

# **CORPORATE GOVERNANCE REFORM WITHIN THE UK BANKING INDUSTRY AND ITS EFFECT ON FIRM PERFORMANCE**

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## **Abstract**

Using a corporate governance scorecard (Corp-Gov Score) measuring twenty-six areas of corporate governance best practices in four UK banks, this study examined whether improved levels of corporate governance led to higher levels of firm performance within the UK banking industry over the time period 1999-2006. The twenty-six measures were split into four sub-sector areas of Corp-Gov Score comprising Board of Directors, Remuneration Policies, Auditing Policies, and Transparency/Disclosure Policies. Using both correlation and regression analysis on the information extracted from the Annual Reports, the study provides evidence about the extent to which UK banks have complied with recent corporate governance reforms post Enron. The results indicate that improvements in corporate governance can enhance the performance of UK banks when measuring using Return on Equity. The biggest sub-sector driver of this improvement is in the area of the Board of Directors. Our results further indicate that large boards within UK banks can have a negative impact on firm performance, and that increases in directors' remuneration does not lead to increased levels of firm performance. Evidence is given that corporate governance within UK banks plays an important role, but how it affects firm performance is open to debate.

**Keywords:** Corporate Governance, Firm Performance, Corp-Gov Score, Return on Assets, Return on Equity, Board Size, Directors' Remuneration

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## **1. Introduction**

When businesses fail, it can have rippling effects not only on the economy but also in the lives of the various interests represented. The impact of the high profile corporate failures such as Enron, Worldcom, Xerox and others such as Barings Bank, Parmalat, BCCI, are cases in point. Attempts to prevent such failures in the future led to radical reforms in the corporate governance framework in many countries, notably the UK and the US. Following recommendations contained in the Higgs Report (2003), the Smith Report (2003) and the Tyson Report (2003), the UK Combined Code for Corporate Governance was redrafted in 2003, 2006 and more recently in 2008. In the US, the enactment of the Sarbanes-Oxley Act (2002) introduced even more

radical reforms in corporate governance.<sup>23</sup> Have these reforms in corporate governance been translated into improved firm performance in these countries? Evidence from research (examined later) provides inconclusive results.

Despite the growing literature in the field associated with corporate governance and firm performance, very little research has been done on corporate governance within banking organisations. This is slightly surprising given the important role that banks play in developing a successful and stable economy (see Caprio et al., 2007).

This paper examines the impact of corporate governance reform within the UK banking industry pre and post Enron and its effect on firm performance. The paper attempts to answer the following key questions: Firstly, has corporate governance reform within the

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<sup>23</sup> Hill (2005) provides a detailed analysis of the regulatory responses to these high profile corporate scandals.

UK banking industry affected firm performance? Secondly, have the major UK banks conformed to the current codes of corporate governance best practices?

Corporate governance encapsulates such a broad area. However, the issue of board size, board composition, directors' remuneration, auditing policies and transparency in corporate reporting are amongst the controversial corporate governance parameters highly debated amongst academics and those which have attracted reforms within many corporate governance codes. Whilst there has been an extensive literature examining the effect of these factors on firm performance, the literature examining these issues within the banking sector are few and far between; with the only current research available being a longitudinal study by Tanna et al. (2008), which specifically focused on the board composition and structure, of 18 banks over the period 2001-2006.

Using a sample of four UK banks, this study examined whether improved levels of corporate governance led to higher levels of firm performance within the UK banking industry over the time period 1999-2006. The choice of the selected time frame was dictated by factors within the reporting environment. Firstly, the collapse of Enron in 2001 led to reforms which saw the redrafting of the UK Combined Code for Corporate Governance in 2003. Starting the investigation from 1999 was to provide an assessment of corporate governance within UK banks over the four year period before the 2003 Combined Code was redrafted. Using 2006 as the cut-off point was to allow an assessment of corporate governance within UK banks four years after the introduction of the 2003 Combined Code. Thus this paper contributes to current academic literature by offering a pre- and post Enron perspective, over a greater timescale, along with investigating other factors that may have an effect on the performance of UK banks.

The importance of investigating corporate governance within the banking industry cannot be undermined in the light of recent corporate failures in the industry including Societe Generale in France, Bear Stearns in the USA and Northern Rock in the UK, amongst others. Furthermore the current "credit crunch" in the global economy is having a direct effect on the whole UK banking industry.

The rest of the paper is organised as follows. Section 2 reviews the literature associated with corporate governance and firm performance. Section 3 analyses the research methods used, whilst Section 4 provides the data analysis and findings. Section 5 presents the summary and conclusions of the paper.

## **2. A Review of Relevant Literature**

There is a large body of empirical research (Bebchuk et. al. (2004); (Brown & Caylor (2005); Buck et. al (2003); Coles et. al. (2008); Conyon & Murphy (2000); Core et. al (1999); Duffhues & Kabir (2008); Durnev & Kim (2003); Eisenberg et. al (1998); Javed & Iqbal (2007); Lipton & Lorsch (1992) and Yermack

(1996), amongst others) which have been undertaken to establish the relationship (if any) between corporate governance and firm performance. Whilst most of these research studies have not specifically focused on the banking industry, nevertheless they provide valuable insight into various areas of corporate governance, and their effect on firm performance. The outcome of these studies has produced mixed results. For example, Javed & Iqbal (2007) found a positive correlation between firm performance, board composition, shareholdings and ownership. However, they found that disclosure and transparency had no significant impact on firm performance. In contrast, Durnev & Kim (2003) found that firms scoring high in transparency and governance rankings are valued higher in the stock market. This is supported by the evidence that firms with greater growth opportunities and greater external financing requirements practice higher quality disclosure and transparency levels than those without.

Despite the growing literature on the relationship between corporate governance and firm performance, very little research has been undertaken to investigate this relationship within the banking sector. This is rather surprising given the pivotal role that banks play in the economic growth and development of any nation (see Caprio et al (2007); Levine (2004) and Arun & Turner (2004)). This theory is based on banks allocating funds efficiently, which lowers the cost of capital to firms, leading to productivity and growth. Furthermore, if banks institute sound corporate governance, increasing the likelihood of raising capital inexpensively, banks can allocate such savings efficiently to firms that promote high levels of corporate governance.

Whilst it is recognised that a sound system of corporate governance is important for ensuring effective accountability and preserving the various interests represented in the corporate sector, the question of whether corporate governance in the banking sector differs from that in the non-banking sector remains largely unanswered. Most of the studies identified earlier, which have considered the relationship between corporate governance and firm performance have concentrated on exploring this relationship outside of the banking sector. Even the few studies (for example, Levine (2004) and Polo (2007)) that have explored this relationship within the banking sector have produced conflicting results. This paper adds to the debate by examining the impact of recent corporate governance reforms within the banking sector in the UK (pre and post Enron) and its effect on firm performance.

