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The influence of internal corporate governance on bank performance - an empirical analysis for Romania

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Abstract

This study investigates, based on empirical analysis, the influence of internal corporate governance on bank performance within the Romanian banking sector, including the characteristics of the management body, ownership structure and an internal corporate governance index. The internal corporate governance index was built to reflect the corporate structure, the structure of committees, the risk management and the internal control framework and the institutional transparency. The results after processing the data collected from the websites of credit institutions, using the multiple regression model, mainly, indicates the following: (1) internal corporate governance index influenced negatively the bank performance, determining the need to improve and countercyclically implement the measures of corporate governance, (2) the need to increase the number of independent members within the management body and (3) the need to change the business behaviour of shareholders in order to reduce exposure to risks.

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Keywords: internal corporate governance; internal corporate governance index; management body; bank performance; Romanian banking sector

1. Introduction

In the context of banks being essential for a proper functioning of the economic activities, a special attention is allocated to ensuring the stability of the banking system. A major role for ensuring the banks stability is played by the corporative governance (CG). The European Banking Authority (EBA) states that internal corporate governance weaknesses caused by insufficient implementation of existing

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guidelines were not a direct trigger of the financial crisis, but an essential factor support (EBA, 2011, p.3). Many studies focused on the implications of CG on bank performance (BP) in order to understand and improve it, a weak corporate governance contributing to banks insolvency (The Basel Committee on Banking Supervision - BCBS, 2010, p.5). This study finds influence of internal corporate governance (ICG) on bank performance (BP) providing guidelines to identify possible weaknesses of CG in the Romanian banking system.

The study contributes to the dedicated literature in several ways. Firstly, the cumulative influence of internal governance framework on bank performance is analyzed, including an internal corporate governance index (ICGI) in this regard. Secondly, the study completes other studies examining governance over a longer period of time, by adding other variables such as frequency of changes and longevity on positions of the MB members (eg Stefanescu, 2011, which analyzed the characteristics of the MB within the Romanian banking on a single year). The study also completes the characteristics of corporate governance which influence risk-taking of banks. Considering that banks within the sample have the same regulator, the results illustrate the effects of regulations at a bank level, our methodology and our findings being indicative in the analysis and the adoption of regulations or for the measures to address the internal governance weaknesses.

The remainder of the paper is organized as follows. Section 2 reviews the literature and hypotheses' development. Section 3 describes the data and the variables. Section 4 describes the methodology and provides the empirical results. Section 5 concludes.

2. Literature review and hypothesis' development

Internal corporate governance (ICG) is a limited but crucial component of corporate governance, focusing on the structure and internal organization of an institution, being influenced by the existing regulations. ICG alignment to the banking regulatory requirements may induce the "agent problem" between shareholders, who wish to maximize the value of investments, and the regulator, who seeks financial stability for each entity and the reduction of the systemic risk (Jensen and Meckling, 1976; Laeven and Levine, 2009). For expressing the BP, similar with other studies, is used return on assets (ROA), return on equity (ROE) and the insolvency risk (Z-score).

2.1. Corporate structure

Guided by the EBA guidelines on internal governance (EBA, 2011), the key mechanism of an efficient ICG includes: corporate structure and organization (CSO), the risk management and internal control frameworks, specialized committees (Audit committee - AC, Risk committee – RC and Remuneration committee - RMC) and institutional transparency. To analyse the aggregate influence of all these components on BP is constructed an *index of internal corporate governance (ICGI)*.

As regards CSO, this should be understood by bank personnel, especially by the management, to have clearly defined roles and responsibilities, not involving risks arising from its own complexity and to ensure independence between activities. Centralizing loan approval activity and delimitation to another organizational level of this activity from those of initiation and monitoring, after a strong dynamic of exposure, correlated with a remuneration policy based on short-term performance, have been a generator factor for risks and latent losses.

