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COMMERCIAL BANKS AS FINANCIAL INCENTIVE MECHANISM OF CORPORATE GOVERNANCE

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Abstract

The article discusses the theoretical aspects of increasing the reliability and stability of the system in commercial banks, ensuring transparency of banks' activities, fully protecting the legitimate interests of all participants in banking activities, and managing bank capital. The mechanism of financial incentives for corporate governance and approaches to assessing the effectiveness of management activities in commercial banks are also covered. The article examines the role of corporate governance in the risk minimization system of a commercial bank, and examines traditional concepts and principles of corporate governance described in foreign literature. The main elements inherent in one or another corporate governance model are described. An analysis is carried out of the reasons for the greatest importance of corporate governance for the banking system in contrast to any other economic elements. The reason for the increasing role of corporate governance during periods of economic crises is considered. The article confirms the hypothesis that the introduction and improvement of corporate governance will optimize the improvement of own and borrowed funds to perform the function of financial intermediation, will help strengthen the business reputation of a commercial bank and increase the share of borrowed funds, which predetermine the increased riskiness of bank liabilities, a noticeable discrepancy between the time structures of liabilities and assets, as well as the critical dependence of a commercial bank on the trust of many depositors.

Keywords: commercial banks, corporate governance, management, equity capital, risks, efficiency, financial stability, credit, resources

INTRODUCTION

With the development of the form of corporate ownership in the country's economy, the relevance of scientific research of the relations that arise in these processes is increasing. In particular, this research is considered important in studying the financial mechanisms of corporate management and clarifying the role of incentives in it. However, one of the effective mechanisms for solving the conflict that arises between the interests of people participating in the decision-making process (managers and owners, large shareholders and minority shareholders) is a properly organized incentive system. Applying the practice of tying the incentive package directly to earnings and even to EVA (economic value added) shows that managers often make short-term decisions that bring quick profits instead of long-term perspective growth decisions. From this point of view, scientific research and improvement of the mechanism of financial incentives of corporate management in corporations allows to regulate a number of negative situations that arise for the shareholder.

LITERATURE REVIEW

In scientific research, the existence of different approaches to the evaluation of the mechanism of financial stimulation of corporate management in banks and the effectiveness of management activities in commercial banks can be reflected in the scientific views of the authors.

A different result could be expected if managers were rewarded in proportion to the company's capitalization, with a separate bonus from net profit at the end of the year. Therefore, it is worth noting that when labor is paid fairly, it is encouraged materially and morally, only then corporate management decisions are made in the right sense and their interests are harmonized[1].

On the other hand, shareholding is aimed at maximizing economic efficiency in the long-term, with the aim of maintaining and increasing management activity, corporate value, and the active involvement of majoritarians in the management[2].

Because, the goal of asset management is to eliminate or correct imbalances and protect bank operations from risks by analyzing the results of the bank's main strategy according to the composition of the balance sheet and profitability[3].

In the long-term aspect, the main goal of asset management is to maximize the market value of the bank's capital. Increasing the market value of the bank's capital creates an opportunity for the development of the bank and the fulfillment of the increasing requirements of the supervisory authorities[4].

At the same time, it is noted that the bank's effective asset management policy should include stabilization or increase of net income in the form of interest, operational change of the balance sheet based on external environment indicators, profit maximization within the risk limit defined in the financial strategy[5].

The pursuit of profit maximization “creates a conflict of interest in which shareholders may give decision-making authority to managers, which is considered within the framework of a concept called agency theory. This theory lays the foundation for the mechanism of corporate management in the modern understanding[6].

In this context, “the corporate governance model should be designed to minimize agency costs. The simplest solution to limit agency costs is to make the manager's salary and benefits strictly tied to the company's stock price. In this case, agency costs are minimized because managers have a strong incentive to maximize shareholder value[7].

The current indicator that relates the manager's contribution to the growth of the company's value is the EVA[8].

In general, increasing the effectiveness of the corporate management system in commercial banks in Uzbekistan and regulating agency relations serve as an important institutional change in the banking and finance sector, which serves to improve the corporate management system.

RESEARCH METHODOLOGY

The research used methods such as systematic approach, comparative analysis, generalization, grouping, comprehensive assessment, and abstract logical thinking.