Board size, board composition, directors' remuneration, separation of Chairman/CEO, transparency/disclosure practices and the existence or otherwise of audit committees are recognised as important factors that can have an effect on firm performance. A review of the literature reveals that a considerable amount of research has been undertaken into ascertaining the impact of board size and board

composition on firm performance (Lipton & Lorsch, 1992; Jensen, 1993; Yermack, 1996; Eisenberg et al., 1998; Cheng, 2008; Coles et al., 2008; Linck, et al., 2008); board composition and firm performance (Baysinger & Butler, 1985; Bhagat et al., 1987; Patton & Baker, 1987; Rosenstein & Wyatt, 1990; Hermalin & Weisbach, 1991; Gibbs, 1993; Jensen, 1993; Bhagat & Black, 2002; Adams & Mehran, 2003; Caylor, 2005) as well as on the relationship between directors' remuneration and firm performance (Crespi & Gispert, 1998; Holthausen & Larcker, 1999; Conyon & Murphy, 2000; Amess & Drake, 2003; Burk et al., 2003; Duffhues & Kabir, 2008. Also, authors (Leftwich, 1983; Brown & Caylor, 2005 and Anderson et al., 2004 amongst others) have investigated the effect of the presence and/or effectiveness of audit committees on firm performance and the impact of transparency/disclosure on corporate governance (Bushman & Smith, 2001; Mallin, 2002; Bushman et al., 2003; Bushman & Smith, 2003; Klapper & Love, 2004 and Berglöf & Pajuste, 2005, to mention these few). However, most of these studies have been undertaken on firms outside of the banking sector. This study adds to existing literature by looking at the impact of these factors on firm performance within the banking industry.

How does corporate governance differ within a banking institution, compared to firms in other industries? The standard agency theory view revolves around managers not acting in the best interests of shareholders. Although this theory may be valid in a number of organisations both Macey & O'Hara (2003) and Arun & Turner (2004) argue that a broader view of corporate governance should be taken within the banking industry. The reasoning behind this thought is two-fold. Firstly, Macey & O'Hara (2003) note that a high proportion of organisations in differing industries produce finance with equity rather than debt, whilst banks typically receive up to 90% of their funding from debt. This gives rise to the question of whether or not management will be acting in the best interest of the shareholders or the debt holders.

Secondly, the banking industry has a higher level of government intervention and regulation than other industries. Caprio et. al (2007) argue that this regulation and intervention could reduce bank valuation as it forces banks to take on less risky propositions than equity holders may expect. On the other hand though, greater government regulation provides a greater level of shareholder protection that may increase both confidence and the likelihood of investment.

Tanna et al. (2008) provide the first analysis on corporate governance within UK banks. Their sample of 18 banks analysed over the time period 2001-2006 with specific emphasis on core corporate governance issues such as board size and composition, and the impact of independent non-executive directors showed that board composition has a positive impact on a variety of efficiency measures, and also supported the notion of non-executive directors bringing both a level

of independence and objectivity. This supports the view of the Basel Committee on Banking Supervision (2006) that states "banks should have an adequate number and appropriate composition of directors who are capable of exercising judgement independent of the views of management, political interests or inappropriate outside interests."(p.7).

Furthermore, Busta (2007) and Alonso & Gonzalez (2006) find a positive relationship between non-executive directors and firm performance. Busta (2007) examined 69 listed banks in principal EU sectors (Germany, France, UK, Spain etc.) over the time period 1996-2005 and found that banks with a higher presence of non-executive directors performed better in terms of market-to-book value and return on invested capital (ROIC). Similarly, Alonso & Gonzalez (2006) examined a sample of 66 commercial banks in six OECD countries between 1996 and 2003 and found a positive relationship between a number of performance measures and the number of non-executive directors. Their findings support the importance of the appointment of independent non-executive directors as recommended by the Basel Committee on Banking Supervision (2006) and would seem to inspire a level of investor confidence.

Research into board size within banks tends to conflict with research into board size within other industries. Lipton & Lorsch (1992), Jensen (1993) and Yermack (1996) all concluded that large boards are ineffective in comparison to small boards due to a variety of factors, including problems with decision making and effective communication. In contrast research into board size and firm performance within the banking industry (Adams & Mehran, 2005; Alonson & Gonzalez, 2006 and Trayler, 2007); show contrasting results. These studies provide evidence that banks can justify a large board. Therefore, the implementation of large boards may well not affect firm performance, and it may even be possible to suggest that larger boards may improve performance when measured against certain variables. This could be due to a number of factors explained by Haniffa & Hudaib (2006) such as providing a greater level of experience and expertise, and a wider range of contacts within the industry. Research evidence (Trayler, 2007; Adams & Mehran, 2005, and Alonso & Gonzalez, 2006) all conclude that large boards within the banking industry may well not constrain firm performance.

In summary, a review of the literature provides evidence of different corporate governance factors that may impact firm performance, including board size, directors' remuneration, and the usefulness of audit committees to name just a few. In the majority of cases, there have been conflicting results due to factors such as the period covered by the study or the industry investigated. Evidence illustrating such contrasting results would appear to support the notion that it is extremely difficult to operate a single corporate governance system worldwide that is applicable to all industries.

Specifically focusing on the corporate governance factors associated with banks, it can be argued that corporate governance does differ within banks compared to that of other industries. Evidence exists that larger boards may well be more effective leading to an improved level of firm performance. Although the appointment of non-executive independent directors is important within other industries, it is of extreme importance within the banking industry, as research evidence reveals that a positive relationship exists between the appointment of independent non-executive directors and the performance of banks. Appropriately, therefore, the following hypothesis is tested:

**H1: Sound corporate governance practices within UK banks will lead to an increased level of firm performance.**

### 3.0 Research Methodology

#### 3.1 Sample Selection

To be included within the sample for the study two key conditions needed to be met by the bank. Firstly, the bank had to be listed amongst the FTSE 100 companies on the London Stock Exchange in 2006. Secondly, Annual Report Data for the period 1999 to 2006 needed to be available, due to the longitudinal nature of the study.

The following banks satisfied the first condition:

1. Alliance & Leicester.
2. Barclays.
3. HBOS.
4. HSBC Holdings.
5. Lloyds TSB Group.
6. Royal Bank of Scotland.
7. Standard Chartered.

However, with regards to the second condition, it was only possible to obtain the annual reports for the following banks for the period 1999 to 2006:

1. Alliance & Leicester.
2. Barclays.
3. HSBC Holdings.
4. Royal Bank of Scotland.

Thus the three banks that did not meet the second condition were eliminated from the study. Therefore, having met both conditions the four UK banks' annual reports were analysed over the time period 1999-2006

providing a combined total of 32 years of data examined for the purpose of this study.

