a strong state influence over the banking sector with an average ownership of 97.6% across banks.

Statistical Tests: The Correlation matrix was created to detect possible multicollinearity among the variables. No correlation above 0.65 was detected suggesting that the multicollinearity did not exist. However, when the author conducted the VIF test, the score was above 10 after which then we had to normalize one of the high scorers by taking the natural log. Then Ln of Bank Size is generated and rerun the test, consequently, the score dropped below 10. Besides, Due to the restricted sample size, bootstrapping with 1,000 replications and clustering by bank ID was employed to derive robust standard errors. This methodology enhanced the reliability of our fixed-effects estimations.

4. Results

Fixed Effects Model with Bootstrapping Interpretations: Overall, the model indicated a high degree of explanation for the variability in ROA with 98% of R-Squared.

However, overall R-squared was on the lower side with 7% which meant that variability among banks may not be well explained by the model. The final model looked like as follows:

ROA/ROE=0.2045−0.2223*BoardIndependence+0.0038*BoardSize+0.0835*Gender Diversity−0.0066*AuditCommitteeSize+0.0028*RiskCommitteeSize+0.3203*Government Ownership−0.0449*BankSize−0.0067*LTD+u_i+ ϵ

During the research, two of the variables were identified as significant – Government ownership and Audit Committee Size. Starting with the former, it showed that the government ownership is associated with financial stability and it can positively affect the ROA with huge degree. The latter though had a negative impact towards profitability, most likely because of efficiency trade-off which means that larger audit committees may face with diminishing decision-making efficiency. While not being statistically significant (close though), board independence’s negative coefficient of -0.2223 suggests that having more independent directors was in fact affecting the profitability of state-owned banks negatively in Uzbekistan. This aligns with stewardship theory which suggests that in certain situations, less independent board of directors may improve organizational performance, particularly in environments where trust, alignments of interests and organizational goals are the focus, not the strict control.

Discussion

One of the key findings is the significant positive effect of government ownership on the performance of banks in Uzbekistan. The results were consistent with the more recent papers studying other emerging markets (Boshnak, 2023; Ahmed et al., 2022; Din et al., 2021) while contrasting with the findings of Al-Malkawi and Pillai (2018) and Iwasaki et al. (2022). In Uzbekistan, benefits of being state-owned such as operational stability and access to resources can be particularly relevant and it highlights that in transition economies while implementing Banking Sector reforms, state-owned banks will benefit the most.

Another significant finding was the discovery of negative effect coming from audit committee size on financial performance in state-owned banks in Uzbekistan. This finding was unexpected and opposed to many other previous conducted studies (Altin, 2024; Musallam, 2020 and DeZoort et al., 2002). In Uzbekistan’s context, the warnings of DeZoort et al., 2002 came true where they stated if the audit committee becomes excessively large, it may experience a diffusion of responsibility and may cause coordination challenges.

There were also three variables which were near significant, of those three 2 were control variables Bank Size and Liquidity (LTD). Although economies of scale are typically advantageous to larger banks, the absence of significance in this instance implies that size alone does not contribute to profitability in Uzbekistan's state-owned banks. Similarly, the loan-to-deposit ratio did not exhibit any substantial influence. This suggests that other factors, such as governance practices, may have a more significant impact on the performance of these institutions.

3.3. Practical Implications

The implications of this research are particularly valuable for policymakers, banking regulators, and leadership in state-owned financial institutions, particularly in emerging markets. In economies where private investment is relatively limited or financial markets experience high volatility, the discovery that government ownership can positively impact financial performance suggests that a precisely calibrated level of state ownership may provide essential stability. This stability could be crucial in environments like in Uzbekistan, where state support could guarantee the continuity and resilience of public sector banks.

Although comprehensive oversight is essential, the efficiency and timely decision-making of audit committees may be compromised by their expansion beyond an optimal size. This suggests that governance structures should strive for a balance that preserves both agility and efficacy, rather than solely concentrating on size.

3.4. Limitations

Limited Sample Size: The results of this research are based on a comparatively small sample, which is restricted to three state-owned banks over a seven-year period. The generalizability of the results to the broader banking industry or other sectors may be restricted by this scope

Data Availability: This study primarily used publicly available financial statements because of the limited availability of detailed corporate governance data in Uzbekistan.

Model and Control variable limitations: This study controlled for characteristics like bank size and LTD ratio, however, including additional factors like market competitiveness or economic indicators could yield a more comprehensive understanding.

Conclusion

To summarize, the study revealed that corporate governance reforms in Uzbekistan's state-owned banks impact financial performance differently across different governance areas. State ownership appears to enhance financial stability while larger audit committees may cause a reduction in efficiency, hence, financial performance. All the insights from this study are beneficial for policymakers, indicating that tailoring governance frameworks to accommodate local requirements might enhance stability and banking performance in transitional economies.

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