As regards *risk management and internal control framework* is in place "theory of agent" between external governance and shareholder interests. According to Laeven and Levine (2009), the minimum

capital requirements are in a positive relationship with risk taking, while other capital regulations and activity restrictions have a negative influence on the risk taking, varying with ownership concentration, the owners trying to compensate the loss of utility by increasing risks. For effective risk management at the bank level, it is required to be organized an internal control system to enable risks identification and assessment, performance of activities according to the law provisions and also to enable the assessment of the efficiency and effectiveness of internal control. At the level of the Romanian banking system in the context of the economic growth, availability of capital for financing, including the foreign capital flows, along with the relaxation of credit conditions and existence of the additional capital to cover the exposures, allowed the increase of credits, short term profits and risks, but also potential losses from materialization of risks. On the other hand, given the existence of the financial crisis, requiring additional capital, the adoption of a remuneration policy based on risk and enhanced internal control are expected to lead to absorption of part of the accumulated risks.

The existence of *committees and the independence of their members* is expected to improve risk management, including corporate governance. In previous studies, Adams and Mehran (2005, 2012) found a negative influence of the number of committees on the Tobin Q variable, determined as the ratio of the entity' market value to book value of its assets. The same influence was observed by Aebi et al. (2012) between RC and ROE. In the Romanian banking system, we consider that organizing a committee to independently review the remuneration policy based on the results of activities and related risks in the context of financial crisis had a negative impact on performance and risk mitigation.

Transparency of the activity is expected to prevent the accumulation of risks as market discipline would limit the funding of imprudent banks. Barth et al. (2004) found that policies requiring disclosure of accurate information strengthen the control of private banks sector and encourage private agents to exert corporate control, thereby promoting stability, performance and development of banks. At the level of the Romanian banking system, we consider that the lack of transparency regarding remuneration policy, risk profile and risk management policies, obstructed the investments based on the assessment of associated risks, increasing thus the uncertainty of the investments and distrust in the system.

Based on these arguments and exposures, we consider the first hypothesis:

Hypothesis 1: ICGI influences negatively ROA, ROE and Z-score.

2.2. Management body

A major role is held by the management body (MB) in adopting and implementing ICG, considering that the other stakeholders such as shareholders or debt holders, are not able to impose effective governance in banks (Levine, 2004). Given the possibility of dual organization of banks in Romania, in the study, the term MB means Board of Directors in the case of an unitary organizational system, respectively the Supervisory Board and Board of Managers in case of a dualist system. EBA considers that, in order to perform its tasks, MB should have a sufficient collective experience and consequently, attention, should be given to the composition, qualifications, appointment and succession of its members (EBA, 2011, p.23).

Many studies have revealed that the *number of members of the MB (BS)* is important for a better CG. Adams and Mehran (2012) and Aebi et al. (2012) have observed that BS is in a positive relationship with Tobin Q, respectively ROE, claiming that increasing the board size generates added value due to growing complexity of banks over time and so a better monitoring and advising of managers is enabled. Cooper (2008) also found a positive relationship reported on ROA. However, increasing the number of members

may lead to problems of coordination, control and flexibility in decision making process. According to Andres and Vallelado (2008) between BS and Tobin Q **an inverted U-shaped relation**, is in place with a limit of these variables beyond which, performance begins to decrease. Reported to Z-score, Pathan (2009) found a positive influence. In the Romanian banking system, Stefanescu did not reveal a **significant influence between BS and ROA and ROE**

As regards the *independent members of MB (BI)*, respectively those members who have no other connection with the credit institution, we expect to be in a positive relationship with BP. Cornett et al. (2009) observed a positive impact of BI on ROA, due to increased surveillance on managers, while Aebi et al. (2012) found a negative impact on ROE during the financial crisis, arguing that banks were pushed by management to maximize shareholder wealth before the crisis and took risks that were understood to create wealth, but later turned out poorly during the credit crisis.

Members of other nationality than Romanian MB (PRV) negatively influenced ROA (Stefanescu, 2011), which may indicate that adaptability to local organizational structure and business environment was affected by risk, implementation of a new culture of risk management proving to be ineffective.

Another composition element of MB in order to create collective management skills, is represent by the **diversity of gender (GEN)**. Previous studies have found a positive influence on financial performance to both men (Stefanescu, 2011) and women (McKinsey et al., 2007).