ANALYSIS AND DISCUSSION OF RESULTS

Taking into account the importance of corporate governance in the banking sector, the Central Bank of the Republic of Uzbekistan pays great attention to this problem and considers this issue as a strategic development goal of the development of the banking system. The main focus is on increasing the effectiveness of risk management, improving the internal control system, increasing the transparency of corporate management and ensuring the rights of owners (including minority shareholders).

The results of scientific research show that it is very important for commercial banks to solve the problem of ensuring the transparency of the composition of bank shareholders. A clear presentation of the last beneficiaries is promising in solving many problems in corporate governance and in expanding the resources involved in the domestic and foreign financial markets.

As a result of the research, it can be observed that banks attach great importance to the effective organization of the bonus mechanism of managers in improving corporate governance. The elements confirming the quality of such a system are as follows[9]:

- tying salaries at all levels of management to the achievements of the company (bank), as well as to the level of responsibility and risk assumed by each participant;
- the introduction of multi-element incentives (fixed part, current variable, long-term variable, on the cafeteria principle - giving the opportunity to choose), taking into account the peculiarity of the psychological acceptance of current monetary payments and competition in the labor market.

While researching this problem, we will consider the basic guidelines of how to form an incentive system within the framework of value management:

1. Strategic and tactical decision-making requires the separation of mechanisms in selected groups, recognizing the conflict between the group's interests, depending on the different levels of ownership of information. The algorithm of tasks and payments to them cannot be applied in the same way to the members of the Supervisory (Directors) Board, the top managers of the parent company, the heads of the components and the executive personnel. For each group, it will be necessary to choose appropriate incentive mechanisms and mechanisms for linking incentives to indicators, evaluation indicators. There may also be cases where certain groups may be excluded from the bonus plan in certain areas of the company's life. During the active growth phase and when a centralized budgeting system is used to seek competitive advantage, the independence of business units is very low, and self-executing personnel are not part of the incentive group. As the company reaches the stage of sustainable development and significant growth in quality, order and creative research, categories that were not previously included can be included in incentive plans.
2. At all stages of the company's (bank's) life (entering new markets, creating new products and technologies; actively using competitive priorities; positioning in markets), certain requirements are created by the management team in taking risks and performing tasks by the executives. It should be concluded that the mechanism of linking incentives to results is not fixed and it is always improving along with the development of the company. A vivid example of the practical application of this principle can be seen in project promotion . However, this approach is not suitable for all companies. Therefore, at the same time, the incentive system can create a customer effect. That is, the organized elements serve to attract and retain in the company necessary managers with personal qualities and competent characteristics. Interpreting the incentive plan as a dynamically evolving system

requires a renewed focus on the need to strategically view the company's development and understand the goals at each stage of the life cycle. By including evaluation elements in the regular salary payment, it allows to implement the customer effect at a high level. Many companies take into account not only the qualifications, but also the skills and innovative qualities that the employee has acquired over the past years in the process of assigning job positions to their employees.

3. Since strategic planning is based on the value assessment of the decisions made (value based management), the first step in the development of the incentive system should be the attachment of strategic goals and tasks to different levels of management. Implementation of the set goals is determined by developing a system of key performance indicators (KPI) . These indicators of performance or quantitative indicators of production, developed for all levels of management, allow to evaluate the goals set in the form of a plan-to-actual diagram in card form (matrices, indicators of different levels of responsibility: CPF; DPF; IPF). Some goals can be expressed in a binary way (fulfilled/not fulfilled), but in most cases a score range of four or five indicators is evaluated.
4. *Economic added value* indicator (EVA) is used in most cases to relate the activities of managers operating in different parts of the company to financial indicators . We will consider exactly this method below. To take into account the psychological features of the reception, a bonus bank system is used, which includes the following:
   - implementation of the idea of disincentive;
   - to overcome the annual (current) incentive limit and mitigate the high negative jumps in total wages caused by externalities.
5. The most important condition for maintaining the incentive system in a working state is the analytical activity of the financier. *The first step* in the development of the incentive system is the placement of indicators on the KPI tree based on the elasticity of value growth in business processes. *The second stage* consists in carrying out the analysis of maintaining the meaning of indicators in a clearly defined period of time. EVA, which is a key factor, should be examined by financiers to see how obsolete they are, and if necessary, replaced by new metrics that are highly correlated to value addition. Although it seems paradoxical at first glance, the use-shoot principle can be used as an element of the KPI system. *Practice shows that trying to include constant, time-varying, stable indicators of efficiency in the incentive system is a mistake that can be made in most cases.* A. Lityagin, a scientist who conducted research in this regard, does not emphasize the study of the obsolescence of the indicators selected in the matrix. In recent years, finance - moral (psychological) finance has been paying attention to the study of these shortcomings. In order to determine the time to replace

