



Turun yliopisto
University of Turku

CORPORATE GOVERNANCE AND FIRM FINANCIAL PERFORMANCE IN UK FINANCIAL INSTITUTIONS

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Peter Agyemang-Mintah

University of Turku

Turku School of Economics
Department of Accounting and Finance

Supervised by

Professor Hannu Schadewitz
Turku School of Economics
University of Turku
Finland

Professor Mika Vaihekoski
Turku School of Economics
University of Turku
Finland

Reviewed by

Professor Collins G. Ntim
Professor of Accounting and Head of Department
Southampton Business School
University of Southampton
United Kingdom

Assistant Professor Jonas Spohr
Faculty of Social Sciences, Business and Economics
Åbo Akademi University
Finland

Custos

Professor Hannu Schadewitz
Turku School of Economics
University of Turku

Opponent

Professor Collins G. Ntim
Professor of Accounting and Head of Department
Southampton Business School
University of Southampton
United Kingdom

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*“Wisdom is the principal thing; therefore, get
wisdom and with all thy getting get understanding”
-Proverbs 4:7 KJV*

ABSTRACT

This thesis consists of four published empirical studies on the effect of three board monitoring committees (namely: audit, remuneration and nomination committees) and board diversity on the performance of UK financial institutions.

The collapse of large financial institutions and non-financial firms, coupled with the global financial crisis in 2007/08, precipitated a number of corporate governance reforms in the UK. Compellingly, the continuous corporate governance reforms all recommended the formation and appointment of key board monitoring committees such as audit, remuneration and nomination, together with board diversity to help improve firms' effectiveness.

This research uniquely examined the effect of these three committees and board gender diversity on the performance of UK financial institutions during the pre/post global financial crisis era.

The empirical results first indicate that the presence of the three board monitoring committees and board gender diversity have a positive and statistically significant link with the financial performance of the sampled UK financial institutions. Subsequent tests conducted during the pre- and post-2007/08 financial crisis periods show mixed results. Specifically, the pre-crisis results show that the establishment of these monitoring board committees (audit, remuneration and nomination) and board gender diversity remained positive and statistically significant before the 07/08 financial crisis. However, the post-crisis period results were not statistically significant, indicating that the 07/08 financial crisis appeared to have affected the financial performance of the financial institutions examined.

Overall, the thesis provides practical implications for governments, policy-makers and regulatory authorities by indicating the importance of monitoring committees and board gender diversity for corporate success.

The findings are consistent with agency, stakeholder and resource dependence theories and group effectiveness theories. This suggests that board committees and board gender diversity enhance board monitoring, bring a diversity of ideas and ultimately improve firm performance.

Keywords: audit, remuneration, nomination, gender diversity, board committee, firm financial performance, UK, pre- and post-2007/08 financial crisis.

Paper type: Empirical research

TIIVISTELMÄ

Tämä väitöskirja sisältää neljä aiemmin julkaistua empiiristä tutkimusta, joissa tarkastellaan hallituksen valvontakomiteoiden (tilintarkastus-, palkkaus- ja nimitysvaliokunnan) sekä hallituksen sukupuolijakauman vaikutuksia rahoituslaitosten suoriutumiseen Yhdistyneessä kuningaskunnassa.

Suurten rahoituslaitosten ja yritysten romahdus sekä maailmanlaajuinen finanssikriisi vuosina 2007/08 sai aikaan suuria muutoksia yritysten hallinnointijärjestelmään Yhdistyneessä kuningaskunnassa. Uudistusten yleinen suositus oli juuri hallituksen valvontakomiteoiden perustaminen sekä hallituksen sukupuolten moninaisuuden huomiointi, kun tavoitteena on yrityksen tehokkuuden parantaminen.

Tässä väitöskirjassa tarkasteltiin ensimmäistä kertaa kolmen edellä mainitun komitean ja hallituksen monimuotoisuuden vaikutuksia Yhdistyneen kuningaskunnan rahoituslaitosten suoriutumiseen ennen maailmanlaajuisia finanssikriisiä ja sen jälkeen.

Empiiriset tulokset osoittivat, että hallituksen valvontakomiteoiden olemassaololla ja niiden sukupuolten välisellä moninaisuudella oli positiivinen ja tilastollisesti merkittävä vaikutus otokseen valittujen rahoituslaitoksien taloudelliseen suoriutumiskykyyn. Kuitenkin erilliset testit, jotka suoritettiin aineistolla ennen ja jälkeen 2007/08 finanssikriisin, antoivat myös eriäviä tuloksia. Erityisesti kriisiä edeltävät tulokset osoittivat, että valvontakomiteoiden (tilintarkastus-, palkkaus- ja nimityskomitea) perustaminen ja hallituksen sukupuolten välinen moninaisuus pysyivät positiivisina ja tilastollisesti merkittävänä ennen rahoituskriisiä 07/08. Kriisin jälkeiset tulokset eivät kuitenkaan olleet tilastollisesti merkitseviä, mikä viittasi siihen, että rahoituskriisi 07/08 oli vaikuttanut tarkasteltujen rahoituslaitosten taloudelliseen suorituskykyyn.

Tämä tutkimus tarjoaa hyödyllistä tietoa hallituksille, poliittisille päätöksentekijöille ja sääntelyviranomaisille osoittamalla seurantakomiteoiden ja sukupuolten välisen moninaisuuden tärkeyden yritysten menestykselle.

Tulokset ovat yhdenmukaisia agentti-, sidosryhmä-, resurssiriippuvuusteorian sekä ryhmän tehokkuusteorioiden kanssa. Tämä viittaa siihen, että valvontakomiteat ja eri sukupuolten esiintyminen hallituksessa edistävät hallituksen valvontamahdollisuuksia sekä synnyttävät erilaisia ideoita, jotka lopulta johtavat yrityksen suorituskyvyn paranemiseen.

Avainsanat: tilintarkastus, palkkaus, nimitys, sukupuolten välinen monimuotoisuus, hallintokomitea, yrityksen taloudellinen suoriutuminen, Yhdistynyt kuningaskunta, finanssikriisi 2007/08.

Tutkimustyyppi: Empiirinen tutkimus

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Kiitos

Peter Agyemang-Mintah

December, 2017, Turku.

ABBREVIATIONS

| | |
|-------------|--|
| ABCP | Asset-Backed Commercial Paper |
| AC | Audit Committee |
| AGM | Annual General Meeting |
| AIDB | Accountancy Investigation and Discipline Board |
| AIFM | Alternative Investment Fund Managers |
| APB | Auditing Practices Board |
| ASB | Accounting Standard Board |
| BCBS | Basel Committee on Banking Supervision |
| BCCI | Bank of Credit and Commerce International |
| BGD | Board Gender Diversity |
| BoE | Bank of England |
| BOFI | Banks and Other Financial Institutions |
| CDO | Collateralised Debt Obligations |
| CIMA | Chartered Institute of Management Accounting |
| CP | Commercial Papers |
| CPMA | Consumer Protection and Markets Authority |
| CRA | Community Reinvestment Act |
| CRO | Chief Risk Officer |
| CEO | Chief Executive Officer |
| CFO | Chief Finance Officer |
| COO | Chief Operation Officer |
| CRS | Congressional Research Services |
| EC | European Commission |
| ECB | European Central Bank |
| FCA | Financial Conduct Authority |
| FE | Fixed Effects |
| FHA/VA | Federal Housing Administration and Veterans Administration |
| FPC | Financial Policy Committee |
| FRC | Financial Reporting Council |
| FRRP | Financial Reporting Review Panel |
| FSA | Financial Service Authority |
| FSCS | Financial Services Compensation Scheme |
| FSMA | Financial Services and Markets Act |
| FTSE | Financial Times Stock Exchange |
| GSE | Government Sponsored Enterprise |
| HM Treasury | Her Majesty's Treasury |
| ICAEW | Institute of Chartered Accountants in England and Wales |
| ICB | Independent Commission on Banking |
| ICGN | International Corporate Governance Network |

| | |
|-----------|--|
| IFRS | International Financial Reporting Standards |
| IMF | International Monetary Fund |
| INEDs | Independent Non-Executive Directors |
| LSE | London Stock Exchange |
| MBS | Mortgages-Backed Securities |
| MPC | Monetary Policy Committee |
| MPC | Monetary Policy Committee |
| NC | Nomination Committee |
| NECA | New Economic Crime Agency |
| NED | Non-Executive Directors' |
| NYSE | New York Stock Exchange |
| OECD | Organisation for Economic Co-operation and Development |
| OEIC | Open-Ended Investment Trust |
| OLS | Ordinary Least Square |
| ONS | Office for National Statistics |
| OTC | Over the Counter |
| POBA | Professional Oversight Board for Accountancy |
| PRA | Prudential Regulation Authority |
| RBS | Royal Bank of Scotland |
| RE | Remuneration Committee |
| RE | Random Effects |
| ROA | Return on Asset |
| SEC | Securities and Exchange Commission |
| SECA | Serious Economics Crimes Agency |
| SIV | Structured Investment Vehicle |
| SME | Medium-Size Businesses |
| TARP | Troubled Asset Relief Program |
| TBTF | Too Big to Fail |
| Tobin's Q | Firm's value/Market value |
| TSB | The Trustee Savings Bank |
| UK | United Kingdom |
| USA/US | United States of America |
| WCD | Women Corporate Directors |

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TIIVISTELMÄ

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Part I

SYNTHESIS

1 INTRODUCTION

1.1 Background and Characterisation of the Research Environment

The Cadbury Report, which sets the foundation for corporate governance ‘best practice’ in the UK and other countries in the world, defines corporate governance as a “*system by which companies are directed and controlled*” (1992, s.2.5; FRC, 2016). This suggests that the process whereby firms are governed and monitored is of great importance to all key players. For example, governance in the financial sectors goes beyond shareholders (equity governance) to include employees, directors, creditors, debtors and the government. This indicates that all stakeholders are deeply involved in the management of financial institutions. Again, the internal corporate governance in financial institutions focuses on shareholders and the board of directors, whilst the external corporate governance concentrates on markets for corporate control such as external auditors, rating agencies, government supervision and regulation (Levine, 2011; Mehran and Mollineaux, 2012; Hopt, 2013; Ntim 2013). This is quite different from non-financial firms’ corporate governance regulation where external corporate control is not very necessary.

However, the unexpected collapse of large financial institutions in the UK such as BCCI bank, Barings Bank, Equitable Life Assurance Society and other non-financial firms, coupled with the global financial crisis in 2007/08, which also affected banks such as Northern Rock, RBS, Lloyds TSB, Dunfermline Building Society, etc., shook the entire UK financial sector and affected the economy¹. The occurrence of these corporate collapses called for major reforms in corporate governance policies in the UK. More precisely, from the 1990s onwards, different corporate governance codes emerged as a result of the reforms to guide firms. Examples of these reforms include the Cadbury Report (1992), Greenbury Report (1995), Hampel Report (1998), Combined Code (2003 and 2006), Walker Review (2009) and FRC (2012, 2014 and 2016), all of which recommended the formation and appointment of key board monitoring committees such as audit, remuneration and nomination as well as board diversity.

Obviously, before financial institutions in the UK can be robust and resilient to corporate failures, there is the need for the board of directors to comply with the corporate governance reforms. They also need to form monitoring committees and ensure there is gender diversity.

¹ The frequent corporate governance reforms in the UK have been necessitated due to the complex nature of the financial institutions’ products and services. The sector is also very complex to manage, as it requires adequate knowledge and experience from decision-makers (Mehran and Mollineaux, 2012; Hopt, 2013).

More importantly, the reforms will see board committee members addressing any corporate governance overlaps, so as to tackle unforeseen events. This will eventually improve the capacity of corporate boards to effectively advise, monitor and discipline corporate executives (West, 2006, 2009; Lipton and Lorsch, 1992; Jensen, 1993, Ntim, 2013).

The role of the directors working on the board monitoring committees is classified into two critical functions of monitoring or oversight and advising or supporting the executive management on important decisions concerning the company (Baldeuius et al. 2014; Leung et al. 2014). The advising/supporting board committees tend to focus on marketing, production, finance, environment and information technology issues. The monitoring committees deal with audit, nomination and remuneration issues, which are intended to protect shareholder interests by advising the board and holding them accountable for their actions. In addition, the monitoring committees offer some advantages, such as having relatively small board sizes. They are also able to meet more frequently and provide sufficient time for meaningful dialogue in order to reach consensus much quicker (Vefas, 1999a, 1999b; Karamanou and Vefas, 2005; Chhaochharia and Grinstein, 2009; Ntim, 2013). The advising and monitoring committees help in bringing individual directors' specialist knowledge and expertise to the board decision-making process and allow the main board to focus on other areas of interest to the firm (Harrison, 1987; Klein, 1998; Carcello et al. 2002; Sun and Cahan, 2009; Ntim, 2013)². Empirically, having monitoring committees can improve firm financial performance by reducing self-dealing activities by opportunistic managers through effective monitoring (Harrison, 1987).

Functionally, for example, the establishment of an audit committee is so important that it requires that at least one member of the committee should have recent and relevant financial experience. Furthermore, the committee's duties should also follow relevant UK professional and regulatory requirements (FRC, 2014 and 2016). The audit committee is responsible for monitoring the integrity of the firm's financial statements; reviewing the firm's internal financial controls and risk management systems; reviewing and monitoring the external auditor's independence and objectivity; and implementing policy on the engagement of the external auditors concerning the supplying of non-audit services, taking into consideration relevant ethical guidance regarding the provision of non-audit services by the external audit firm (Cadbury Report, 1992; Smith Review, 2003; FRC, 2014 and 2016).

The remuneration committee is responsible for ensuring that the interests of the agents and shareholders are aligned to the long-term success of the firm relating to salary, bonus, share options, performance-related pay scheme, pension scheme and commissions (Cadbury Report, 1992; FRC, 2014 and 2016). Finally, the nomination committee is responsible for making appointments and recommendations to the board on the evaluations of the balance of skills, experience, independence and

² The board serves as the link between the people who provide capital (the shareholders) and the people who add value to the capital (the managers). The board also becomes the liaison between either the concentrated or dispersed shareholders of a company (Monks and Minow, 2004). The board committees also hold the final accountability and responsibility for corporate success or failure (Ibrahim and Angelidis, 1994).

knowledge of the board members. The committee is also responsible for preparing a description of the role and capabilities required for a particular appointment. The committee should include a description of the board's policy on diversity including gender (*ibid*).

Even though the formation of the remuneration and nomination committees is important to the firm's legislator, the establishment of an audit committee brings more legislative and regulatory requirements to the firm and less freedom than the remuneration and nomination committees (FRC, 2014 and 2016). This also serves as a motivation and gives an incentive to study all these three committees instead of focusing solely on the audit committee.

Further, the UK corporate governance code requires a board to have these three committees (audit, remuneration and nomination) since they are considered key groups because of their functions relating to organisational success (Cadbury Report, 1992; Combined Code, 2006; FRC, 2014 and 2016). The Walker Review (2009) on banks and other financial institutions recommended the creation of a risk committee; however, in some firms the functions of the audit committee also cover risk management and therefore there will not be a need for an additional committee. This suggests that, in some firms, the committees could be different and there could be more than three of them, but all aim to scrutinise decisions and solve organisational problems within the firms. Additionally, every board monitoring committee should have terms of reference indicating its functions and responsibility as to what it will do (Cadbury Report, 1998; Walker Review, 2009; FRC, 2016).

For the purpose of this research, the emphasis will be on these three committees mentioned above, as their establishment can still help solve organisational issues. Also, the empirical literature regarding financial institutions' internal corporate governance board committees and their association with firm financial performances is still at its emerging phase (Dalton et al. 1998; Laing and Weir, 1999; Ntim, 2013). The limited empirical evidence available makes this research worthwhile as it will help shed additional insights on the effects of board committees and the presence of women on corporate boards on firm financial performance in the UK.

Apart from the board monitoring committees, this research will also look at gender diversity, specifically female gender on the corporate board of UK financial institutions. When the nomination committee appoints males and females onto the corporate board with the aim of balancing divergent views and improving the firm's financial performance, we define it as board gender diversity (BGD). Julizaerma and Sori (2012) describe women as individuals with the ability to manage any firm due to their characteristics, which are believed to be emotional, meticulous and particular in any decision-making process. Kramer et al. (2007) indicate that women are known to ask tough questions and bring unity into leadership positions. Terjesen et al. (2009) also reveal that diversity in boards brings unique human capital and helps enhance board independence as diverse groups create different opinions and can help improve the quality of decision-making (McLeod and Lobel, 1992). Rose (2007) argues that companies with a high degree of board diversity

may serve as a positive signal to prospective job applicants looking to join the company.

Board gender diversity (BGD) has become an issue of discussion because of four benefits that a firm tends to gain from the diversity. Namely, BGD improves a firm's financial performance; creates opportunities to attract a wider pool of talent; the firm becomes more responsive to the market (Doldor et al. 2012); and, finally, board gender diversity enables firms to strengthen their corporate governance policies (*ibid*).

Generally, the debate on board gender diversity is supported by two primary arguments. The first argument holds the view that women with competent skills, experience and qualifications deserve the opportunity to serve on corporate boards. The second argument suggests that positive gender diversity amongst corporate directors results in better governance and enhances the performance of a firm. The second argument means that the representation of women on the board should serve solely to improve performance; otherwise, firms will merely be engaging in 'tokenism.'

Also, gender diversity has become an issue to countries as well. For example, the European Commission (EC) is considering imposing quotas of female representatives on corporate boards across the EU. Countries such as Norway and Spain have legislations where there is a quota for women selected for membership on the corporate boards (Adams and Ferreira, 2009). Malaysia has imposed a 30% quota and Brazil targets 40% for state-controlled firms (The Economist, 2014).

The formation of board monitoring committees and the presence of women on the corporate board when established can help the board to monitor and advise the executive management on important decisions concerning the firm and eventually have an impact on the firm's success. However, the formation and adoption of corporate governance codes such as the establishment of board committees and the presence of women on UK corporate boards are on a voluntary basis. This means that firms can either '*Comply* with the code or *Explain*' reasons for non-compliance, as firms are not obliged to either establish these committees or consider female gender representation as an alternative to board successes (FRC, 2014 and 2016; Mintah, 2015). For a firm to comply with the UK corporate governance code, it means they have adopted corporate governance provisions and roles such as audit, nomination, remuneration and gender diversity among others in the board functions. The '*Comply* or *Explain*' nature of corporate governance in the UK offers an optional or voluntary regulation for firms in terms of adoption of the code, unlike the US-style of mandatory regime ('comply or else'). This makes corporate governance in the UK more flexible than in other countries (Akbar et al. 2015)³.

Regardless of the importance of board committees and gender diversity for UK financial institutions, the 2007/08 global financial crisis had a significant effect on these firms. The financial crisis started when the mortgage market in the United

³ <https://www.sec.gov/about/laws/soa2002.pdf>; <https://www.federalreserve.gov/bankinforeg/default.htm>. Accessed on 20/09/2016.

States (US) collapsed (Mizen, 2008). Before then, the mortgage industry experienced a high housing bubble, which was later turned into a burst. This burst led to the fall of mortgage prices, and eventually led to the collapse of large financial institutions in the US and other parts of the world. The UK economy was greatly hit due to diversification of investment and global market trade. Also, financial institutions with bad governance structure prior to the crisis engaged in high-risk investment and had high returns. Obviously, they made high profit in good times but they were hit hard after the financial crisis. Bad governance in the financial sector lead to massive risk taking and potentially high returns. The over-riskiness (high risk above normal) was then revealed only after the financial crisis when the profitability of those firms dropped astronomically. The financial crisis did not only affect financial institutions, it also affected non-financial firms. This means that institutions are interlinked and depend entirely on each other for survival.

In order to empirically carry out this research, the thesis will set two main objectives. The first objective attempts to discover if the presence of board committees among UK financial institutions influenced firm financial performance during the pre/post financial crisis period. The second objective seeks to find out if gender diversity within the corporate board influenced firm financial performance in the UK during the pre/post crisis period. Previous empirical results on board committees, the presence of women on the corporate board and firm financial performance have been examined mostly in non-financial firms and have produced mixed empirical results. For example, studies by Klein (1998), Adams and Ferreira (2009), Ntim (2013), Leung et al. (2014), Conheady et al. (2014), Gyapong et al. (2015), Akbar et al. (2015) and Khosa, (2017) all showed mixed outcomes. This research will help unravel the link between the existing internal corporate governance reforms such as the three monitoring board committees and board gender diversity on the financial performance of UK financial institutions.

Interestingly, prior empirical research on corporate governance and firm performance has been conducted around agency theory (Filatotchev and Boyd, 2009; Ntim, 2009). As a result, agency theory is adopted as the main theoretical framework for this study as well. However, agency theory is also supplemented with shareholder, stakeholder, resource dependence theory and group effective and diversity theories. The rational behind the choice of these theories in this research is discussed below.

First, agency theory is defined as “one in which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent” (Jensen and Meckling, 1976)⁴. For example, the use of agency theory suggests that the establishment of an audit committee helps reduce agency costs and information asymmetry by facilitating timely release of unbiased accounting information by

⁴ The emergence of board committees into the corporate governance structure has been driven by agency theory where the agents (managers) have to work in the best interest of the principals (shareholders) (Fama and Jensen, 1983; Jensen, 2001). Additionally, the establishment of the committees by the board of directors has become a market solution to organisational problems by ensuring that the interests of shareholders and managers are closely aligned. This will also help to bridge any differences between the agents (managers) and the principals (shareholders) (Bozec, 2005; Kang et al.2007).

managers to shareholders and ensures that corporate activities are properly audited (Jensen and Meckling, 1976; Fama and Jensen, 1983, Wild, 1994; Klein, 1998). Also, effective monitoring by the audit committee may help minimise financial misinformation to shareholders and increase firm financial performance. The use of agency theory indicates that the remuneration committee will ensure that share options, superannuation payment, commission, bonuses and pension packages given to executive management (agent) are in line with the principal's (shareholders) expectation and interest. This helps reduce agency problems and increase firm financial performance. Additionally, the use of agency theory proposes that the nomination committee should appoint the right candidates for the board's success. This minimises the agency conflict by improving board independence and the quality of appointed directors, thereby improving the firm's financial performance (Vefeast and Theodorou, 1998; Vefeast, 1999b). Furthermore, agency theory demonstrates that a gender diversified board may help minimise agency conflict by improving the board's monitoring. This is because directors from different backgrounds will have a different lens or perspective on the firm's business activities (Low et al. 2015). As firms appoint female directors, they see an increase in their financial value as a result of extra monitoring, which, in turn, may reduce the extent of agency problems (Ntim, 2013).

Second, stakeholder theory states that corporations should maximise the welfare of a number of stakeholders of the firm instead of only its shareholders. Unlike the shareholder model, the stakeholder theory suggests that corporations should be inclusively pursuing the interests of a group of identifiable stakeholders who may either directly or indirectly affect the success of the firm (Blair, 1995). Moreover, our empirical evidence provides positive reinforcement that stakeholder model offers inclusive support for all members within the society to offer their resources in return for the expectation that their interests will be promoted (March and Simon, 1958; Hill and Jones, 1992; Jensen, 2001, 2002). The stakeholder model advocates that the boardroom composition should be adjusted to reflect the expectations of all stakeholders. For example, through the appointment of female directors, in order to increase the firm's financial performance (Low et al. 2015; Blair 1995; Finegold et al. 2007).

Third, stewardship theory is contrary to agency theory; it posits that executive managers are reliable and trustworthy individuals and that they should be empowered to run firms because they are good stewards of the resources entrusted to them (Nicholson and Kiel, 2003; Letza et al. 2004; Davis et al. 1997).

Fourth, resource dependence theory suggests that the implementation of internal corporate governance structures, such as a board of directors, is not only necessary for ensuring that managers are effectively monitored, but also serves as an important link between the firm and the critical resources that it needs to maximise financial performance (Pfeffer, 1978). Furthermore, our empirical evidence provides positive support for resource dependence theory, which suggests that the role of the nomination committee will ensure that the firm uses its available resources such as background and skills, experiences and talents for the benefit of shareholders. The nomination committee appoints board members and executives who will consider the

external environment such as competitors and external opportunities in order to increase the firm's financial performance. Also, resource dependence theory demonstrates that gender diversity improves the firm's decision-making and helps align the organisation with its external environment and resources, thereby enhancing the firm's financial performance. These benefits occur because women are able to bring to the board different attributes, experiences and ideals that lead to a better appreciation of business complexities, which eventually improves the firm's financial ability and corporate governance quality as well (Carter et al. 2003; Adams and Ferreira, 2009; Carter et al. 2010; Baranchuk and Dybig, 2009).

Fifth, group effectiveness and diversity theories suggest that people with common interests interact and work together (Ruigrok et al. 2006). Further, our empirical evidence provides positive support for group effectiveness and diversity theory, which suggests that people with complementary backgrounds such as education, skills and talent might have the potential to advance the firm's success through their committee membership (Ruigrok et al. 2006).

Finally, the theories suggest that board committees (i.e. audit, remuneration and nomination and board gender diversity) enhance board monitoring, bring diversity of ideas and ultimately improve firm performance.

