Exploring the Impact of Corporate Governance on the Financial Performance of Private Banks in Ethiopia

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Abstract

This study aimed to examine the impact of corporate governance on the financial performance of private banks in Ethiopia. Using descriptive statistics and panel regression analyses, the research focused on six selected private banks from 2016 to 2023. The findings from the descriptive statistics revealed slight differences in Return on Assets (ROA), with Awash International Bank achieving the highest ROA at 2.70%, while Abyssinia Bank recorded the lowest at 2.19%. Notably, all banks had positive ROA values, reflecting their ability to generate income from their assets. Awash International Bank's strong performance highlights its effective asset management practices. For Return on Equity (ROE), Dashen Bank led with 22.50%, whereas Abyssinia Bank posted the lowest at 13.60%, showing Dashen Bank's superior profitability and returns to shareholders. The panel regression analysis identified several significant factors affecting ROA, including firm age, management efficiency, CEO duality, and asset quality. For ROE, firm age, board size, management efficiency, CEO duality, and capital adequacy were influential. These factors are crucial determinants of profitability for private banks in Ethiopia.

Key words: 'Capital adequacy'' 'corporate governance'' 'Return to Asset'' 'Return to Equity''

INTRODUCTION

Corporate governance refers to the systems and practices that guide how corporations are managed and controlled, including the roles of the board of directors, CEO duality, shareholder rights, and transparency. Effective corporate governance is essential for ensuring accountability and fostering sound decision-making within organizations. Globally, it has been proven that strong governance structures can positively impact financial performance, particularly in banks. These structures enhance risk management, operational efficiency, and overall stability.

In Ethiopia, the banking sector is undergoing rapid transformation, with private banks facing increased competition, regulatory challenges, and risk management issues. As the sector evolves, effective corporate governance becomes even more critical for improving financial performance and ensuring long-term stability. By strengthening governance practices, private banks in Ethiopia can enhance their operational efficiency, better manage risks, and adapt to the growing demands of the market.

LITERATURE REVIEW

Recent research continues to underscore the connection between corporate governance and enhanced financial performance. Chizema (2011) and Uwuigbe and Olusanmi (2012) observe that well-established governance structures, particularly corporate boards with diverse and non-executive members, improve decision-making and managerial supervision. These findings align with the earlier work of Fama and Jensen (1983), which suggests that governance mechanisms help reduce agency costs and improve company outcomes by enhancing oversight and aligning management interests with those of shareholders. Letting et al. (2012) further emphasize the strategic benefits of diverse boards, which lead to improved corporate decision-making and long-term performance.

The relationship between firm age and financial performance remains a topic of debate. While studies by Papatogonas (2007) and Rashid et al. (2010) suggest that older firms tend to be more profitable due to accumulated experience and stability, Dogan (2013) argues that increased firm age can sometimes hinder profitability due to rigidity and an inability to adapt to market changes. This contrast highlights the complex dynamics that influence corporate success over time.

In the context of management efficiency, more recent studies by Abdu (2018), Anteneh (2018), and Wondwossen (2018) confirm its crucial role in improving financial performance. Efficient management, as these studies point out, leads to optimal resource utilization, which in turn boosts the financial health of organizations. These insights build upon earlier findings by Palepu and Healy (2008), who highlighted the importance of management efficiency in driving business performance.

Capital adequacy also plays a significant role in financial stability, particularly within the banking sector. Wanjiru et al. (2024) emphasize the necessity of sufficient capital to help banks withstand financial challenges. This contrasts with the findings of Aggarwal (2019), who found no direct link between board size and financial performance, although Perera et al. (2016) suggest that in more complex environments, larger boards may offer enhanced oversight and strategic guidance.

METHODS AND MATERIALS
Data and Source of Data

This study employs secondary panel data collected from six private banks in Ethiopia between 2016 and 2023, yielding a total of 48 observations. Bank-specific variables were primarily sourced from the annual reports of the banks, which were accessed through their websites. Convenience sampling was utilized to select the sample for this research.

Methods of Data Analysis

Descriptive statistics such as mean, median, standard deviation, correlation, and panel regression analysis were used to analyze the data. Financial performance, measured by return on assets (ROA) and return on equity (ROE), served as the dependent variable. The independent variables included firm age, board size, management efficiency, capital adequacy, CEO duality, and asset quality.

