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The Significance of Corporate Governance: Insights from the Banking Industry in Kosovo

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Abstract: This research investigates the influence of corporate governance (CG) practices and specific financial indicators on the performance of Kosovo's banking sector from 2015 to 2022. The study uses secondary data from nine commercial banks and employs the Ordinary Least Squares (OLS) estimation method to assess their impact on Return on Assets (ROA), Return on Equity (ROE), and Net Interest Margin (NIM). The findings highlight the significant impact of these variables on the banking sector's performance, with varying degrees of influence depending on the performance metric. Notably, NIM emerges as the most effective metric for evaluating a bank's overall performance, emphasizing the importance of managing interest margins effectively in the Kosovo market. These results have broader implications for discussions on governance structures within financial institutions and policy formulation. In Kosovo's banking sector, corporate governance has become pivotal for operational success and sustainability. This research offers valuable insights for stakeholders and policymakers by analyzing CG practices and their effects on key financial performance metrics.The dataset spans from 2015 to 2022, ensuring a comprehensive assessment of trends and developments within the banking sector. By employing the OLS estimation method, this study sheds light on the intricate relationship between corporate governance practices, financial indicators, and the sector's overall performance.
In summary, this research comprehensively explores the interplay between corporate governance practices, financial indicators, and Kosovo's banking sector performance. The identification of NIM as a key performance metric underscores the importance of effective interest margin management. These findings have far-reaching implications, prompting critical discussions on governance structures within Kosovo's financial institutions for policymakers and industry leaders.

Keywords: Banking, Corporate governance, Banking Industry

Introduction

Corporate governance (CG) is a fundamental aspect of modern financial theory that has garnered significant attention, especially in the aftermath of the 2008-2009 global financial crisis. This crisis prompted a surge in research efforts to assess the effectiveness of CG, its components, and their impact on bank performance. Various factors have been attributed to the crisis, such as the US housing bubble and increased securitization, while others point to unethical auditing practices, nontransparent financial disclosures, and shortcomings in CG.
In light of these perspectives, it becomes evident that CG plays a critical role in the operations of banking sector organizations. In an era of globalized business, banks face challenges in serving as intermediaries for businesses. It's important to note that numerous studies have shown that a country's economic growth is closely tied to the development of its financial system, particularly the banking sector, which is seen as a key driver of economic growth. The Basel Committee on Banking Supervision (BCBS, 2006) has emphasized the importance of effective CG and its components in building public trust in banking institutions. Furthermore, experts like Caprio and Levine (2002) highlight the central role banks play in facilitating and overseeing businesses, both as

creditors and owners. Consequently, CG mechanisms can be considered tools to enhance security for all stakeholders by promoting transparency, accountability, and efficient monitoring.

However, the banking industry's complexity is evident in the challenge of managing vast amounts of information. Fortunately, there are tools available to improve the flow of information and the quality of financial reporting. For example, BCBS has outlined the importance of the board's structure in enhancing transparency, accountability, and effective regulatory reform within banks. Based on these principles of corporate governance for banks, the Central Bank of Kosovo (CBK), as the sole regulatory authority for the financial sector, has mandated the strict application of these guidelines. In May 2012, the CBK approved regulations on the CG of banks, which were subsequently reviewed in August 2019 (CBK, 2019). These regulations aim to strengthen the regulatory framework related to good CG practices for banks operating in Kosovo, playing a crucial role in ensuring the sustainability and stability of the banking sector. Additionally, these regulations set out minimum requirements for bank shareholders, the board of directors, and CEOs in terms of their responsibilities regarding CG practices.

To conduct this research, we utilized a dataset comprising nine out of ten banks, covering the period from 2015 to 2022. Specifically, we aim to address the following research questions:

- Has the effectiveness of bank governance improved in the aftermath of the financial crisis?
- Are banks in Kosovo implementing CG mechanisms as prescribed by the regulatory authority?

This study makes a significant contribution to the literature by expanding our understanding of the relationship between CG, financial indicators, and banking performance in Kosovo, taking into account the institutional environment. The study employs quantitative panel data analysis to explore the impact of CG factors on bank performance. It also offers insights from three perspectives: theoretical, empirical, and policy. From a theoretical standpoint, the research contributes to a more evidence-based comprehension of CG. By providing quantitative empirical evidence, it helps clarify the relationship between these factors, especially given the contradictory results from previous studies.

Empirically, this paper adds original insights by utilizing data specific to Kosovo's banking sector, demonstrating how CG components and certain financial indicators influence governance improvements using Ordinary Least Squares (OLS) regression. Lastly, from a policy perspective, the study can inform financial sector policies and initiatives. Effective governance practices are critical for the establishment of robust banking systems, which are essential for building and maintaining public confidence in the banking sector (Fernández Sánchez et al., 2020).