1.2 The Purpose, Research Questions and Methodology of the Study

This research has two main purposes; the first is to examine the impact of board committees (audit, remuneration, nomination) and the presence of gender diversity on the financial performance of UK financial institutions. The second purpose is to empirically ascertain if the establishment of these committees and the presence of gender diversity impacted firm financial performance during the pre/post global financial crisis era.

In order to achieve the research purpose mentioned above, the following research questions will be answered:

1. Does the establishment of board committees (audit, remuneration and nomination) among UK financial institutions influence their financial performance? If so, what were their effects on the firms' financial performance during the pre- and post-financial crisis periods?
2. Does the presence of women (gender diversity) within the board influence the firms' financial performance and what is the impact of board gender diversity on the firms' financial performance during the pre/post financial crisis periods?

In achieving the research purposes and addressing the set questions, this study will use annual report data extracted from DataStream (Thomson Reuters) for 63 financial firms covering a period of 12 years (from January 2000 to December

2011)⁵. The selected financial institutions include banks, insurance companies, pension funds, mortgage companies and asset management companies. As suggested by Botosan (1997), annual reports are the major reporting documents to use for research and using annual reports is in line with prior studies (e.g. Ho and Williams, 2003; Cheung et al. 2007; Mangena and Chamisa, 2008; Ntim, 2009; Ntim et al. 2013; Zagorchev and Gao, 2015; Gyapong et al. 2015; Mintah, 2015).

The sample selection for this research is distinct from previous corporate governance research because for a firm to be selected it should have a full 12 years of annual reports and their dependent variables – that is firm's value (Tobin's Q) and financial accounting (ROA), together with the controls – must be available on DataStream. The available data created a total of 756 firm-year observations. The 756 firm-year observations are very extensive and unique when compared with some previous studies such as April et al. (2003), who received only 20 annual reports for examining intellectual capital disclosures among mining firms; Zagorchev and Gao (2015), who used 41 corporate governance datasets to cover 2002-2009; Aanu et al. (2014), who used 25 firms in Nigeria from 2004 to 2011; Fire and Meth (1986), who obtained 36 annual reports in order to study the information requirements for the analysis of investment companies; and Lee et al. (2015), who used only 53 firms with two years' ROA and Tobin's Q.

The dependent variables such as, ROA is defined as the book value of operating profit at the end of a financial year, divided by the book value of total assets at the end of a financial year (Yermack, 1996; Beiner et al. 2006). ROA measures how efficiently and effectively a firm's managers operate and use its assets to generate profits (Ross et al. 1998). On average, a higher ROA suggests effective and efficient use of a firm's assets in maximising the value of its shareholders' investments by the management team (that is, internal corporate governance structures). ROA is an effective measure of performance because it eliminates the problem of size, which makes it easier for comparisons to be drawn (Lev and Sunder, 1979). Demstetz and Lehn (1985) recommend that, for accounting profit, ROA may reflect year-to-year fluctuations in underlying business conditions more effectively than stock market rates of return. This is because stock market rates of return reflect expected future developments that may dissemble current fluctuations in underlying business conditions. ROA has been used widely in corporate governance studies (Core et al. 2006; Haniffa and Hudaib, 2006; and Cui et al. 2008; Ntim, 2009).

Tobin's Q (firm value)⁶, as an additional dependent variable, is defined as the market value of equity plus the book value of total assets minus the book value of equity divided by the book value of total assets (Chung and Pruitt, 1994; Beiner et

⁵ DataStream is a database provided by Thomson Reuters known as '*the world's leading source of intelligent information for businesses and professionals*'. According to Thomson Reuter's website, the company is seen as the world's most trusted information and news organisation.⁵ http://thomsonreuters.com/about/awards_recognition/. Accessed on 19/11/17.

⁶ Tobin (1969) first introduced the concept of '*Q*' which was meant to capture a firm's propensity to invest. Since its introduction, '*Q*' has now come to stay among financial economic researchers as a proxy for measuring a firm's performance (Lang et al.1995; Opler and Titman, 1993).

al. 2006). Tobin's Q will be used as a measure of financial performance; that is, as a proxy for the market's valuation of the quality of a firm's internal corporate governance structures. This study will follow Chung and Pruitt's (1994) approximation of Q, which has been demonstrated as correlated 96.6% with the original Q-ratio⁷. It is normally referred to as the ratio of the market value of the outstanding financial claims on a firm with regards to the current replacement cost of its assets. The Q-ratio measures the effectiveness with which a firm's management is able to use its assets to generate value for shareholders (Lewellen and Bradrinath, 1997). A higher Q-ratio suggests greater effectiveness of a firm's internal corporate governance structures, as well as a better perception of a company's financial performance by the market (Haniffa and Hudaib, 2006).

Tobin's Q has been used extensively as a proxy for financial performance, not only in corporate governance literature (Yermack, 1996; Gompers et al. 2003; Henry, 2008) but also in corporate finance literature (Chung and Pruitt, 1994; Perfect and Wiles, 1994). This gives it an advantageous performance proxy because its empirical validity is grounded in a rigorously established empirical literature.

The decision to use these two financial measures is for two reasons. First, prior evidence suggests that insiders (managers) and outsiders (shareholders and other stakeholders) value corporate governance in different ways (Black et al. 2006). The accounting-based measure of performance (ROA) attempts to capture the wealth effects of corporate governance mechanisms from the perspective of company management (insiders), while the market-based measure (Q-ratio) represents the financial valuation of corporate governance structures by investors (outsiders). These two measures have also been used by prior studies (e.g. Black et al. 2006; Henry, 2008; Gompers et al. 2003; Klapper and Love, 2004; Haniffa and Hudaib, 2006; Guest, 2009; Ntim et al. 2015). In the same vein, this current research will also follow prior empirical studies and use ROA and Tobin's Q as dependent variables.

Second, each financial measure has its own strengths and weaknesses with no consensus within the literature on a particular measure as being the 'best or better' proxy for financial performance (Haniffa and Hudaib, 2006). Hence, using the two measures represents an attempt to examine the strongest of the results against both accounting- (ROA) and market-based measures (Tobin's Q) of financial performance (Haniffa and Hudaib, 2006). The use of these two financial measures will help to ascertain the empirical results attained while using accounting (ROA) and market-based measures (Tobin's Q). In order to obtain the appropriate financial measure during the pre/post financial crisis era, the use of ROA and Tobin's Q will be examined.

In order to eliminate the influence of other firm characteristics on the results, the following control variables were used including: growth, capital structure, firm size,

⁷ Approximations for Tobin's Q have also been developed by Lindenberg and Rose (1981), Lang and Litzengerger (1989), Perfect and Wiles (1994), and Lewellen and Badrinath (1997), among others. However, Chung and Pruitt's (1994) approximation is adopted here because it does not only correlate highly (96.6%) with the original Q, but also is simple and less costly in terms of computational effort and intensity of data required.

big four, foreign/dual-listing (DUAL), industry and year dummies. These controls were chosen based on corporate governance theories and other prior empirical studies (see, for example, Chenhall and Moers, 2007; Van Lent, 2007; Larker and Rusticus, 2008; Black et al. 2006; Henry, 2008; Gompers et al. 2003; Klapper and Love, 2004; Haniffa and Hudaib, 2006; Guest, 2009; Ntim, 2013; Gyapong et al. 2015; Ntim et al. 2015; Mintah, 2015 and 2016). The use of these controls will help prevent any omitted variables bias and endogeneity (Chenhall and Moers, 2007; Ntim, 2009).

To analyse the data for this research, panel data analysis such as Ordinary Least Square (OLS) and Random Effects (RE) and Fixed Effects (FE) models were used. Panel data analysis favours several consecutive years of data (Cheng et al. 2008). The merit of using panel data is that it has more degrees of freedom; less collinearity among variables; more cross-sectional and time series variability; more efficiency; and accounts for more observable firm-level heterogeneity in individual-specific variables (Gujarati, 2003; Cheng et al. 2008; Ntim et al. 2013; Danso and Adomako, 2014; Krause and Tse, 2016). The use of panel data in corporate governance research minimises inherent statistical problems, such as endogeneity (Larcker and Rusticus, 2007). Additionally, previous corporate governance researchers also used panel data (Haniffa and Hudaib, 2006; Gompers et al. 2003; Klapper and Love, 2004; Haniffa and Hudaib, 2006; Guest, 2009; Ntim, 2013; Gyapong et al. 2015; Ntim et al. 2015). Third, using panel data is in line with conventional capital market-based research (Fama, 1965). For instance, OLS is used to analyse the relationships that exist between the variables. However, according to the Durbin-Hausman test, fixed effects (FE) and random effects (RE) regression should be preferred. The use of a fixed effects (FE) model deals with analysing variables that change with time; fixed effects control for all time-invariance coefficients; assumes that the coefficient cannot be biased; and takes care of endogeneity problems. The random effects (RE) model, on the other hand, helps to measure variation across entities. It also deals with any issues relating to heterogeneity in the regression and with any exogeneity problems. Depending on the particular paper, either of these regression estimates have been used in order to ascertain the empirical outcome and to check if some of the results could be consistent with each other.

Collectively, the empirical results ascertained from the research purpose, questions and methodology first indicate that the establishment of the three monitoring committees (audit, remuneration, nomination) and the presence of women on the UK corporate board had a positive and statistically significant link on the firms' financial performance. Subsequent tests conducted during the pre- and post-2007/08 financial crisis periods show mixed results. Specifically, the pre-crisis results show that these monitoring board committees and board gender diversity remained positive and statistically significant before the 07/08 financial crisis. However, the post-crisis period results were not statistically significant, indicating that the 07/08 financial crisis appeared to have affected the financial performance of the financial institutions examined. A reasonable explanation is that, even though the financial crisis was over from 2009 to 2011, the entire UK economy experienced an economic downturn as the crisis created panic cash withdrawals from customers in

various banks. Investors and shareholders were unwilling to invest in companies, especially financial institutions, because of a fear they might lose their investment. Banks in the UK were also unwilling to lend to businesses. Furthermore, the harsh macro-economic conditions globally and in the UK after the crisis overshadowed the importance of firms having board committees and the presence of women on the corporate board (Review of HM Treasury's response to the financial crisis report, 2012)⁸. These situations impaired the efficiency of the entire financial market and also affected the 2009 to 2011 financial years, irrespective of whether firms had robust corporate governance mechanisms in place or not.

The result supports the theoretical expectations that better-governed firms should be associated with higher financial returns than their poorly-governed counterparts (Black et al. 2006; Cheung et al. 2007; Ntim, 2009). Even though the '*Comply or Explain*' nature of corporate governance in the UK offers an optional regulation to firms, the results obtained indicate that the establishment of these monitoring committees does not only become a market solution to organisational problems but can also accelerate firms' financial performance (Black et al. 2006; Cheung et al. 2007; Ntim, 2009).

1.3 Motivation and the Reasons for Examining UK Financial Institutions

The selection of UK financial institutions instead of other corporate establishments is based on the following reasons. First, prior to the start of my PhD programme, I worked in a number of UK financial institutions, which offered me the opportunity to understand how continuous corporate governance reforms affect financial institutions policies in terms of compliance. Also, working in UK financial institutions provided me with the first-hand information as to how these firms acted and an understanding of the various corporate governance mechanisms put forward by the government during the pre/post financial crisis era. This research will empirically ascertain if the existence of the monitoring board committees and the presence of women on the board (which are important corporate governance policies) could have an impact on the firms' financial performance during the pre/post crisis period. This will serve as the first drive for this research.

Second, the financial sector in the UK, for instance, is the biggest in Europe and the second biggest in the world, after the US. According to the Office for National Statistics (ONS, 2015), the sector provides a major source of revenue to the government, employment to citizens, returns to shareholders and foreign exchange to the economy (BoE and HM Treasury 2015; Mintah, 2015). Due to the uniqueness of the sector to the country's development, its corporate governance mechanism goes beyond shareholders to include stakeholders (Hopt, 2013; Mehran and Molliex, 2012).

⁸ <http://www.bbc.co.uk/news/business-20811289>, Accessed 16/01/17.

The third motivation steering this study is that the choice of UK financial institutions research is unique and different from non-financial firms because financial institutions are highly regulated and very volatile compared to other sectors of the economy (Macey and O'Hara, 2003; Zagorchev and Gao, 2015). High regulation on financial institutions means that they have to pay a deposit to the Bank of England (BoE) as insurance for customers in case of any uncertainty (Macey and O'Hara, 2003; Zagorchev and Gao, 2015). Also, financial institutions in the UK are controlled, monitored and regulated by the Bank of England (BoE); the Financial Conduct Authority (FCA); and the London Stock Exchange (LSE), for firms listed on the Stock Exchange. Apart from the domestic controls, international bodies such as the International Corporate Governance Network (ICGN), the Organisation for Economic Co-operation and Development (OECD), the International Regulatory Framework for Banks (Basel III), the International Monetary Fund (IMF) and the World Bank also help in terms of policies and regulatory guidance as to how these financial institutions should operate in line with global standards (Berger et al.1995; Zagorchev and Gao, 2015; HM Treasury, 2015; Mintah, 2016). International regulatory policies and guidance create some uniqueness in financial institutions' corporate governance as compared to other firms.

Fourth, unlike other sectors of the economy, the financial sector businesses are very complex to control and manage, as they require adequate knowledge and experience from decision-makers. However, the value generation process in the financial sector is different compared to many other sectors. The board of directors in every financial institution needs to understand all complex financial products such as swap, derivative, the economic indicators, risk to the company and their controls. Any failure of responsibility on the part of management and the board of directors will have consequences for the entire financial sector (Hopt, 2013). In addition, the financial sector is tightly interconnected. Because of this complexity, researchers often exclude financial institutions' data from their sample when conducting empirical studies, yet they are central to the functioning of the broader economy, including non-financial firms (Ntim, 2013, 2017; Yermack, 1996; Guest, 2009; Lim et al. 2007; Levine, 2003). This research will take advantage of this and focus on financial institutions.

Fifth, unlike other firms, there are continuous corporate governance reforms in the financial institutions to deal with any challenges that might disrupt the sector due to the complex nature of its products and services. This obviously makes the corporate governance mechanism in the financial sector unique from other firms as it always requires continuous improvement in dealing with any new challenges (examples of such reforms are the Cadbury Report, 1992; Greenbury, 1995; Hampel, 1998; Combined Code, 1998, 2003, 2006; Turnbull, 1999, 2005; Myners, 2001; Higgs, 2003; Tyson, 2003; Smith, 2003). Also, the financial crisis in 2007/2008 led to the establishment of additional corporate governance reforms by the UK government. These reforms include the Walker Review (2009), Financial Services Bill (2010) and the FRC (2012, 2014, 2016). There was also the creation of the new Monetary Policy Committee (MPC) by the Bank of England (BoE) and the Single Financial Regulator known as the Financial Conduct Authority (FCA) (Hodson and Mabbett, 2009; ICB, 2010). The purposes of these reforms are to

cover any overlaps in corporate governance policies and avoid future market failures in UK financial institutions. As it stands, none of the corporate governance reforms have been empirically tested on financial institutions and their impact on firm financial performance is not yet known. This research will empirically test this.

Sixth, corporate governance in the UK is normally a self-regulation or voluntary compliance regime ('Comply or Explain') rather than the US-style of mandatory regime ('comply or else'). This means that each financial institution can either comply with a code or provide reasons for non-compliance. Firms that do not comply with the codes should have an alternative practice, similar to those firms that do comply (FRC, 2014; Akbar et al. 2015; Mintah, 2016). This research will collectively determine firm financial performance for UK financial institutions which complied with the adoption of board committees such as audit, remuneration and nomination and the presence of gender diversity among their corporate board. This comply or explain nature in UK corporate governance will offer opportunities to empirically ascertain firms which complied with the reforms and make contributions to the extant literature.

The seventh motivation driving the board gender diversity research in the UK is that gender diversity issues are very important to several countries. For example, the European Commission (EC) has been considering imposing quotas for female representation on corporate boards across the EU. In addition, lobbying groups such as Women Corporate Directors (WCD) are actively pushing for more women to be present in the boardroom⁹. Gender diversity research in the UK will help enhance the implementation of the policy in the UK, and the outcome of this research will provide empirical support to any group interested in gender issues and contribute immensely to the gender research gap (Mintah and Schadewitz, 2017).

Finally, the UK operates under the Anglo-American business model where companies exist primarily to 'maximise shareholder's value and interest' (Lazonick and O'Sullivan, 1997). This is based on the assumption that ownership is separate from control in an Anglo-American model (Berle and Means, 1932). The Anglo-American model can succeed when the board committees and board composition are aimed at serving the purposes of maximising shareholders' value and interests in the firms.

This research is very unique because, as it stands, no empirical research has been undertaken in UK financial institutions up to this point. The research will also help fill any gap in the corporate governance research literature.

⁹ (<http://www.womencorporatedirectors.com>, WomenCorporateDirectors. Accessed on 06/02/2016.

1.4 Outline of the Thesis

This thesis comprises the following, chapter two covers the theoretical background.

Chapter three discusses the global financial crisis during the 2007/08 period. This section gives the full details of the causes of the financial crisis.

Chapter four discusses corporate governance issues in UK financial institutions and various reforms which have taken place.

Chapter five discusses the role and functions of the board and its committees. The establishment of board committees, namely audit, remuneration and nomination, and the presence of gender diversity within the board are all discussed.

Chapter six gives the summary and contributions of each articles.

Finally, the last section contains the original published articles from the thesis.

2 THEORETICAL BACKGROUND

2.1 Introduction

Corporate governance is a system whereby directors are entrusted with the responsibilities and duties concerning the affairs of the firm (Sheikh and Chatterjee, 1995). In order to achieve these responsibilities, the board of directors form committees where individual directors bring their specialist knowledge and expertise. The committees scrutinise the highest decision-making within the firm and provide solutions to organisational problems by liaising between shareholders and managers (Harrison, 1987). In addressing the functions and responsibilities of the board committees, this research will have these purposes: first, to ascertain if board committees and the representation of women among UK financial institutions improve firm financial performance; and, second, to examine if board committees and the representation of women impacted the firm financial performance during the pre/post global financial crisis era.

To achieve these research purposes above, theories such as shareholder, stakeholder, agency, stewardships, resource dependency theory and group effectiveness will help to find answers to the research questions and gives a better understanding as to why we should pursue this research empirically. Specifically, these theories trace the corporate governance-financial performance relationship literature and develop the hypotheses among the variables examined (Ntim, 2009). The use of these theories is in line with previous empirical studies (such as Hambrick and Mason, 1984; Main and Johnston, 1993; Murphy, 1998; Carter et al. 2003; Nicholson and Kiel, 2003; Ruigrok et al. 2006; Campbell and Minguez-Vera, 2008; Adler, 2010; Ntim, 2009; Ntim et al. 2013; Nguyen et al. 2015; Perryman et al. 2016).

Section 2.2 discusses the definition of corporate governance and the subsequent sections deal with the supporting theories for the research.

2.2 Discussions of the Content of Corporate Governance

The term 'Governance' comes from the Latin word '*gubernare*', which means to control, govern or steer. Corporate governance refers to the 'act or process of governing', which is a never-ending process (Tricker, 1984). Corporate governance deals with 'who controls corporations and why'. The 'who' is the owners of the corporations (shareholders) and the 'why' deals with the connections between

ownership, social responsibility, economic progress and the role of the markets in ensuring that there is stability (Colley et al. 2005)¹⁰.

A modern corporation, according to Berle and Means (1932), deals with a limited liability company where the owners are not personally liable for the debts or any legal obligation of the firm. Here, management is separated from corporate control, where the owner does not have direct involvement in the business. Corporate governance can work better where shareholders receive reliable and trustworthy information to monitor and evaluate management decisions. These decisions will help set stock prices based on expected profitability and risk (Colley et al. 2005; Berle and Means, 1932).

Recent corporate governance research has increased in the last decade (Gillan, 2006). It is a subject which derives from different disciplines including finance, accounting, economics, ethics, law, management, politics, psychology, business history and organisational behaviour. Different researchers define corporate governance differently. In fact, there is no universally accepted definition (Keasey et al. 1997; Denis et al. 2001; Gillan, 2006; Ntim, 2018).

Corporate governance has been narrowly defined as “*the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment*” (Shleifer and Vishny, 1997, p.737). This definition means that corporations exist to maximise the wealth of their owners (West, 2006). The Cadbury Report (1992, s.2.5) defined corporate governance as the “*system by which companies are directed and controlled*”. The Cadbury Report set the foundation for corporate governance ‘best practice’ in the UK and other countries in the world which incorporated some or all of its recommendations into their own corporate governance codes. Parkinson (1993, p.159) defined corporate governance as the “*process of supervision and control intended to ensure that the company’s management acts in accordance with the interests of shareholders*”. Here, supervision and control will reduce agency cost and achieve shareholders’ objectives.

Gregory (2001) also defines corporate governance as the means by which a firm’s managers are held accountable to capital providers. Here, managers become very responsible to the principal, who is the provider of capital to the company. Monks and Minow (2001) see corporate governance as the relationship among shareholders, management and board as it helps to determine the direction and performance of corporations. This definition focuses on internal corporate governance and

¹⁰ As the world economy flourished globally, it created capitalism, which resulted in a very small number of people becoming very wealthy while the rest stayed poor; the wealthy people could not be trusted as they created great personal wealth at the expense of their customers, workers and the public. The government responded by creating laws and regulations intended to limit the excesses and abuses of the free and unrestrained market which existed at the time (see, Colley et al. 2005, pp. 2-6).

In the end, capitalism created an opportunity for governments to be vigilant in business activities. This created the chance for businesses to unite their capital (money) and grow larger, making each investor to own a portion or shares of the businesses in which they invested and thus they became known as shareholders. The shareholders (owners) elect directors as their representatives to manage the affairs of the business. The board of director’s delegates responsibility to the Chief Executive Officer (CEO) whom they hire to handle the day-to-day affairs of the company. The CEO then becomes accountable to the board of directors, which collectively and individually is accountable to the shareholders (Colley et al. 2005, pp. 2-6; Huse et al. 2005, pp. 14-24).

shareholders. Denis et al. (2001) affirm that corporate governance allows self-interested managers (the controllers) to maximise the value of the firm on behalf of shareholders (the owners). Here, corporate governance gives managers a responsibility to achieve shareholder value.

Similarly, corporate governance has also been defined as “*a system whereby directors are entrusted with responsibilities and duties in relation to the direction of a company’s affairs*” (Sheikh and Chatterjee, 1995, p. 5) or “*ways of ensuring that corporate actions, agents and assets are directed at achieving the corporate objective established by the corporation’s shareholders*” (Sternberg, 2004, p.28). These definitions mean that, in order to maximise the wealth of owners or shareholders, there is a need for an assembly of shareholders, board of directors and executive management (Letza et al. 2004; West, 2006); this makes the corporation accountable to its shareholders, by ensuring that they appoint the right directors and that the right governance mechanisms exist (Cadbury Report, 1992; Ntim, 2009).

Shareholders have the power to reject board decisions or remove board members from office in a general meeting; however, the board of directors is responsible for ensuring that the company is properly governed. These responsibilities include setting the company’s strategic aims, providing well-qualified leaders to put the strategy into action, supervising management performance, firing management for incompetence and reporting to shareholders for their stewardship (Cadbury Report, 1992; Ntim, 2018). The above definitions of corporate governance focus on the relationship between the manager and the shareholder, which is seen as very narrow (Ntim, 2009).

A ‘narrow’ governance structure can be seen in cases where it concentrates on key internal governance mechanisms that interact to satisfy shareholders’ value; that is, it is only for the benefit of shareholders instead of that of all stakeholders (Sternberg, 2004).

Sir Adrian Cadbury during the World Bank Report (1999, p.vii) ‘broadly’ defined corporate governance as being “*concerned with holding the balance between economic and social goals and between individual and communal goals, the aim is to align as nearly as possible the interests of individuals, corporations and society*”. Tricker (1984, p.6) defines corporate governance as a “*direction, which helps to oversee and control the executive actions of management so that they can satisfy legitimate expectations of accountability and regulation beyond the corporate boundaries*”. This latter definition means that, once there is a clear regulation for management to follow, shareholders and other stakeholders can go beyond the corporate boundaries to hold management accountable for their actions. Similarly, the Organisation for Economic Co-operation and Development (OECD, 2004, p.11) broadly defines corporate governance as “*a set of relationships between a company’s board, its shareholders and other stakeholders. It also provides the structure through which the objectives of the company are set, and the means of attaining those objectives, where performance monitoring is determined or the system of checks and balances, both internal and external to companies, which ensure that companies discharge their accountability to all their stakeholders and act in a socially responsible way in all areas of their business activity*” (Solomon et al. 2004, p.14).

These definitions mean that corporate governance goes beyond the internal corporate structure to include external stakeholders as well (OECD, 2004; Gillan, 2006; Mallin, 2007). As defined, internal corporate governance structures will include shareholders, the board of directors and the executive management, whilst the external corporate governance mechanism will include shareholders, the legal system, all staff in the organisation, executive directors, customers, regulators, local communities, the government, debtors and creditors. This means that the corporation exists as a social entity which is accountable and responsible to all stakeholders (Freeman et al. 1983; Mallin, 2007).