Based on the findings of the literatures, the following hypothesis was developed to test the impact of corporate governance on financial performance presented in Table 2.

Table 1. Hypotheses formulation on the impact of corporate governance on financial performance of private banks in Ethiopia

	Hypothesis
H1a	Firm age significantly impacts on Return on Asset in private banking Sector
H1b	Board size significantly impacts on Return on Asset in private banking Sector
H1c	Management efficiency significantly impacts on Return on Assets in private banking sector
H1d	CEO duality significantly impacts on Return on Asset in private banking Sector
H1e	Capital adequacy significantly impacts on Return on Asset in private banking Sector
H1f	Asset quality significantly impacts on Return on Asset in private banking Sector
H2a	Firm age significantly impacts on Return on Equity in private banking Sector

H2b	Board size significantly impacts on Return on Equity in private banking Sector
H2c	Management efficiency significantly impacts on Return on Equity in private banking Sector
H2d	CEO duality significantly impacts on Return on Equity in private banking Sector
H2e	Capital adequacy significantly impacts on Return on Equity in private banking Sector
H2f	Asset quality significantly impacts on Return on Equity in private banking Sector

Model Specification for Corporate Governance and Financial Performance of Private Banks

To assess the effect of corporate governance on the financial performance of private banks, we employed panel regression analysis, given that our data comprises observations across multiple variables over different time periods. In this context, return on assets (ROA) and return on equity (ROE) are considered the dependent variables that evaluate financial performance. The general model specification for examining the influence of corporate governance on the financial performance of Ethiopian private banks is presented as follows:

Model 1: ROA with independent variables:

$$ROA_{it} = \alpha_i + \beta_1 ME_{it} + \beta_2 FAGE_{it} + \beta_3 CA_{it} + \beta_4 BDSIZE_{it} + \beta_5 CEO_{it} + \beta_6 AQ_{it} + e_{it} \quad ....(1)$$

Model 2: ROE with independent variables:

$$ROE_{it} = \alpha_i + \beta_1 ME_{it} + \beta_2 FAGE_{it} + \beta_3 CA_{it} + \beta_4 BDSIZE_{it} + \beta_5 CED_{it} + \beta_6 AQ_{it} + e_{it} \quad ...(2)$$

where:

ROA_{it} is Return of Asset which is financial performance of bank i at time t

ROE_{it} is Return of Equity which is financial performance of bank i at time t

α_i is intercept

β's are regression coefficients

ME_{it} is Management efficiency of bank i at time t

$FAGE_{it}$ is Firm age (bank)

CA_{it} is capital adequacy of bank i at time t

$BDSIZE_{it}$ is board Size

CED_{it} is CEO duality

AQ_{it} is asset quality of bank i at time t

e_{it} is Error term which assumes normally distributed with mean 0 and variance σ^2

RESULT AND DISCUSSION
Descriptive Summary Result

To evaluate the financial performance of private banks in Ethiopia, a descriptive analysis was conducted using return on assets (ROA) and return on equity (ROE). The Basel Accords consider banks with an ROE of 15% or higher to be in good standing. Table 3 shows that all selected banks met this standard except Abyssinia Bank, which recorded 13.60%, 9.3% below the requirement.

For ROA, all banks exceeded the Basel standard of 1%, with Awash International Bank achieving the highest at 2.70% and Abyssinia Bank the lowest at 2.19%. Positive ROA indicates effective income generation from assets, with Awash leading in asset management.

ROE ranged from 13.60% for Abyssinia Bank to 22.50% for Dashen Bank, indicating Dashen's strong shareholder returns. Higher ROE typically boosts investor confidence, while Abyssinia's lower ROE suggests weaker performance.

In management efficiency (ME), an ME ratio above 25% signals good performance. All banks except Abyssinia and United met this threshold, demonstrating effective management.

All banks maintained capital adequacy ratios above 8%, meeting Basel and National Bank of Ethiopia standards. For asset quality, all banks surpassed the Basel threshold, signaling strong asset quality across the sector.