As regards the *Board members with experience in the banking and insurance sector including the economic university (DwFB)*, **a negative influence was observed on the bank performance during the crisis (Aebi et al., 2012) and a positive influence related to risk taking (Minton et al., 2010).**

As regards the *non-executive members of MB (OUT)*, previous studies have revealed either that they improve performance through a better monitoring and advising of the managers (Andres and Vallelado, 2008; Stefanescu, 2011) or that they have a negative influence, due to independence associated costs, lack of company-specific knowledge (Coles et al., 2008). However, Adams and Mehran (2012) observed no significant influence on Tobin Q variable. A positive influence was found on risk-taking (Pathan, 2009) and in relation to capital growth during the financial crisis (Erkens et al., 2010).

Cornett et al. (2009), quoting Brown and Maloney (1999), stated that shareholders gave incentives to MB members to carefully monitor the managers, reducing thereby the “agent “conflict between managers and shareholders, the problem being also by Fama (1983). Cornett et al. (2009) observed that *members who hold shares (DwHS)* positively influenced ROA, while Spong and Sullivan (2007) found that they improved ROE and the Z-score. We believe that, targeting the increase of financial benefits from salaries and dividends, when substantiated the decision making on investment dynamics, they missed a proper assessment of the fact that not honouring the obligations by the borrowers, complemented with the efforts to attract resources to cover the differences between the maturity of assets and liabilities, it may lead to a lower profitability and decapitalization.

Establishing performance criteria that predominantly targets the growth of profitability, may lead, in the context of economic growth, to an easily fulfilment of those criteria by accumulating latent risks and neglecting the objective of long-term stability. However, continuity in function allows a better understanding of the entity, but may result in routine and inadaptability to working environment modifications. In the context of expansion of banking activity, we believe that *continuity in function (DUR)* negatively influence ROA.

In order to perform a prudent activity in which an effective investment of resources, a limitation of debts and risks exposure to be pursued, to the MB members is supposed to be ensured a certain stability, for example to eliminate the uncertainty regarding their continuity in function and so to allocate more attention to fulfilment of their duties.

Based on our previous findings and assessments, we consider the hypothesis 2:

Hypothesis 2: MB characteristics influences the performance of banks.

2.3. Ownership structure

It is also expected that the *ownership structure* influences the activity performed and thus CIP. Interests of shareholders to maximize profits, along with increased competition, have led to riskier investments, leading to increased risks and lower profitability. In addition, increasing the share of foreign ownership is expected to implement a better CG, to increase competitiveness, to ensure an easier access to funding. On the other hand, they lead to assets and associated risks growth, including lacking a sufficient knowledge about the Romanian business environment. Laeven and Levine (2009), observed that risk-taking varies positively with shareholder power within the structure of CG and regarding the Romanian banking system, Stefanescu (2011) found that foreign ownership had a positive influence on ROA. Thus, the third hypothesis can be defined as follows:

Hypothesis 3: Ownership structure influences negatively ROA and Z-score.

3. Data and the variables

3.1. Specification of data and variables

To express the ICG variables, we considered three groups, the first to express *the corporate structure and adopted measures to mitigate risks*, the second to express *the general characteristics of the MB* and the other to express *the ownership structure*. Data were collected quarterly from the websites of Romanian banking institutions listed at Bucharest Stock Exchange, for the period 2004-2011, from the financial statements, independent auditor's reports, annual reports, corporate governance codes and reports, reports on transparency and disclosure requirements.

The first group consists of 6 components, each including other items for their own characterization. These are *dummy* variables whose value is 1 or 0, 1 indicating the presence of the analyzed attribute and 0 the absence of it respectively. These values are given based on questions about existence or inexistence of each variable sub-components. The first component is the *CSO*, its value being the sum of the scoring applying for the three *dummy* variables used in its determination, respectively: (1) is the organizational structure clear and transparent?; (2) are loans approved at the centralized level?; (3) don't they perform non-standard or non-transparent activities, namely complex derivative activities or under jurisdictions that impede transparency of operations - offshore -?.