### 3.2 Corporate Governance Scorecard (Corp-Gov Score)

In order to examine the relationship between corporate governance and firm performance, a corporate governance scorecard was developed (see Javed & Iqbal (2007), Brown & Caylor (2005), and Black, Jang & Kim (2006) to name a few) to measure a variety of corporate governance practices adopted by each bank. To construct the scorecard, it was necessary to determine what constitutes a measure of corporate governance. Using information obtained from a number of sources including the Combined Code (1998), the redrafted Combined Code (2003), previous academic research, and the ISS Corporate Governance Best Practices and User Guide Glossary (2003) twenty-six areas of corporate governance best practices were ascertained. These formed the basis for scoring the annual report of each bank for compliance with different areas of corporate governance.

These twenty-six measures were categorised into four main sub-sections comprising:

- a. Board of Directors – seven measures.
- b. Remuneration Policies – five measures.
- c. Auditing Policies – five measures.
- d. Transparency/Disclosure Policies – nine measures.

Further details of each aspect measured are provided in **Appendix 1**. Using information extracted from the yearly Annual Report of each bank, each measure of corporate governance was coded either **1** or **0**. If compliance was achieved on a measurement criterion it was coded **1**, if not, it was coded **0**. Thus the maximum score obtainable by each bank was 26, in any given year, using the corporate governance scorecard system. Corp-Gov Score was then used to illustrate how successful each bank was in complying with any of the four sub-categories of corporate governance measures above, in any given year, providing the basis for determining how each aspect of corporate governance impacted the performance of the banks.

### 3.3 Firm Performance

The review of literature suggests that it is extremely difficult to find a consistent measure of firm performance, as different authors have used different measures, including **Tobin's Q** (market value of assets / book value of assets), **Return on Assets** (Net Income / Total Assets) and/or **Return on Equity** (Net Income / Shareholders Equity), amongst others.

In this paper, the performance measurement criteria adopted was determined by the availability of data required for each measurement criterion. Data for the entire period of investigation, 1999 to 2006 had to be available. Given that data in relation to the market value of assets could only be obtained for the years

2002-2006, it was not possible to use **Tobin's Q**. Hence, both **Return on Assets** and **Return on Equity** were used to measure the performance of the four sample banks for the period 1999 to 2006. Information relating to net income, total assets, and shareholders' equity was extracted from individual bank's Annual Report.

#### 4. Data Analysis and Findings

Table 1 below provides year on year summary statistics for the Corp-Gov Score detailing the extent to which UK banks conformed to the codes of corporate governance best practices post Enron. The table reports the mean, median, standard deviation, minimum, and maximum values of Corp-Gov score for each of the sampled years, and shows whether or not Corp-Gov Score was improving year on year, as well as how Corp-Gov Score may have been affected by the redraft of the Combined Code (2003), following the collapse of Enron in 2001.

**Table 1.** Summary Statistics of Corp-Gov Score

	1999	2000	2001	2002	2003	2004	2005	2006
Mean	15.5	15.75	16.5	16.5	23.5	23.75	24.5	24.25
Median	15	16	16.5	16.5	23.5	24	24	
Std.Dev.	1.73	2.22	1.73	2.38	0.58	0.5	1	1.26
Min	14	13	15	14	23	23	24	23
Max	18	18	18	19	24	24	26	26

Table 1 reveals that the mean and median values of Corp-Gov Score increased from 15.5 and 15 respectively in 1999 to 24.25 and 24 in 2006. A steady upward trend took place from 1999 to 2002 with the mean value of Corp-Gov Score increasing from 15.5 in 1999 to 16.5 in 2002. The significant leap took place between 2002 and 2003, with the mean of Corp-Gov Score increasing from 16.5 to 23.5. A slight upward trend then followed after 2003 except for 2005 to 2006 where the mean score slightly decreased by 0.25.

**Appendix 2** provides year on year summary statistics in relation to the four Corp-Gov Score sub-areas, showing the mean, median, standard deviation, minimum, and maximum values for each of the years examined.

In each of the four sub-areas an increasing trend is recorded over the time period 1999-2006, with the Transparency/Disclosure sub-area of Corp-Gov Score showing the greatest increase. From a mean score of 2.5 in 1999, a slight upward trend results in a mean score of 3 in 2002. The increase in mean value is then extremely dramatic; increasing to 8.75 in 2003, illustrating a situation where near full compliance was attained by all the UK banks that were sampled. Full compliance in all transparency and disclosure areas by all banks was finally achieved in 2005, and continued into 2006.

One possible explanation for such an improvement in transparency and disclosure would be the attempt by UK banks to be seen to be transparent following the collapse of Enron<sup>24</sup> and to reduce the information asymmetry between management and

shareholders. Information asymmetry, from an agency theory perspective, results in managers being far more knowledgeable about a company's activities than potential or current investors. The redraft of the Combined Code in 2003 may also explain such a dramatic increase in mean score. Greater emphasis has been placed on transparency and disclosure since the redraft, and the above data would support the view that transparency and disclosure are improving within the UK banking system.

The Corp-Gov Score summary statistics on Table 1 (and **Appendix 2**) reveals that UK banks have complied with corporate governance reform post Enron. A considerable increase is seen in Corp-Gov score between 2002 and 2003, when UK banks have had to conform to changes within the redrafted Combined Code in 2003. It would also follow that UK banks are taking corporate governance reforms seriously and are trying to assure 100% compliance in order to promote investor confidence in their industry.

#### 4.1 Corp-Gov Score Analysis

This section tests the hypothesis:

**H1: Sound corporate governance practices within UK banks will lead to an increased level of firm performance.**

Regression and correlation analysis are used to establish if a causal relationship exists between Corp-Gov Score and firm performance when measuring firm performance using Return on Assets and Return on Equity, both being the dependent variables ( $y$ ) and the Corp-Gov Score within any given year being the independent variable ( $x$ ).

<sup>24</sup> One of the reasons for the collapse of Enron was the fact that the directors tried to conceal huge losses from the market by creating 'special purpose entities' which were used to defraud shareholders.

The scatter plots below, Figures 1 and 2, illustrate if any relationship exists between the two variables, with a regression line of best fit inserted.