Table 2. Descriptive result of financial performance of selected private banks in Ethiopia

Bank	CA	AQ	ME	ROA	ROE
Awash International Bank	12.73%	1.59%	29.51%	2.70%	21.39%
Abyssinia Bank	16.24%	1.26%	23.93%	2.19%	13.60%
Dashen Bank	12.40%	1.61%	27.92%	2.69%	22.50%
Nib International Bank	15.45%	1.84%	27.98%	2.55%	16.54%
United Bank	11.80%	1.46%	24.30%	2.30%	19.41%
Wegagen Bank	16.78%	0.96%	26.95%	2.58%	15.50%

Table 3 shows an average Return on Assets (ROA) of 0.025 (2.5%), indicating that firms earn a profit of $0.025 per dollar of assets. The standard deviation of 0.05 suggests significant variability, with ROA values ranging from 0.004 (0.4%) to 0.037 (3.7%). The average Return on Equity (ROE) is 0.181 (18.1%), reflecting strong shareholder returns, and a low standard deviation of 0.005 indicates consistency across firms, with ROE values from 0.031 (3.1%) to 0.356 (35.6%).

In terms of Management Efficiency, the average ratio is 0.267 (26.7%), but the higher standard deviation of 0.06 indicates considerable variation among firms, with values ranging from 0.064 (6.4%) to 0.385 (38.5%). Firms have an average age of 20.16 years, with a standard deviation of 3.05 years, suggesting a mostly mature cohort with ages between 14 and 27.

CEO Duality averages 0.00, indicating that no firm has a CEO also serving as the board chair, ensuring a separation of powers; the standard deviation of 0.00 confirms this governance structure is consistent across all firms. The average board size is 9.00, with a standard deviation of 0.00, indicating uniformity that may limit diversity in perspectives.

For Capital Adequacy, the average ratio is 0.142 (14.2%), with a standard deviation of 0.025 and values ranging from 0.103 (10.3%) to 0.21 (21%), reflecting differences in financial strategies. Lastly, the average Asset Quality ratio is

0.014 (1.4%), with a standard deviation of 0.07, indicating variability from 0.0007 to 0.027 and suggesting differing levels of asset quality among firms.

Table 3. Descriptive result of financial performance with independent variables of selected private banks

Variable	Obs.	Mean	Std. Dev.	Min	Max
Return On Assets	48	0.025	0.05	0.004	0.037
Return On Equity	48	0.181	0.005	0.031	0.356
Management Efficiency	48	0.267	0.06	0.064	0.385
Firm Age	48	20.16	3.05	14.00	27.00
CEO Duality	48	0.00	0.00	0.00	0.00
Board Size	48	9.00	0.00	9.00	9.00
Capital Adequacy	48	0.142	0.025	0.103	0.21
Asset Quality	48	0.014	0.07	0.0007	0.027

The results in Table 4. show a strong positive correlation (0.887) between return on assets (ROA) and market equity (ME), suggesting that better-capitalized banks tend to achieve higher returns. A moderate positive correlation (0.354) exists between ROA and asset quality (AQ), indicating that higher asset quality improves financial performance. However, ROA and firm age (FAGE) have a weak negative correlation (-0.116), implying older banks may face challenges affecting performance. ROA shows an insignificant relationship with cost efficiency dividend (CED) at 0.021, and weak negative correlations with capital adequacy (CA) at -0.019 and bank size (BDSIZE) at -0.072, suggesting minimal impact from these factors. The weak correlation between ROA and CA suggests changes in capital adequacy do not notably affect performance. Additionally, ME has a negative correlation with FAGE (-0.342), showing that older firms tend to have lower market equity. CA also negatively correlates with AQ (-0.256), indicating a potential trade-off that warrants further study. In summary, while market equity and asset quality are key factors affecting ROA, other variables exhibit weaker or negligible correlations, setting the stage for further regression analysis to better understand their impact on bank performance.