one indicator with another, it is necessary to conduct continuous monitoring (analysis of the value correlation created with the selected indicators). It is also important that indicators take into account the changing position of the investor (owner) in the capital market.

6. To mitigate possible situations and to correct analysts' errors, a hidden implementation of the principle, which takes into account the mental acceptance of monetary payments, is used. In this case, the new indicators and mechanisms used to tie incentives to certain indicators are implemented only on paper (within half-year, one-year periods) without informing the employees. If no conditions occur, the system is implemented live.

Profitability calculated on the basis of other indicators was 10%. In connection with EVA, the transition to a new form of labor compensation, the concept is mandatory according to the authors. EVA is adjusted after-tax operating income that excludes the cost of capital incurred by the company for equity holders to the extent that alternative returns are available in the market. EVA is calculated based on the weighted average cost of capital (WACC). The complexity of the EVA model is that it accurately calculates the amount of capital actually used and the amount of income actually earned. In most cases, EVA is not compatible with traditional financial accounting in the interpretation of expenses incurred for scientific research and research, advertising expenses, and expenses incurred for personnel development.

EVA = NOPAT – cost of capital = NOPAT – invested capital x WACC.

Research shows that in many companies implementing the ideas of Stern-Stewart, incentives are offered based on the new indicator EVA.

Table 1. Relative parameters of high-level management evaluation[1].

Traditional assessment parameters of current incentives	New evaluation indicators
Absolute financial indicators of activity results	
EPS, EBITDA	EVA, FCF
Relative financial performance indicators	
TSR, ROA, ROE	EVA/CE, CFROI
Growth indicators	
Income growth; Revenue growth	EVA growth. The difference between actual EVA and expected EVA
	Option model based on EVA
Indicators used in the formation of long-term incentives	
Stock price (stock and fundamental calculations)	Refillable bonus banks
Identified cases: accepted projects, access to the stock market	Linking the accumulated bonus bank amount to the value of the stock options

[1]EPS (earnings per share) - profitability per share, EBITDA (earnings before interest and tax, depreciation and amortization) - income before debt interest payments, taxes, amortization payments, TSR (total shareholder return) - total shareholder income, ROA (return on assets) - return on assets, ROE (return on equity) - return on capital, FCF (free cash flow) - free cash flow, CFROI (cash flow return on investment) - cash flow from investment, NOPAT (net operational profit after tax) - net operating profit after tax.

One of the problems with the traditional drawing based on variable incentives is that the amount that the manager receives is limited. The incentive system offered by EVA is, in most cases, built linearly on the basis of evaluation, and its high point is not indicated[10]. Therefore, managers are given unlimited incentives for their achievements, and punishments for their mistakes (see chart 1 in Figure 1). The participation rate (depending on the different levels of management) is entered in the range of 0.2%–5%. For the lower level of control, k=0. The participation rate for middle management is set at 2%. For example, if the amount of EVA for 2022 is 100 million soums, the current bonus is 2 million soums. If next year EVA is 120 million soums, the incentive will be 2.4 million soums.

It should be noted that there are some disadvantages of such a drawing. The specific disadvantages consist of:

1. In companies with a negative EVA value, this system does not work;

2. Managers can artificially change the value of EVA to get the current incentive. It would be more correct to tie the current incentive to the growth of the indicators for the period (for example, for the year), or to the change in relation to the expected result (plan);

3. A reduction in the acceptance (psychological understanding) of unlimited payouts when extraordinarily large incentives derail subsequent performance. An incremental approach to incentives through bonuses can be seen in Chart 2 in the Figure 1. Chart 2 in the Figure 1 shows that incentive plans can take into account both current and past performance (the chart can also include k_3, k_4 indicators). According to the absolute value, attention is paid to the dynamics of the indicator, therefore $k_2 >> k_1$. Evaluation of the share of creation of EVA is effective only when EVA has a positive indicator, while the indicator of change in EVA motivates managers to improve performance. That is, even if the current value of EVA is negative, value can expand due to loss reduction, and in this case the manager is motivated to reduce losses. Unlike traditional methods, this method does not set the upper and lower limits of incentives. The more managers work, the higher the incentives they receive.