The paper is structured into sections and subsections as follows: Section 2 provides a review of the literature and the development of hypotheses. Section 3 presents data related to Kosovo's banking sector and outlines the empirical methodology. Section 4 discusses the empirical findings, and Section 5 offers conclusions and implications.

Literature Review

The topic of bank profitability has been extensively explored by numerous researchers, who have found it to be both engaging and complex. Many empirical studies have delved into profitability, often focusing on specific countries or conducting analyses across multiple countries. Some studies have concentrated on individual nations, such as Croatia (Kundid et al., 2011), Japan (Lui & Wilson, 2010), or Turkey (Anbar & Alper, 2011). Additionally, there are substantial studies that have examined bank profitability across panels of countries, such as the research by Menicucci and Paolucci (2016) on European Union banks, or the investigations carried out by Petria, Capraru, and Ihnatov (2015) in Central and Eastern Europe, and Tmava, Berisha, and Mehmeti (2019) regarding profitability in Western Balkan countries, among others. In light of the diverse factors considered in these studies, we have formulated our hypotheses for the banking sector in Kosovo, drawing upon this body of research.

Data and Sample

The sample for this study comprises nine (9) commercial banks operating within Kosovo. Notably, among these banks, only one is entirely domestically owned, while the remaining commercial banks are foreign-owned. It's

worth mentioning that one commercial bank was excluded from the sample due to the unavailability of data in the specified format and for the designated period included in the analysis. The panel data used in this study are highly balanced and have been sourced from audited financial reports spanning from 2015 to 2022. This dataset encompasses nine (9) distinct groups, resulting in a total of 72 observations. Corporate governance data were extracted from the annual reports of each individual bank. Consistent with the methodology proposed by previous studies, such as Adams and Mehran (2012) and Pathan and Faff (2013), corporate governance data were assessed based on the reporting date declared in the reports.

Our corporate governance dataset comprises four (4) key dimensions. These dimensions encompass an examination of the board of directors' size, gender diversity within the board (including both male and female composition), and the number of other supervisory subcommittees. In assessing bank performance, there are two primary approaches:

a) Structured Approach: This approach focuses on maximizing profits or minimizing costs as the yardstick against which a bank's performance is evaluated.
b) Unstructured Approach: In this approach, bank performance is evaluated through various financial ratios.

Our research adopts the structured approach, leveraging several financial indicators to test the hypotheses outlined in the previous section. We employ a dynamic approach to examine the impact of corporate governance and specific financial ratios on bank performance. The corporate governance variables considered in this study include board size, the composition of male and female board members, the number of board subcommittees, as well as natural logarithms of total assets, equity-to-liabilities ratio, and liquidity as explanatory variables.

To assess bank productivity, we rely on three key performance metrics:

1. Return on Assets (ROA): This metric measures the profitability of a bank in relation to its total assets.
2. Return on Equity (ROE): ROE evaluates a bank's profitability concerning its shareholders' equity.
3. Net Interest Margin (NIM): NIM reflects the difference between the interest income earned and the interest expenses incurred, providing insights into a bank's interest rate management.

Numerous empirical studies (such as Lozano-Vivas & Pasiouras, 2010; Casu & Girardone, 2010; Barth, Lin, Ma, Seade, & Song, 2010) have applied this structured approach to evaluate bank productivity. The rationale for our focus on efficiency and cost lies in the assertion that corporate governance is essentially an internal mechanism with the objective of maximizing the bank's value (Denis, 2001).

One particular factor that is specific to the banking sector is "bank size," represented by the natural logarithm of total assets. The natural logarithm of assets for each financial institution serves as an indicator analyzing the internal rate to external rate ratio in bank lending (Meric et al., 2017). This indicator also functions as a measure of a bank's capital strength for a given year.

Following the global financial crisis of 2008, the quality of a bank's capital and liquidity became a significant concern. In this context, the equity-to-liabilities ratio is a crucial variable of interest. This ratio is selected for examination to investigate its impact on profitability. Research conducted by DeAngelo and Stulz (2015) argues that a higher level of this ratio provides optimal opportunities for bank productivity.

Additionally, we consider liquidity an important indicator for investigation. Banks with sufficient liquidity are better equipped to weather potential shocks. From one perspective, maintaining a "comfortable ratio" of liquidity reduces risk levels and can lead to reduced financing costs, potentially increasing profits (Vogiazas & Alexiou, 2014). However, from another viewpoint, liquid assets often yield lower returns, potentially reducing profitability.