Table 4. Correlation coefficient result of independent variables with ROA

	ROA	ME	FAGE	CED	CA	BDSIZE	AQ
ROA	1.000000	0.887011	-0.116281	0.021277	-0.019186	-0.071927	0.353890
ME	0.887011	1.000000	-0.341589	0.036532	0.057013	-0.036363	0.359659
FAGE	-0.116281	-0.341589	1.000000	-0.185170	-0.321885	0.117344	-0.202410
CED	0.021277	0.036532	-0.185170	1.000000	0.177151	-0.050069	0.036983
CA	-0.019186	0.057013	-0.321885	0.177151	1.000000	0.007778	-0.255607
BDSI	-0.071927	-0.036363	0.117344	-0.050069	0.007778	1.000000	0.004386

AQ	0.353890	0.359659	-0.202410	0.036983	-0.255607	0.004386	1.000000

The results presented in Table 5. reveal that the correlation coefficient between return on equity (ROE) and market equity (ME) is 0.673772, indicating a strong positive relationship. This suggests that enhancements in management efficiency are linked to higher ROE, underscoring the crucial role effective management plays in boosting a bank's profitability. In contrast, the correlation between ROE and firm age (FAGE) is relatively weak at 0.059502, which implies little to no linear relationship. This indicates that the age of the firm does not significantly impact its return on equity within this sample.

Additionally, the correlation coefficient between ROE and CEO duality is -0.103229, suggesting a slight negative relationship. This indicates that when the roles of CEO and Chairperson are combined, the bank's ROE may decrease, which could raise concerns regarding governance. A strong negative correlation of -0.597445 suggests that higher capital adequacy (CA) is associated with lower ROE. This may imply that maintaining substantial capital reserves could restrict profitability, as a larger share of resources is allocated to capital rather than being utilized for profit generation. Furthermore, a correlation coefficient of -0.123580 indicates a weak negative relationship, suggesting that an increase in board size might correspond with a slight decline in ROE. This could point to potential inefficiencies in governance or decision-making processes when boards are larger.

On the other hand, a correlation of 0.422536 indicates a moderate positive relationship between ROE and asset quality. This suggests that higher asset quality is associated with improved profitability, highlighting the significance of maintaining high-quality assets to maximize returns. In summary, the correlation analysis demonstrates notable relationships between ROE and several explanatory variables. Both management efficiency and asset quality show positive correlations with ROE, indicating that improvements in these areas could enhance financial performance. Conversely, the strong negative correlation with capital adequacy suggests that this factor may require further exploration to understand its broader implications. The varying strengths of these relationships illustrate the complexity of how different factors interact to influence return on equity.

Table 5. Correlation coefficient result of independent variables with ROE

	ROE	ME	FAGE	CED	CA	BDSIZE	AQ
ROE	1.000000	0.673772	0.059502	-0.103229	-0.597445	-0.123580	0.422536
ME	0.673772	1.000000	-0.341589	0.036532	0.057013	-0.036363	0.359659
FAGE	0.059502	-0.341589	1.000000	-0.185170	-0.321885	0.117344	-0.202410
CED	-0.103229	0.036532	-0.185170	1.000000	0.177151	-0.050069	0.036983
CA	-0.597445	0.057013	-0.321885	0.177151	1.000000	0.007778	-0.255607
BDSIZE	-0.123580	-0.036363	0.117344	-0.050069	0.007778	1.000000	0.004386
AQ	0.422536	0.359659	-0.202410	0.036983	-0.255607	0.004386	1.000000

Panel Regression Analysis Result

Before conducting the panel regression analysis, it is crucial to confirm that the underlying assumptions of regression analysis are satisfied, which our findings indicate has been achieved. Consequently, we implemented the panel regression analysis as specified in Equations (1) and (2) presented in Tables 6 and 7. The overall goodness of fit and effectiveness of the regression models, Model 1 and Model 2, were evaluated based on how well they explain the variation in the dependent variables, ROA and ROE. The R-squared value demonstrates the proportion of variance in the dependent variable explained by the independent variables, indicating a strong fit and suggesting that both models effectively capture significant variability in the data.

Additionally, the log-likelihood value reflects predictive accuracy, with higher values indicating better fit, thus supporting our models' alignment with observed data. The F-statistic assesses overall model significance, showing that our models account for variation in the dependent variable more effectively than a model without predictors. The associated p-value is well below 0.05, confirming statistical significance at conventional levels and indicating that at least some independent variables meaningfully contribute to explaining the dependent variables in both models.