Figure 1

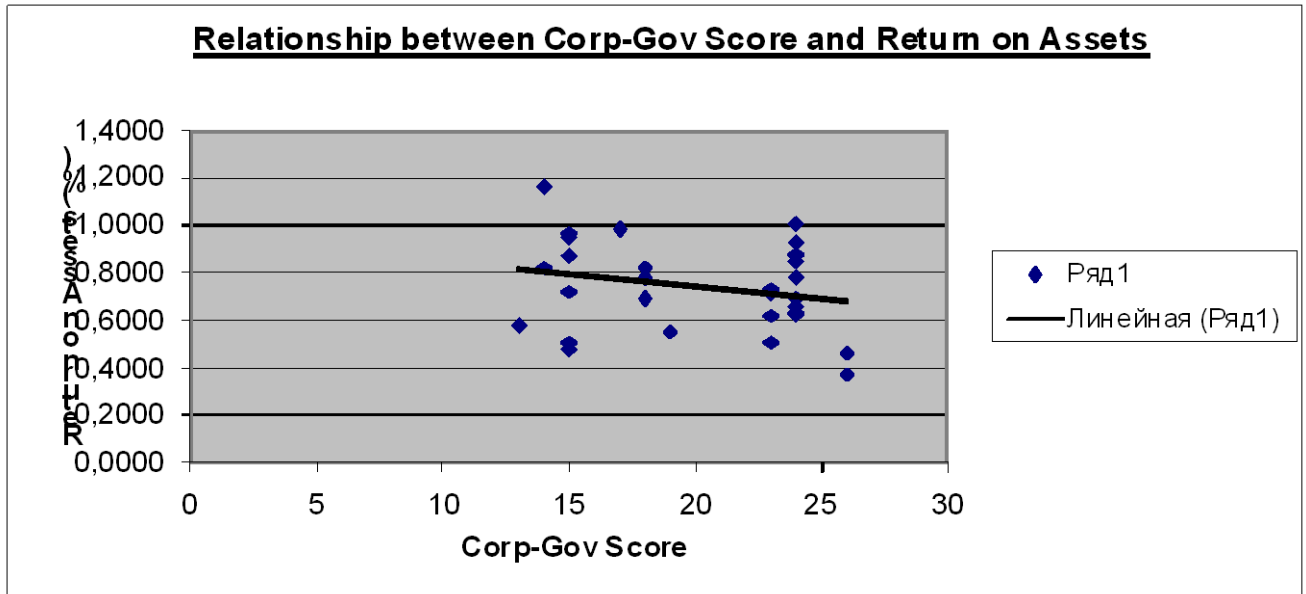
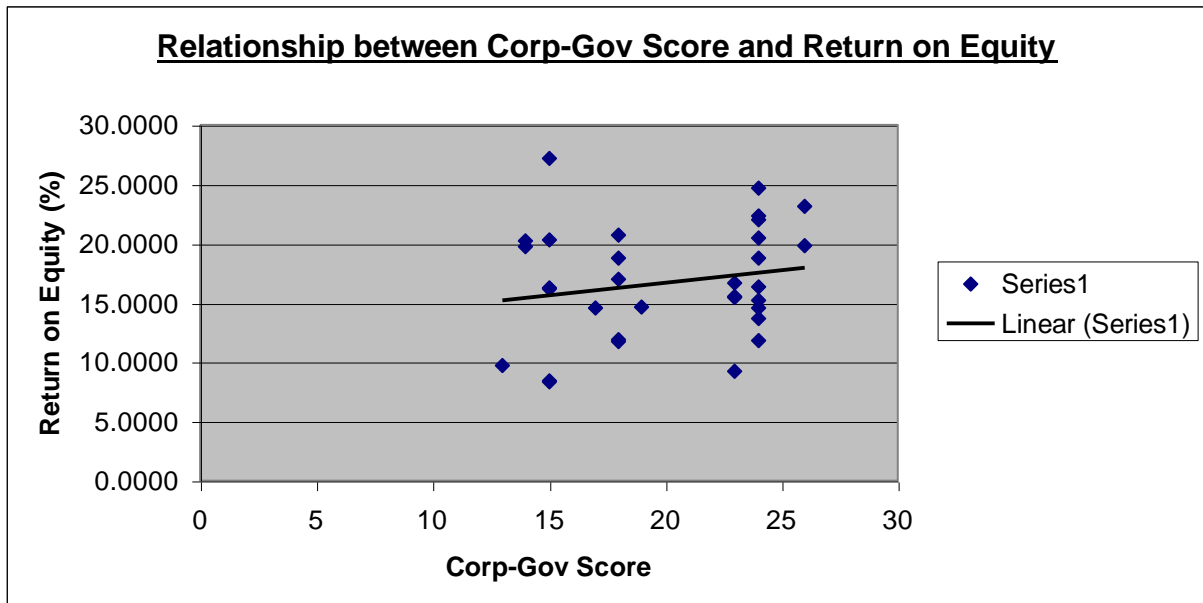


Figure 2



The scatter plots reveal contrasting results depending on the performance measurement criterion used. When performance is based on Return on Assets, a negative relationship exists between Corp-Gov Score and Return on Assets, as indicated by the downward slope of the regression line of best fit. It can be seen that as Corp-Gov Score increases the Return on Assets would appear to decrease. These results are further confirmed using Pearson’s product moment correlation coefficient. The result of the correlation analysis on the two variables reveals a correlation coefficient of  $-0.246$ . This represents a weak negative relationship,

albeit significant. This result would suggest an initial rejection of the hypothesis that improved corporate governance within UK banks leads to an increased level of firm performance.

However, Figure 2 reveals that when Return on Equity is used as a measure of firm performance, a positive relationship results. In other words, a relationship exists between Corp-Gov Score and Return on Equity, as the upward slope of the regression line of best fit suggests. An opposite trend to Return on Assets is noted, for as Corp-Gov Score increases, the Return on Equity also increases. Again

the Pearson’s product moment correlation confirms this with a correlation coefficient of 0.191 when correlating Return on Equity and Corp-Gov Score. Again this denotes a weak positive relationship. In this case the hypothesis that improved corporate governance within UK banks leads to an increased level of firm performance could be accepted.

Corp-Gov Score consists of twenty-six factors that are split into four different sub-areas of Corp-Gov Score. This section of the paper provides regression and correlation analyses of each of the four sub-areas to determine which areas are influencing Corp-Gov Score. The matrix below illustrates the Pearson Product Moment correlation of each Corp-Gov Score sub-area measured against both Return on Assets and Return on Equity.

**4.2 Sub-Area Corp-Gov Score Analysis**

**Pearson’s Product Moment Correlation Matrix**

<i>Corp-Gov Score Sub-Sector</i>	<i>Return on Equity</i>	<i>Return on Assets</i>
Board of Directors	0.6128	-0.3640
Remuneration Policies	-0.1139	-0.1939
Auditing Policies	-0.2332	-0.0304
Transparency/Disclosure	0.1457	-0.1959

The correlation matrix provided provides evidence that the main sub-area that influences Corp-Gov Score certainly seems to be the Board of Directors. A high positive relationship exists between Board of Directors Corp-Gov Score and the Return on Equity. Therefore the negative relationship between the Board of Directors Corp-Gov Score and Return on Assets is rather curious. Figure 3 and 4 below illustrate these findings, with a regression line of best fit inserted.