The aim of the ‘narrow’ and ‘broad’ corporate governance structures is to examine how both external and internal governance mechanisms can be run in order to maximise firm value, and increase performance for the benefit of shareholders and other stakeholders as well (Freeman et al. 1983; Mallin, 2007; Aguilera et al. 2009; Ding et al. 2008).

A ‘narrow’ corporate governance structure is often referred to as ‘shareholding’ because it focuses on companies to ensure that they become accountable and responsible to shareholders, whilst the ‘broad’ corporate governance structure is often called ‘stakeholding’ because it perceives firms to be responsible and accountable to all stakeholders (Freeman et al. 1983; Mallin, 2007; Aguilera et al. 2009; Ding et al. 2008).

The models of corporate governance have both national and legal origins. Specifically, the ‘shareholder’ model is more common in Anglo-American countries such as the UK and US which have common law origins, whilst the ‘stakeholder’ corporate governance structure is common in continental Europe and Asia; that is, Germany and Japan, respectively (Mallin, 2006; Aguilera et al. 2009).

The next section will give detailed information about the shareholder model.

2.2.1 *The Shareholder Model*

Shareholders’ ideology has become entrenched as a principle of corporate governance among companies based in the US and UK (Lazonick and O’Sullivan, 1997; Ntim, 2009). The OECD principles of corporate governance which were issued in 1999 state that “*corporations should be run, first and foremost, in the interest of shareholders*” (OECD, 1999, p.15). This means that companies exist primarily to “*maximise shareholders’ value and interest*” (Lazonick and O’Sullivan, 1997, p.13). This is also based on the assumption that ownership is separate from control in the Anglo-American model (Berle and Means, 1932); that is to say, the providers of capital, the owners and/or shareholders, surrender the day-to-day management (control) of the business to a group of managers consisting of a ‘Unitary’ board of directors and executive management who are most often not owners of the business. Multiplicity of shareholders or ownership in this corporate governance model is often relatively widely diffused (Berle and Means, 1932).

The implication of dispersed ownership is that the power of shareholders to exercise control over the way their business is run is greatly impaired (Blair, 1995; La porta et al. 1998). This raises the issue of agency problems: the agency theory suggests that shareholders have to delegate the control of their business to a few directors and managers who then become the agents to run the company on their behalf, but there is a risk that these directors and managers will pursue their own interests to the detriment of the owner (shareholders) (Smith, 1776; Berle and Means, 1932; Jensen and Meckling, 1976). This is because managers are both opportunistic and rational, meaning that the majority of managers and directors are more likely to pursue their own interests rather than those of the shareholders (Weimer and Pape, 1999).

However, the shareholder model also offers solutions to the agency problem. First, it suggests that restrictions on factor markets must be removed to encourage competition (Letza et al. 2004). Second, it calls for the introduction of a voluntary corporate governance code of ethics and conduct, which is supported by business principles of accountability, discipline, fairness and transparency, to regulate managers and directors' behaviour (Cadbury Report, 1992). Third, it suggests the strengthening of the managerial incentive system by instituting performance-linked executive compensation schemes to help align shareholder-managerial interests (Weimer and Pape, 1999). It also calls for an efficient contract governing the relationship between the owners of capital and labour (Jensen and Meckling, 1976; Letza et al. 2004).

However, the shareholding model rejects external interventions and additional obligations imposed on corporations by government and central authorities because they can distort free market operations (Hart, 1995). Instead, it perceives a firm's existing governance arrangements as the outcome of a bargaining process, which has been freely entered into by corporate insiders and outsiders (Keasey et al. 1997). Specifically, as part of an economic model, it assumes that factor markets such as capital and managerial labour are efficient, self-regulated and backed by additional voluntary mechanisms such as voluntary corporate governance codes which are more effective in reducing the divergent activities of managers (Keasey et al. 1997; Letza et al. 2004).

The rejection of external interventions by central regulatory authorities which rely on free market regulation is also based on a core premise that the major source of finance to a corporation is equity instead of debt financing (Ntim, 2009). Equity capital is raised from the capital market where capital can move to investment that offers the highest risk-adjusted returns (Friedman, 1970). Equity markets are well developed in Anglo-American countries, such as the UK and US, more than in continental European countries like Germany and France, helping shareholders in Anglo-American countries to easily transfer their capital from a poorly-governed company to a better-governed one (Weimer and Pape, 1999)¹¹.

Despite all the good aspects of the shareholder model (Keasey et al. 1997), the model still has several drawbacks (Blair, 1995; Gamble and Kelly, 2001). These include

¹¹ The introduction of institutional investors has sped up the convergence of corporate governance systems towards the Anglo-American model (Aguilera and Cuervo-Cazurra, 2009).

shareholder power and democracy, stakeholder interests, social morality and ethics, efficient factor markets and an excessive short-term emphasis (Blair, 1995; Letza et al. 2004; Sternberg, 1997 and 2004). The first drawback of the shareholder model, according to Blair (1995), is that shareholders lack sufficient power to control management and prevent misuse of corporate resources as reported by the shareholder model. The shareholder model argues that corporations should be primarily established for the benefit of shareholders, so that power can rest entirely with the shareholders in order for them to choose the persons to whom business operational power should be delegated (Blair, 1995; Letza et al. 2004; Sternberg, 1997 and 2004). This entitles them to hire or fire a board of directors at an annual general meeting (AGM) (Schwartz, 1983; Sheikh and Chatterjee, 1995). In practice, it has been argued that the ability of shareholders to exercise meaningful control over the direction of their company is very limited by the same procedures which govern such meetings and corporate officers' elections, since it is the directors rather than shareholders that generally set the agenda for the AGM, which means that directors can determine the issues that come up for voting (Blair, 1995; Sternberg, 2004).

The second weakness of the shareholder model is the lack of real shareholder power where directors, who are expected to be the first line of defence for shareholders, also suffer from many imperfections (Denis and McConnel, 2003; Brennan, 2006). Sternberg (2004) argued that, because the executive directors of a corporation are also normally its managers, they are less willing to recognise or correct their own mistakes. While non-executive directors' accountability to shareholders usually arises in the way in which they are nominated, officially appointed and remunerated (Kakabadse and Korac-Kakabadse, 2002; Sternberg, 2004), in an Anglo-American model, the appointment procedure is such that most non-executive directors are nominated by the chief executive or the board themselves, making them insufficiently independent of management and insufficiently accountable to shareholders (Vinten, 2001; Sternberg, 2004). The increase in corporate governance reforms, in the Anglo-American countries, has led to an improved procedure for appointing board members (Aguilera and Cuervo, 2009; Filatotchev and Boyd, 2009).¹²

The third criticism of the model is the short-termism of activities which has also been levelled against the Anglo-American corporate governance model, where they are interested in short-term financial performance such as short-term returns on investments, short-term corporate profits, short-term management performance, short-term share prices and short-term expenditures. This arises because of substantial reliance on the existence of an efficient capital market, which also puts huge pressure on managers to perform for short-term gains instead of focusing on long-term profit (Blair, 1995; Keasey et al. 1997; Kakabadse and Korac-Kakabadse, 2002; Letza et al. 2004). A recent review of corporate governance suggested that the financial crisis that was the 'Credit Crunch' in the global financial markets was partly caused by 'reckless risk-taking behaviour' which is associated with a 'short-term bonus culture' among senior executives of major financial institutions

¹² The UK's 2006 Combined Code, for example, made all listed firms establish independent nomination committees, and also required that the nomination committees be constituted and chaired by independent non-executive directors.

in the UK and US (Walker Review, 2009; Ntim, 2009; Financial Service, Bill 2010).

Another attack on the shareholder model is that it ignores the social, ethical and moral responsibilities of the corporation as an important societal institution (Freeman and Reed, 1983; Blair, 1995; Kakabadse and Korac-Kakabadse, 2002). Other models, such as the stakeholder model, advocate the belief that businesses should be run to maximise the wealth of all shareholders and equally serve the interests of the wider stakeholder groups such as employees, creditors, suppliers, customers, local communities and the government (Freeman and Reed, 1983; Berle and Means, 1932; Sheikh and Chatterjee, 1995). As a result of this, the Anglo-American model's exclusive emphasis on the powers and rights of shareholders results in ignoring the interest of other legitimate stakeholders (Blair, 1995).

The shareholder model has also been criticised as lacking the capacity to give serious consideration to ethical and moral issues. A controversial ethical and moral criticism is that the Anglo-American governance model encourages excessive executive remuneration¹³ (Sternberg, 2004). According to Kakabadse and Korac-Kakabadse (2002), the average CEO of a medium-sized American corporation earns 531 times more in pay, bonuses and stock options than an average factory worker; although good corporate governance is expected to empower the weaker sections of society¹⁴ (Kakabadse and Korac-Kakabadse, 2002).

However, the last decade has seen an increase in corporate social responsibilities in Anglo-American countries¹⁵ towards employees, customers, the local environment, local communities and governments, making shareholders part of the stakeholders of the firm; therefore, if shareholders' values are maximised then societal value is similarly maximised (Mallin, 2007; Jensen, 2002; Ntim, 2009). The stakeholder model will be discussed in the next section.

2.2.2 *The Stakeholder Model*

The stakeholder model states that corporations should maximise the welfare of a number of stakeholders of the firm instead of only its shareholders. Unlike the shareholder model, where corporations are established exclusively for the interests of shareholders, the stakeholder model suggests that corporations should be inclusively pursuing the interests of a group of identifiable stakeholders who may either

¹³ Excessive remuneration may not be limited to Anglo-American countries alone because the 2009 Mercer Global Executive Remuneration Survey suggested that executive remuneration is not only high in shareholding countries like the UK and US but also traditional stakeholder countries such as the Netherlands, Germany and France (Aguilera and Cuervo-Cazurra, 2009).

¹⁴ The lower or weaker sections of society are lower-level employees, unskilled and semi-skilled staff. The financial crisis has shown that, despite government intervention to bail-out most banks using taxpayers' money, senior executives continue to pay themselves high salaries and bonuses, which eventually means that wealth will be transferred from ordinary taxpayers to already rich senior banking executives (Keller and Stocker, 2008; Farrell, 2009; Walker Review, 2009).

¹⁵ These are countries that have adopted the stakeholder model such as the UK and US.

directly or indirectly affect the success of the firm. Stakeholders include staff, customers, creditors, debtors, local communities and the government, an ideology often found in Germany, France, Sweden, Denmark, other European countries, Japan and other Asian countries (Blair, 1995; Ntim, 2009).

The stakeholder model has offered an inclusive governance concept where it is suggested that firms are made up of social groups in which each group can be seen as supplying the firm with important resources or contributions and in return should expect their interests to be promoted (March and Simon, 1958; Hill and Jones, 1992; Jensen, 2001 and 2002). It acknowledges all the contributions made by each variable in the model; that is, shareholders supply the firm with capital while they receive a risk-adjusted return on their investment. Creditors provide loans to the firm, and in return they want the loan to be repaid with interest and on time. Local communities also supply businesses with their location, local infrastructure and workers and, in exchange, expect the firm to improve the quality of life in the communities. Managers and employees also provide the firm with their time and skills; in return, they expect to receive a sustainable income from the organisation. The government also provides roads, electricity, water, and laws governing corporation and competition, and in return it expects firms to pay their corporation and income tax to help its social development (Hill and Jones, 1992; Jensen, 2001 and 2002; Ntim, 2009).

The stakeholder governance model argues that the absence of broader stakeholder participation in the running of public corporations will always cause a problem in the shareholder model (Letza et al. 2004). Specifically, Keasey et al. (1997) argue that agency conflict could be reduced by firms through contracts between the various stakeholders of the firm, and that the firm should be run rationally in economic terms to broadly maximise the wealth of all stakeholders (Hill and Jones, 1992). This rejects the assumption that shareholders are the only key important people in the firm (Blair, 1995).

The stakeholder model offers several solutions: it proposes a two-tier corporate board structure as a way of achieving a broader representation of the interests of a larger group of stakeholders of the firm (Schilling, 2001; Mallin, 2007). For example, in a stakeholder governance framework like France, companies will normally have a dual board structure where the first structure is a supervisory board and the second structure is management. The supervisory board consists of investors who are shareholders and creditors, employees (union groups), suppliers, customers and government appointees who represent a group in the society (Schilling, 2001). The supervisory board then mandates management to run the company in the interest of all stakeholders (Schilling, 2001; Mallin, 2007). However, the governance framework in the UK is based on a one-tier system where a single board is formed to run the affairs of the firm.

The stakeholder model also encourages corporate management to focus on building trust and long-term relationships between the firm and its stakeholders (Letza et al. 2004). It supports and encourages closer contact between shareholders, creditors, managers, employees and suppliers, and the integration of business ethics as a solution to achieving a balance among all stakeholders (Rwegasira, 2000).

According to La Porta et al. (1998), there is a negative relationship between ownership concentration and investor protection, which can be explained by legal origin. For example, the Anglo-America countries like UK and US have dispersed ownership with higher investor protection comparable with other countries like continental European and Asian countries such as Germany, France and Japan which tend to have high ownership concentration with weaker investor protection (Ntim, 2009).

The stakeholder model has also received several criticisms. The first criticism is that it is not compatible with the concept of business (Sternberg, 1997 and 2004; Letza et al. 2004), making corporations strive to achieve a fair balance in distributing the benefits of the firm to a number of stakeholders, which prevents the firm from pursuing a single objective function that favours particular groups (Sternberg 1997; Jensen 2001 and 2002). This is not consistent with the notion of business where the returns of capital invested (shareholders) benefit all stakeholders (Sternberg, 1997; Jensen 2001 and 2002).

The second criticism is that the stakeholder model makes the number of people whose needs and benefits the company needs to take into consideration simply unlimited (Freeman, 1984; Hummels, 1998; Sternberg, 1997 and 2004). This means that stakeholders could be anybody ranging from employees to debtors, creditors and the government, among others. Yet, it is mandated that a balance be struck in the distribution of benefits to all stakeholders. This divergent balance among stakeholders' interests is sometimes an unworkable objective (Sternberg, 1997 and 2004; Jensen, 2001 and 2002).

The third criticism is that the stakeholder model is incompatible with the corporate governance concept of accountability, where directors have to be accountable to shareholders, managers to directors, employees to managers, and managers and directors become accountable to shareholders (Sternberg, 1997 and 2004; Rossouw et al. 2002; Solomon, 2007). The stakeholder model recommends that firms should be accountable to all their stakeholders rather than only their shareholders (Friedman and Reed, 1983; Letza et al. 2004). It has been argued that multiple accountability works if the purpose is unambiguous to everyone involved (Sternberg, 1997 and 2004; Gamble and Kelly, 2001).

The fourth criticism is that the stakeholder model provides no effective standard against which corporate agents can be judged (Sternberg, 1997 and 2004; Letza et al. 2004). That is, corporate agents are mandated to run the business primarily to balance all stakeholders' interests.¹⁶

Table 1 below presents a summary of the shareholder and stakeholder models of corporate governance, with agency theory following afterwards.

¹⁶ The rise in globalisation and the liberalisation of the stock market are increasing converging stakeholder and shareholder models together. For example, the stock market in Japan, a traditional stakeholder model, is as well developed as its counterparts in the UK and US which reflect the shareholder model (Filatotchev and Boyd, 2009).

Table 1: Summary of the Shareholder and Stakeholder Models of Corporate Governance

| Summary | Shareholder Model | Stakeholder Model |
|-----------------------------------|--|--|
| <i>Theoretical Assumption</i> | | |
| Purpose of corporation | Maximisation of shareholder Value | Maximisation of all stakeholders' wealth |
| Problem of governance | Agency Problem | Absence of stakeholders' participation |
| Cause of problem | Shareholders do not have enough control | Governance failure to represent stakeholders' interests |
| <i>Background</i> | | |
| Assumptions about causation | Self-interested human behaviour | Traditional mentality of private capitalism |
| Type of economic organisation | Rational economic unit with profit motive | Social economic unit with stakeholder welfare motive |
| Proposition | Market efficiency of economy | Social efficiency of economy |
| Rejection | Any external interventions | The principal-agent model |
| Source of discipline | External market forces | Internal social forces |
| <i>Major features</i> | | |
| Board structure | One-tier (executive and non-executive board) | Two-tier (executive and supervisory boards) |
| Major source of finance | Equity from the capital markets | Debt from banks |
| Role of capital markets | High | Low |
| Role of banks | Low | High |
| Ownership concentration | Low/diffused | High/concentrated |
| Regulatory orientation | Self-regulation | Statutory regulation |
| Legal system/ origin | Common law/Anglo American: UK, US/commonwealth | Civil law/continental Europe: France, Germany and Japan |
| Time horizon of economic benefits | Short-term | Long-term |
| <i>Major Solutions</i> | | |
| Solution | Removing restrictions on markets. Strengthening the incentive system. Introducing a voluntary code of governance. Introduction of a combination of efficient contracts | Trust and long-term contractual associations between the firm and stakeholders. Inter-firm co-operation. Employee participation Introducing business ethics |

Sources: Compiled from Keasey et al. (1997), Weimer and Pape (1999), Letza et al. (2004) and Ntim (2018).

2.2.3 Agency Theory

If a business is owned by numerous shareholders or the general public, this affects the way in which it is controlled (Solomon and Solomon, 2004). The shareholders of the business (owners) delegate the running of the company to management (agent); Berle and Means (1932) discussed this process as a divorce of ownership and control which has created the ‘agency problem’. Agency theory can be traced back to Berle and Means (1932) and to Adam Smith’s (1776) book entitled ‘*The Wealth of Nations*’. Smith argued that company directors (agents) were not likely to be as careful with other people’s money (principal) as with their own (Letza et al. 2004).

According to Jensen and Meckling (1976, p.308), agency theory is defined as “*one in which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent*”.

As stated by Huse (2007) and Eisenhardt (1989), there are two main streams in agency theory, a positive stream and a normative stream. The positive stream focuses on the separation of ownership and control in large corporations. Here, the shareholders are the principal while the management is the agent (Huse, 2007; Eisenhardt, 1989). The normative stream is called the common agency theory, which considers all the principal-agent relationships. Here, the board members are considered as the agent for the owners as well as the principal for the management; other principals apart from shareholders may be included. Agency theory argues that boards should monitor the actions of agents (managers) on behalf of their principals (shareholders) (Huse, 2007; Eisenhardt, 1989).

The relationship between the principal and the agent incorporates two major interdependent problems. The first is the problem with information asymmetry between the principal and the agent and the second is the possibility of conflicts or divergence of interest between the principal and the agent (Hill and Jones, 1992). In terms of divergence of interest, the agent does not necessarily make decisions in the best interest of the principal; rather, the agent (manager) prefers to pursue his or her own personal objectives instead of the primary objective of wealth maximisation for shareholders. Managers display ‘egoism’ and engage in self-dealing activities which provide high short-run profit instead of engaging in long-term investment for the benefit of the shareholders (Boatright, 1999). Demirag and Tylecote (1992) argue that British companies engage in ‘short-termism’ which has the tendency to foreshorten the time horizon applied to investment decisions; short-term activities by management create divergent objectives (see, for example, Eisenhardt, 1989).

The agency problem arises because of three major assumptions. First, it is assumed that the principal and the agent may have different attitudes towards risk-bearing (Eisenhardt, 1989). Second, the principal and the agent may essentially have different goals and interests (Eisenhardt, 1989). Third, both parties to the relationship are assumed to be utility maximisers (opportunistic) to the extent that, even if their

goals or risk preferences were not too inherently different, all things being equal, there would be a reason to believe that a rational agent would not always act in the best interests of the principal (Jensen and Meckling, 1976).

Agency theory is concerned with aligning the conflicting interests of principals and agents (Jensen and Meckling, 1976; Fama, 1980). It recommends that the principal can limit divergences from his or her interests by establishing appropriate incentives or control mechanisms to limit the incidence of opportunistic action by the agent (Jensen and Meckling, 1976). Jensen and Meckling (1976) argue that establishing these control mechanisms unavoidably generates three major costs: that is, firstly, the principal can expend resources to design a monitoring system (monitoring costs) which aims at reducing the behavioural activities of the agent. This may also include efforts on the part of the principal to control the behaviour of the agent through contractual agreements regarding budget restrictions, compensation policies and operating rules (Jensen and Meckling, 1976).

Second, the principal may require the agent to spend resources (such as bonding costs) to guarantee that certain actions would not harm the principal. The agent may *ex-ante* incur bonding costs in order to win the right to manage the resources of the principal (Hill and Jones, 1992). Finally, Jensen and Meckling (1976) argue that, despite instituting monitoring and bonding mechanisms, that is, governance structures, there will still be some divergence between the agent's decisions and those decisions which will maximise the welfare of the principal, which is defined as *residual loss*. The sum of the principal's monitoring expenditures, the agent's bonding expenditures and any remaining residual loss is known as *agency costs* (Jensen and Meckling, 1976).

Agency costs can be reduced when the shareholders' interests are aligned with the managers' (agent) through the passing of shareholder resolutions; here, a group of shareholders collectively lobby on issues with which they are dissatisfied in order to align part of the agent's interest (Solomon and Solomon, 2004; Hill and Jones, 1992). Their collective lobbying helps them monitor and engage with the agent (see Hill and Jones, 1992).

In reducing agency costs, the following steps should be taken. First, shareholders can organise one-to-one meetings between managers to help clarify issues of concern. Such meetings can influence corporate behaviour in a very significant way (Holland, 1998). However, the Hampel Report (1998) suggested that institutional investors do not want to be involved in these meetings as they can create a lot of controversy and insider dealing where members can take advantage of private information to sell shares in a company on receipt of this information (Solomon and Solomon, 2004).

Second, the board should invest in information systems in order to control agent opportunism. Information is regarded as a commodity; this means that it has a cost and can be purchased (Eisenhardt, 1989). Information comes in the form of budgeting, annual reports, directors and from management (Pearce et al. 1985; Ungson and Steers, 1984). When the board has adequate information on the firm, it helps control managerial opportunism (Fama and Jensen, 1983).

Information is needed to monitor executive behaviours as it helps to know these behaviours. When the board provides richer information, it helps to determine the frequency of board meetings, the number of board subcommittees and the number of board members with managerial and industry experience. Top executives are more likely to engage in behaviours that are consistent with stockholders' interests (Perrow 1986; Fama and Jensen, 1983).

Third, the board should identify any systemic and non-systemic risks associated with the firm, as every organisation is assumed to have uncertainties in its business. The uncertainty comes in terms of risk/rewards trade-offs. Risk acceptance will influence the firm's profitability, which should be accepted by the principal (Perrow 1986; Eisenhardt, 1989).

Fourth, shareholders can depend on regulation or formal guidance directing how managers should conduct themselves professionally to shareholders. Regulations help companies to become more accountable to their shareholders and other stakeholders (Shleifer and Vishny, 1997; Solomon and Solomon 2004).

Shleifer and Vishny (1997) argue that agency problems are crucial to the contractual view of the firm, which can affect the principal's writing complete contracts with the agent. Hart (1995) offers three reasons why the principal and agents tend to write incomplete contracts. First, it is difficult for people to think ahead and plan for any future contingencies. Second, negotiating effectively for a contract is very difficult, especially where one has prejudice and prior experience which will not help in making a fair decision (Hart, 1995; Wearing, 2005). Third, it is very difficult for any written contract to be made outside the court rules; the authority of the court is needed to interpret and enforce the contract when the need arises (Hart, 1995; Wearing, 2005). Aghion and Bolton (1992) argue that, due to incompleteness of the contract between the agent and the principal and wealth constraints, it is not possible to resolve all potential conflicts between the agent and the principal (Letza et al. 2004; Wearing 2005).

Fifth, shareholders can also divest or sell their shares in a company in which they are not happy with the management. This action is seen as the ultimate decision shareholders will have to make because selling of their shares may affect their stake in the organisation and, in extreme cases, selling of their shares may affect market confidence and share prices, especially when they hold a huge investment in the firm (Solomon and Solomon, 2004).

Finally, Jensen and Ruback (1983) reiterate that shareholders can discipline management using the stock market through the takeover mechanism; that is, if shareholders are not satisfied with management structures, they can vote in favour of a takeover bid. The threat of takeover becomes a disciplining force on managers, as they cannot stand to lose their jobs (Solomon and Solomon, 2004). In summary, managers' and shareholders' interests should always align in order to minimise governance-related problems within the firm. The next section discusses stewardship theory.

2.2.4 Stewardship Theory

Stewardship theory is different from agency theory, information asymmetry and signalling theories that place much emphasis on managerial opportunism and monitoring (Davis et al. 1997). It posits that executive managers are reliable and trustworthy individuals and that they should be empowered to run firms because they are good stewards of the resources entrusted to them (Nicholson and Kiel, 2003; Letza et al. 2004; Davis et al. 1997). Stewardship theory makes some assumptions about the behaviour of senior managers. First, it assumes that the behaviours of the executives are aligned with the interest of the principals (Davis et al. 1997). The second assumption is that the organisational structure is designed so that managers can take effective actions and enhance shareholder returns (Donaldson and Davis, 1994).