Impact of Firm Age on ROA & ROE

The coefficient for firm age (FAGE) is 0.000931 with a p-value of 0.0000, indicating a positive relationship between firm age and ROA (see Table 7). This suggests older firms generally achieve better financial performance, allowing us to reject the null hypothesis regarding firm age's impact on return on assets. Table 8 also shows a positive coefficient for firm age with respect to ROE, statistically significant at $p < 0.01$, reinforcing that firm age positively affects return on equity. These results highlight the benefits of experience and the development of effective business practices over time, aligning with research by Zhao and Lu (2023) and Akingunola and Odebiyi (2021), while contrasting with Dogan's (2013) findings of a negative relationship between firm age and profitability.

Impact of Management Efficiency on ROA & ROE

The coefficient for management efficiency (ME) is 0.098315, with a p-value of 0.0000 (Table 7), indicating that increased management efficiency correlates with higher ROA, suggesting that a unit increase in ME leads to a 0.098315 rise in ROA. Thus, management efficiency significantly impacts return on assets, allowing us to reject the null hypothesis. Similarly, the coefficient for management efficiency in Table 8 is positive and statistically significant ($p < 0.01$), indicating that improved management efficiency substantially increases ROE. Our findings align with numerous studies that affirm the importance of effective management practices for bank profitability, although they differ from Anteneh (2018) and others who found a negative correlation in Ethiopian banks.

Impact of Capital Adequacy on ROA & ROE

In Table 7, the coefficient for capital adequacy (CA) is 0.010288, but it lacks statistical significance ($p = 0.6059$), indicating insufficient evidence to conclude that capital adequacy significantly affects ROA. In contrast, Table 8 reveals a negative and statistically significant coefficient for capital adequacy ($p < 0.01$), suggesting that higher capital adequacy ratios correlate with lower ROEs. This relationship may stem from high capital adequacy leading to decreased profitability due to reduced lending activities. Therefore, capital adequacy significantly impacts return on equity, with enough evidence to reject the null hypothesis, aligning with Wanjiru et al. (2024), who concluded that capital adequacy positively influences financial performance.

Impact of Board Size on ROA & ROE

Table 7 indicates that the coefficient for board size is -0.000491, with a p-value of 0.1563, suggesting no significant relationship between board size (BDSIZE) and ROA. Thus, we cannot reject the null hypothesis regarding board size's effect on ROA. This finding aligns with Aggarwal (2019), which found no relationship between board size and bank performance. Conversely, Table 8 shows a statistically significant negative coefficient for board size ($p < 0.05$),

suggesting that larger boards may be linked to lower returns on equity, allowing us to reject the null hypothesis for ROE. This supports Perera et al. (2020), though it contradicts other studies that found different relationships.

Impact of Asset Quality on ROA & ROE

The coefficient for asset quality (AQ) is 0.102356, with a p-value of 0.0815, indicating borderline significance. This suggests higher asset quality may positively impact ROA (Table 7), although further research is necessary to confirm its significance. The findings also indicate a marginally significant positive effect on ROE (p < 0.10), supporting the conclusion that asset quality significantly influences ROE. These results align with research by Ayiro Roselyne et al. (2022) and others confirming asset quality's impact on financial performance.

Impact of CEO Duality on ROA & ROE

The coefficient for CEO duality indicates a significant positive association, suggesting that when the CEO also serves as Chair of the Board, it correlates with improved ROA (Table 7). This finding implies that unified leadership facilitates coherent strategic decision-making, despite the prevailing governance view advocating for role separation. Additionally, the positive coefficient in Table 8 shows that CEO duality enhances ROE, indicating potential advantages from singular leadership. Thus, we conclude that CEO duality significantly influences both ROA and ROE, aligning with Vo and Nguyen (2014), who found a positive correlation between CEO duality and financial performance.