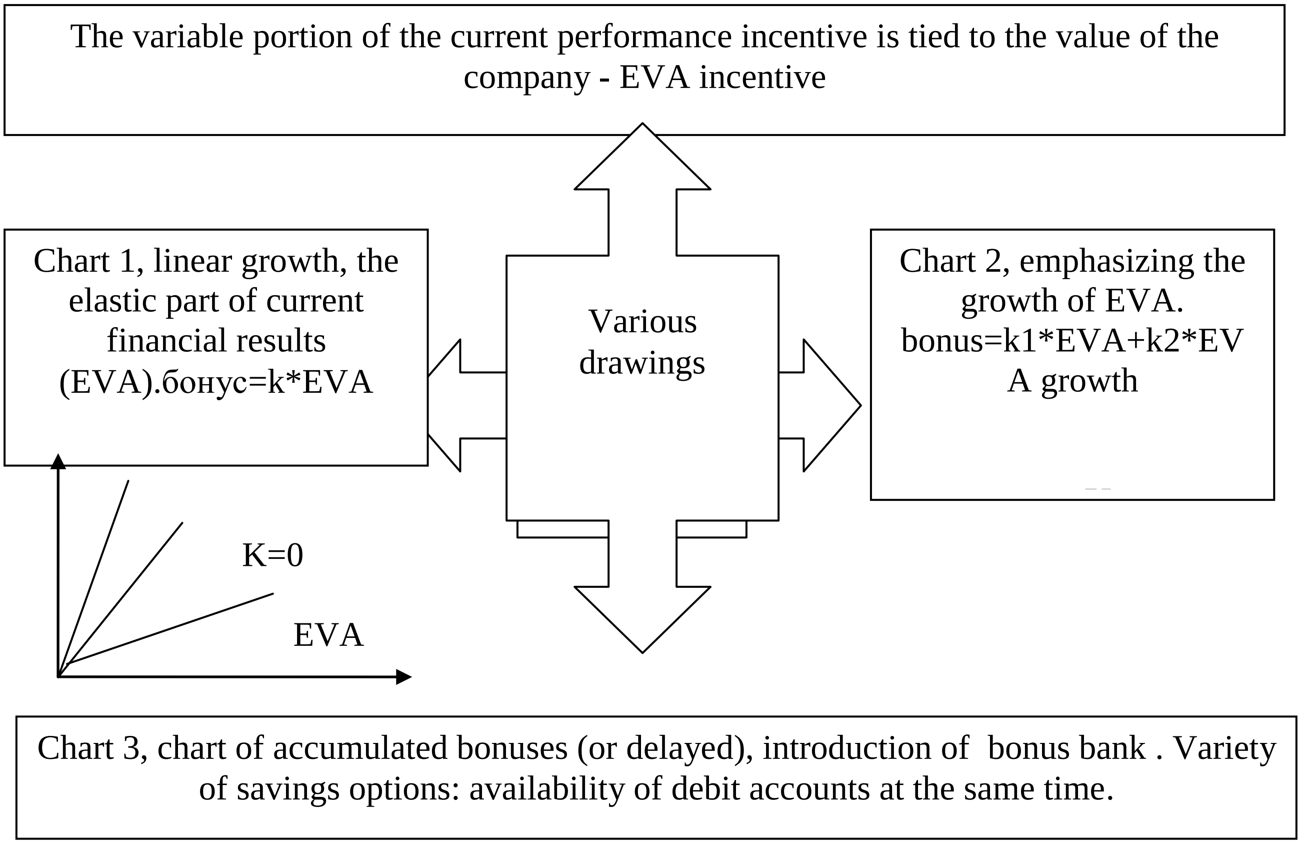

Figure 1. Moving from a linear scale of bonus incentives to a bonus bank

Bonus = k_1*EVA+k_2*EVA,

where

k_2 = coefficient of participation in EVA growth;

k_1 = coefficient of participation in value creation (EVA) during the period, only positive EVA is significant (if EVA is negative, k_1=0);

ΔEVA=change in EVA over a specified period of time (eg, one year).