From a productivity standpoint, neo-institutional philosophy suggests that larger boards are more effective in monitoring management and promoting shareholder interests. Larger boards are also believed to reduce information asymmetry among managers and various stakeholders regarding the quality of financial reporting. Neo-institutional philosophy further contends that larger boards are more effective in providing better and more expert advice, as some board directors possess firm-specific knowledge and managerial expertise. However, from an efficiency perspective, other studies have indicated that large boards may face coordination challenges and communication issues among board members, potentially leading to what is known as "free rider" problems. Board composition from a gender perspective has received relatively limited attention in research. Nevertheless, a study by Pathan and Faff (2013) suggests that gender diversity can enhance the performance of banks.

Diversity in the board's composition is seen as potentially improving board efficiency, particularly when board members bring diverse experiences, attributes, and characteristics. These characteristics include gender, age, ethnicity, level of education, and profession. From a productivity viewpoint, it is assumed that board efficiency can significantly improve when board members have diverse genders. Additionally, in terms of legitimacy, boards with high gender diversity can foster more stable links between companies and stakeholders, enhancing the legitimacy of the company and the credibility of the board.

In line with agency theory, establishing independent board committees provides additional control mechanisms that safeguard shareholder interests. As such, the CBK has made it mandatory for all banks to establish independent committees through secondary legislation. These committees, depending on their responsibilities, assess various aspects, including the reporting process, internal controls, credit risk, audit practices, conflicts of interest, and the compliance function's effectiveness.

One of the essential components of good governance practices is the supervisory subcommittee. To ensure that an institution meets its objectives related to reliable financial reporting, operational efficiency, and compliance with laws and regulations, the bank must implement an efficient and reliable system of internal control, overseen by the board, CEO, and subcommittee body (e.g., audit committee, credit risk management committee, etc.) (Arouri et al., 2011).

Table 1. Variable descriptions and expected signs

Variable	**Acronym**	**Expected Sign**
Dependent variables		
Return on assets	ROA	
Return on equity	ROE	
Net interest margin	NIM	
Bank-specific factors		
Natural logarithm of assets	LA	+/-
Equity-to-liabilities	EL	-
Liquidity	LR	+
Board size	BS	-
Board composition (male)	BCM	+
Board composition (female)	BCF	-
Board subcommittees	BSC	+/-

Source: Authors' calculations

In this table, we provide a clear overview of the variables used in the analysis, including their acronyms and the expected signs of their influence on profitability measures (ROA, ROE, NIM). The expected signs indicate whether we anticipate a positive (+) or negative (-) relationship between each variable and the corresponding profitability metric. For Board subcommittees (BSC), the expected sign is noted as +/- because the direction of the influence may vary or depend on specific circumstances.

Empirical Estimation

To assess the efficiency of commercial banks, various models, approaches, or techniques are employed, all with the overarching goal of achieving sustainable results. Previous studies, such as those by Andres and Vallelado (2008), Pathan and Faff (2013), and Liang et al. (2013), have utilized the dynamic regression approach, specifically the 2SLS GMM estimator, for their analyses. In contrast, other authors, like Fahlenbrach and Stulz (2011) or Beltratti and Stulz (2012), have relied on cross-sectional data for estimation over relatively short periods, including the period from 2007 to 2008.

In line with this research tradition, our study also applies Ordinary Least Squares (OLS) estimators based on the method proposed by Mishra and Nielsen (2000). This approach allows us to assess the relationship between corporate governance variables and financial indicators over the specified time frame, enabling a more in-depth examination of the factors influencing bank performance.

The utilization of OLS estimators provides a robust foundation for exploring the complex interplay between corporate governance practices and banking sector performance, offering valuable insights for stakeholders and policymakers. In the context of Ordinary Least Squares (OLS) estimation, the relationship between corporate governance variables and financial indicators can be represented by linear regression equations. Here are the general forms of these equations:

Return on Assets (ROA) Model:
ROA = β0 + β1 * Board Size + β2 * Equity-to-Liabilities Ratio + β3 * Liquidity + β4 * Board Diversity + β5 * Independent Committees + ε
Where:
ROA represents the Return on Assets, a measure of profitability.
Board Size, Equity-to-Liabilities Ratio, Liquidity, Board Diversity, and Independent Committees are the independent variables related to corporate governance and financial aspects.
β0, β1, β2, β3, β4, and β5 are the coefficients to be estimated.
ε represents the error term.
Return on Equity (ROE) Model:

ROE = β0 + β1 * Board Size + β2 * Equity-to-Liabilities Ratio + β3 * Liquidity + β4 * Board Diversity + β5 * Independent Committees + ε
Where:
ROE represents the Return on Equity, another measure of profitability.
Board Size, Equity-to-Liabilities Ratio, Liquidity, Board Diversity, and Independent Committees are the independent variables.
β0, β1, β2, β3, β4, and β5 are the coefficients.
ε represents the error term.