Table 6. Panel regression analysis for ROA with independent variables

Variable	Coefficient	Std. Error	t-Statistic	Prob.
ME	0.098315	0.006754	14.55555	0.0000
FAGE	0.000931	0.000172	5.427645	0.0000
CA	0.010288	0.019772	0.520336	0.6059
BDSIZE	-0.000491	0.000340	-1.446896	0.1563
AQ	0.102356	0.057160	1.790685	0.0815
CEO DUALITY	0.113210	0.049111	1.8111	0. 0111
C	-0.018788	0.006710	-2.800081	0.0081

	Effect Specification			

Cross-section fixed (dummy variables)

R-squared	0.894115	Mean dependent var	0.025018	
Adjusted R-squared	0.865497	S.D. dependent var	0.005515	
S.E. of regression	0.002023	Akaike info criterion	-9.370700	
Sum squared resid	0.000151	Schwarz criterion	-8.941883	
Log likelihood	235.8968	Hannan-Quinn criter.	-9.208650	

F-statistic	31.24346	Durbin-Watson stat	1.350617
Prob(F-statistic)	0.000000		

Table6. Panel regression analysis of ROE with independent variables

Variable	Coefficient	Std. Error	t-Statistic	Prob.
FAGE	0.004651	0.001576	2.952380	0.0054
CA	-1.204860	0.181576	-6.635574	0.0000
BDSIZE	-0.007147	0.003119	-2.291754	0.0277
AQ	0.692747	0.524941	1.319668	0.1951
CEO Duality	0.341601	0.153281	2.228593	0.0041
C	0.118604	0.061622	1.924714	0.0620

Effects Specification

Cross-section fixed (dummy variables)

R-squared	0.908678	Mean dependent var	0.181564
Adjusted R-squared	0.883997	S.D. dependent var	0.054540
S.E. of regression	0.018576	Akaike info criterion	-4.935844
Sum squared resid	0.012767	Schwarz criterion	-4.507027
Log likelihood	129.4602	Hannan-Quinn criter.	-4.773793
F-statistic	36.81612	Durbin-Watson stat	1.079260
Prob(F-statistic)	0.000000		

With the results of a regression analysis presented in Tables 6 and 7, we can systematically verify the hypotheses formulated for this study and presented in the table below. The regression analysis provides essential insights into the relationships between the independent and dependent variables, allowing for a robust evaluation of the proposed hypotheses. In Table 7 and Table 8, the regression coefficients, standard errors, and significance levels for each independent variable are detailed. These statistics indicate the extent to which each variable influences the outcome variable and whether these relationships are statistically significant. If the p-values are below the conventional threshold of 0.05, we can confidently reject the null hypothesis for those variables, suggesting that they have a meaningful impact on the dependent variable. Overall, the regression analysis serves as a powerful tool in confirming the theoretical propositions of this study, allowing for a clearer understanding of the dynamics at play.

Table 9. Hypothesis result

	Hypothesis	Verdict
H1a	Firm age significantly impacts on Return on Assets in private banking Sector	Significant

H1b	Board size significantly impacts on Return on Assets in private banking Sector	Not significant
H1c	Management efficiency significantly impacts on Return on Assets in private banking sector	Significant
H1d	CEO duality significantly impacts on Return on Assets in private banking Sector	Significant
H1e	Capital adequacy significantly impacts on Return on Assets in private banking Sector	Not significant
H1f	Asset quality significantly impacts on Return on Assets in private banking Sector	Significant
H2a	Firm age significantly impacts on Return on Equity in private banking Sector	Significant
H2b	Board size significantly impacts on Return on Equity in private banking Sector	Significant
H2c	Management efficiency significantly impacts on Return on Equity in private banking Sector	Significant
H2d	CEO duality significantly impacts on Return on Equity in private banking Sector	Significant
H2e	Capital adequacy significantly impacts on Return on Equity in private banking Sector	Significant
H2f	Asset quality significantly impacts on Return on Equity in private banking Sector	Not significant

CONCLUSION

In conclusion, the analysis revealed several critical factors that significantly influence Return on Assets (ROA) and Return on Equity (ROE). For ROA, the significant determinants identified were firm age, management efficiency, CEO duality, and asset quality. For ROE, the analysis highlighted firm age, board size, management efficiency, CEO duality, and capital adequacy as significant factors. Overall, these findings underscore the multifaceted nature of financial performance, revealing that both asset management and corporate governance play pivotal roles in influencing a firm's profitability. Understanding these factors can empower stakeholders to make informed decisions aimed at enhancing both ROA and ROE.

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