Third, it assumes that, since top managers spend their entire working lives in the company they run, they are more likely to understand the business than outside directors and thus can make superior decisions (ibid). Fourth, executive managers possess superior formal and informal information about the firm they manage, which can aid better decision-making (ibid). Finally, competitive internal and external market disciplines and the fear of damaging their future managerial capital ensure that agency costs are minimised (Fama, 1980; Fama and Jensen, 1983). As a result of this, proponents of stewardship theory contend that better financial performance is likely to be associated with internal corporate governance practices that grant managers greater powers, such as combining the positions of company chair and CEO (Donaldson and Davis, 1991; 1994). Managers now have a choice whether to behave as stewards or as agents, so that they can provide shareholders with a framework of psychological and situational factors based on the choice they make (Davis et al. 1997; Ntim, 2009).

2.2.5 Resource Dependence Theory

Resource dependence theory suggests that the implementation of internal corporate governance structures, such as a board of directors, is not only necessary for ensuring that managers are effectively monitored, but also serves as an important link between the firm and the critical resources that it needs to maximise financial performance (Pfeffer, 1978). First, the board and non-executive directors can offer essential resources such as expert advice, experience, independent suggestions and knowledge to the principal (Haniffa and Cooke, 2002). Second, they can bring reputation and critical business contacts to the firm (ibid). Third, the board can facilitate access to business/political elite information and capital to the company (Nicholson and Kiel, 2003). Finally, the board can provide a critical link to a firm's external environment and stakeholders such as government, suppliers and competitors. Nicholson and Kiel (2003) argue that boards that provide a higher level of

links to the external environment are associated with better access to resources, which can have a positive impact on companies' financial performance¹⁷.

Resource dependence theory suggests that the presence of gender balance on a board committee improves decision-making and helps align the organisation with its external environment and resources, thereby enhancing the firm's financial performance. These benefits occur because women are able to bring to the board different attributes, experiences and ideals that lead to a better appreciation of business complexities, which eventually improves the firm's corporate governance quality (Carter et al. 2003). Section 2.2.6 discusses the group effectiveness and diversity theories.

2.2.6 *Group Effectiveness and Diversity Theories*

Group effectiveness and diversity theories suggest that people with common interests interact and work together. Overall, the theory implies that people with complementary backgrounds such as education, skills and talent commit themselves to a common goal for the firm (Ruigrok et al. 2006). The group could be made up of people of different genders, cultures, ethnicity and geographical diversity working together to maximise shareholders' wealth (ibid). This means that all members of the group are mutually accountable to each other. When the group members are accountable to each other, it brings collaboration and efficiency to the organisation.

According to Hambrick and Mason (1984), a diverse board benefits from strategic decision-making and increased creativity due to the presence of different cognitive abilities among board members. Every firm should consider appropriate skills, talent and educational background when recruiting new staff. Their skills should always complement and enable them to collaborate with other members of the group in order to achieve the long-term objectives of the firm (Ruigrok et al. 2006).

The establishment of different board committees such as audit, remuneration and nomination committee and the presence of gender diversity among UK financial institutions are to complement each other in the firm's strategic decision-making.

2.3 Conclusion

This chapter gives a detailed definition of corporate governance mechanisms which exist in the UK and other parts of the world. It can be argued that there is no universally accepted corporate governance definition even though most authors

¹⁷ Pfeffer (1978) introduced the notion that environments are the source of scarce resources and organisations are dependent on these finite resources for survival. A lack of control over these resources eventually creates uncertainty for firms operating in that environment. He suggested that organisations must develop ways to exploit these resources, which are also being sought by other firms, in order to ensure their own survival.

normally cite the Cadbury Report (1992). However, this study will rely on both the Cadbury Report and Sheikh and Chatterjee's (1995) corporate governance definition to support this research theme.

The UK's corporate governance follows the Anglo-American model where firms exist primarily to maximise shareholders' interest and rely on a single or unitary board for the decision-making process. The formation of the unitary board can be based on the needs and direction of the firm. For the purpose of this research, emphasis will be placed on the establishment of audit, remuneration and nomination committees within the unitary board and how the presence of women on the unitary board can impact the firm's financial value (Lazonick and O'Sullivan, 1997; Berle and Means, 1932).

This chapter discusses other theories used in supporting the empirical research and its functions to the firm. These theories can be summarised as follows. The stakeholder model has shown that firms exist to satisfy both the internal and external systems such as employees, creditors, debtors, regulatory systems, and political and economic institutions within which firms operate (Lazonick and O'Sullivan, 1997; Berle and Means, 1932).

Agency costs can be curtailed when shareholders' interest is aligned with manager/agent's (Blair, 1995). Stewardship theory is contrary to agency theory; it states that executive managers are reliable and trustworthy individuals and that they should be empowered to run firms because they are good stewards of the resources entrusted to them (Nicholson and Kiel, 2003; Letza et al. 2004; Davis et al. 1997). Resource dependence theory suggests that the implementation of internal corporate governance structures, such as a board of directors, is not only necessary for ensuring that managers are effectively monitored, but also serves as an important link between the firm and the critical resources that it needs to maximise financial performance (Pfeffer, 1978). Also, group effectiveness and diversity theories suggest that people with common interests interact and work together (Ruigrok et al. 2006). These theories will give a better understanding of the research purpose and why it should be addressed empirically.

The theories also offer a review of the existing theoretical literature that tries to link corporate governance structures such as board committees, gender diversity and firm financial performance. These theories trace the corporate governance-financial performance relationship literature and develop the hypotheses among the variables examined. The theories will help predict the research situation and give an understanding of the study (Ntim, 2009).

3 CORPORATE GOVERNANCE AND THE FINANCIAL CRISIS

3.1 Introduction

This chapter deals with corporate governance and the global financial crisis that took place during the 2007/08 period. One of the objectives of the thesis is to examine if the 2007/08 global financial crisis influenced firm financial performance. The next objective of this research is to examine if the establishment of board committees and the appointment of females (Board Gender Diversity) onto the corporate boards of UK financial institutions can improve a firm's value. This section will give an explanation of exactly what happened during the crisis era. The causes of the financial crises are discussed below.

3.2 The Global Financial Crisis and its Causes

The global financial crisis or credit crunch which ran from 2007/08 shook the entire financial sector and affected the UK economy. Similar crises have also taken place before this global crisis. For example, the Great Depression of 1930, the Asian financial crisis in 1997 and the economic recession in 2001.

Since financial institutions in the UK have been operating before and after the 2007/08 crisis, my research will ascertain if a firm's financial performance prior to the crisis and after the crisis is related to the establishment of its board committees.

The 2007/08 financial crisis started due to the collapse of the real estate market in 2006 in the US when subprime mortgages were the first symptom of a credit boom that turned to bust and of a real estate shock¹⁸ (Mizen, 2008). The subprime mortgages were an innovation of the 1990s, stimulated by laws, financial deregulation and the Community Reinvestment Act of 1977, which gave incentives to lenders to extend loans to individuals with low income and limited or outright poor credit histories (Wallison 2009; Fratianni et al. 2009). Banks had to show that they were meeting the objectives of the act by making a certain number of loans to people with low or moderate income (Fratianni et al. 2009). Credit evaluations were replaced by more flexible procedures that justified lending to the target clientele (Fratianni et al. 2009). According to Wallison (2009), two government-

¹⁸ The subprime market basically means below the standard set. A subprime mortgage is a mortgage given out to borrowers with lower income and lower credit rating. Institutions have to charge very high interest rates to compensate for the risk. This offered the opportunity for some borrowers to be given a loan that they had no hope of repaying, and the problem arose when more people failed to pay back their mortgages than the banks had anticipated. Eventually, the borrowers defaulted on their payment and this led to the crisis in 2007 (Brummer et al., 2007).

sponsored intermediary agencies, Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Mortgage Corporation), were entrusted with the mission to supply the USA housing market with cheaper housing. These two agencies were under pressure from the US government to increase lending to minorities and low-income homebuyers. Government policy over many years caused this problem, as they enforced the reduced lending standards that were essential to the growth in home ownership and the housing bubble (Wallison, 2009). As at 1979-1985, the demand for credit was very high in the US as compared to the demand for money; that is, 11.34% demanded money while 38.47% demanded credit. This is because, the better credit one has, the easier it is to gain access to loans, mortgages and other credit cards (Bernanke et al. 1988).

By 1997, Fannie was offering a 97% loan-to-value mortgage; by 2001, it was offering mortgages with no down payment at all. By 2007, Fannie and Freddie were required to show that 55% of their mortgage purchases were LMI (low-to-moderate income) loans and, within those goals, 38% of all purchases were to come from underserved areas and 25% were to be loans to low-income and very low-income borrowers. Meeting these goals required them to purchase loans with low down payment and other deficiencies that would mark them as subprime (Wallison, 2009). According to Heilpern et al. (2009), \$2 trillion out of \$11 trillion outstanding mortgages in 2007 were subprime. Efforts to reduce mortgage-lending standards were led again by the Department of Housing and Urban Development (Wallison, 2009).

However, Fannie Mae and Freddie Mac had a mortgage ceiling of around \$200,000. This meant that they could not borrow more than this threshold, so the banks and other mortgage agencies moved in to fill the gap. At the same time, banks and other lenders were finding it not useful to look to prime borrowers with large amounts of equity in their homes, secure jobs and rising incomes. Such borrowers were demanding the finest rates in a highly competitive marketplace and organising their existing home loans so that they could benefit from the record low interest rate. The prime market was losing its allure, making real estate agents, mortgage brokers and bankers turn their sights on the millions of people with less collateral and lower incomes who were yearning to climb the housing ladder. Borrowers were able to reach through the invention of subprime loans; house builders and construction firms were able to cater for the boom by building millions of cheap homes. This gave people with no prospect of fulfilling the 'American Dream' a chance to own their own homes (Brummer et al. 2007)¹⁹.

¹⁹ The introduction of the CRA and the use of Fannie Mae and Freddie Mac to increase the housing market for minorities and low-income homebuyers led to excessive promotion of house ownership without adequate and sufficient regulation in the financial sector, which resulted in increased credit, bad loans and increased speculation in the housing market. The bubbles in housing prices dragged down the banks and the economy in the US, which eventually spread to other parts of the world because of globalisation in the banking sector. Secondly, Fannie Mae and Freddie Mac used their affordable housing mission to avoid additional regulation by Congress during the government sponsored enterprise (GSE) in order to increase their support for affordable housing on accumulation of mortgage portfolios. Between 2005 and 2007, Fannie and Freddie brought approximately \$1 trillion in subprime or Alt-A mortgages, which is estimated to be \$2 trillion, which also accounted for the weakness in bank assets which was an underlying cause of the financial crisis (Wallison, 2009).

The next section will highlight some of the factors that contributed to the global financial crisis of 2007/2008.

3.2.1 *Global Imbalance and Interest Rates*

Global imbalances started with the Asian financial crisis of 1997, when most countries borrowed too much in foreign currency and had difficulties in repaying it. The IMF then asked various governments to raise interest rates and cut government spending (Allen and Carletti, 2010).

Money kept too long in the aftermath of the 2001 recession is said to have fuelled the credit bubble (Bustillo and Velloso, 2009). During 2002 and 2003, when Japan experienced deflation, the Federal Reserve cut the Federal Funds rate to 1% for a year. Interest rates were raised between 2004 and 2006 in a more gradual way. The gradual tightening process encouraged broad risk-taking behaviour and made most countries link their currencies to the dollar (Allen and Carletti, 2010; Mallaby, 2008).

However, Mallaby (2008) argues that “*the credit bubble has its origins in a two-headed monetary order, where some countries allow their currencies to float, while others peg their currency closely to the dollar*”. For example, China pegged their currency against the dollar for five years, making their currency very cheap for exporters (Mallaby, 2008). Cheap exports from China created huge trade surpluses which were later pumped back through the purchase of US assets, (mortgage) inflating a credit bubble. This also created a huge capital flood in the US market. The flood of capital fuelled the financial boom by pushing interest rates down (Mallaby, 2008). As interest rates fall or home prices rise (cash-out financing) to a point at which home owners can make some equity, they then treat their homes as savings, drawing out funds to buy cars, boats and second homes (Wallison, 2009).

According to Wallison (2009), 86% of homeowners cashed out a total amount of \$327 billion in 2006, which means that there was not enough equity to support the mortgage market when prices fell or in times of uncertainty.

3.2.2 *Regulation and Supervision*

The deregulatory factor in the US is often cited as one of the causes of the financial crisis. Another school of thought also argued that the failure to regulate new financial instruments was the result of the crisis. The passage of the Gramm-Leach-Bliley Financial Services Modernisation Act in 1999 repealed part of the Glass-Steagall Act of 1933, opening up competition among banks, securities, insurance companies and many others. Basically, the Glass-Steagall Act prohibited a bank from offering investment, commercial banking and insurance services. This new law let commercial banks, security firms and insurers offer an array of financial services, and different oversights were split among different government agencies.

For example, the SEC oversees the brokerage of companies. Bank regulators oversee supervision of bank operations and the state insurance commission oversees the insurance business. No single agency had authority over an entire company (Bustillo and Velloso, 2009). As argued by Stiglitz (2009), the repeal of Glass-Steagall brought investment and commercial banks together, which caused the demand for high returns, which are obtained through high leverage and big risk-taking. Failure by government agencies to regulate innovated financial instruments, as well as risk management, left room for companies to take ‘excessive risk and asset price inflation’; even where financial institutions are regulated, they still get around it (Bustillo and Velloso, 2009).

Also, banking regulatory policy introduced in 1988 and known as Basel, ensures that banks are adequately capitalised. *“Banks assets are assigned to different risk categories and the amount of capital that a bank holds for each asset is pegged to the asset’s perceived riskiness”* (Wallison, 2009). This means that AAA asset-backed securities are less than half as risky as commercial loans. These rules provided an *“incentive for banks to hold mortgages in preference to commercial loans or converting portfolios of whole mortgages into mortgages-backed securities (MBS) portfolio rated. This substantially reduces their capital requirements”* (ibid). The prime mortgage is often high loan-to-value ratios or other indicators of low quality. The Basel regulation encouraged commercial banks to hold only a small amount of capital against the risk associated with residential mortgages and, as the risk increased because of inadequate lending coupled with a ballooning of home prices, the Basel capital became increasingly insufficient for the risks to banks holding mortgages and mortgage-backed securities (Wallison, 2009)²⁰.

In addition to that, credit rating agencies such as Standard & Poor’s, Moody and Fitch Ratings badly misjudged the risks associated with mortgage-based securities. The rating agencies paid attention to the revenue paid by issuers rather than investors and had a large fraction of their revenues originating from rating financial products with complex structures (Bustillo and Velloso, 2009). *“As rating agencies began to receive a large proportion of their income from rating products, they lost their objectivity and started giving ratings that weren’t justified”* (Allen and Carletti, 2010).

3.2.3 Securitisation – Structured Finance

Securitisation of assets is the process which involves repackaging and selling-off balance sheet assets like mortgages into a secondary market for investors. Structured finance comes from banking and financial innovation aimed at transferring credit risk from individual financial institutions to the market as a whole (Wallison, 2009).

²⁰ For example, *“the Basel accord requires banks to set capital aside against contingencies in order to avoid defaults, banks looked for ways around the rules by shifting assets off their balance-sheets through securitization structured investment vehicles and Credit Default Swaps (CDSs) to cut the risk of borrowers defaulting”*. When the market unravelled, these assets threatened to come back onto the balance-sheets (Bustillo and Velloso, 2009).

This mortgage-backed securitisation helped the banks to modify their balance sheets, and risk exposure and cost of capital by raising extra cash resources to enable them to lend to households. Securitisation provided banks with the financial support to increase the supply of mortgage funds to many homeowners (Heilpern et al. 2009). The mortgage-backed securities were sold to investors that had different appetites for risk, so the subprime mortgage debt was mixed with AAA-rated mortgages and well packaged for investors. The mortgage loans were sometimes turned into a bond for investors to buy and a credit agency will have used obscure alchemy to bless the bond with a triple-A rating, making it appear very good to investors to buy (Wallison, 2009). This provided a good portfolio diversification for investors and also improved liquidity for the banks (Heilpern et al. 2009).

Some of the loans were also packaged as Mortgage-Backed Securities (MBS) and Commercial Papers (CP) or transferred as sponsored Structured Investment Vehicle (SIV). This SIV in turn packages the loans into residential MBS or CP which will receive a credit risk score by rating agencies. The SIV obtains funding by borrowing short term in the commercial paper market and from banks. If the SIV is unable to refinance itself, it can count on contingency support from its sponsoring banks (Fратиanni et al. 2009). It was estimated that a total of \$1,800 billion of SIVs and commercial paper was held by banks in 2007 (IMF 2008).

However, there was a problem with the structured finance; that is, the originator or the bank did not conform to standards of disclosure and also the product was too complex for rating agencies to properly evaluate (Fратиanni et al. 2009). This type of loan became the second main issue that caused the credit crunch because investors all over the world purchased these corporate bonds; these subprime loans were often amalgamated into mortgage-backed securities, which were then sold to financial institutions across the world and eventually found their way into companies (Brummer et al. 2007). This loan was absolutely safe because they had the backing of the US Federal Government.²¹

²¹ Between 1996 and 2007 mortgage-backed securities accounted for three-quarters of the annual US securitisation market (Heilpern et al., 2009 p.113). According to Geradi et al. (2006), two regulatory adjustments were introduced which promoted the growth of securitisation; that is, the modification of accounting regulation which was introduced by the Federal Home Loan Board (FHLBB) in October 1981, and the Government Sponsored Enterprise (GSE) in which the under-listed companies (Fannie Mae and Freddie Mac) were exempted from state investor protection laws.

Securitisation also became very popular in the United States when the government National Mortgage Association (Ginnie Mae) securitised mortgages composed of Federal Housing Administration and Veterans Administration (FHA/VA) mortgages backed by the US government for resale in a secondary market in 1968 (Mizen, 2008). In 1981, the Federal National Mortgage Association (Fannie Mae) began to issue Mortgage-Backed Securities (MBSs) and afterwards the new, private securitised products were started for prime loans without the backing of the government (Mizen, 2008). There also emerged the European Asset Securitisation in the 1990s, which was picked up in 2004 in the Netherlands, Spain and Italy. It was less popular in Germany, France and Portugal (Mizen, 2008). According to Mizen (2008), more than half of the on securitisation was sold outside the European area, with one-third sold to institutions in the UK between 2005 to 2006 by commercial and investment banks through the Special Purpose Vehicles (SPVs) which were created for that purpose (Gorton and Souleles 2005). After the securitisation was introduced, a new market for Collateralised Debt Obligations (CDOs) consisting of Asset-Backed Securities emerged. The CDOs had claims of different seniority which offered different payments (Mizen, 2008; Chomsisengphet and Pennington-Cross, 2006).

3.2.4 *Bankers' Position*

The fourth factor that caused the crisis was the incentive systems available for the bankers (Wallison, 2009). Banks also made a lot of money through mortgage fees, commissions and bonuses by setting up new loan businesses. The underwriting rules in banks were thrown out and some of the loans required low documentation or no documentation, and some even needed no proof of income or credit history²² (Brummer et al. 2007). The use of brokers and agents on commission which was driven by 'quantity' not 'quality' added to the problem; brokers also fraudulently reported information to ensure a mortgage arrangement had occurred; they did not care so much about their reputation (Mizen, 2008). Finally, excessive compensations given to bankers and managers in the financial sectors made them take excessive risks with investors' money. Larger compensation is always tied to short-term profits, which makes the bankers take big incentives to take larger risks than are warranted by the goal of maximising shareholders' profits (Bustillo and Velloso, 2009).

3.2.5 *Lack of Liquidity*

The fifth reason is that when the bust occurred most companies especially financial institutions were affected by liquidity. The Asset-Backed Commercial paper started facing liquidity risks, institutions started switching from commercial paper to government securities, causing Treasury yields to decline. Banks also refused to lend to each other due to a lack of commitment to Asset-Backed Commercial Paper (ABCP) structures. This made countries inject liquidity into the economy. The European Central Bank (ECB) injected €95 billion of liquidity into the Euro zone (Mizen, 2008).

The US also injected \$24 billion into the market; later on, the government subsequently injected \$700 billion, which was known as the Troubled Asset Relief Program (TARP), in a form of preferred stock to banks and car manufacturing companies such as General Motors and Chrysler, and insurer AIG had \$70 billion, Bank of America \$45 billion and Citigroup \$45 billion and \$5 billion in support of loan guarantee²³.

The UK government also injected £50 billion, which was used to buy stakes or shares in the banks that were greatly affected by the crunch such as Northern Rock, Royal Bank of Scotland (RBS) and Lloyds TSB. The government also promised

²² According to Crotty (2008), "*banks and mortgage brokers pushed the mortgage sales because they earned fees in proportion of the volumes they wrote*". They also earned large fees by selling the mortgage on mortgage-backed securities (MBS) and collateralised debt obligations (CDOs) in the form of securitisations. The mortgage was given a high AAA rating by credit agencies in order for it to look very attractive to buy.

²³ http://www.nytimes.com/interactive/2011/08/04/business/20110804-bailout-totals-graphic.html?scp=1&sq=government%20bailout&st=Search_ Accessed on 9/08/2012.

£250 billion to help banks refinance debt; the central Bank of England also agreed to double its lending to £200 billion in a special liquidity scheme²⁴.

3.3 Aftermaths of the Financial Crisis in the UK

The financial crisis brought about instability in the financial sector, which was enjoying efficient, stable and fair financial markets. The instability affected the wider economy, allocation of capital within countries, and left individuals and business unable to access savings or to raise finance. The government then created a ‘memorandum of understanding’ between HM Treasury, the Bank of England (BoE) and the Financial Conduct Authority (FCA) which was complemented by the Financial Ombudsman Service and the Financial Services Compensation Scheme (FSCS) in order to provide customers with the right to redress and compensation. This instability made the government to undertake certain actions such as strengthening the stability and resilience of the financial systems in the UK and globally; reducing the chance of individual banks facing difficulties; providing compensation and creating confidence for consumers; and strengthening the BoE and ensure they coordinate with other agencies such as FCA and HM Treasury. Apart from relaxation in regulation during the crisis, securitisation also brought financial instability into the UK economy at this time. This is where loans purchased and other assets were then packaged and sold to investors and other banks.

The credit rating agencies also created a lot of challenges in the systems where information they provided did not reflect the full picture on the ground.

The BoE provided liquidity assistance to assist banks such as Northern Rock, RBS, Lloyds TSB and Dunfermline Building Society, among others, who were having liquidity problems during the period of financial instability. This meant that the FCA had to come up with a proposal which could make companies disclose their company information. The FCA agreed to scrutinise banks and communicate this information to customers.²⁵

The next section will deal with government regulating policies introduced during the financial crisis.

3.4 Government Regulating Policies

The UK currently has a tripartite financial regulatory body which comprises the Bank of England (BoE), the Financial Conduct Authority (FCA) and HM Treasury (the Treasury), which are collectively responsible for financial stability. After the financial crisis, there were deficiencies in the UK’s regulatory systems because of

²⁴ <http://www.telegraph.co.uk/finance/financetopics/financialcrisis/3155514/Financial-crisis-50billion-bank-rescue-package-to-be-announced.html>. Accessed on 08/08/12.

²⁵ The Aftermaths of the financial crisis in the UK information is retrieved from Financial Instability Report, which is available at HM Treasury and the BOE website 20/12/2011.

government intervention preventing RBS, Bradford & Bingley Building Society, Dunfermline Building Society, Northern Rock and Lloyds TSB from collapsing. This brought about serious deficiencies in the UK's regulatory systems, where the monolithic financial regulators, the FCA, were accused of having insufficient focus to identify and tackle issues early. "*The FCA identified serious shortcoming in its supervision of Northern Rock prior to their failure in 2007*" (HM Treasury 2017). The BoE did not have the tools to fulfil its responsibility. The Treasury also did not have a clear responsibility for dealing with a crisis, which means that no single institution had the full responsibility or authority to monitor the systems, identify the risks to financial stability and act decisively to tackle them. The new regulatory structure will reduce the systematic risks that financial services pose and ensure that economically advantageous activity is not driven away by inappropriate regulation (HM Treasury 2017; BoE 2017).

Also, the government agreed to create a New Prudential Regulation Authority (PRA) which will be responsible for the day-to-day supervision of financial institutions. The establishment of the New Consumer Protection and Markets Authority (CPMA) was also another policy agenda created by the government to help regulate the conduct of all financial service firms. The government also created a New Economic Crime Agency (NECA) which will bring together various government agencies into a single force to help tackle financial crime. The policy also includes setting up an Independent Commission on Banking in order to investigate the structure and competition of UK banks. Helping small- and medium-size businesses (SME) to access finance was also one of the policies created by the government. Finally, the policy brought about the introduction of a banking levy so that banks may have fair contributions in terms of risk²⁶. Below is a description of the new financial service regulators and their functions (HM Treasury, 2017; BoE, 2017).