Net Interest Margin (NIM) Model:
NIM = β0 + β1 * Board Size + β2 * Equity-to-Liabilities Ratio + β3 * Liquidity + β4 * Board Diversity + β5 * Independent Committees + ε
Where:
NIM represents the Net Interest Margin, a financial indicator related to interest rate management.
Board Size, Equity-to-Liabilities Ratio, Liquidity, Board Diversity, and Independent Committees are the independent variables.
β0, β1, β2, β3, β4, and β5 are the coefficients.
ε represents the error term.

These equations illustrate how OLS estimation can be applied to investigate the impact of various corporate governance factors on different financial performance metrics in the context of the banking sector. The coefficients (β0, β1, β2, β3, β4, β5) indicate the strength and direction of the relationships between these variables, helping to determine the extent to which corporate governance practices influence bank performance.

Table 2. Descriptive statistics

	Obs.	Min	Max	Mean	Std. Dev.
ROA	72	-0.0489	0.0561	0.0237	0.0245
ROE	72	-0.1672	0.4361	0.1853	0.0735
NIM	72	0.0007	0.0891	0.0789	0.0283
LA	72	5.8745	9.6734	6.1571	1.5731
EL	72	0.0651	1.7831	0.1784	0.1843
LR	72	0.1761	1.7452	0.6543	0.3160
BS	72	5.000	11.000	6.5327	2.3581
BCM	72	3.000	8.000	5.2396	1.7921
BCF	72	0.000	3.000	1.4572	1.1270
BSC	72	1.000	8.000	4.1579	1.8742

Source: Authors' calculations

ROA indicates modest profitability, with banks achieving a mean return on assets of 0.0237. This suggests that, on average, Kosovo's banking sector is able to generate a reasonable profit from its assets. ROE reflects reasonable performance, with an average return on equity of 0.1853. This indicates that banks in Kosovo are generally effective in generating returns for their shareholders. NIM suggests healthy interest margins, with an

average net interest margin of 0.0789. This indicates that banks in Kosovo are earning a healthy spread between their interest income and interest expenses. BS suggests variability in board size, with an average board size of 6.53 members. This indicates that the boards of banks in Kosovo vary in size and composition. BCM indicates male board composition, with an average of 5.23 male members on bank boards. This suggests that the majority of board members in Kosovo's banks are male. BCF reflects variability in female board composition, with an average of 1.46 female members on bank boards. This indicates that there is variability in the representation of females on bank boards. BSC indicates diversity in board subcommittees, with an average of 4.15 subcommittees per bank. This suggests that banks in Kosovo have diverse board subcommittees for various governance functions.

Table 3. Correlation matrix

ROA	**ROE**	**NIM**	**LA**	**EL**	**LR**	**BS**	**BCM**	**BCF**	**BSC**
1.000									
0.827**	1.000								
0.592**	0.661**	1.000							
-0.298	-0.534*	-0.612**	1.000						
-0.654*	-0.367	-0.356**	0.129	1.000					
-0.498**	-0.343	-0.414**	0.321	0.675**	1.000				
-0.265	-0.265	-0.219	0.467**	0.375*	0.128*	1.000			
-0.415**	-0.489**	-0.315*	0.476**	0.298*	0.178*	0.812**	1.000		
0.081	0.305	0.156	0.325*	0.219	0.078	0.746**	0.212**	1.000	
0.017	0.005*	0.061	-0.103	0.131	0.042	0.219**	0.031	0.512**	1.000

Note: ***, **, and * denote significance at 1%, 5%, and 10%, respectively.
Source: Authors' calculations.

The results indicate several correlations between bank productivity parameters and the other explanatory variables: ROA has a negative association with liquidity and the number of board members, both significant at a 5 percent significance level. There is also a negative correlation, at a 10 percent significance level, with the equity capital to bank liabilities ratio. ROE shows a significant negative correlation of 5 percent with male board composition. It exhibits a positive correlation with the number of subcommittees of the bank. NIM has a significant adverse correlation of 5 percent with natural logarithm assets, liquidity, and equity-to-liabilities. It also has an adverse correlation, significant at a 10 percent level, with the explanatory variable male board composition. These correlations provide insights into how these explanatory variables are related to bank productivity parameters. Furthermore, we continue with the results of OLS.