We will consider the application of diagram 2 through the following example.

k_1=1%; k2=30%

EVA (2021)=100 million sums

EVA (2022)=120 million sums

Bonus for 2021 = 1 million sums

Bonus for 2022 = 1% of 120 + 30% of 20 = 1.2+6=7.2

Chart 3 in Figure 1 provides for the establishment of a bonus bank. This chart promotes the idea of linking current incentives to long-term outcomes. If managers fail to meet the long-term and current expectations of owners, then they should be punished. Figure 1 shows that the bonus is not paid in full when it is earned, but a certain part of it is paid in the current year, and a certain part is kept in a certain account, in a hypothetical bank. This specific bank account is adjusted by adding or subtracting a certain amount each year. During a period of good activity, the bank balance expands, and vice versa, when activity deteriorates, the bank balance shrinks. Chart 3, in some sense, follows from Chart 2 as a result of the increase of *k* characters.

The peculiarity of the bonus bank is that additional bonuses accumulate and are paid in the future only when the activity is successful. Thus, delaying bonuses reduces the likelihood of managers making short-term decisions to expand the current incentive package, encouraging them to evaluate projects with a longer horizon when making decisions.

Of course, all such short-term results have a negative impact on long-term growth and in themselves create the need for constant monitoring of financial incentive mechanisms[11].

The implementation algorithm will look like this (Figure 1):

1. The participation coefficient k 1 and k 2 are requested and the bonus for the current year is determined, which is equal to:
   $k_1 \times EVA + k_2 \times \Delta EVA$
2. The annual variable part of the bonus is not equal to the current year's bonus. The current payout ratio is entered, for example, 1/3 of the earned bonus. In this case, 2/3 of the bonus is transferred to the bank. The drawing of the bank bonus in practice can also provide for a debit account, that is, a negative result for the year will reduce the amount of savings in the bank account.
3. The current incentive package provided by the bank bonus is organized by such an algorithm that part of it should be made up of the current bonus and part of the accumulated bonus. Thus, even if the company has a negative financial result, the total bonus (as a percentage of salary) can be taken from the bank bonus.

It is possible to use the bank bonus system in the formation of the incentive system for bank management and employees of Uzbekistan. This mechanism allows the practice of tying the incentive package directly to earnings and even to EVA, and influences managers to make long-term growth decisions.

CONCLUSIONS AND SUGGESTIONS

In most cases, commercial banks invest in high-risk projects to increase the current EVA, and this leads to a decrease in the value of the company due to the high cost of capital. There may be situations such as underestimation of the costs of bad debts , failure to write off unusable raw materials and goods, and extension of amortization. All of these listed cases make it possible to artificially increase the current value of EVA and, as a result, to increase the standard incentive package for the manager. Reductions in investment in research and development costs, human resources, and information systems may not be noticeable at first glance, but lead to a rapid decline in value.

In our opinion, the important positive side of the bonus commercial bank is that by spreading the variable part of the incentive over time, it allows efficient managers to overcome situations that negatively affect the financial position of the company as a result of external influences (for example, in business cycles). In contrast to situations where bonuses are calculated over a period of time, in a bonus bank situation, managers do not receive very high incentives in successful years, and in turn, do not go without incentives in less successful years. Also, being removed from current incentives is psychologically more damaging than having late payments adjusted (reduced balance sheet).

Thus, the second unique and important aspect of commercial banking is that its volumes are not limited. All accumulated funds belong to the employee, but their use is delayed and the amount of funds may decrease if the company's performance deteriorates. The issue of indexation of the amount in the account remains controversial. Cost of capital for indexation – WACC is unlikely to be used.

The main capital of commercial banks performs several important functions in ensuring daily operations and long-term operation of banks, and various negative fluctuations in the global financial and economic system have shown that the management of legal and reputational risk of banks is of great importance for commercial banks and various stakeholders.

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