The Financial Policy Committee (FPC) was established as a committee of the BoE, responsible for macro-prudential regulation which involves macro-issues that affect economic and financial stability. It will also have the power to address the risks, requiring the PRA to implement its decisions by taking action concerning any firm. Cooperation will exist between the FPC, the PRA and the CPMA in order to ensure that the FPC is kept fully informed on any issues that might affect financial stability. The FPC will be accountable to the BoE Court of Directors, which will review FPC procedures, and also to Parliament, as it will be required to publish biannual financial stability reports, which will be scrutinised by the Treasury Select Committee (HM Treasury, 2017; BoE, 2017).

²⁶ The financial crisis has given the government good reason to review financial services regulation and the introduction of new reforms. The government introduced the financial Services Regulation bill in order to reform the regulatory framework, where the government agreed to transfer the control of macro prudential regulation and oversight of micro prudential regulation from the FSA to the BoE. The reason for government action is the belief that only central banks have the required authority, knowledge and understanding of macroeconomics and markets to make macro prudential judgements. Since the financial crisis reiterated that central bank's is the lender of last resort, it means they need to familiarity with every aspect of the institutions that they may need to support. The government then establish the following bodies to undertake functions currently performed by FSA, Cannon *et al* (2010).

The Prudential Regulation Authority (PRA) will be established as a subsidiary of the BoE. It will be responsible for the micro-prudential regulation of financial institutions, including retail and investment banks, building societies, broker-dealers and insurance companies. The PRA will strengthen the financial systems and maintain its resilience to any future crisis. It will also be responsible for the authorisation, regulation and supervision of all firms subjected to prudential regulation. The government will consider any modification or alternatives to the financial services and Markets Act (FSMA 2000) that are required to accomplish this objective. The PRA will be accountable to the BoE Court of Directors and accountable to Parliament (HM Treasury 2017; BoE 2017).

The Consumer Protection and Markets Authority (CPMA) will take on the FCA's responsibility for consumer protection and become a single conduct regulator, responsible for the Financial Ombudsman Service, the Consumer Financial Education Body, consumer credit and the Financial Service Compensation Scheme. It will also be responsible for the conduct of all firms, retail and wholesale, in their dealings with consumers. The CPMA is a strong consumer champion and promotes confidence in financial services and markets (HM Treasury, 2017; BoE, 2017).

The Serious Economics Crimes Agency (SECA) will take over the work of the FCA, the Serious Fraud Office and the Office of Fair Trading in handling serious economic crime.²⁷

The next section deals with the Independent Commission on Banking created as part of government regulation policies.

3.5 Independent Commission on Banking

The Independent Commission on Banking (the Commission) was established by the government in June 2010 to examine the structure of the UK banking sector. The Commission aims to make banks more resilient to shocks by requiring them to hold more capital relative to their lending activity and more access to liquidity.

The Basel Committee on Banking also proposed major changes to bank capital and liquidity requirements and related regulatory changes. The Independent Commission on Banking highlighted issues which affected financial instability, as detailed below.

The Basel Committee on Banking Supervision (BCBS) set out banking capital requirements for all banks to adopt in order to ensure that there is continuous liquidity in the banking system. Following the financial crisis, the BCBS announced the strengthening of capital requirements to remedy the deficiencies since most banks did not hold enough cash against risk exposures. The Basel III changes will increase the quality of capital by placing greater emphasis on its capacity to absorb losses. The capital will also increase on certain asset classes such as trading book

²⁷ Government additional reform policy information was taken from the HM Treasury websites and BoE website on the 19th August 2011.

assets and securitisation. This will make banks retain capital above minimum requirements and will increase their resilience to shocks; the implementation time for Basel III has been extended to the end of 2018²⁸(ICB, 2010, p. 58). Institutions that failed during the crisis did so mainly due to liquidity problems; Basel III aims to improve liquidity risk management by requiring banks to establish a liquidity risk tolerance level, developing contingency fund plans and senior management oversight of liquidity risk. The FCA also introduced the liquidity regime to implement the BCBS²⁹ (ICB, 2010).

The crisis raised concerns that the Generally Accepted Accounting Principles in the US and other countries were inadequate. This allowed the drive to converge with the principles-based International Financial Reporting Standards (IFRS)³⁰ (ICB, 2010). The weaknesses in the capital and accounting framework meant that bank employees were “*remunerated on the basis of reported profits that were neither time-nor risk-adjusted*” (ICB, 2010) and led to incentives that were not always aligned with the long-term interests of the bank. The FCA introduced a remuneration Code in order to promote effective risk management such as salary, bonus, cash and shares³¹ (ibid). “*The increasing systemic importance of hedge funds has made authorities to review the regulatory requirements placed on managers*” (ICB, 2010). The proposed new directive on Alternative Investment Fund Managers (AIFMs) regulated depositors and administrators in terms of minimum capital requirement concerning portfolio size, governance and risk management, which will enhance transparency for investors and supervisors (ICB, 2010).

The increase in derivatives for speculative purposes, particularly OTC (over the counter), during the financial crisis allocated risk across the financial system. OTC derivative transactions are reported to a trade repository which collates and distributes information to regulators and the market. The EU proposed restrictions on speculative trading which include a ban on credit default swaps (CDI) and disclosure of short positions (ICB, 2010).

Supervisory authorities have been encouraged to coordinate, share information and manage capital requirements among member countries. The EU established three new authorities to oversee banking, securities and markets, insurance and pensions, and the European Systemic Risk Board. The UK introduced the New Prudential Regulatory Authority, the Financial Policy Committee as a subsidiary of the BoE and the Consumer Protection and Markets Authority responsible for business regulation, market supervision and consumer protection (ICB, 2010).

A new tax code of 50% on bonuses over £25,000 paid to banking staff was introduced in December 2009. A new banking levy was established in order to encourage banks to move to less risky investment in which the tax code is calculated with reference to the firm’s liabilities (ICB, 2010).

²⁸ Independent Commission on Banking information is retrieved and accessed on June 2017 p. 58.

²⁹ Independent Commission on Banking information is retrieved and accessed on June 2017 p. 58.

³⁰ Independent Commission on Banking information is retrieved and accessed on June 2017 pp 59

³¹ Independent Commission on Banking information is retrieved and accessed on June 2017 p. 59.

The next section provides the conclusion to the chapter.

3.6 Conclusion

This chapter highlights some of the causes of the 2007/2008 global financial crisis in the UK and other parts of the world. The financial crisis was a result of global imbalance, regulation and supervision, securitisation, bankers' position and lack of liquidity. Based on the factors discussed, we can argue that the crisis was a result of negligence emanating from all stakeholders.

After the crisis in the UK, banks and other financial institutions were rescued or bailed out by the government with taxpayers' money to prevent them from collapsing. If the government had not rescued these banks, their failure could have caused unacceptable disruption to the overall financial system which would have been difficult to contain.

Apart from the government rescuing these banks from collapsing, the deficiencies in the financial system were addressed through the establishment of government regulating policies such as the new Prudential Regulation Authority (PRA), which is responsible for the day-to-day supervision of financial institutions; the New Consumer Protection and Markets Authority (CPMA), which is responsible for consumer protection; the Financial Policy Committee (FPC), which is responsible for macro-prudential regulation which involves macro-issues that affect economic and financial stability; the Serious Economic Crimes Agency, which is responsible for handling serious economic crime; and, finally, the Independent Commission on Banking, which is responsible for examining the structure in the banking sector such as accounting reporting procedures, bonuses, OTC trading, etc. (HM Treasury, 2017; BoE, 2017).

Additionally, the deficiencies in the financial sector as a result of the crisis were not only handled through government regulation policies but also through various corporate governance reforms and the need for firms to have board committees (audit, remuneration and nomination) in place to ensure that important decisions were properly securitised and checked thoroughly in order to prevent any future negligence. Also, the reforms helped to cover any overlaps in corporate governance policies and avoid future market failures in UK financial institutions (Walker Review, 2009; FRC 2014 and 2016). One motivation for this research is to examine if the establishment of these board committees and the presence of women influenced UK financial firms' return on asset (ROA) and market or firm value during the pre/post financial crisis period.

4 CORPORATE GOVERNANCE IN UK FINANCIAL INSTITUTIONS

4.1 The Financial Services Industry in the UK

The financial services industry in the UK is seen as the world-leading hub for this industry, after the US. The sector offers services such as banking, insurance, mortgage, asset management and mutual funds to all stakeholders (BoE, 2013 and HM Treasury, 2013). These services create corporate and income tax for the government, returns on investors (shareholders) and employment for the citizens. Services and products offered by the financial services industry are discussed below.

Banks are seen as places where individuals and businesses deposit their money and assets, transfer money from one person or company to another, invest in government bonds, apply for loans and letters of credit, and ensure that funds ‘pass hands’ in a legal and structured manner. The banks are the largest segment in the UK financial services industry, which employs over 400,000 members of staff. A bank which is resilient, fair to customers and serves the wider economy is of importance to the nation’s development (BoE, 2013; HM Treasury, 2013).

The insurance industry has been established to provide guarantees of compensation for any loss, damage or death in return for the payment of a premium. The insurance industry employs over 300,000 people and forms 25% of total net worth in the UK. The UK insurance industry is the largest in Europe and the third largest in the world (BoE, 2015; HM Treasury, 2015). The UK is the largest centre for asset management in Europe with £4 trillion of assets under management. Asset management normally refers to investment such as stocks, bonds and real estate. The sector employs 24,000 workers (BoE, 2015; HM Treasury, 2013).

Furthermore, the mutual fund is also a collection of equity from investors with the purpose of investing in securities such as stocks, bonds and money market instruments. Examples of mutual fund are unit trust, open-ended investment trust (OEIC), mutual insurers, cooperatives and credit unions³².

³² Information on Introduction to the Financial Services Industry in the UK was taken from the HM Treasury websites on the 19th June 2013. ³² The deficiencies in the financial system during the financial crisis led to the establishment of the Financial Policy Committees (FPCs) and Prudential Regulation Authority (PRA) by the Bank of England (BoE) to help regulate the financial industry. The Financial Services Authority (FSA) was given more powers and changed its name to the Financial Conduct Authority (FCA).

Additionally, the mortgage industry is also another financial service sector in the UK. A mortgage is a loan secured to buy a house or property and paid in instalments over a set period of time, with a promise that money borrowed will be repaid (HM Treasury, 2013). The financial crisis in 2007 started as a result of the way and manner in which the mortgage industry was handled during that time. Due to government support of the mortgage industry, Lloyds Banking Group and RBS were asked by the government in 2010 to lend £3bn and £8bn respectively (BoE, 2013; HM Treasury, 2013).

The authorities governing UK financial institutions are made up of tripartite regulators, the Bank of England, HM Treasury and the Financial Conduct Authority (BoE, 2013; HM Treasury, 2013 and FCA, 2013), whose job is to see to it that the financial institutions enjoy a level of stability, growth and transparency to stakeholders. Apart from these three regulators, the London Stock Exchange (LSE) regulates companies that want to be listed on the stock market in order to generate external funds from investors. LSE requirements include compliance with all UK corporate governance codes. The UK government revises and amends corporate governance policies on a continuous basis, in order to address any issues (BoE, 2013; HM Treasury, 2013 and FCA, 2013). The next subsection discusses corporate governance in banks and financial institutions.

4.2 Corporate Governance in Banks and Financial Institutions

The financial crisis prompted researchers and stakeholders to examine banks and other financial institutions' activities closely. Modern economies need a well-functioning financial system, which means that any flaws in the financial institutions greatly impact the economy (Mehran and Mollineaux, 2012). Corporate governance of banks and other financial institutions differs from other sectors of the economy. It goes beyond shareholders (equity governance) to include employees, directors, creditors, debtors and the government, (Hopt, 2013; Mehran and Mollineaux, 2012). The sector is also very complex to control and manage as it requires adequate knowledge and experience from decision-makers. The board of directors in every financial institution needs to understand all complex financial products, risks to the company and their controls. Any failure of responsibility on the part of management and the board of directors will have consequences on the firm's corporate governance (Hopt, 2013).

Financial institutions are governed by laws, regulations and informal rules such as social values, norms and government tax code. These same laws and regulations can serve as financial instruments that can become a weapon of mass financial destruction or can create an economy-wide bubble. The laws and regulations can also create an incentive for the failure of the management of financial institutions, their owners, creditors and debtors (Macey and O'Hara, 2003).

Any decision by the banks and other financial institutions is influenced by internal governors such as the board of directors and risk officers. The external governors

such as market participants³³, regulators and legislators also influence the firm's actions (OECD, 2009; Basel Committee, 1999; Levine, 2011). The interests of these groups are not equal and do not always align because each wants a different outcome or risk profile for financial institutions. Regulators also face different incentives as to how they intervene in the markets in the interest of society, as they exist to protect the public (Levine, 2011).

Corporate governance is used to identify the problem spots where any laws, regulations and tax codes can become incentives which could lead to undesired firm behaviour or instability in the financial system (Mehran and Mollineaux, 2012). Governance of financial institutions depends on two kinds of principles: that is, first, which institution is most desirable for the country and, second, the mechanism or institutions needed to achieve that ideal desirability (Mehran and Mollineaux, 2012).

For banks and other financial institutions to be efficient, regulators can take steps to increase market discipline and disclosure, first by mandating the production of information outside of markets through increased regulatory disclosure. Information disclosure in banks is primarily compliance-based. Second, potential producers of information can be motivated by changing their incentives. Executive compensation should be linked with market prices of financial instruments. The lack of transparency in the banking industry has become a symptom of the causes of bad governance. Banks and other financial institutions face corporate governance problems as a result of the deposits they receive, insurance, and regulation of the product and services (Mehran and Mollineaux, 2012)³⁴. The failure of banks and financial institutions during the financial crisis can be classified into three forces.

First, there is an ideological belief that self-regulation of financial markets has been entrenched in all sectors of the economy, which has undermined effective public oversight of the markets (Tomasic, 2009). Second, there is a belief that government monitoring of the financial market had the effect that public legal institutions were either underdeveloped or undermined (*ibid*). Third, the political importance of developing and maintaining London as a major financial centre meant political pressure could be seen to have a bearing on regulations and regulators as

³³ The internal corporate governance in banks and financial institutions focuses on shareholders and the board of directors whilst the external corporate governance concentrates on markets for corporate control such as auditors and rating agencies (Hopt, 2013; Levine, 2011). The board of directors has a duty to the shareholders to promote safety and soundness in the financial markets and provide an independent oversight of management's decision-making. The board has a responsibility for evaluating the organisational strategy, risk appetite, organisation and internal controls. When financial institutions face difficulties, the board also faces pressure and its integrity becomes questionable (Mehran and Mollineaux, 2012; Macey and O'Hara, 2003).

³⁴ Market participation can exert discipline upon financial firms by ensuring that there is control within the banking industry. This control is subject to supervision, regulation and legal requirements. Regulation can encourage markets to monitor all the financial institutions. Information and disclosures play a role to minimise market failures and regulators can increase market discipline by increasing disclosure and by directly motivating potential producers of information through change of incentives (Mehran and Mollineaux, 2012; Macey and O'Hara, 2003).

they have to ensure they meet international standards. Any effective corporate regulatory regime must be based on corporations being committed to maintaining appropriate governance policies and standards as part of corporate culture. Corporations cannot rely solely on the state to set up policies on intervention and monitoring of the regulation of the financial market if they are not ready to comply with any new regulations. Companies should support the state by implementing policies set up by the government (Tomasic, 2009).

Further, rating agencies should evaluate the quality of financial products such as swap, derivative and any other conflict of interest that might arise among companies. However, it is argued that rating agencies played a role in escalating the 2007/2008 financial crisis (Tomasic, 2009; Coffee, 2009).

Furthermore, lawyers and auditors in an organisation should play a large role in ensuring corporate integrity is maintained and preventing any professional misconduct that may arise as it will undermine corporate effectiveness (Tomasic, 2009; Armour and McCahery, 2006; Coffee, 2006; Fuchita and Litan, 2006; Dravis, 2007). Additionally, the internal corporate risk monitors should assess risk thoroughly, as it proved to be a major problem among banks during the financial crisis. For example, Paul Moore in HBOS failed to communicate risk taken by his bank to stakeholders before the crisis (Tomasic, 2009).

Finally, hosting London as a financial centre needs to be balanced by the risks that emanate from the companies as it may lead to the need to impose heavy financial burdens on taxpayers, who may be called upon to rescue any failed financial institution with a view to maintaining stability in the markets (Tomasic, 2009).

4.3 Too Big to Fail Financial Institutions

Large financial institutions, especially banks in the UK, were classified as too big to fail (TBTf) because of their size, market capitalisation, interconnectedness to the global world and years of existence. Banks and building societies such as Royal Bank of Scotland (RBS), which is part of NatWest Bank and was established in 1727, Lloyds TSB Bank, established in 1965, Northern Rock, 1850, Bradford & Bingley, 1851, Dunfermline Building Society, 1869, Bank of Scotland, known as HBOS, which was formed in 1695 and is now part of Lloyds Banking Group, Alliance & Leicester Bank, which was formed in 1985 and became part of HBOS in 2001, which is part of the Lloyds Group; these banks have existed too long to have failed (Labonte, 2013)³⁵.

These banks were rescued by the government (taxpayers' money) during the financial crisis and were classified as too big to fail or systemically important by policy-makers as their failure could cause unacceptable disruption to the overall

³⁵ The UK Government has an 82% stake in RBS from bailing out the bank with taxpayers' money.

financial system which would be difficult to contain³⁶. Before the crisis, the government had no policy to rescue TBTF firms, but they were rescued once the crisis struck. Taxpayers argued that a bad use of financial decisions must be financially punished (Labonte, 2013).

Interest rates in the UK were cut to 0.5% to make it easier to borrow. ‘*Quantitative Easing*³⁷’ was also introduced as a method of increasing liquidity in the market by buying assets from financial institutions in order to inject cash and reduce interest rates. A car-scrapping scheme was introduced to encourage the motor industry to produce more cars. The government also reduced its expenditure and the public-sector budget was reviewed in order to avoid waste³⁸ (HM Treasury, 2013; Financial Service Bill, available from August 2011).

Before the crisis, the banks held a greater percentage of large assets from insurance, mortgage, mutual funds and brokerage firms, but the financial crisis reduced the number of assets and increased mergers and acquisitions among these institutions (Labonte, 2013; Tarullo, 2011). The International Monetary Fund (IMF) argues that the causes of the financial crisis were due to firms that were too interconnected with each other. This means that any activity or risk in one firm or market segment flows easily into another. When an interconnected firm failed, other firms had difficulty in absorbing it because of the disruption to the flow of credit (Labonte, 2013; IMF Selected Issues, 2009).

Stakeholders believe government protection for these banks from losses provided a shield and created an incentive to monitor the banks’ riskiness. Government assistance concerning TBTF includes preventing systemic risk from spreading among the banks and other sectors of the economy and stricter prudential regulation to ensure that investors, rating agencies, creditors and counterparties curb excessive risk-taking by TBTF firms. This regulation will minimise the spillover effect to the economy (Labonte, 2013). Preventing TBTF was necessary for maintaining the stability of the financial systems in the short run but arguably it is predicted to cause moral hazard, less stable financial systems and weaken market discipline in the long run (Labonte, 2013). Moral hazard is a situation where TBTF firms expected that their failure could be prevented by the government, which will serve as an incentive to take greater risks because

³⁶ In June 2013, Sir Mervyn King, at that time Governor of the Bank of England (BoE), announced during the Mansion House speech that these banks are “too big to fail, too big to jail or simply too big”, <http://www.bbc.com/news/business-22980749>. Accessed on 20/03/14. Also, In July 2013, Marc Labonte, specialist in macroeconomic policy, published a paper for the Congressional Research Service on Systemically Important or ‘Too Big to Fail’ Financial Institutions, Congressional Research Service 7-5700, www.crs.gov/R42150. Accessed on 01/03/14.

³⁷ The government spent £50bn of its initial £125billion programme of ‘*Quantitative Easing*’ to pump more funds into the economy by purchasing government bonds, Accessed on 02/03/14.

³⁸ Congressional Research Services (CRS) Report R42083, Financial Stability Oversight Council: A Framework to Mitigate Systemic Risk, by Edward V. Murphy (May 2013). Accessed on 02/03/14. ³⁸ Congressional Research Services (CRS) Report R41073, Government Interventions in Response to Financial Turmoil, by Baird Webel and Marc Labonte (February 2010). Accessed on 02/03/14. ³⁸ In July 2013, Marc Labonte, specialist in macroeconomic policy published a paper for the Congressional Research Service on Systemically Important or ‘Too Big to Fail’ Financial Institutions. Congressional research Service 7-5700, www.crs.gov/R42150. Accessed on 01/03/14.

they are shielded from any negative effect of those risks. The incentive to support TBTF created the government responsibility of bearing any extreme losses they incurred³⁹.

Government rescue benefited firm's management, owners (shareholders), creditors, depositors, account holders and counterparts. Depending on government assistance, all these stakeholders could be protected from losses. As part of government rescue, management was replaced; for example, the rescue of RBS, Northern Rock and HBOS called for the removal of the then CEOs of the banks. When management believe that losses will lead to their removal, they will prefer to take excessive risk which will guarantee them higher expected profit or returns leading to higher bonuses. Shareholders also bore some losses through stock dilution, which was smaller than if the company had filed for bankruptcy (Labonte, 2013).

As part of rescuing the TBTF banks, the Bank of England (BoE) tightened capital and liquidity standards among banks as part of the prudential regulation. This initiative was supported by the Basel III accord of new international capital requirement among banks. The banks are subjected to higher capital standards and a higher supplementary leverage ratio. The Bank of England (BoE), which has full oversight of bank supervision and regulation, can eliminate TBTF firms by changing their size: banks should be required to sell part of their businesses, divest assets or break up to the point that they are no longer TBTF.

Banks should be prevented from holding or operating in multiple lines of financial business such as banking, investment, insurance and mortgages. If these lines of business can be separated, it will eliminate the TBTF problem. Reducing the firm could reduce the riskiest activities of large firms and make it easier to regulate and monitor their activities. A policy can be established to limit or ban TBTF firms engaging in activities that are deemed to be too risky. For example, banks have been urged not to participate in proprietary trading of private securities with their own funds or engage in derivatives (Labonte, 2013)⁴⁰.

Also, lack of regulatory authority and failed regulation contributed to the TBTF problem in the recent crisis⁴¹. Regulation and supervision could be used to control and guide the banks and financial institutions. The Basel III international agreement on banks' regulation, capital and liquidity standards should be taken seriously (Labonte, 2013).

Finally, the crisis led to the establishment of additional corporate governance reforms to prevent this from occurring again. For example, the Walker Review (2009), Financial Service Bill (2010) and FRC (2012, 2014, 2016). Also, the government created a new Monetary Policy Committee (MPC) headed by the Bank of

³⁹ Bank of England (BoE) Prudential Regulation on Banks: <http://www.bankofengland.co.uk/PRA/Pages/default.aspx>. Accessed 10/03/14.

⁴⁰ Financial Crisis Inquiry Commission, "Governmental Rescues of 'Too Big To Fail' Financial Institutions," Preliminary Staff Report, August 2010, Ch. 3, http://fcicstatic.law.stanford.edu/cdn_media/fcic-reports/2010-0831-Governmental-Rescues.pdf. Accessed on 10/03/14.

⁴¹ Andrew Haldane and Robert May, "Systemic Risk in Banking Ecosystems," *Nature*, vol. 469, January 2011, p. 351. Accessed on 01/03/14.

England (BoE) and a single financial regulator known as the Financial Conduct Authority (FCA) (Hodson and Mabbett, 2009). The purpose of all these reforms and regulation is to cover any overlaps in corporate governance policies and avoid future market failures in UK financial institutions.

4.4 Corporate Governance Lessons from the Financial Crisis

When large banks and other financial institutions were affected during the financial crisis, it created a concern about their corporate governance (Sun et al., 2011). The concern was whether those institutions had proper corporate governance practice before and during the financial crisis. According to Sun et al. (2011), those institutions were involved in the innovation of new financial products, derivative and investment trading, which were highly risky and formed the basis of the crisis. According to Sun et al. (2011), there has been a debate about the extent to which corporate governance contributed to the crisis; this debate has created three different views and positions on the subject, as outlined below⁴².

The first view is that the crisis had little to do with or was unrelated to the companies' corporate governance. According to Sun et al. (2011), researchers have argued that, since the 1970s, corporate governance in the United States, Europe and other countries has improved significantly (Adams, 2009; Cheffins, 2009). For example, companies have introduced independent directors, and implemented board committees such as nomination, audit and compensation committees. Chair/CEO positions have been separated and salaries of company executives have increased to ensure transparency and accountability. Minority shareholders have been protected, institutional shareholders have become more active in monitoring and companies have created value incentives for shareholders (Adams, 2009; Cheffins, 2009).

Also, since the 1990s, corporate governance codes in many countries have improved and other international organisations such as the Organisation for Economic Co-operation and Development (OECD), the Bank for International Settlements, Basel Committee on Banking Supervision, the Securities and Exchange Commissions, Cadbury Report, Combined Code, Financial Reporting Council, the World Bank and the IMF have intensively spread and encouraged the strengthening of corporate governance practices among companies and countries to ensure that investors are protected. Corporate accountability and transparency have improved as a result of these interventions (Rezaee, 2007). The conclusion concerning this argument is that companies were governed satisfactorily before and during the financial crisis (Cheffins, 2009).