Further analysis of the correlation matrix shows that most of the sub-areas of Corp-Gov Score have a negative relationship with firm performance. As can be seen the only positive relationship exists between Board of Directors Corp-Gov Score, and Transparency/Disclosure Corp Gov-Score, when measuring against Return on Equity. All other sub-sectors illustrate a negative relationship, which could lead to the conclusion that increases in Corp-Gov Score within these areas actually have a detrimental effect upon firm performance.

**Figure 3**

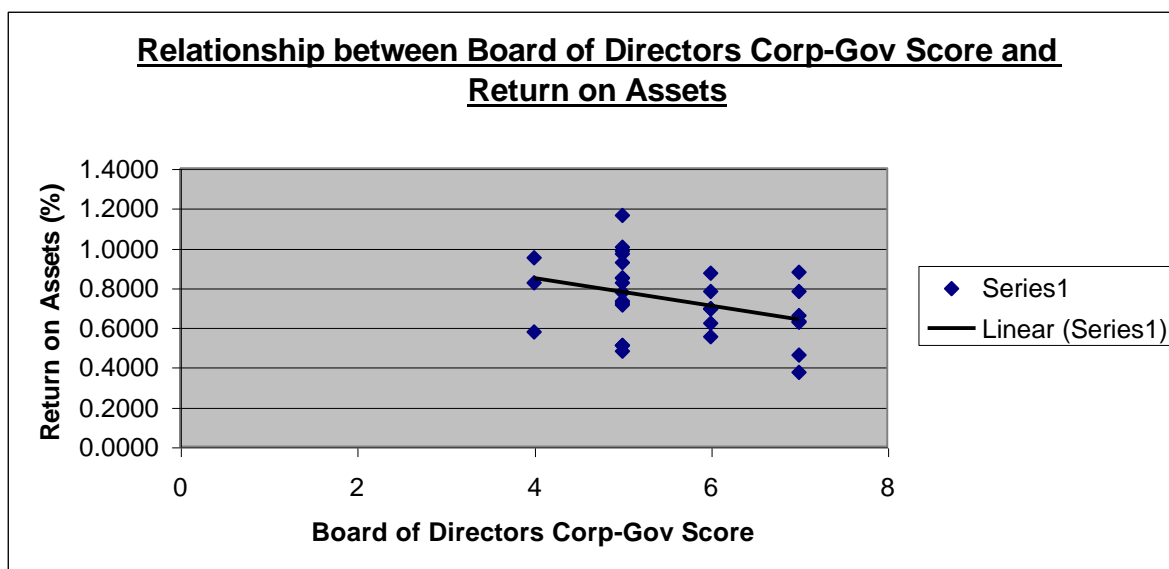
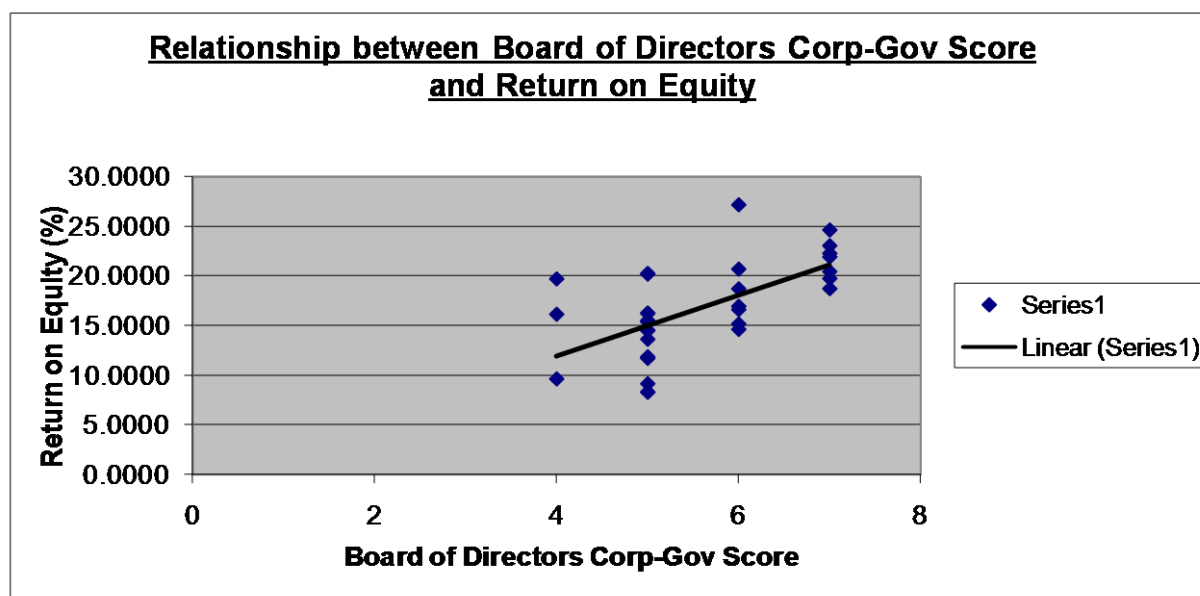


Figure 4



4.2.1 Board Size Analysis

A review of relevant literature reveals that the extent to which board size impacts firm performance produced mixed results. Using regression and correlation analysis, this paper attempts to establish if

a causal relationship exists between the size of the board of UK banks, and both Return on Assets, and Return on Equity. Table 2 provides summary statistics for each bank, along with the combined totals, which is described as the UK banking industry.

Table 2. Summary Statistics of Board Size between 1999-2006

	Barclays	RBOS	HSBC	Alliance Banking & Leicester	UK Industry
Mean	13.38	16.25	21	11.63	15.56
Median	13	16	21	12	15
Mode	13	16	20	12	12
Min	12	14	20	10	10
Max	15	18	22	13	22

The table reveals that the board size of the sampled banks ranged between 10 and 22 with a mean for the UK banking industry of 15.56. This finding is similar to that of Alonso & Gonzalez (2006) and Busta (2007), also within the banking industry, who obtained mean board sizes of 16.45 and 15.72 respectively. On the other hand Tanna, Pasiouras & Nnadi (2008) in their study of UK banks found the mean number to be only 12.1, suggesting that board sizes have been trimmed down.

Regression and correlation analyses were performed to establish if a statistically significant relationship exists between board size and firm performance, using both Return on Assets, and Return on Equity. Figures 5 and 6 display the results with the regression line of best fit inserted.