The second component is the *committee structure (CS)* and it illustrates the existence and the independence of committees supporting the MB activity and the continuity of the external auditor. Its value is the sum of the scoring for the next six *dummy* variables: (1) is there an audit committee?; (2) the members of the audit committee are independent?; (3) is there a remuneration committee?; (4) are members of the remuneration committee independent?; (5) is there a risk committee?; (6) has external auditor been replaced after a maximum of 5 years period?

The third component is the *risk management framework (RM)*, whose value is determined by summing the scores awarded to the following five *dummy* variables: (1) are exposure limits on loans established?; (2) are capital requirements for credit risk established?; (3) are capital requirements according to the

internal procedures for risk assessment established?; (4) are remuneration policies based on risks established?; (5) are tests for highlighting the extreme conditions (stress tests) performed?.

The fourth component is the *internal control framework (IC)* used to assess the implementation of the internal control system. Its value is the sum of scores obtained by the following three *dummy* variables: (1) is there an internal control function?; (2) is there a compliance function?; (3) is there an internal audit function?.

The fifth component is the *institutional transparency (T)*, determined by summing up the scores awarded to the five *dummy* variables used to assess whether the public has access to: (1) the financial statements, (2) the capital structure, the MB members and committees, (3) the structure of incentives/remuneration, (4) the risk management policies and (5) the internal governance policy.

Using the methodology used by Barth et al. (2007) for the construction of the external governance index, we calculated the *internal corporate governance index (ICGI)* by summing up the score for each sub-component which expresses the corporative structure and the measures adopted in order to mitigate risks.

The second group includes nine variables indicating the characteristics of the MB. The first variable is *BS* and represents the number of members of the MB. The second variable is *BI* and expresses the proportion of independent members in the total number of MB members. We define the independent member as the member who has no other relationship with the entity except the one of administrator. The third variable is *PRV* and signifies the proportion of members of other nationality than Romanian in the total number of the MB members. The fourth variable is *GEN* and represents the number of men within MB. The next variable is *DwFB* and represents the proportion of members with experience in the banking and insurance sectors including the academic economical environment in the total number of MB members. The sixth variable is *OUT* and means the proportion of the non-executive members in the total number of the MB members. The seventh variable is *DwHS* and represents the proportion of members holding shares in the total number of the MB members. The eighth variable is *DUR* and represents the average length in service of the MB members expressed in years of service at the end of each period, calculated as simple arithmetic average between the cumulative length in service of all the existing members and their number. The ninth variable is a *dummy* variable that illustrates if the MB members were not removed from their service to periods of 1 year length or function have not been occupied all through the period observed (*CNG*).

Variables used to assess the influence of the ownership structure on the BP is represented by the *foreign ownership proportion (FRGN)*, calculated as the ratio of foreign capital in the total capital and *major shareholder share (MS)*, which indicates the proportion of the capital held by the main shareholder.

Furthermore, the variable *nominal gross domestic product (NGDP)* in current prices at the end of observable period was also included as control variable, using data available from the NBR website (<http://www.bnro.ro>). This has also as an objective to capture the macroeconomic influence on BP.

To measure the BP, it is calculated *return on assets (ROA)*, as the ratio between net profit and total assets, *return on equity (ROE)*, as the ratio between the net income and the capital and the *insolvency risk (Z-score)*, which equals the capital asset ratio plus the average value of ROA divided by the standard deviation of ROA. The *Z-score* variable was used also by Spong, K. and Sullivan, JR (2007) and measures the distance from insolvency.

3.2. Descriptive statistics

The descriptive statistics of the value of the variables used are presented in table no.1. For all the variables, the values of the mean and of the median are relatively close, revealing the decrease of sample heterogeneity. The average value of ROA is 0.8%, ROE is 34.9% and Z-score is 7.73. Value of standard deviation (SD) of the variable Z-score indicates mainly a higher dynamic of assets than that of capital, respectively due to debts.