However, with no significant correlation between corporate governance and the financial crisis, Cheffins (2009) argues that the sharp decline of stock markets in 2008 did not necessarily relate to firm performance; his argument is based on an empirical study of 37 firms from the S&P 500 index during 2008. He concluded

⁴² The argument on corporate governance lessons from the financial crisis was written by Sun et al. (2011).

that corporate governance in those firms functioned well and did not fail during the financial crisis (Cheffins, 2009; Sun et al. 2012).

The second view of the debate is that the financial crisis was associated with corporate governance policies that were not well implemented among companies. Lack of implementation caused the failure (Sun et al. 2011). According to the OECD Sterling Group on Corporate Governance, there were four weak areas in corporate governance which contributed to the financial crisis: executive remuneration, risk management, board practices and the exercise of shareholder rights (Sun et al. 2011). Each member country agreed to comply with all four areas even before the crisis, but major failure among institutions during the crisis appears to be due to lack of implementation of the principles (OECD, 2009). According to the OECD, an ineffective implementation of existing corporate governance arrangements and principles was the key issue that caused the financial crisis (Sun et al., 2011).

The OECD committee stated that using voluntary codes and corporate initiative is the best way to implement any legislation and regulation regarding corporate governance. The Financial Reporting Council in the UK (2010) states that there were no major problems with corporate governance codes prior to the financial crisis, and the only problem was with the implementation of the codes and principles by companies. If a company can comply with the code, this in itself constitutes good governance (Financial Reporting Council, 2010; Sun et al. 2011).

The third view in the debate is that systemic failure of corporate governance caused part of the financial crisis. Identification of OECD areas of corporate failure in the second debate cannot be agreed with by all stakeholders. Many stakeholders are of the view that the failure of the companies during the financial crisis may not be purely an implementation issue, but a fundamental systemic failure of institutional arrangements supported by shareholder interest, profit maximisation, incentive systems, rational human behaviour, agency problems and efficient markets for corporate control (Sun et al. 2011).

According to Heineman (2008), the board failure during the financial crisis constituted systemic failure of the broad governance movement in the organisation. Caulkin (2009) states that the financial crisis was due to both the failure of the invisible hand of market (board of directors) and a failure of the visible hand of management.

In current times, corporate governance has centred on how to increase shareholders' wealth and how agents pursue self-seeking projects. Caulkin (2009) argues that the Anglo-American corporate governance paradigm troubled the financial industry and the entire economy. Visser (2010) states that greed has been encouraged in our industry due to government policies, institutional arrangement, ideologies and culture. Agents have become self-seeking, leading to executive greed, leveraging and risk transfer, which has also led to banking and financial market greed.

Sun et al. (2011) argue that the Anglo-American model of corporate governance, especially in the US, has permitted or tolerated excess power and wealth at the hands of CEOs, and an opportunity for executives to pursue high-risk activities in

order to enrich themselves at the expense of shareholders, investors and other stakeholders. The Anglo-American model of capitalism has been promoted to the world and evidence shows it led to the collapse of the financial institutions during the crisis.

Sun et al. (2011) support the third debate above and agree that corporate governance reforms in developed countries have generated fruitful outcomes, such as independent boards, establishment of committees, shareholder activism and widely accepted codes and principles as best practices. Sun et al. (2011) further state that the problems of corporate governance can be systemic and fundamental issues which involve models, approaches and the orientation of corporate governance systems.

4.5 Corporate Governance Reforms

From 1918 to 1982, the British government improved and amended the Companies Act laws, industrial laws and insolvency laws practice. The objectives of these amendments were to attract foreign investors, protect workers, and sustain and maintain companies. From 1992 onwards, corporate governance practice was established and has become part of the rules guiding the way businesses should operate. The Cadbury Report (1992, s.2.5) defined corporate governance as the “*system by which companies are directed and controlled*”. In addition to that, in 1995, the Greenbury Report was introduced to help handle remuneration packages for the CEO and other directors. The Hampel Report (1998) was established to help review the Cadbury and Greenbury reports and inform companies about the positive contribution of good corporate governance. Further, the Combined Code was introduced in 1998 to formulate a consolidation of all corporate governance principles in the Cadbury, Greenbury and Hampel reports. However, internal control and risk management in an organisation was address by the Turnbull’s report (1999).

Also, Myners’ (2001) report was established to promote greater shareholder activism and enhance institutional investors. Additionally, the FSA Review (2002) made some changes to corporate governance policies in September 2002 because of significant changes in both European Union and UK regulatory environments. Higgs’ (2003) report focused on the role and effectiveness of Non-Executive Directors (NEDs), which covers the number of meetings the board should have, reporting the committee’s activities annually, together with the attendance records of individual directors. Furthermore, Tyson’s (2003) corporate governance reform report focused on the recruitment and development of NEDs and how board membership could be broadened, and recommended that board diversity in background, skills and experience of NEDs could enhance board effectiveness by bringing a wider range of knowledge on issues relating to corporate performance and improve stakeholders’ relationships.

Additionally, Smith’s (2003) report states that audit committees should act independently from the executive to protect the interests of shareholders in relation to

financial reporting and internal control. Also, in 2003, the Combined Code committee recommended that there should be no concentration of power in the hands of one or two individuals and that at least half of the board should be Independent Non-Executive Directors (INEDs). The Financial Reporting Council (2004) report was set up in March 2004 and included five major reporting bodies: the Accounting Standard Board (ASB), the Auditing Practices Board (APB), the Professional Oversight Board for Accountancy (POBA), the Financial Reporting Review Panel (FRRP), and the Accountancy Investigation and Discipline Board (AIDB). The aim of the FRC committee was to maintain an effective combined code on corporate governance and promote its widespread application.

Myners' (2004) report centred on how managers will be more accountable to institutional investors in terms of delivery performance. Also, the Turnbull Guidance Report (2005) was established to address risks and issues associated with companies hiring external auditors. The report recommended that companies have robust internal controls. Besides, in 2006, the Combined Code corporate governance reform report states that the company chairperson should serve on (but not as chair of) the remuneration committee, where s/he is considered independent on appointment as chair and that the positions of chair and CEO should not be occupied by a single person.

During the financial crisis, the Turner Review report (2009) was established to assess the causes of the global financial crisis in order to make changes to regulation and supervision within the banking systems. In the same vein, the Walker Review (2009) was also established after the financial crisis to help assess the corporate governance issues in the banking and financial industry during the financial crisis. In addition to that, in 2010, 2012, 2014 and 2016, the Financial Reporting Council reviewed available corporate governance codes and encouraged shareholders to monitor the codes as well. Emphasis about the corporate governance reforms was also placed on the board's leadership, effectiveness, accountability, remuneration, high-quality audit, risk management, internal control, and financial and business reporting among the firms.

Various corporate governance reforms took place after the first Cadbury Report in 1992, aiming at protecting shareholders' rights, reducing agency conflict, improving executives' (managers') accountability, ensuring transparency to all stakeholders and conforming to international good governance practice. Every reform addresses one corporate failure or another that happens from time to time. When corporations fail to perform based on expected standards, it means corporate governance policies have also failed to address the relevant issues and therefore corporate governance standards have broken down (Christine, 2006; Wearing, 2005). Continuous reform is needed to cover any overlap in corporate governance policies and avoid market failures. However, whether any new reform (new guidance and codes) is sufficient to help prevent any future occurrences of failed corporate governance, only time will tell.

Table 2 below gives the full details of various corporate governance reforms which have taken place in the UK.

Table 2: Corporate Governance Reforms in the UK

| Report | Recommendations |
|---------------------------|--|
| Wrenbury Committee (1918) | The committee was established to amend the Companies Acts 1908-17, particularly due to the Second World War, which affected the economy, and to attract foreign capital into the country. |
| Greene Committee (1926) | The committee was established to report on the Company Law amendment. Here, a statutory law was proposed for companies to set up an account for their business activities. |
| Cohen Committee (1945) | This formed part of the Company Law Amendment. The committee recommended that shareholders be given a greater degree of control over directors. Directors were also recommended to receive payment on their retirement. |
| Jenkins Committee (1962) | The committee also reported on the Company Act 1948; here, prevention of fraud in companies, duties of directors and the rights of shareholders were recommended. |
| Alan Bullcock (1977) | The committee came up with a recommendation on how to handle industrial action, which was rampant at that time. The idea was to solve industrial disputes and control workers' participation in industrial action. |
| Cork Report (1982) | The committee dealt with insolvency law and practice. They recommended reforms of the UK insolvency law. There were too many companies going bankrupt and that were left to die. Cork advocated a rescue culture and companies' restoration. |
| Cadbury (1992) | The Cadbury committee dealt with the issue of the quality of a company's financial reporting. Their report also outlined board composition, the appointment and independence of non-executive directors, executive directors' contracts and remuneration, and a company's financial reporting and controls. They also required a company to have a minimum of three non-executive directors. The first official definition of corporate governance was established as a system by which companies are directed and controlled. |
| Greenbury (1995) | The Greenbury committee focused mainly on board remuneration, which includes the establishment of a remuneration committee for setting the remuneration packages for the CEO and other directors. Disclosure of directors' remuneration and remuneration policy was recommended. |
| Hampel (1998) | The committee was set up to review the Cadbury and Greenbury reports, aiming to avoid a 'box-ticking' exercise by the companies. The aim was to inform companies about the positive contribution of good corporate governance. Companies were recommended to use corporate governance to offer safeguarding for shareholders' investment through a sound system of internal control and risk management. |
| Combined Code (1998) | The Combined Code was formulated through a consolidation of all principles and recommendations outlined in the Cadbury, Greenbury and Hampel reports. This was updated in 2003, incorporating the recommendations from the Higgs review (2003) and Smith (2003). It states that at least one-third of the board should be non-executive directors. |
| Turnbull (1999) | This committee dealt with internal control and risk management in an organisation and stressed that the responsibility of the board is to ensure that internal control systems are in place and that companies should report on their systems of internal control and risk management to shareholders. |
| Myners (2001) | This was established to promote greater shareholder activism and enhance institutional investors |

| Report | Recommendations |
|------------------------------------|---|
| FSA Review (2002) | The Financial Service Authority made some changes to corporate governance policies in September 2002 because of significant changes in both European Union and UK regulatory environments. This review included assessing the existing rules on corporate governance, making sure that there are continuing obligations encompassing corporate communication, shareholders' rights and ensuring financial information is available for investors. |
| Higgs (2003) | The committee focused on the role and effectiveness of Non-Executive Directors (NEDs), which includes the number of meetings the board should have, reporting the committee's activities annually together with the attendance records of individual directors. Also, the CEO should not at the same time become the chair of the same company. The NEDs should also meet as a group once a year without executive directors being present. The company annual report should indicate whether such meetings have occurred. |
| Tyson (2003) | The committee focused on the recruitment and development of NEDs and how board membership could be broadened. They recommended that board diversity in background, skills and experience of NEDs could enhance board effectiveness by bringing a wider range of knowledge on issues relating to corporate performance and improve stakeholders' relationships. |
| Smith (2003) | The committee states that audit committees should act independently from the executive to protect the interests of shareholders in relation to financial reporting and internal control. The committee states that the role of external auditors and their relationship with companies. This is similar to the Sarbanes-Oxley Act, 2002. |
| Combined Code (2003) | The committee recommended that there should be no concentration of power in the hands of one or two individuals and that at least half of the board should be Independent Non-Executive Directors (INEDs). The Code also stated that, except for smaller companies, at least half of the board, excluding the chair, should comprise NEDs as a determinant of board independence. A smaller company should have at least two Independent Non-Executive Directors. |
| Financial Reporting Council (2004) | This was set up in March 2004 and comprised five major reporting bodies: the Accounting Standard Board (ASB) the Auditing Practices Board (APB), the Professional Oversight Board for Accountancy (POBA) the Financial Reporting Review Panel (FRRP), and the Accountancy Investigation and Discipline Board (AIDB). The aim of the committee was to maintain an effective combined code on corporate governance and promote its widespread application, giving guidance on internal control, influencing EU and other corporate governance developments, maintaining boardroom professionalism and diversity, encouraging company boards and, finally, to help institutional shareholders to interact effectively. |
| Myners (2004) | Assessed institutional investment. This helps to monitor and make managers more accountable for their performance. |
| Revised Turnbull Guidance (2005) | Revised Turnbull guidance was issued in 2006, aimed at encouraging organisations to take account of risks associated with their external auditor leaving the market. They recommended that organisations should disclose more information to shareholders and other stakeholders concerning auditor selection. They also considered the impact of internal control as a way of improving companies. |
| Combined Code (2006) | The Combined Code 2006 suggests that the company chairperson should serve on (but not as chair of) the remuneration committee, where s/he is considered independent on appointment as chair. At least half of the board of directors should be independent NEDs, the positions of chair and CEO should not be occupied by a single person, and Senior Independent Directors (SIDs) should be appointed. The committee also states that boards should undertake a formal and rigorous evaluation of their own performance, and institutional investors should also avoid 'box ticking' when assessing companies' corporate governance. |

| Report | Recommendations |
|------------------------------------|---|
| | Companies should apply formal and transparent procedures when recruiting new directors and NEDs should only be reappointed after six years' service; their reappointment should also be very rigorous. Finally, NEDs can only continue with their service after nine years following annual re-elections and they should be considered as no longer independent. |
| Turner Review (2009) | Assessed the causes of the global financial crisis in order to make changes to regulation and supervision within the banking systems. Turner recommended that firms should have remuneration policies that are consistent with risk management in the company and that remuneration committees should make independent judgements on remuneration, risk and risk management. Finally, international regulatory bodies around the world should help to solve the financial crisis since they contributed to it. |
| Walker Review (2009) | Walker (2009) assessed the corporate governance in the banking and financial industry during the financial crisis. His recommendations included risk management at board level, remuneration incentive, and a balance of skills and experience among directors and executives. Effective board practice and independence was required for a company's performance. Audit, risk, remuneration and nomination committees were recommended. The role of institutional shareholders in engaging and monitoring of board effectiveness was emphasised. |
| The Financial Service Bill (2010) | Regulated banks and other financial institutions on remuneration of executives, rules by FSA and their disciplinary power, short selling and consumer protection. This aimed at avoiding over-risky activities by companies. |
| Financial Reporting Council (2010) | The FRC report (2010) focused on addressing the financial crisis and assessed corporate governance compliance in other listed companies. The report encouraged shareholders to monitor the corporate governance code and ensure that the board followed it. Boards were encouraged to think deeply about their tasks and their implications for the company. |
| Financial Reporting Council (2012) | The FRC report (2012) focused on the board's leadership, effectiveness, accountability, remuneration and relations with shareholders. The code is there to guide board members on how best they can discharge their responsibilities and the training they need for their task. |
| Financial Reporting Council (2014) | The UK Corporate Governance Code (2014) emphasised risk management, internal control, and related financial and business reporting among firms. The report states that the board should also explain to shareholders any risks they will undertake in order to achieve the company's strategic objectives. |
| Financial Reporting Council (2016) | The UK Corporate Governance Code (2016) focused on enhancing high-quality audit and assurance work, proposed revisions to the ethical standard, auditing standards and UK corporate governance code, and provided guidance on audit committees. |

4.6 Conclusion

This chapter discusses the financial services industry in the UK and draws lessons from various corporate governance reforms that have taken place. The sector offers service products such as banking, insurance, mortgage, asset management and mutual funds.

The management of these financial industries goes beyond shareholders (equity governance) to include employees, boards of directors such as audit, remuneration and nomination committees, creditors, debtors and the government (Hopt, 2013; Mehran and Mollineaux, 2012). The sector also requires adequate knowledge and

experience from decision-makers – for example, audit, remuneration and nomination committees – in their discharge of duties and responsibilities to the firm. This knowledge and experience should help the decision-makers in their understanding of financial products, risk management, internal controls and the appointment of members for executive positions. Any failure of responsibility on the part of management and the board will have consequences for the firm's corporate governance.

The financial services industry in the UK has encountered various corporate governance reforms since the 2007/2008 crisis. The aims of these reforms are to protect shareholders' rights, reduce agency conflict, improve executives' (managers') accountability, ensure transparency to all stakeholders, conform to international good governance practice and avoid financial institutions' market failure in the future.

5 THE ROLE AND FUNCTIONS OF THE BOARD AND ITS COMMITTEES

5.1 The Board Structure

Corporate board structure can be classified as either unitary (one-tier) or dual board (two-tier) depending on the country. A unitary board of directors is a form of board structure which is characterised by one single board, which consists of both management and non-executive or independent directors. The unitary board is responsible for all aspect of the company's activities. The shareholders elect the directors of the board at the company's annual general meeting to help manage the company on their behalf (Mallin, 2006). The unitary board structure is predominant in the Anglo-Saxon countries such as the United States, the UK, Ireland, Australia and Canada. The unitary board consists of executives or managers of the company, non-executive directors (NEDs) and independent non-executive directors (INEDs) with no ties to the company (Kojima, 1997).⁴³

A dual board, on the other hand, consists of a supervisory board and an executive board of management. The dual board creates a clear separation between the functions of supervision – that of monitoring – and of management. The duty of the supervisory board is to oversee the direction of the business whilst the management board is responsible for the running of the business. Members of one board cannot be members of the other, creating a distinction between management and control (Mallin, 2006). It is the responsibility of shareholders to appoint the members of the supervisory board whilst the supervisory board appoints the members of the

⁴³ The Executive Directors are employees of the company and operate under a contract for services. Examples are the Chief Executive Officer (CEO), Chief Finance Officer (CFO) and Chief Operational Officer (COO). The Non-Executive Directors (NEDs) and Independent Non-Executive Directors (INEDs) are not employees but operate under a contract of services. The NEDs and INEDs are appointed by the company shareholders to oversee the activities of the executives in the company. The NEDs and INEDs also appoint the executives to run the day-to-day business of the company (Kojima, 1997).

An Independent Non-Executive Director (INED) does not have any material or personal relationship with the company except his/her sitting fees. Unlike a Non-executive Director (NED), who can own shares or probably be a former CEO, CFO or COO in the same company, an independent non-executive director (INED) is an independent member who only comes to provide professional, practical and intellectual advice to the board. INEDs are mostly finance experts, lawyers, IT experts or people with a large amount of working experience in similar industries (Kojima, 1997).

The role of the NEDs and INEDs is to provide strategic advice to the company and monitor and supervise operational activities in the company. They are seen as experts and they form part of the audit, nomination, compensation and compliance or risk committees (CIMA 2006). Due to the criteria for the selection of Independent Non-Executive Directors (INEDs), they are seen as people who give an independent judgement on issues of strategy, performance, resources, appointments and standards of conduct (Kojima, 1997). The executive directors or management are seen as internal directors while NEDs or INEDs are referred to as external directors.

management board (Mallin, 2006). The two-tier board operates in countries such as Germany, Austria, France, the Netherlands, Japan and China (Mallin, 2006).

Both systems (unitary and dual) appoint the members of the managerial body or team, and in one-tier (unitary) systems there is a closer relationship and better information flow among directors (executive and non-executive directors) whilst, in the dual board, there is a more distinct and formal separation between the supervisory board and those being supervised, because of the separation of management board and supervisory board structures (Mallin, 2006). The UK operates a unitary board responsible for the management and governance of the company (Tricker, 1996). Under the unitary board, all executive directors appear to be monitoring and supervising their own performance (CIMA, 2006). In addition to that, in the two-tier structure, members of the supervisory and executive boards meet separately and do not share the same responsibilities, making it difficult for the two boards to interact, exchange views and experiences together, unlike the unitary board (Walker Review, 2009). According to the Walker Review (2009), the two-tier model did not yield better outcomes than the unitary boards in the period before the recent crisis.

The role of the non-executive directors will be discussed in the next section.

5.2 The Role of Non-Executive Directors

The appointment of non-executive directors (NEDs) has been suggested as a way in which a firm can reduce agency costs and information asymmetry problems (Fama, 1980; Lipton and Lorsch, 1992; Jensen, 2001). The “*responsibilities of the NED are to control executive directors to ensure that an individual person or group cannot unduly influence the board’s decisions. Secondly, the non-executive directors can contribute to the general leadership and development of the company*”⁴⁴ (Cadbury, 1992; s.4.10-4.12). According to the Walker Review (2009), NEDs should be knowledgeable and understand the nature of the business in order to contribute during board discussions. The NEDs should be given induction and orientation about the company before they assume responsibility. They should devote between 30 and 36 days’ time commitment for their role. This should be indicated in their letter of appointment. The NEDs are part of the unitary board and they should be able to challenge and test proposals on strategy put forward by the executive.

NEDs are expected to monitor executive directors’ actions and to work with them as part of the board. They have a responsibility for checking the integrity of financial reporting, nomination of executives and executive remuneration. Where necessary, NEDs can remove an executive director and plan for a successor. NEDs should constructively challenge and help develop proposals on company strategy, scrutinise the performance of management in meeting agreed goals and objectives, and monitor

⁴⁴ Non-Executive Directors here include independent non-executive board members as well.

performance (Cadbury, 1992). They also have to put in place systems of risk management which are robust and defensible (Cadbury, 1992)⁴⁵. These duties can sometimes create a conflict of interest, as discussed by Ezzamel and Watson (1997). The OECD (2004) principle also argues that boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest.

However, there are two theoretical views on NEDs; that is, those in favour of more NEDs or those who prefer more executive directors on corporate boards (Fama, 1980; Lipton and Lorsch, 1992; Jensen, 2001). Those who support more NEDs on the board usually base their arguments on three theories: resource independence theory, agency theory, and information asymmetry and signalling. Agency theory proposes that boards dominated by inside executive directors are less accountable (Fama, 1980; Sonnenfeld, 2002). In line with Fama's (1980) argument, NEDs possess some important features. First, they bring independent judgement to the board, which enhances decision-making (Cadbury Report, 1992; Chhaochharia and Grinstein, 2009). Second, they offer their expertise in the form of skills, experience, business contacts and personal reputation (Haniffa and Hudaib, 2006; Baranchuk and Dybvig, 2009). Finally, the existence of competitive and efficient labour markets both within and outside the firm ensures that NEDs perform their monitoring function effectively and efficiently (Fama, 1980; Fama and Jensen, 1983). Also, Fama (1980) and Fama and Jensen (1983) argue that, once top internal management gain control of the corporate board, they are more likely to cooperate among themselves to deprive shareholders of their wealth. This also reduces healthy competition among managers to improve their performance.

Furthermore, Black et al. (2006) argue that the appointment of independent NEDs helps to reduce information asymmetry by credibly signalling insiders' intent to treat outsiders or potential shareholders fairly and, by implication, ensures the safety of their investment. This will also send signals to market insiders to rely on the decisions of experts, as well as an appreciation of the importance of separating the decision-making and control functions (Fama and Jensen, 1983).

However, relating to stewardship theory, there is an argument that, if a corporate board is dominated by NEDs, it may impact negatively on firm performance (Baysinger and Hookisson, 1990; Weir and Laing, 2000; Bozec, 2005). Weir and Laing (2000) assert that NEDs often command less knowledge about the business and find it too difficult to understand the complexities of the company. This problem is that outside directors are usually part-timers who also sit on different company boards, leaving them with very little time to devote to their monitoring and advisory duties (Bozec, 2005; Jiraporn et al. 2009).

By contrast, Nicholson and Kiel (2003) argue that high levels of executive directorships are linked with high access to information, which leads to high quality in

⁴⁵ The Cadbury Report suggests that NEDs should "*be selected with the same impartiality and care as senior executives and they should be selected through a formal process and their appointment should be considered by the board as a whole*" (Cadbury, 1992, p.4.15). The Cadbury Report also states that the calibre of the non-executive members of the board is of special importance in setting and maintaining standards of corporate governance (Cadbury, 1992).

decision-making, which can impact positively on firm financial performance. Crucially, “*outside directors would usually not have the same access to informal sources of information and knowledge within the firm, as a result of that, decisions made by a board dominated by NEDs would be of a lower quality*”, which would then lead to low firm performance (Nicholson and Kiel, 2003; pp.589). It has also been argued by Haniffa and Hudaib (2006) that corporate boards dominated by outside directors tend to hold back managerial initiative and strategic actions as a result of excessive managerial supervision.

Prior empirical evidence regarding the percentage of NEDs and a firm’s financial performance suggests a mixed relationship. The literature indicates that boards dominated by NEDs deliver higher performances (Weir et al. 2002). Weir et al. (2002) used Tobin’s Q and a sample of 311 UK listed firms from 1994 to 1996, in which they reported a positive relationship between the percentage of NEDs and a firm’s performance. Gupta and Fields (2009) examined a US sample of 744 independent NED resignations from 1990 to 2003 to ascertain the value that the market places on board independence. They reported that, on average, the announcement of independent NED resignations results in a 1.22% loss in a firm’s market value. This suggests that investors appreciate board independence, as independent boards are associated with greater monitoring of managerial behaviour (Gupta and Fields, 2009). Also, Mangena and Tauringana (2008) reported that boards dominated by NEDs perform better, based on a sample of Tunisian and Zimbabwean listed firms respectively.