The pictures that emerge from Figures 5 and 6 are quite interesting. When firm performance was analysed using Return on Equity, as shown in Figure 6 a considerably negative relationship is noted, represented by the steep downward regression line of fit. Furthermore the Pearson's product moment correlation is  $-0.604$  indicating statistically a fairly strong negative relationship. The results suggest that as the number of directors increased within UK banks, the Return on Equity fell considerably. This adds validity to the arguments proffered by some authors (Lipton & Lorsch, 1992; Yermack, 1996; Eisenberg et al. 1998; Cheng, 2008, amongst others) that constraining board size improves firm performance.



Figure 5

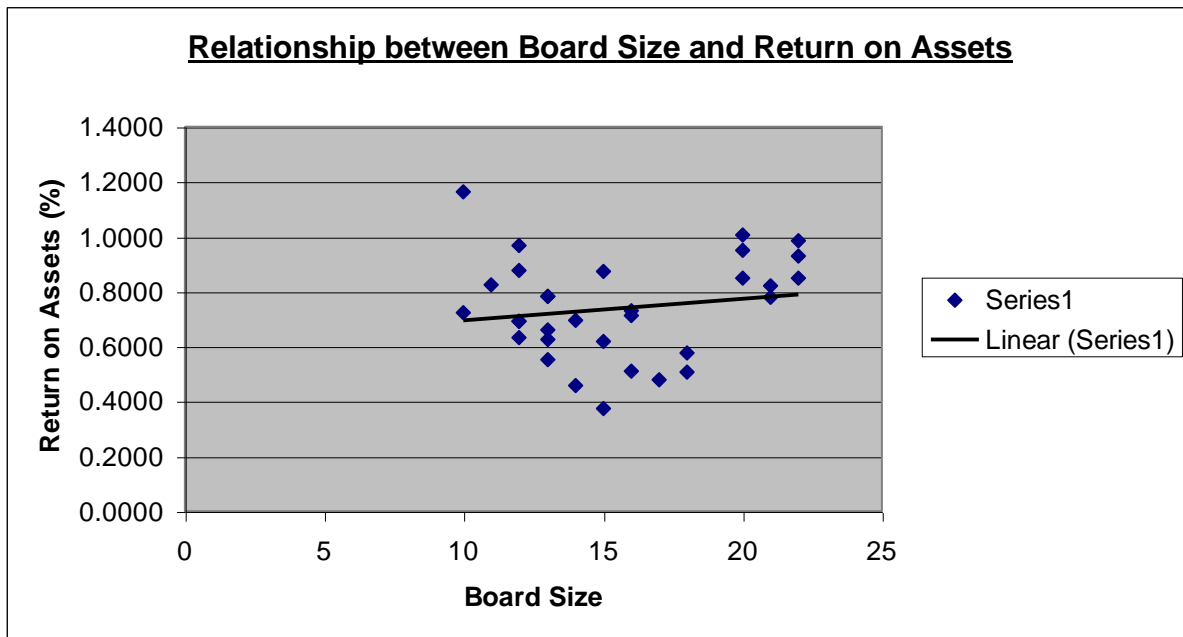
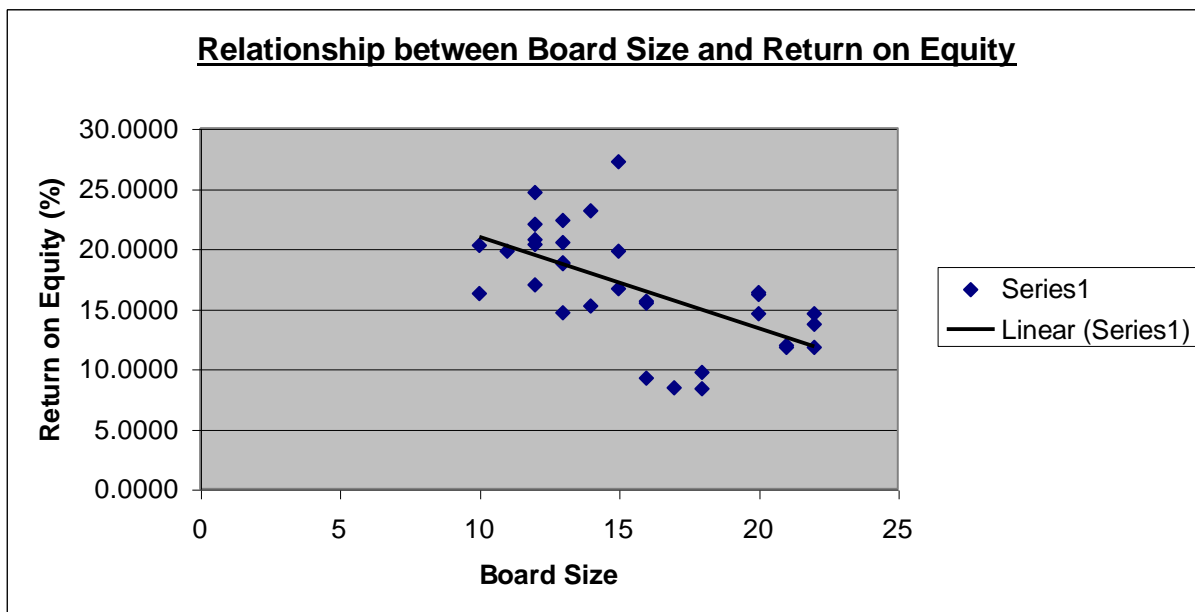


Figure 6



#### 4.2.2 Directors' Remuneration Analysis

This paper also examined whether or not a relationship exists between directors' remuneration and firm performance. For the purpose of this research overall directors' remuneration comprised of the remuneration of all Board members, including the Chairman. Regression and correlation analysis was performed, using both Return on Assets, and Return on Equity as measures of firm performance, to ascertain if any significant relationship exists. Figures 7 and 8 display the results of the data analysis.