Table 1. Descriptive statistics

Indicators	Minimum	Maximum	Mean	Median	SD
ROA	-0.053	0.031	0.008	0.008	0.012
ROE	-0.491	1.942	0.349	0.233	0.415
Z-score	3.511	21.938	7.732	6.500	4.275
CO	2	3	2.448	2	0.497
CS	4	6	4.710	4	0.90
RM	2	5	2.681	2	1.214
IC	2	3	2.241	2	0.428
T	2	4	2.534	2	0.747
ICGI	12	21	14.612	13	3.207
BS	6	13	9.421	10	2.047
BI	0.076	0.222	0.113	0.100	0.031
PRV	0	0.700	0.328	0.308	0.197
GEN	4	12	8.526	9	2.291
DwFB	0.273	1	0.718	0.810	0.207
OUT	0.270	1	0.526	0.538	0.129
DwHS	0.200	1	0.681	0.809	0.228
DUR (years)	2.029	11.125	5.552	5.371	1.697
CNG	0	1	0.655	1	0.475
FRGN	0.105	0.891	0.436	0.483	0.214
MS	0.145	0.891	0.435	0.413	0.206
NGDP (billions LEI)	52.290	183.943	110.384	111.035	33.277

The implementation of the governance requirements for CSO, CS and IC are situated above the average. Regarding the implementation of RM and T requirements, these are situated approximately at the average level. The standard deviation value of ICGI illustrates the implementation of a part of risk management measures, such as setting capital requirements according to internal procedures for risk assessment, establishing remuneration policies based on risks and conducting stress tests within a short period and for a time range smaller than that observed. BS median indicates approximately 10 members. OUT is 52.6% on average, which indicates 5 nonexecutive and 5 executive members, DwFB is 71.8%, which indicates approximately 7 members with financial experience, PRV is 32.8%, which indicates approximately 3 members of foreign nationals. Among the MB members, the majority are men and in average one is independent. The average value of CNG is 65.5%, indicating a relative instability at the level of MB composition. On average, DUR is approximately 5.5 years. As regards the FRGN and MS, on average, they are about 43%.

4. Methodology and results

Our empirical approach uses a mixture of time series and cross-sectional data for this research. According to Andres and Vallelado (2008), the most efficient tool for their research is the analysis of panel data. Using the Eviews software for the analysis, we used the fixed effects regression model (FEM)

and the Pooled Least Squares method to estimation the influence. By including the fixed effects, we limit both the effect of the omitted variables, allowing us to take into account the heterogeneity of the sample, meaning the specific features for each bank (e.g. management style and philosophy, business strategy, etc.) and the effect of the potential extreme values caused by the small number of cross-sectional units (Adams and Mehran, 2012).

To emphasize the dependence between the variables expressing BP (dependent variables) and those expressing the internal corporate governance (independent variables), we used multiple regression models presented below:

$$Y_{ijt} = \alpha_j + \beta * ICGI_{ijt} + \theta k * F_{jt} + \gamma n * O_{jt} + m * \ln(NGDP) + \alpha_j + u_{jt} \quad (1)$$

where Y_{ijt} is the vector of dependent variables, i being in turn, ROA, ROE and $\ln(Z\text{-score})$; α_j is the intercept term; β is the coefficient of the ICGI; θk is the coefficient of the characteristics of the MB variable (F_{jt}); γn is the coefficient of the ownership structure variable (O_{jt}); m is the coefficient of the NGDP variable; α_j is the unnoticed effect of unit j ; u_{jt} is the error term; t is the time period and j is cross-sectional observation unit.

Table 2 reports the results from regressions of ROA, ROE and $\ln(Z\text{-score})$. The results of the regression models indicate that ICGI has a negative impact on ROA, ROE and Z-score. This is explained by increasing the volume of assets based on more relaxed governance requirements, after which, in the context of the financial crisis, subsequent to the implementation of new internal governance requirements, the value of the assets remained relatively constant, while the net profit fell, mainly due to the increased costs for provisioning to cover the credit risks and to a decline of income from investments. The ICGI's influence on Z-score is supported by the findings of Laeven and Levine's (2008) on the influence of minimum capital requirements on risk taking. Thus the first hypothesis is well argued and demonstrated.