By contrast, other researchers have reported a negative percentage of NEDs link with firm performance (Yermack, 1996; Agrawal and Knoeber, 1996; Laing and Weir, 1999). For example, Bozec (2005), using a sample of 25 Canadian firms from 1976 to 2005, finds that the relationship between the percentage of NEDs and performance is negative.

Similarly, Sanda et al. (2005) report that Nigerian firms with a low percentage of outside directors perform better than those with more NEDs. This suggests that NEDs can bring independence and experience to bear upon board decisions. Vefas and Theodorou (1998), Weir and Laing (2000) and Haniffa and Hudaib (2006) indicate that the percentage of NEDs has no impact on performance. For example, Hermalin and Weisbach (1991) used a sample of 142 US listed firms in which they reported no relationship between board composition and performance. Vefas and Theodorou (1998) conducted a study in the UK to find out the wealth effects of outside directors, which was statistically insignificant. Furthermore, Haniffa and Hudaib (2006) used a sample of 347 Malaysian listed firms, in which they reported a statistically insignificant relationship between the percentage of NEDs and performance.

5.3 Board of Directors and the Establishment of Committees

The board of directors is elected by shareholders to scrutinise the highest decisions within the company (Denis and McConnell, 2003; Fama, 1980; Vafeas and The-

odorou, 1998). Board of directors exist not only because of state or country incorporation laws but also because the boards serve as market solutions to organisational problems⁴⁶ (Bozec, 2005). According to Kang et al. (2007), the board of directors is part of the company's internal governance mechanism which ensures that the interests of shareholders and managers are closely aligned.

The directors of the board perform the dual functions of monitoring and advising the executive on important decisions concerning the company (Baldenius et al. 2014). This statement has been supported by Harrison (1987), who argues that there are two generic types of board committee – that is, monitoring or oversight and management supporting or operating. The monitoring or oversight is intended to protect shareholder interests by providing an objective and independent review of the corporate executive. The operating board committees advise management and the board on any major business decisions (Jensen and Meckling, 1976; Fama and Jensen, 1983). The board manages the business and affairs of the corporation (Eisenberg, 1992). Fama and Jensen (1979) stated that the primary responsibility of the board is to provide expert information, evaluate existing information and ratify the firm's long-term strategies and investment decisions.

The monitoring and advising of upper management is to reduce agency conflicts (Klein, 1998; Fama and Jensen, 1983). Shareholders want managers to work in their interest; that is, maximise shareholders' wealth. Managers, in contrast, may maximise their own personal satisfaction by engaging in self-dealing activities (ibid). Agency theory suggests that a central monitoring function of the board is to ensure that corporate activities are properly audited. The board should also ensure that directors and senior management are adequately remunerated and nominate qualified individuals for appointments to fill directorial and top management positions (Chhaochharia and Grinstein, 2009; Jiraporn et al. 2009)⁴⁷. Almost every corporate governance code has called for institutions to establish board committees in order to help improve board efficiency (Cadbury Report, 1992; Combined Code, 1998 and 2006; Sarbanes-Oxley Act, 2002).

The establishment of subcommittees covers areas such as auditing, remuneration, nomination, etc. (Charkham, 2005; FRC, 2014). These committees are appointed to assist in the dispatch of business activities by considering more detail than would be convenient for the whole board. Second, the committees are established to increase objectivity because of inherent conflicts of interest such as executive remuneration, etc. The Cadbury Report recommended that audit and remuneration committees should be formed and also proposed that a nomination committee should also be established in order to bring transparency to the appointment of board members. This has also been confirmed by the Combined Code (2006) and

⁴⁶ According to Monks and Minow (2004), the board serves as the link between the people who provide capital (the shareholders) and the people who add value to the capital (the managers). The board also becomes the liaison between either the concentrated or dispersed shareholders of a company. Ibrahim and Angelidis (1994) stated that the board holds the final accountability and responsibility for corporate success or failure.

⁴⁷ As formulated in the OECD Corporate Governance Principles (2004), which state that Board members should act on a fully informed basis, in good faith, with due diligence and care and in the best interest of the company and the shareholders.

the Financial Reporting Council (2012; 2014 and 2016), which states that there should be a nomination committee to lead the board appointment processes. Jiraporn et al. (2009), using data from the investor responsibility research centre (IRRC), argue that board committees help to improve board efficiency.

The empirical evidence on the role of the board and board subcommittees shows mixed results. Wild (1994), Chhaochharia and Grinstein (2009), Sun and Cahan (2009) and Harrison (1987), all using US data, indicate that there is a positive result between board committees and firm performance. For example, Wild (1994) used a sample of 260 US firms from 1966 to 1980 to examine market reaction before and after the establishment of audit committees. His evidence suggested that their presence can enhance managerial accountability to shareholders. Harrison (1987) argued that the composition of board committees helps in bringing individual directors' specialist knowledge and expertise to bear on the board decision-making process. He stated that it allows the main board to devote attention to specific areas of strategic interests and responsibility.

Evidence provided by Karamanos and Vefas (2005) using a sample of 275 *Fortune* 500 firms indicated that the presence of audit committees is positively associated with financial performance. Mangena and Chamisa (2008) used a sample of 81 South African listed firms and concluded that the presence of an audit committee significantly reduces the possibility of a firm being suspended from the stock exchange. This means that the presence of audit committees improves internal monitoring, reduces internal fraud and enhances compliance with corporate regulations. Vefas (1999) used a sample of 606 large US listed firms, in which he documented a positive relationship between the establishment of nomination committees and the quality of new director appointments. This means that a nomination committee can improve board quality, which can improve the effectiveness with which it carries out its monitoring and advisory roles. In separate studies, Chhaochharia and Grinstein (2009) and Sun and Cahan (2009) each used a sample of US listed firms in which they reported a significant decrease in CEO compensation for those companies that had compensation committees compared with those without compensation committees. This suggests that the establishment of independent compensation committees is linked with better monitoring of managerial compensation (Chhaochharia and Grinstein, 2009; Sun and Cahan, 2009).

In contrast, other researchers have evidence that the presence of board committees impacts negatively on firm performance. For example, Main and Johnston (1993) used a sample of 220 large British listed firms to examine the role of the remuneration committee in British boardrooms. They reported that the presence of a remuneration committee is associated with higher executive pay, which reduces shareholder value. Similarly, Vefas (1999) investigated 307 US listed firms from 1990 to 1994, and he reported a negative relationship between the establishment of board committees (such as audit, remuneration and nomination) and the value of a firm. Also, Yermack (1996), Klein (1998) and Agrawal and Knoeber (1996) all find a negative relationship between board compositions and firm performance. Agrawal and Knoeber (1996) argue that firm performance is negatively related to

the percentage of outsiders on the board; they state that boards are not optimally constructed to maximise firm value.

Finally, other research studies suggest no empirical relationship between board committees and performance (Klein, 1998; Vafeas and Theodorou, 1998; Laing and Weir, 1999). Klein (1998) used a sample of 486 US firms over the period 1992 to 1993 to examine the association between the presence of audit, compensation and nomination committees and financial performance, but found no statistically significant relationship. Klein (1998) demonstrated that her result is robust irrespective of the changes in the composition of the committee's membership. Vafeas and Theodorou (1998) used 250 UK listed firms in 1994 to investigate the impact of audit, remuneration and nomination committees on the performance of these companies. They found no evidence in favour of the idea that the existence of the three board committees significantly affects financial performance. Further, studies conducted by Laing and Weir (1999), Weir et al. (2002) and Bozec (2005) using data from the UK indicate that the establishment of a board committee has no significant impact on the firm's financial performance. Furthermore, Dulewicz and Herbert (2004) use data from the US and ascertain that the establishment of a board committee has no significant impact on the firm's financial performance.

Finally, Hermalin and Weisbach (1991), Daily and Dalton (1992) and Daily and Dalton, (1992) find no relation between board composition and firm performance; their view is that the relative percentage of inside (outside) directors has no bearing on how well firms do.

The establishment of key board committees such as audit, remuneration and nomination, and board gender diversity are discussed in the next sections.

5.3.1 *The Audit Committee*

The audit committee is one important committee for a board. The Smith Review made clear the important role of the audit committee, such as acting independently from the executive and ensuring that the interests of shareholders are protected in relation to financial reporting and internal control (Smith Review, 2002). The audit committee role in terms of '*oversight*', '*assessment*' and '*review*' indicates the high-level overview that audit committees should take and also ensures that they have adequate systems of control in place. They are also responsible for reviewing the scope and outcome of the audit and to ensure that the objectivity of the auditors is maintained, such as reviewing of audit fees and fees paid for any non-audit work, and the independence of the auditors. The committee serves as a bridge between the internal and external auditors and the board, in order to ensure that the board is fully aware of all relevant issues related to the audit. The committee may also be involved in arrangements for whistle-blowers and also assess any systems in place to identify and manage financial and non-financial risk in the company (Mallin, 2006). The Combined Code (2006) states that the board should establish an audit committee of at least three members – or two for smaller companies – and

the members should all be independent non-executive directors and at least one should have relevant experience in that area (Combined Code, 2006).

The Financial Reporting Council (FRC) guidance on audit committees, which was formerly known as the Smith Report, was first published in 2003 and later updated in 2008 and 2012. Other reports such as the Cadbury Report (1992) and the Combined Code (2006) comment on the role and duties of the audit committee. The aim of these reports is to assist company boards in implementing a section of the UK Corporate Governance Code regarding audit committees and to assist directors serving on audit committees in carrying out their role (FRC 2012; Mallin, 2006).

The audit committee should ultimately be responsible for the appointment, performance assessment and dismissal of the Head of Internal Audit or outsourced Internal Audit Provider (ICGN, 2009). They should meet regularly with the firm's external and internal auditors to review the company's financial statements, audit process and internal accounting controls. This reduces agency costs and information asymmetry, by facilitating the timely release of unbiased accounting information by managers to shareholders (Klein, 1998). They may also help to minimise financial fraud and increase the firm's performance (Klein, 1998). The Combined Code (2006) states that the board should establish an audit committee of at least two or three members, for smaller companies, where members should all be independent non-executive directors and at least one should have relevant experience in auditing.

The role and responsibility of the audit committee, according to the FRC and ICAEW guidance, are to monitor the integrity of the financial statement, review all audit fees, review fees paid for any non-audit work and check the independence of the auditors. It is also responsible for reviewing internal financial controls and risk management, making recommendations to the board regarding appointment, reappointment and removal of external auditors and approving remuneration for the board and external auditors (FRC 2012; ICAEW, 2014; Combined Code, 2006; Cadbury Report, 1992). The audit committee should ultimately be responsible for the appointment, performance assessment and dismissal of the Head of Internal Audit in the company (ICGN, 2009). The audit committee meets regularly with the firm's external and internal auditors to review the company's financial statements, audit process, risk and internal controls, (FRC 2012; ICAEW, 2014).

The audit committee serves as a bridge between the internal and external auditors and the board, should be involved in arrangements for whistle-blowers, and assess any systems in place to identify and manage financial and non-financial risks in the company (Mallin, 2006). Once these responsibilities take place, the audit committee will reduce agency costs and information asymmetry as it helps to facilitate release of unbiased accounting and financial information by managers to shareholders in a timelier manner (Klein, 1998). Wild (1994) finds a significant increase in the market's reaction to earnings reports released after audit committee formation. This means that, once companies form an audit committee, it will have a significant positive impact on their earnings. However, Menon and Williams (1994) suggest that the mere formation of an audit committee does not mean that

the committee is actually relied on by the board of directors to enhance its monitoring ability.

To reduce information asymmetry, it is recommended that the audit committee should be independent and non-executive members of the board (FRC 2008 and 2012). This assertion has been supported by the Olivencia Report (1998), stating that the audit committee should be composed of independent members. Bedard et al. (2004) argue that, due to the financial reporting oversight of the audit committee, it is better for its members to be independent. Cohen and Hanno (2000) state that independent audit committee members help to evaluate management decisions regarding risk assessment. Research by Klein (1998) and Dechow et al. (1996) argues that the inclusion of audit committee members as independent helps to minimise financial fraudulent activities in the company. This argument has been supported by Pucheta-Martinez and Fuentes (2007), McMullen (1996), Maassen (2002) and Beasley (1994), stating that the inclusion of the audit members on the board has a positive impact on the firm and improves both the internal and external reporting quality. McMullen (1996) and Maassen (2002) state that the function of the audit committee helps to reduce illegal activity and prevent fraudulent financial reporting. Beasley (1994) argues that audit committees play an important role in preventing and detecting management fraud because audit committee members may be often the first non-management personnel to identify a potential irregularity. The audit committee members' ability to probe decisions made by management helps in assessing various management decisions (Gendron et al. 2004).

Further studies, by Carcello and Neal (2003), find a positive relation between independent audit committee and company financial reporting disclosure. Good financial disclosure creates value and goodwill for a company. Siagian and Tresnaningsih (2011) support the Carcello and Neal (2003) argument by stating that directors and audit committees that are independent from management should improve the firm's reporting system and the quality of reported earnings because they are not subject to potential conflicts of interest that reduce their monitoring capacity. The audit committee should be made up of independent directors with experience and the ethical repute of taking the correct decisions in the firm's interest, along with other members. Research conducted by Conyon (1994) indicates that 90% of large UK quoted firms had audit committees in 1993. Supporting Conyon's (1994) research, Collier (1993) analyses audit committee adoption for 142 UK firms and argues that the adoption of audit committees among companies is in response to their agency cost of equity, debt and for information asymmetry.

Empirically, the evidence regarding the relationship between audit committee and firm financial performance shows mixed results (see, for example, Carcello et al. 2002; Carcello and Neal, 2003; Felo et al. 2003; Van der Zahn and Tower, 2004; Choi et al. 2004; Karamanou and Vafeas, 2005; Defond et al. 2005; Chan and Li, 2008; Davidson et al. 2005; Bedard et al. 2004; Chtourou et al. 2001; Klein, 1998; Bradbury et al. 2006; Yermack, 1996; Abdul Rahman and Ali 2006; Klein, 1998; Zha, 2006) showing different empirical results.

Furthermore, Carcello et al. (2002) examine board characteristics and audit fees; their findings indicate that board independence and audit fees are positively correlated. They argue that the independent audit committee demands higher audit quality beyond normal standards, hence, external auditors charging higher fees. In similar studies, Carcello and Neal (2003) and Felo et al. (2003) document a positive relation between audit committee independence and financial reporting quality. Van der Zahn and Tower (2004) conducted research on the relationship between audit committees and earnings' management using a sample of 485 firms from Singapore between 2000 and 2001. Their findings indicate that audit committee members who are more independent are also more effective, diligent and independent in producing earnings management. Choi et al. (2004) find that larger audit committees are effective and include members with varied professional expertise to monitor financial reporting practices. Research by Karamanou and Vefcas (2005) finds that, in firms with effective board and audit committee structures, managers are likely to make good earnings' forecasts and their forecasts are likely to be precise and accurate and eventually become more favourable to market response. This empirical research shows that a good audit committee is linked to higher-quality financial disclosure for the firm.

Another piece of research on audit committees having a positive impact on firm performance was carried out by Defond et al. (2005), which states that the announcement effect of 850 newly appointed outside directors to audit committees between 1993 and 2002 shows a positive significant abnormal return to the firms. Chan and Li's (2008) research findings indicate that audit committees that are independent result in positive firm value. This means that the independent member is not under any influence. Their research also shows that all three of the committees – audit, nominating and compensation – will have a positive impact on the firm since their members' knowledge and experience can be shared during board meetings.

The establishment of audit committees can also have a negative impact on firm performance. This has empirically been researched by Davidson et al. (2005), who studied a sample of 434 listed Australian firms during the 2000 financial year; their findings indicate that non-executive directors on the audit committee board are found to be significantly associated with lower earnings' management for the firm. Bedard et al. (2004) find that audit committee independence is negatively associated with the likelihood of aggressive earnings' management. Research by Chtourou et al. (2001) and Klein (1998) find that independent directors on the audit committee are negatively associated with earnings' management. Also, Bradbury et al. (2006) researched board size and audit committee size in firms in Singapore and Malaysia, showing significant correlation with Tobin's Q as a measure of firm's value. This result is consistent with the findings of Yermack's (1996) research where a sample of 452 large US industrial corporations between 1984 and 1991 shows that a small board of directors is more effective. It appears that a large audit committee size and large board size may not be good for the company; instead, a small board size and small audit committee size may help decisions to be made quickly.

Another piece of research on audit committees shows no significant relationship with firm performance. For example, Abdul Rahman and Ali (2006) find no significant relationship between audit committee independence and earnings' management in Malaysian firms. Klein (1998) finds no evidence of a significant association between an audit committee which is independent and earnings' management. In another study, Zha (2006) uses a sample of firms from 2002 to 2004 immediately after the release of the code of conduct by the Chinese Securities Regulatory Commission (CSRC), showing that the presence of audit committees has a positive impact on increasing earnings' quality while audit committee independence has no significant impact.

5.3.2 *The Remuneration Committee*

Remuneration of directors has been a subject of discussion and debate as part of an effort to establish good corporate governance among owners of capital. Mallin (2006) describes the remuneration committee as a 'hot' issue which attracts a lot of attention from investors and the general public. The board of directors plays an important role in safeguarding shareholder interests by designing executive compensation contracts to monitor CEOs and executive directors' behaviour (Hermalin and Weisbach, 2003). Management compensation is seen as salary, bonus, performance-based remuneration in shares, share options, superannuation payment, commission, company car, private health insurance or participating in profit sharing with shareholders, large pension contributions and other miscellaneous earnings from the company. These benefits are also known as 'fat cat payment' (Conyon et al., 1995; Finkelstein and Hambrick, 1989; Gregg et al. 1993; Main and Johnston, 1993). The salary and other fringe benefits are determined by the remuneration committee and are based on a director's qualifications, experience, past success and firm size (Herdan et al. 2011; Conyon and Peck, 1998). The directors and CEOs expect salary increases on a yearly basis. For example, a newly elected CEO or director will expect a higher salary and other benefits than the current CEO (Herdan et al. 2011).

The principle concerning CEO or directors' pay is that no one should take part in determining his or her own pay (Conyon and Peck, 1998). The Cadbury Report (1992) states that boards should appoint remuneration committees, consisting mainly of Non-Executive Director (NED), and chaired by a NED. The committee should propose to the board the remuneration of the executive directors taking into consideration outside advice. The executive directors should play no part in decisions concerning their own remuneration (Cadbury Report, 1992).

The Greenbury Committee (1995), which deals with management pay reform, recommended the adoption of remuneration committees consisting mainly of NEDs or outside directors. The Turner Review (2009) recommended that the remuneration committee should monitor risk in the company closely as part of their decision-making.

The Walker Review (2009) recommended that the chairperson should encourage contributions from the directors when it comes to decision on risk. The risk committee should also be separated from the audit committee for all FTSE 100-listed banks and insurance companies and that the Chief Risk Officer (CRO) should be appointed to the board of banks and other financial institutions (BOFIs), so that s/he can participate in risk management and oversight process at the highest level (Walker Review, 2009).

The Financial Service Authority (FSA, 2012) amended the remuneration code relating to banks, building societies and investment firms. The code was classified into three parts: that is, first, assessment of performance on an individual level; second, the nature of the business or unit concerned; third, the overall results or performance of the firm; the aim of the amendment is not to reward failure.

According to the Financial Reporting Council (FRC, 2014), executive directors' remuneration should be designed to support any long-term success of the company. Performance of executives should be transparent in order not to attract any ambiguity. The remuneration committee should also reward NEDs based on the time and responsibilities they commit to the organisation.

The Combined Code (2008) and OECD Principles of Corporate Governance (2004) recommended a long-term remuneration contract for directors since it will give the principal enough time to observe the long-term outcomes of any financial activities in the company (Melis et al. 2012). The committee should design an effective compensation contract so that executives or management will have an incentive to behave consistently with shareholders wishes (Daily et al. 1996; Conyon and Peck, 1998). Williamson (1985) argues that the absence of an independent remuneration committee is akin to an executive writing his or her employment contract with one hand and signing it with the other hand. According to Williamson, the establishment of a remuneration committee helps to exercise board control and design reward structures for management which are consistent with the interest of shareholders (Conyon et al. 1995; Ezzamel and Watson, 1997; Main and Johnston, 1993). However, Abugu (2012) argues that the existing rules regarding monitoring of directors' remuneration packages are ineffective, as they do not address directors' perks, expenses and other perquisites of office. According to him, the perks and other expenses claimed are more valuable to the director than the actual remuneration package and contribute to avenues for using company capital.

The remuneration committee was established to reward incentives to agents in ways that benefit the principal (shareholder) and make directors accountable (Abugu, 2012). The interests of shareholders (principal) and executive directors (agents) should be aligned (Melis et al. 2012). Holmstrom (1979) states that the principal is always better off with more information about agent behaviour than when s/he has less information. Bolodeoku (2007) states that remuneration packages should be regulated in order not to create a burden to shareholders. However, according to Herdan et al. (2011), many agents (managers) work more efficiently when they receive strong motivation such as perks, bonuses, fringe benefits and stock options from the principal.

Remuneration of directors and company performance has been an issue of concern in some Anglo-Saxon countries such as the UK and America, which focus more on the shareholder model (Solarz, 2006). For example, in the UK, investors and shareholders were shocked after the news about huge payments of £1.7 billion in bonuses to the managers of the Royal Bank of Scotland (RBS), despite the bank making a £3.6 billion loss during the 2009 financial year. This shows that executives in companies award themselves compensation packages irrespective of the company performance (Solarz, 2006). The board members working on the remuneration committee at RBS should have stopped this bonus payment, considering the £3.6 billion losses from the bank after the financial crisis. Shlomo et al. (2013) state that high remuneration benefits can lead to excessive risk-taking and negative externalities, as employees will not take into account the potential negative effect of any decisions on their firms and society.

Empirical evidence on remuneration committees shows mixed results. For example, Main and Johnston's (1993) evidence shows that management pay was significantly higher in companies that adopted remuneration committees. Murphy (1998) investigates the relative success between cash compensations, firm performance and market-sector performance between 1970 and 1996. His research reveals no clear correlation between cash compensation and manager performance. However, remuneration of managers was correlated positively with firm performance, but remuneration was negatively correlated with market-and-sector performance. Gregg et al. (1993) examine 288 large UK firms from 1983 to 1991. Their evidence shows that directors' pay relates strongly to firm size. They argue that a 50% increase in a firm's revenue results in a 10% increase in directors' remuneration. Also, during 1998, Conyon and Peck studied remuneration committees and the executive pay of 94 UK companies in the period 1991-1994. They report that the proportion of non-executive directors on a remuneration committee is positively related to senior management pay and also found that pay was sensitive to performance. They also state that compensation levels are greater in firms that adopt compensation committees. In response to the Conyon and Peck (1998) research, Anderson and Bizjak (2003) studied 110 large firms from the New York Stock Exchange (NYSE), which showed that CEO compensation is actually lower in firms where the CEO is a member of the compensation committee. This shows that compensation committees organised by directors seek the best interest of the shareholders (Anderson and Bizjak, 2003). Also, Lewellen (2012) studied 50 US firms from 1942 to 1963 to ascertain the relationship between CEO compensation and firm performance. His research shows that generating profit strongly depends on CEO compensation.

Research by Murphy (1998) and Gibbons and Murphy (1992) states that the pay relating to performance is smaller in large firms and that the optimal pay performance relation may decline with firm size for two reasons: that is, if shareholder wealth increases with firm size and the CEO's direct effect on firm value may decrease with firm size. O'Reilly et al.'s (1988) research demonstrates that CEO compensation is greater when CEOs from different companies sit on a firm's compensation committee. Crespi and Gispert (1998) studied large Spanish companies to ascertain the relationship between board remuneration and firm performance.

Their research shows that remuneration has a stronger or positive impact on the firm book values than for stock market measures.

Other empirical research on remuneration committees shows a negative impact on the firm. For example, Bertrand and Mullainathan's (2001) research shows that CEO compensation is less strong or weak when the company is better managed. This means that a well-managed company can handle its remuneration to the satisfaction of both shareholders and executives. John and John (1993) studied top management compensation in firms and their results show a negative relationship between pay-performance and leverage. They concluded that managerial compensation could play a role in minimising agency cost. Gregg et al. (2010) studied large UK firms and found that CEO pay has a negative or weak impact on firm performance. After their research, the data was split into two time periods; that is, 1983-1988 and 1989-1991. They found that CEO pay is positively related to firm performance for the first time after the split.

Finally, other empirical research on remuneration committees shows no significant impact on firms. For example, Daily et al. (1998) find no link between excessive pay received by CEOs and remuneration committees which are dominated by executive directors. Newman and Mozes (1999) supported this research when they analysed 161 firms from the US in 1992 and stated that there is no relationship between CEO pay and executive director participation in the remuneration committee. This means that executive directors do not necessarily influence CEO pay during remuneration meetings.