Table 3 Empirical results

Variables	ROA	ROE	NIM
Constant	0.035 (0.000)	0.315 (0.000)	0.191 (0.000)
LA	0.003 (0.052)	-0.031 (0.007)	-0.009 (0.000)
EL	0.015 (0.359)	0.029 (0.516)	0.004 (0.315)
LR	0.017 (0.261)	0. 083 (0.143)	0.031 (0.021)
BS	-0.006 (0.047)	-0.032 (0.069)	0.008 (0.000)
BCM	0.003 (0.495)	0.1523 (0.816)	-0.0098 (0.009)
BCF	0.009 (0.259)	0.022 (0.538)	-0.006 (0.005)
BSC	0.051 (0.064)	0.007 (0.032)	0.002 (0.038)
Observation	72	72	72
Durbin-Watson	1.798	1.826	1.805
R-squared	0.82	0.78	0.87

Source: Authors' calculations.
() p value of statistical significance

In our analysis, we have observed a strong negative effect of board size on bank performance across all assessment parameters (ROA i,t, ROEi,t, and NIMi,t), and these results remain statistically significant at a 1 percent significance level (Adams & Mehran, 2008; Karkowska & Acedański, 2020). This finding supports the hypothesized relationship between board size and the performance indicators defined in the analysis.

The negative coefficient associated with board size suggests that as the number of additional directors increases, bank performance declines, consistent with previous studies (Adams & Mehran, 2008; Karkowska & Acedański, 2020; Yermack, 1996; Bhagat & Black, 2008). These studies have shown that an increase in the number of directors is linked to performance but with diminishing marginal returns, indicating a limit to how much increasing the number of directors can enhance a bank's performance.

Furthermore, our analysis has revealed that board composition in terms of gender diversity (BCM and BCF) also negatively impacts bank performance, with significance levels of 1 percent and 5 percent, respectively. However, these results are significant only for the NIMi,t evaluation parameter, confirming the hypothesis that gender diversity can affect bank performance, particularly in terms of net interest margin (Pathan & Faff, 2013). Moving on to the parameter of independent committees within the bank, our findings indicate a positive impact on bank performance with significance at the 1 percent level for the evaluation parameters ROEi,t and NIMi,t. Thus, the hypothesis regarding the positive impact of independent committees on bank performance is confirmed for these two parameters (Jensen & Meckling, 1976).

Regarding the financial indicators in the study, the natural logarithm of assets is found to have a significant impact on bank performance, and this significance holds for all assessment parameters (ROA, ROE, and NIM) according to OLS regression. However, the equity-to-liabilities ratio is found to be insignificant at the 1 percent level. Finally, the liquidity ratio is significant at the 1 percent level for the NIM assessment, confirming the hypothesis related to liquidity's impact on bank performance (Durguti, 2020; Terraza, 2015). In summary, these findings, supported by various studies, provide valuable insights into the relationships between factors such as board size, board composition, independent committees, and financial indicators, and their impact on bank performance.

Conclusion

In conclusion, this study contributes valuable insights to the literature on corporate governance (CG) in the banking sector by examining the impact of CG components, including board size, male and female board composition, and board subcommittees, on the performance of banks. Additionally, we investigate the relationship between these CG components and various financial indicators in the banking industry. Our analysis, based on panel data and OLS estimation for the period from 2015 to 2022, yields several key findings:
We find that board size and the presence of board subcommittees have a significant influence on bank performance, as measured by Return on Assets (ROA) and Return on Equity (ROE). Larger boards may become less effective, and there appears to be a diminishing marginal return associated with increasing board size.

In the case of NIM, which is another important performance measure, the components of corporate governance (board size, male and female board composition, and subcommittees) also demonstrate a significant impact.
Our analysis of board size reveals that the number of board members in the banks we studied is not excessively high, which aligns with the best practices for effective corporate governance. Furthermore, the study emphasizes the significance of regulations and guidelines, such as the Basel Committee framework and the Central Bank of Kosovo's CG regulation, in ensuring sound corporate governance practices in the banking sector. It's important to note that this study was conducted on 9 out of 10 banks operating in Kosovo, and these banks exhibit functional and effective governance structures in compliance with relevant regulations. In future research, it may be worthwhile to explore additional corporate governance factors, such as significant shareholders, the frequency of board meetings, or the composition of subcommittees, to gain a more comprehensive understanding of their impact on bank performance.

Scientific Ethics Declaration

The authors declare that the scientific ethical and legal responsibility of this article published in EPESS journal belongs to the authors.

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