Table 2. Return on assets (ROA), return on equity (ROE) and insolvency risk (Z-score) regressions. Given the majority of MB members are men and proportion of foreign ownership is approximately equal to the principal shareholder, we removed from the regressions one variable from each of the two pair. Because in most of the specifications many of explicative variables are not significant, in order to check the robustness of the results from the regressions, we added or removed, one by one, a variable, both forward and backward to get a narrow model. In all the regression models, the estimation of the parameter was made by adjusting the errors for heteroskedasticity. To test the significance associated to the estimated coefficients we use the Wald test (1943), whose results emphasize that F-statistic is statistically significant. *, ** and *** indicates statistical signification of estimated coefficients and Wald test at a level of 0%, 5% and respectively, 10%. Figures in parentheses present the t-statistics.

Variables	ROA	ROE	Ln(Z-score)
ICGI	-0.001* (-4.717)	-0.048* (-3.393)	-0.017* (-2.696)
BI	0.051** (1.796)	0.994*** (1.858)	0.981* (2.696)
PRV		0.666** (1.914)	0.432* (2.915)
GEN	0.001 (1.547)		
DwFB	0.012 (1.423)	0.249*** (1.932)	-0.844* (-4.823)
OUT		0.258 (1.200)	-1.170* (-5.334)
DwHS		-0.618** (-2.038)	0.452** (2.513)
DUR	-0.001 (-1.434)		
CNG			-0.049 (-1.239)
FRGN	-0.016* (-2.641)		
MS			-1.107** (-2.437)
Ln(NGDP)	0.009* (2.239)	0.476* (5.466)	0.107** (1.988)
No. of obs.	112	112	112
R ²	0.50	0.59	0.89
Wald test, F stat	1984.560*	19.924*	38.550*

Unlike in other studies (eg, Adams and Mehran, 2011, Aebi et al., 2012, Pathan, 2009), BS does not significantly influence the BP, similar with Stefanescu's findings (2011). BI's influence is positive in

relation to ROA, ROE and Z-score illustrating a safer placement of resources. PRV variable coefficient shows that members of other nationalities contribute to shareholder remuneration (ROE) and the decrease of risk (Z-score). Similar to Stefanescu (2011), the influence of men on ROA is positive, but statistically insignificant, the increase of profitability being subject to risks accumulation related to active exposures. Experienced MB members improves the financial performance (ROA and ROE), but the trend to increase the exposures for profit gain weakens the financial stability of banks (Z-score). Non-executive members enhance the remuneration of shareholders (ROE), but, statistically insignificantly, contributing to the risks exposure (Z-score). MB members with shares, negatively influence ROE, different from Spong and Sullivan findings (2007). However, similar to Spong and Sullivan (2007), it reduces risks exposure through the long-term stability of return on assets. Instability of MB members worsened Z-score, but the influence is not statistically significant. Thus, based on the findings exposed, the second hypothesis, that the characteristics of MB influence the performance of banks is verified.

The foreign capital influence on ROA is negative. This may indicate that making placements in order to recover the invested capital, led to a lower return than expected due to the materialization of the associated risks. The majority of the ownership contributed to the increase of the risks (Z-score), due to lower return on assets. These findings support the third hypothesis regarding the influence of ownership structure on bank performance.

5. Conclusions

The results of the study illustrates that the aggregate influence of internal corporate governance components is negative as regards to ROA, ROE and Z-score, highlighting the need for relaxation during the economic recession periods and tightening during the economic growths.

Regarding the characteristics of the board members, the findings support the idea of increasing the number of members of other nationalities (PRV) and those independents (BI), which should be allowed to make independent and objective decisions. DwHS has also a cautious influence on risk taking. Negative influence on the performance of CNG and DUR support EBA recommendation regarding the existence of a clear policy on the appointment, retention and succession of the MB members. DwFB positive influence on financial performance supports the requirement to include more financial experts in the constituency of the MB, but conditioned to remedy the business behaviour regarding the risks exposure. This recommendation also applies to OUT and to ownership.

Overall, the results illustrate the importance of the internal corporate governance within banks, whose quality influences the normal course of operations and the financial stability.

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