5.3.3 The Nomination Committee

The empirical research on nomination committees is still at its early stages. The role of the nomination committee is not as debatable as the remuneration and audit committees yet the nomination committee is responsible for the selection of the board members such as audit, remuneration, CEO and chairperson (Huse et al. 2011; Ruigrok et al. 2006). The nomination committee helps determine the company's leadership, which is very important for the survival of the company (Tarry 2009; Vafeas, 1999). Eminent and Guedri (2010) state that the mission of the nomination committee is to define the profiles of directors needed for the board and recommend future director candidates and in so doing reduce the influence of the CEO on the selection process. The role of the nomination committee is to appoint personnel to the board (Cadbury Report, 1992). In the past, nomination of personnel to the board was carried out through personal connections, making it difficult for the board to obtain people with the relevant skills and experience to help the company to develop (Combined Code, 2006).

According to the Financial Reporting Council (2014), the nomination committee should ensure that the appointed board members have the appropriate balance of skills, age, gender, educational qualifications, experience, independence and knowledge of the company to enable them to discharge their duties successfully. Also, members should receive induction and should regularly update and refresh

their skills and knowledge of the company. Byrne (1971) states that individuals with similar backgrounds may share similar life experiences and values and, for this reason, they may find interaction with each other easier than individuals with different experiences and values. The nomination committee should also plan for succession in case a board member leaves (Combined Code, 2006). To reduce agency conflict, the committee should improve board independence and the quality of appointed directors (Vefas and Theodorou, 1998; Vefas, 1999).

The nomination committee should comprise independent non-executive directors and it should be chaired by the chairperson or an independent non-executive director. The chairperson cannot chair the nomination committee when it is dealing with the appointment of a successor to his or her role. The nomination committee members should not be re-elected for more than six years and consideration should be given to gender, diversity and the time commitment of board members to the board (FRC, 2014; Cadbury Report, 1992). Westphal and Milton (2000) state that a board committee member representing a minority on the board is likely to favour new board members who are similar to her or him. The size of the nomination committee ranges from three to five, depending on the size of the company (Tarry, 2009). In the past, the nomination committee was seen as serving as a rubber-stamping exercise where it would take recommendations both from the CEO and the Chair. Now, the nomination committee has brought a more rigorous and professional approach to the selection of board members. The committee is now engaged in assessment of the company, executing strategy for the company and seeking external advice when the need arises (Tarry, 2009). Shivdasani and Yermack (1999) show that CEO involvement in board selection is associated with a lower proportion of outside director appointments.

In making the nomination committee more effective, the Combined Code (2006) advocated a formal, rigorous and transparent procedure for the appointment of new directors and stated that the committee should lead in the appointment of the board. Some nomination committees only meet when there is a vacancy to be filled during the year (Callahan et al. 2003). According to Conyon and Mallin (1997), firms in the UK have been very slow in adopting nominating committees, which shows a symptom of failure of the corporate governance system. McKnight and Weir's (2009) research also states that nomination committee existence could be costly and yet there has been consistent recommendation of nomination committee adoption in UK corporate governance regulation since 1992. The adoption of the nomination committee will help the board to create a well-composed succession process and an effective board.

The empirical evidence on nomination committees is limited. Callahan et al. (2003) use principal component analysis (PCA) to ascertain management involvement in directors' nomination during a sample of 106 firms from 1989 to 1992 via a PCA method. Their result shows a positive relationship between management participation in the director selection process and corporate performance. Again, empirical evidence shows that nominating committee meetings are associated with poor performance, and the presence of the CEO and other directors' involvement in the nominating responsibility process is positively related to firm performance

(Callahan et al., 2003). Zajac and Westphal (1996) state that the presence of independent non-executive directors (NEDs) in the nomination committee and selection process will be positively associated with firm performance. Kaczmarek et al. (2012) use a panel of FTSE 350 companies from 1999 to 2008 to find the increasing presence of female or non-British nationals on nomination committees. Their research shows a positive impact between board gender diversity and performance. They also reported that the presence of the CEO on the nomination committee shows a positive impact on the firm.

Vafeas (1999) use a sample of 606 large US listed firms and find a positive relationship between the establishment of nomination committees and the quality of new director appointments. This means that the nomination committee can improve board quality, which can in turn improve the effectiveness with which it carries out its monitoring and advisory roles. Vafeas and Theodorou (1998) use 250 UK listed firms in 1994 to investigate the impact of audit, remuneration and nomination committees on the performance of these companies. They find no evidence in favour of the idea that the existence of the three board committees significantly affects financial performance. Vafeas and Theodorou (1998) argue that nomination committees help to achieve good governance in firms, since they ultimately determine the quality of appointed directors. Shivdasani and Yermack (1997) state that CEO membership in nominating committees is associated with fewer independent directors on the board. This means that CEO involvement in the nomination committee will result in lower stock price reactions at the announcement of non-executive director appointments.

The next section shows the function of the board and discusses the gender diversity representation within the board.

Table 3: The Board Committees and their Functions

| Audit Committee | Remuneration Committee | Nomination Committee |
|---|---|--|
| <ul style="list-style-type: none"> • The board should establish an audit committee of at least three, or in the case of smaller companies two, independent non-executive directors. • The audit committee should be made up of independent non-executive directors, with at least one individual having expertise in auditing or relevant financial experience. • The committee monitors the integrity of the firm's financial statement. • The committee reviews external auditing independence. • The committee checks non-audit services. • The committee provides an oversight of internal controls, approval of financial statements and other significant documents prior to agreement by the full board. • Ensure high-level compliance to all stakeholders. • Reporting financial information to the shareholders. • The committee makes recommendations to the board, for it to put to the shareholders for their approval in a general meeting, in relation to the appointment, re-appointment and removal of the external auditor. • Carries out investigations and may deal with matters reported by whistle-blowers. • Reviews the company's risk management systems. | <ul style="list-style-type: none"> • The board should establish a remuneration committee of at least three, or in the case of smaller companies two, independent non-executive directors. • The company chairperson may also be a member of this committee, but not its chair. • The remuneration committee decides on the remuneration of executive directors, and senior executives. • This committee should be made up entirely of independent non-executive directors. • The committee formulates a written remuneration policy that attracts and retains appropriate talent. • The remuneration committee offers a competitive basic salary and fringe benefits that can attract and retain people of the right calibre. • Decides on performance-related rewards such as bonuses linked to medium- and long-term targets, shares, share options and pension benefits. • The committee should compare executives' benefits relative to other companies. • The committee should ensure that remuneration for non-executive directors does not include share options or other performance-related elements. • The committee should avoid rewarding poor performance. Compensation of directors should reflect company's performance. • If the remuneration committee appoints consultants, they should be identified in the annual report and a statement made as to whether they have any other connection with the company. • The committee should invite shareholders to approve all new long-term incentive schemes. | <ul style="list-style-type: none"> • There should be a nomination committee which should lead the process for board appointments and make recommendations to the board. A majority of members of the nomination committee should be independent non-executive directors. The chairperson or an independent non-executive director should chair the committee, but the chairperson should not chair the nomination committee when it is dealing with the appointment of a successor to his or her role. • There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board. • The search for board candidates should be conducted, and appointments made, on merit, against objective criteria and with due regard for the benefits of diversity on the board, including gender. • The board should satisfy itself that plans are in place for orderly succession for appointments to the board and to senior management, so as to maintain an appropriate balance of skills and experience within the company and on the board and to ensure progressive refreshing of the board. • The nomination committee should make available its terms of reference, explaining its role and the authority delegated to it by the board. • The nomination committee should evaluate the balance of skills, experience, independence and knowledge on the board and, in the light of this evaluation, prepare a description of the role and capabilities required for a particular appointment. • The committee should appoint non-executive directors for specified terms subject to re-election and to statutory provisions relating to the removal of a director. |

5.3.4 Gender Diversity

According to Van der Walt and Ingley (2003), gender diversity is a representation of different ages, genders, ethnicity, culture, religion, independence, knowledge, educational and professional background, skills, expertise and experience appointed into the boardroom to help in the decision-making process. For the purpose of this study, we define gender diversity as the case where the nomination committee includes both male and female members to serve on the board. This creates gender diversification and welcomes divergent views to the board. The nomination committee does not recruit solely because of gender but to offer a level-playing field to anyone who has the potential to help transform the firm positively⁴⁸. According to Eagly and Johannesen-Schmidt, (2001) women can be perceived as people who lack the requisite managerial skills and the same level of competency as men. They are also considered as ‘communal’ rather than possessing the ‘agentic’ qualities usually associated only with men. These qualities are viewed as being essential attributes of a good leader. A study by Hillman et al. (2002) argues that women have different backgrounds and characteristics that make them unique when compared with conventional directors. Women are known to ask tough questions and bring unity into leadership positions (Kramer et al. 2007).

Generally, the debate on gender diversity involves two arguments (Carter et al. 2010). The first argument holds the view that women with competent skills, experience and qualifications deserve the opportunity to serve on corporate boards. The second argument suggests that positive gender diversity amongst corporate director’s results in better governance and enhances the performance of a firm. This second argument is that the representation of women on the board should serve solely to improve performance, otherwise firms will be engaging in ‘tokenism’.⁴⁹ If the nomination committee can show the importance of the presence of women on the corporate board, it will be easier for them to build a business case about their competency to the shareholders (Carter et al. 2010; Patterson, 1997).

The appointment of women to the corporate board will enable them to share their knowledge and experience and increase divergent views and opinions within the corporate boardroom. All things being equal, people perceive things differently irrespective of their gender, and a combination of males and females participating in corporate boardroom discussions can help yield better results for the firm. This is supported by McLeod and Lobel (1992), who state that individuals with different opinions from diverse groups can improve the quality of decision-making and take into account the views of underrepresented groups. A study by Perryman et al. (2016) views that heterogeneity in decision-making by the corporate board helps to solve problems and enhances the presence of better decision-making because

⁴⁸ Kreitz (2008) defines diversity as a significant difference that distinguishes one individual from another.

⁴⁹ Board gender diversity research has also been influenced by the term ‘tokenism’. This is the practice of representing a small group or minority in order to give an appearance of sexual or racial equality within a workforce (Kanter, 1977). Tokenism is described as a way in which a firm makes a perfunctory gesture of inclusiveness towards minority groups. Here, a person (woman) can meet a certain requirement but does not possess the auxiliary characteristics that are expected for a particular job or position such as sexual or racial difference (Zimmer, 1988).

the board can engage in the critical analysis of issues. A survey by Catalyst (2011) indicates that out of the Fortune 500 firms, between 2004 and 2008, the 148 financial institutions with women on the corporate board outperformed those without women board members. Rose (2007) argues that a high degree of board diversity in a company may serve as a positive signal to prospective job applicants looking to join that company.

The balancing of the presence of males and females on any corporate board is not only a problem for firms but is also an issue for several countries as well⁵⁰. For example, the European Commission (EC) is also considering imposing quotas of female representatives on corporate boards across the EU. Norway and Spain have legislation where there is a quota for women selected for membership on boards (Adams and Ferreira, 2009); Malaysia has imposed a 30% quota and Brazil targets 40% for state-controlled firms.⁵¹ There are also lobbying groups such as Women-CorporateDirectors (WCD), who actively push for more women to be present in the boardroom⁵². Research by Rose (2007) reported a significant adoption of women onto the corporate boards of firms in Scandinavian countries⁵³. Other countries, such as the United Kingdom (UK), Australia, Belgium, Italy and the Netherlands have expressed a desire to follow the Scandinavian example of voluntarily appointing more women directors to the corporate board (Liu et al. 2014).

⁵⁰ In December 2013 Twitter came under pressure from the media for neglecting to include women on their board. The CEO responded that the appointment of board members should not be a matter of just 'checking a box'. However, the company later appointed Marjorie Scardino as the first female director on the board. Twitter took a bold step in addressing this issue. <http://www.wired.com/2013/12/twitter-board-bumbled-gender-issues/>. Accessed 10/02/2016.

⁵¹ <http://www.economist.com/blogs/economist-explains/2014/03/economist-explains-14>. Accessed 06/02/16.

⁵² <http://www.womencorporatedirectors.com>. Accessed 06/02/16.

⁵³ Board gender diversity is very important in Scandinavian countries (Carter et al. 2010).

6 SUMMARY AND CONTRIBUTIONS OF THE ARTICLES

6.1 Article 1: Audit Committee (AC)

The first paper investigates the relationship between audit committee (AC) adoption and the firm's financial value in UK financial institutions. The paper also examines if the establishment of an audit committee impacted the value of UK financial institutions during the pre/post global financial crisis era. This is the first paper to provide such evidence and helps fill the gap in the current literature.

The audit committee is responsible for monitoring the integrity of the firm's financial statements; reviewing the firm's internal financial controls and risk management systems; acting as a bridge between the internal auditors; and monitoring the external auditor's independence and objectivity. It also helps to implement policy on the engagement of the external auditor concerning the supplying of non-audit services, taking into consideration relevant ethical guidance regarding the provision of non-audit services by the external audit firm (Smith Review, 2003; FRC, 2014 and 2016).

The financial sector is a very challenging and complicated business nowadays and therefore its financial accounting reporting and disclosures have become demanding. The establishment of audit committees by UK financial institutions can help monitor the integrity of the firms' financial statements and review of all financial reporting. This paper uses secondary data from 63 financial institutions in the UK covering a 12-year period.

Finally, the theoretical foundation surrounding the audit committee research is focused on agency theory. Agency theory is defined as "*one in which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent*" (Jensen and Meckling, 1976; p.308). The formation of an audit committee by the board of directors is designed to overcome agency problems and helps enhance the firm's monitoring and effectiveness. However, a recent study by Khosa (2017) indicates that the presence of an audit committee can mitigate the agency costs between managers and shareholders. Also, the establishment of an audit committee helps to align the interests of management with those of the shareholders (Hillman and Dalziel, 2003). The establishment of an audit committee as part of best corporate governance practice helps to reduce agency costs and information asymmetry by ensuring that a firm's activities are conducted in line with the expectations of the principal and the agent.

Contribution of Audit Committee Article

The empirical results indicate that audit committee (AC) adoption among UK financial institutions has a positive and statistically significant relationship to the firm's value as a measure of financial performance. The results during the pre-crisis period also indicate that audit committee adoption made a positive and significant contribution to the firm's value. However, the adoption of an AC during the post-crisis period did not yield any impact on the firm's value. Our results suggest that, after the financial crisis (2009-2011), the entire UK economy was experiencing an economic downturn and financial firms were no exception.

To the best of the author's knowledge, this research is among the first studies to examine empirically the role of AC adoption on UK financial institutions and such committees' impact on firm value. Second, prior to the financial crisis in 2007/2008 and afterwards, no single study has been conducted on the effects of AC adoption and its impact on either the pre- or the post-financial crisis periods. This is the first paper to provide such empirical evidence. This study fills any missing gaps in the audit committee (AC) and firm's value relationship which exists in UK financial institutions (Mintah and Schadewitz, 2017).

6.2 Article 2: Remuneration Committee (RC)

The second paper still uses data from the 63 financial firms in the UK over a period of 12 years to address the presence of remuneration committees on UK financial performance. The purpose of this paper is first to address the question of whether the presence of remuneration committees can influence the corporate board in terms of financial performance. Second, what was the impact of the remuneration committee on UK financial firms during the pre/post global financial crisis periods? In answering these questions, the research makes an original contribution to the literature.

The duties of the remuneration committee are to scrutinise the decisions of the board concerning: rewards, salary, bonus, share options and superannuation payments for executives (Conyon et al. 1995; Finkelstein & Hambrick, 1989; Gregg et al. 1993; Main & Johnston, 1993). Remuneration payments to executives are paid based on individual qualifications, experience, size of the firm and the success of the firm (Herdan et al. 2011; Conyon and Peck, 1998). The committee will help safeguard shareholders' interests by designing remuneration contracts that monitor the behaviour of both the CEO and executive management (Hermalin and Weisbach, 2003). Agency theory is used as the theoretical literature in supporting this remuneration committee research.

Contribution of Remuneration Committee Article

The empirical results obtained indicate that the establishment of an RC has a positive and statistically significant effect on a firm's market value (Tobin's Q). Subsequent tests conducted show that the presence of an RC had a positive and statistically significant relationship on the firm's ROA during the pre/post global financial crisis. The firm's market value (Tobin's Q) measured during the pre-crisis indicates a positive and statistically significant impact on the firm. The firm's market value did not show any significant relationship to RC during the post-crisis period. The reason is that the use of different dependent variables (ROA and Market Value) produced different empirical results. These results are so important because, up to this point, no empirical research has been undertaken in UK financial institutions concerning the presence of the remuneration committee and how it impacts a firm's Market Value (MV) and ROA (Mintah, 2016).

6.3 Article 3: Nomination Committee (NC)

The third paper discusses the nomination committee, which is responsible for ensuring that the right personnel, skills, talent and experience have been selected and appointed to help take the right strategic decisions for the firm (Financial Reporting Council 2012; 2014 and 2016). The selection of qualified personnel should include women who have the impetus for organisational success. When the nomination committee selects the right profile, it can heighten the probability of success for the firm. Due to the limited empirical research on the presence of the nomination committee and its impact on firm financial performance, this research is the first to empirically assess this aspect of UK financial institutions. This study helps to strengthen the debate on the association between the nomination committee and firm financial performance in the UK.

The theoretical argument used to support this empirical research is drawn from studies conducted by Ruigrok et al. (2006) where agency, resource dependence and group effectiveness theories were used to support their work.

First, agency theory primarily focuses on the separation of ownership and control that exist in organisations and the relationship between the principal and the agent (Berle and Means, 1932; Jensen and Meckling, 1976). The nomination committee, which is part of the board, ensures that the right executives and board members are appointed to control and reduce agency problems between the principal (owners) and agent (executive management).

Second, resource dependence theory suggests that the role of the nomination committee will ensure that the firm uses its available resources such as background and skills, experiences and talents for the benefit of shareholders. The nominating committee (NC) should be able to appoint board members and executives who will consider the external environment, such as competitors, and external opportunities for the firm (Pfeffer, 1978).

Third, group effectiveness and diversity theories suggest that people with common interests interact and work well together. The theory implies that people with complementary backgrounds such as education, skills and talent commit themselves to a common goal for the firm (Ruigrok et al. 2006). The group could be made up of different gender, culture, ethnicity and geographical diversity working together to maximise shareholders' wealth (ibid). This means that all members of the group are mutually accountable to each other. When the group members are accountable to each other, it brings collaboration and efficiency to the organisation. The role of the nomination committee is to consider appropriate skills, talent and educational background when making board appointments. Gender diversity should also be taken into consideration when recruiting for the firm. The NC will ensure that any person recruited to the board would both complement and collaborate with other members of the group in order to achieve the long-term objectives of the firm (Ruigrok et al. 2006).

The three theories used in this study complement each other and support the existence of the nomination committee within UK financial institutions.

Contribution of Nomination Committee Article

The results from this study indicate a positive and statistically significant association between the nomination committee and the firm's market value (Tobin's Q). Prior empirical studies by Callahan et al. (2003) confirm that the presence of a nomination committee results in a positive relationship with the firm's corporate performance. Other empirical studies carried out during the crisis era indicate a positive and statistically significant impact on firms' ROA during the pre/post financial crisis period. The empirical evidence gleaned highlights that the adoption of a nomination committee has a significant impact on a firm's financial performance (Mintah, 2015).

6.4 Article 4: Board Gender Diversity (BGD)

The final paper, which originated from the establishment of nomination committees, discusses board gender diversity, especially the role of women within the corporate board. Board diversity is a case where there is a fair representation of males and females on any corporate board, with the aim of balancing divergent views and improving financial performance. Board gender diversity (BGD) has become an issue for discussion because of four benefits that a firm tends to gain when having a more gender diverse board, which are: improving financial performance; opportunities to attract a wider pool of talent; becoming more responsive to the market; and, finally, the ability to strengthen its corporate governance policies (Doldor et al. 2012).

The Financial Reporting Council in the UK (FRC 2014) requires firms listed on the FTSE to publish an annual report about their boardroom diversity policies. This

will help strengthen the firms' corporate governance policies on gender diversity. In spite of several research projects on board gender diversity (BGD), this research is unique when compared to other previous empirical works because, primarily, it is the first time that such research has empirically ascertained board gender diversity and firm value in UK financial institutions and, in particular, during the pre/post financial crisis era.

Research on board gender diversity (BGD) has a mixed theoretical proposition. This means that there is no single theory predicting the relationship between women on the corporate board and firm financial performance (Carter et al. 2010). The first and most dominant theory used in supporting BGD research is agency theory.

Agency theory deals with the separation of ownership from control, and the relationship that exists between the principal/owner and the manager/agent (Berle and Means, 1932; Jensen and Meckling, 1976). Boards with diverse backgrounds (male and female) perform strategic functions such as monitoring and advising, and bringing diversity into the decision-making process in boardrooms, which eventually increase firm performance (Johnston and Malina, 2008).

The second theory deals with the stakeholder model, which states that a firm should maximise the welfare of a number of its stakeholders instead of only its shareholders (Blair, 1995). As stakeholders might have different expectations to those perceived by shareholders, the boardroom composition should be adjusted to reflect the expectations of all stakeholders, such as through the appointment of female directors (Low et al. 2015). For example, customers and the government may use their shareholding rights to push for diverse boards because of the need for social integration (Ntim, 2013).

Third, resource dependence theory suggests that firms exist so that they can critically use the resources available to maximise their financial performance (Pfeffer, 1978). Our empirical evidence provides positive support for this theory which suggests that gender diversity improves decision-making and helps align the organisation with its external environment and resources, thereby enhancing the firm's financial performance (Carter et al. 2003). Board gender diversity results are consistent with agency theory, stakeholder model and resource dependence theory predictions.

Contribution of Board Gender Diversity Article

This paper has contributed to the corporate governance literature by offering new insights on the board diversity and firm's value relationship. The outcome of this empirical research shows that the presence of females on the corporate boards of UK financial institutions has a positive and statistically significant relationship to the firm's value. Before the financial crisis era, that is, during the pre-crisis situation (2000-2006), our evidence reveals that the presence of females on the corporate board also had a positive and statistically significant impact on the firm's

value. This means that women contributed significantly to the firm's value. However, after the financial crisis period, the presence of females on the board did not have any significant effect on the firm's value. A reasonable explanation may be that, even though the financial crisis was over from 2009 to 2011, the entire UK economy was still experiencing an economic downturn and financial firms were no exception, irrespective of whether there was female representation on any corporate board. Furthermore, the harsh macro-economic conditions after the crisis overshadowed the importance of having women on the corporate board. This has nothing to do with their competence but is due to uncontrollable systemic factors which are beyond their control. Overall, the findings are consistent with prior studies (Mintah and Schadewitz, 2017).

6.5 Conclusion from the Articles

This thesis has empirically demonstrated the consistent recommendations of various corporate governance reforms in the UK regarding the establishment of board committees such as audit, remuneration and nomination and the presence of women on the corporate board (see, for example, Cadbury Report, 1992; Greenbury Report, 1995; Combined Code, 2008; Walker Review, 2009; FRC, 2012; and many others).

Specifically, using a sample of 63 financial firms from 2000 to 2011 (a total of 756 firm-year observations) and corporate governance data collected from annual reports, the articles have mainly examined the relationship between board committees and firm financial performance in the UK financial institutions. The articles have explicitly shown how these committees and the presence of women on the board were able to impact the firms during the pre/post financial crisis period. The UK financial institutions were chosen for this research because the UK has the biggest earnings in terms of GNP and is the second biggest market after the US for financial services.

Collectively, the empirical results ascertained indicate that the establishment of audit, remuneration and nomination committees and the presence of women on the UK corporate boards had a positive and statistically significant relationship to the firms' financial performance. The result supports theoretical expectations: that better-governed firms should be associated with higher financial returns than their poorly-governed counterparts. Even though the '*Comply or Explain*' nature of corporate governance in the UK offers an optional regulation to firms, the results obtained show that the establishment of these committees does not only become a market solution to organisational problems but can also accelerate a firm's financial performance (Ntim, 2009).

This research constitutes one of the first studies to examine the role played by UK financial institutions and the presence of women on the board and how they influence firm financial performance in the pre/post global financial crisis period. This

study has filled a major gap in the corporate governance literature by empirically ascertaining this.

Overall, our findings are consistent with agency, stakeholder, resource dependence and group effectiveness and diversity theories which suggest that board committees and the presence of women in UK financial institutions enhance board monitoring and bring new experience and business knowledge to the decision-making process in the boardrooms, thereby improving the firm's financial performance.

This new research is important for policy-makers, regulators and the government as it has shown that the establishment of board committees and the presence of women on the corporate board is not a sign of '*tokenism*' or a symbolic gesture, but that women have the propensity to enhance firm financial performance.

Despite the numerous benefits of this thesis, this research still has some limitations. The data used is from UK financial institutions; other sectors were excluded. The data covers 63 financial institutions' annual reports extracted for 12 years, generating 756 firm-year observations. The sample size is not large enough to make a generalisation of the findings to all financial institutions.

Future research could examine the impact of board committees on the financial performance of manufacturing firms or educational industry in the UK. New research could also look at CEO compensation and how it impacted on the firms during the pre/post financial crisis era. Finally, other studies can also look at the effect of gender and ethnic diversity on other sectors of the UK economy.

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*“Knowledge is of no value unless you put it
into practice” -Anton Chekhov*

“For wisdom is a defense as money is a defense, But the excellence of knowledge is that wisdom gives life to those who have it” -Ecclesiastes 7:12, NKJV

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