Figure 7

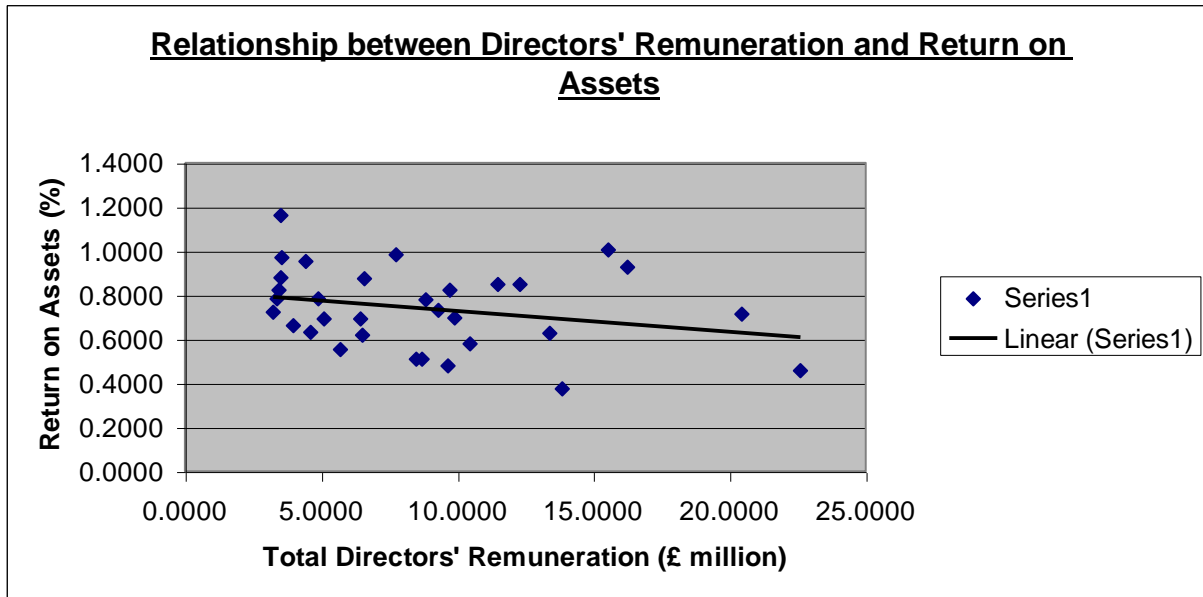


Figure 8

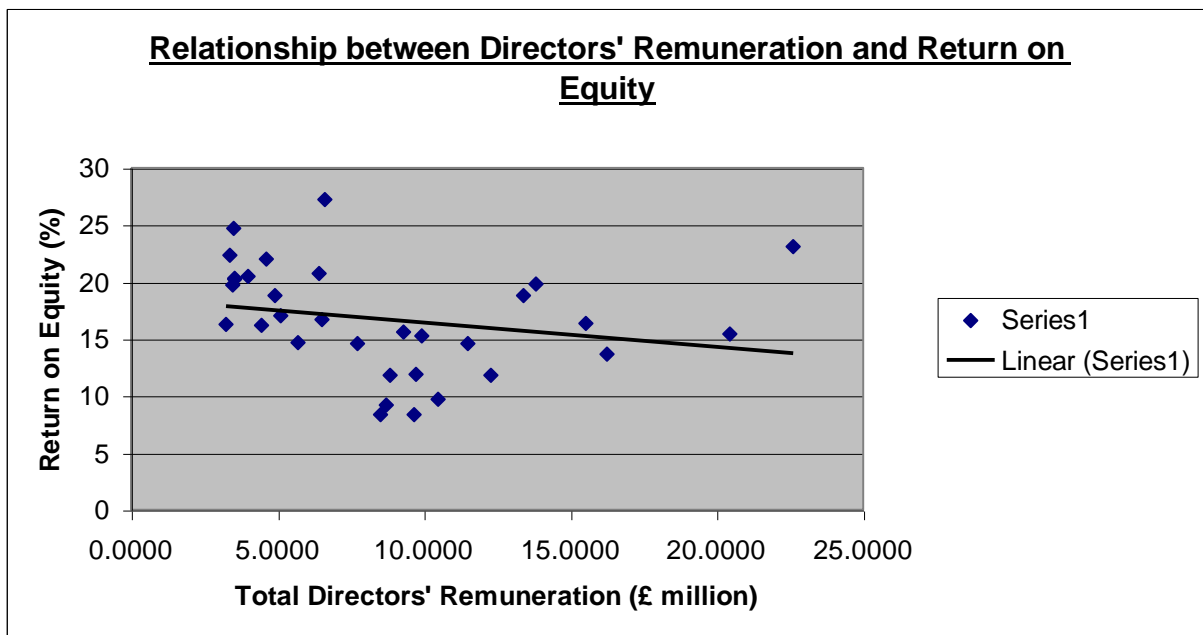


Figure 5 showing the relationship between the number of directors and the Return on Assets is also interesting. The Pearson's Product Moment correlation coefficient between the two variables, 0.166, suggests a weak positive relationship between the number of directors and the Return on Assets. The picture emerging from the scatter plots in Figure 5 suggests that the data may possibly be skewed. The summary statistics on Table 2 reveals that between 1999 and 2006, HSBC had a considerably larger board than any of the other UK banks. This notwithstanding, the scatter plot presented in Figure 5 shows that even

though HSBC had a larger board the bank seemed to have performed reasonably well when measurement is based on the Return of Assets. On the other hand if the data relating to HSBC was to be removed and the other three banks analysed, even without the regression line of best fit, it can be seen that a negative relationship would exist, just through observing the scatter plot data. However, on the basis of the whole sample, it could be presumed that a weak positive relationship exists between the number of directors and Return on Assets.

For both figures, the regression line of best fit has a slight downward slope. The Pearson's correlation coefficient measuring the relationship between directors' remuneration and the Return on Assets is – **0.2636**. Similarly the relationship between Return on Equity and directors' remuneration is – **0.2249**. Both cases reveal relatively weak negative correlations, even though they still provide evidence that a relationship exists. These results give a clear indication that as directors' remuneration increase, both Return on Assets, and Return on Equity decrease. This adds validity to the arguments presented by some authors such as Conyon & Murphy (2000), Buck et,al (2003), and Duffhues & Kabir (2008).

Although the findings provide evidence that a relationship exists between directors' remuneration and firm performance, the results should be accepted with caution. The limitations associated with working with remuneration data over a longer time frame (in this study 1999-2006) is that no account is given for the time value of money, or inflationary measures. On the basis of this argument, it would be expected that directors' remuneration would increase year on year, and investors and shareholders alike would expect excessive increases to be accompanied by an increase in firm performance. Whether or not this takes place is highly debatable, and academic literature has provided little evidence that increasing directors' remuneration leads to increased levels of firm performance.

## **5. Summary and Conclusion**

Whilst the relationship between corporate governance and firm performance has been widely discussed in academic literature, very little research has been undertaken on how a wide variety of corporate governance variables affect the performance of UK firms in the banking industry. This is quite surprising given the importance of corporate governance in banks because of the pivotal role they fulfil in any economy. This study fills the gap within the existing literature, by analysing the relationship between a number of corporate governance variables and their impact on two differing measures of firm performance. The sample for the study consists of four major UK banks over the time period 1999-2006. The paper also examined the extent to which UK banks have conformed to the current corporate governance codes of best practices, post Enron.

Using Corp-Gov Score, a governance measuring scorecard system, evidence is provided that UK banks are making every effort to promote high levels of corporate governance. Further evidence is provided that following the redraft of the Combined Code (2003) a greater emphasis has been placed on a variety of corporate governance factors, specifically transparency and disclosure. All banks attained almost full compliance in all areas of Corp-Gov Score within 2006, providing further support to the argument that UK banks are attempting to improve corporate governance and reporting mechanisms.

Statistically, the relationship between a number of different corporate governance variables and firm performance was analysed. The results suggest that a positive relationship exists between Corp-Gov Score and Return on Equity, confirming the hypothesis that sound corporate governance practices lead to an increased level of firm performance based on this criterion of measurement. The single most important sub-area of corporate governance which has a positive effect on firm performance (or shows an increase in the Return on Equity) is the Board of Directors (here implying board composition). As compliance within this sub-area of Corp-Gov Score increases, it results in a significant positive increase in the Return on Equity. This positive relationship offers a clear indication that UK banks need to make every effort to maintain compliance with this sub-sector in an attempt to increase firm performance when measured using Return on Equity.

On the other hand this paper provides evidence that some aspects of corporate governance can have a detrimental effect on firm performance depending on which measurement criterion is used. A negative relationship is established when examining the relationship between the overall Corp-Gov Score and Return on Assets, including when analysing each sub-area of corporate governance. This led to a rejection of the hypothesis that sound corporate governance practice leads to an increased level of firm performance when Return on Assets is used as the measure of performance.

In the area of board size evidence is presented supporting the notion that board size should be constrained to maximise firm performance. A significant statistical negative relationship is established between increased board size and Return on Equity. The additional benefits that larger boards have such as bringing greater expertise, and greater knowledge, would appear not to be supported by the evidence obtained in this paper. Furthermore, when examining the relationship between directors' remuneration and firm performance, statistical evidence shows a weak negative relationship. The question that may need to be addressed given this finding is whether additional board members and increasing levels of directors' remuneration are helping to maximise shareholder wealth.

To conclude, the findings of the study reported in this paper provide mixed results. Corporate governance compliance has been shown to increase firm performance in some areas but not all. This would bring about the question "why do UK banks want to comply with corporate governance areas of best practice if it is actually harming the performance of the firm?" The answer to this question is possibly two-fold. Firstly, if UK banks do not offer compliance with the Combined Code investor confidence may be damaged, making them a less likely investor proposition. Secondly, drawing upon agency theory, corporate governance is seen as a means to try and reduce the information asymmetry between

management and investors. This would follow that investors are more likely to invest in UK banks that offer high levels of both transparency and disclosure, as more informed and better decisions would be made.

Further research could possibly extend this study by examining a number of additional corporate governance mechanisms, leading to an expansion of Corp-Gov Score. Additionally, it would be interesting to examine the relationship between differing corporate governance variables and their effect on firm performance in a cross-country setting of banking organisations. This would allow a greater perspective of the banking industry on a more global scale. Further expansion of this research could take place by removing the restraint that the UK banks had to be listed within the FTSE 100 on the London Stock Exchange. In this scenario the number of sampled banks available to analyse within the UK would increase, offering a broader perspective of the UK banking industry. Finally additional research could be conducted using Corp-Gov Score within other financial service sectors. This could encompass such areas as insurance services, or building societies.

Banks retain a pivotal position within any economy, and the corporate governance mechanisms used to monitor UK banks will always be under scrutiny. Mixed results have been obtained when analysing differing corporate governance areas and their relationships with firm performance. This study has illustrated that corporate governance within UK banks plays an important role, but how it affects firm performance is still open to debate.

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## Appendix 1

### Board of Directors

1. Percentage of Non-Executive Directors is above 50%
2. Split Chairman / CEO.
3. Senior Independent Director.
4. Full Non-Executive Director Independence (100% Compliance)
5. Size of Board of Directors is at least six but no more than 15 members (taken from ISS Best Practice of Corporate Governance 2003)
6. CEO serves on no more than two additional boards of other public companies (taken from ISS Best Practice of Corporate Governance 2003)
7. Nomination Committee comprises of Non-Executive Directors (100% Compliance) (taken from ISS Best Practice of Corporate Governance 2003)

## Appendix 2

### Remuneration Policies

1. Presence of a Remuneration Committee.
2. Performance Related Pay Options.
3. Remuneration Committee comprises of Non-Executive Directors (100% Compliance)
4. Annual Remuneration Review Undertaken.
5. Disclosure of both Executive and Non-Executive Director Remuneration.

### Auditing Policies

1. Presence of an Audit Committee.
2. Internal Audit Function.
3. Full Non-Executive Directors on Audit Committee (100% Compliance)
4. Audit Committee Report.
5. Non-Audit Services paid to auditors are less than audit fees (taken from ISS Best Practice of Corporate Governance 2003)

### Transparency/Disclosure

1. Disclosure of Number of Board Meetings.
2. Disclosure of Number of Audit Committee Meetings.
3. Disclosure of Number of Remuneration Committee Meetings.
4. Disclosure of Number of Nomination Committee Meetings.
5. Disclosure of attendance of Board Meetings.
6. Disclosure of attendance of Committee Meetings
7. Disclosure of full Biographical Details of Board Members.
8. Disclosure of relations with shareholders.
9. Disclosure of performance evaluation of Board.

**Appendix 2.** Table showing Summary Statistics of Board of Directors Corp-Gov Score

	1999	2000	2001	2002	2003	2004	2005	2006
Mean	5.25	5	5.25	5	5.75	6	6.25	6
Median 5.5	5	5	5	5.5	6	6.5	6	
St.Dev. 0.96	0.82	0.5	0.82	0.96	1.15	0.96	1.15	
Min	4	4	5	4	5	5	5	5
Max	6	6	6	6	7	7	7	7

Table showing Summary Statistics of Remuneration Policies Corp-Gov Score

	1999	2000	2001	2002	2003	2004	2005	2006
Mean	4.5	4.75	5	5	5	5	5	4.75
Median 4.5	5	5	5	5	5	5	5	
St.Dev. 0.58	0.5	0	0	0	0	0	0.5	
Min	4	4	5	5	5	5	5	4
Max	5	5	5	5	5	5	5	5

Table showing Summary Statistics of Auditing Policies Corp-Gov Score

	1999	2000	2001	2002	2003	2004	2005	2006
Mean	3.25	3.25	3.25	3.5	4	4	4.25	4.5
Median 3	3	3	3.5	4	4	4.5	5	
St.Dev. 0.5	0.5	0.5	0.58	0.82	0.82	0.96	1	
Min	3	3	3	3	3	3	3	3
Max	4	4	4	4	5	5	5	5

Table showing Summary Statistics of Transparency/Disclosure Corp-Gov Score

	1999	2000	2001	2002	2003	2004	2005	2006
Mean	2.5	2.75	3	3	8.75	8.75	9	9
Median 2	2.5	3	3	9	9	9	9	
St.Dev. 1	0.96	1.15	1.15	0.5	0.5	0	0	
Min	2	2	2	2	8	8	9	9
Max	4	4	4	4	9	9	9	9