“CEO duality and bank performance: the consistent null”

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Impact of leadership structure on bank performance has received considerable scrutiny from multiple stakeholders. Despite the empirical attention given to the leadership structure-bank performance relationship, extant evidence remains inconclusive. Against this drawback, this paper aims to examine the connotation of ‘optimal’ corporate governance, the key governance mechanisms and the effects of corporate governance on firm value. In addition, the authors will discuss the key aspects in which banks differ substantially from generic firms and why such unique characteristics require a different governance approach. The authors will also provide a review of the contention surrounding leadership structure, the extant empirical research on the impact of leadership structure on bank performance, methodological approaches, and their findings. Moreover, the paper will present the justifications proposed by researchers for the mixed evidence found in the empirical literature. In light of this inconsistency, the authors question the wisdom of continuing to search for conclusive evidence that would delineate and substantiate the leadership structure-bank performance relationship instead of focusing on alternative governance mechanisms that could be a more optimal choice for banks seeking sound corporate governance. The authors recommend conducting future research on understanding the board’s audit committee functions and its role in maximizing the economic value added of a bank.

Keywords: bank performance, corporate governance, leadership structure, CEO duality, ownership, audit committee.

JEL Classification: G21, G28, G30, G32, G34.

Introduction
Impact of leadership structure on bank performance has received considerable scrutiny from multiple stakeholders including regulators, investors, clients, and the community. The optimal board leadership structure remains a contemporary and contentious issue that has yet to be determined.

Despite the empirical attention given to the leadership structure-bank performance relationship; extant evidence remains inconclusive. The authors suggest that this inconclusiveness may be credited to the insufficiency of analyses relied on to scrutinize this relationship, an insufficiency that might be constructively addressed by focusing on alternative governance mechanisms, namely, the functions of the board’s audit committee.

Against this drawback, the rest of this paper is organized as follows. Section 1 explores the aim and the meaning of ‘optimal’ corporate governance, the key governance mechanisms, the effects of corporate governance on firm value and how corporate governance research is expanding and changing. Section 2 describes the key aspects in which banks differ substantially from generic firms, why such unique characteristics require a different governance approach, and how governance mechanisms can be counter-productive in certain instances. Section 3 reviews the contention surrounding leadership structure, the extant empirical research on the effect of leadership structure on bank performance, methodological approaches, and their findings. The final section presents the justifications proposed by researchers for the mixed evidence found in the empirical literature and in light of this inconsistency, questions the wisdom of continuing to search for conclusive evidence that would delineate and substantiate the leadership structure-bank performance relationship instead of focusing on alternative governance mechanisms that could be a more optimal choice for banks seeking sound corporate governance. It recommends conducting future research on the functions of the board’s audit committee and its impact on bank performance and concludes with a briefing of the responsibilities, powers, authorities and discretion of a bank’s board audit committee and its role in maximizing the economic value added of a bank.

1. Corporate governance and value creation
An eclectic topic, corporate governance falls at the juncture of several pertinent bodies of literature: management, business, law, finance, economics, and public policy. Corporate governance is a set of controls and mechanisms that regulate how firms should be governed so that they run efficiently and effectively.

According to Garcia-Sanchez (2010), the Organization for Economic Cooperation and Development (OECD) in its 2004 Principles of Corporate Governance structures the goal of corporate governance as follows.

The final goal of corporate governance is to increase the firm’s economic efficiency and strengthen its growth, as well as to foment confidence in the investors, by providing a structure for setting objectives that will serve the interests of society and the shareholders, and determining the means that can be used to attain these objectives and supervise their fulfillment (p. 312).

Gugler, Mueller and Yurtoglu’s (2003) study (as cited in Sahut and Bouleme, 2010) define “a strong corporate governance system as one that aligns ma-
nagerial and shareholder interests and thus leads managers to maximize shareholder wealth” (p. 321). The objective of corporate governance mechanisms is twofold: to narrow the gap between managerial and shareholder interests and to increase firm performance and/or firm value (Denis, 2001).

Diverse studies on corporate governance have emphasized the correlation between governance and firm performance either from a universal viewpoint, or in terms of a particular governance mechanism (Sahut & Bouleme, 2010). Within this context, four mechanisms are regularly discussed in the literature: Board Independence, Board Size, Leadership Structure, and Incentive Pay Packages (Sahut & Bouleme, 2010). Nevertheless, what comprises optimal corporate governance and the necessary reinforcing mechanisms, remain vague and incipient (Bliss, 2011).

The relation between optimal corporate governance and value creation remains a topic of extensive deliberation and discussion. According to Sahut and Bouleme, governance is generally perceived, by listed companies, as a means of control rather than a support tool to the main strategic drivers. As such, researchers have started to widen their understanding of corporate governance by considering broader perspectives on theory, studying a wider variety of mechanisms, employing diverse methodological approaches, embracing an extensive set of techniques, considering governance and accountability in diverse frameworks, seeking to study models in uncharted markets, and lengthening the limited time horizon (Brennan & Solomon, 2008). Brennan and Solomon’s analytical framework demarcates the extent to which corporate governance research is expanding and moving away from the traditional body of work. The framework depicts corporate governance research through six dimensions: theory, accountability mechanisms, methodology, business sector/context, globalization and time horizon. Within such a diverse context, this paper focuses on the impact of board leadership structure on bank performance.

2. The intricacies of bank governance

According to the Basel Committee on Banking Supervision (BCBS), corporate governance of financial institutions is essential to ensure a rigorous financial structure and, subsequently, a country’s economic development (De Andres & Vallelado, 2008). Thus, inefficiencies in financial intermediation would affect economic growth and being the dominant financial institution, bank insolvencies can result in systemic crises which have adverse consequences on the global economy (Duygun Fethi & Pasiousras, 2010). Consequently, bank performance has been of great interest to stakeholders including regulators, investors, clients, and the community (Mullineux, 2006). Cooper (2009), Mülber (2009) and others, describe the key aspects in which banks differ substantially from generic firms. First, bank operations are more opaque than firms operation in other sectors of the economy (Mülber, 2009), thus making it hard for outsiders to evaluate the risk and value of their loans in relation to non-financial firms (Hagendorff, Collins & Keasey, 2007) and even banks themselves find it challenging to measure the riskiness of other banks accurately (Mülber, 2009). Pillar 3 of the Revised Framework of the Basel Committee on Banking Supervision (Basel II) addresses this issue by outlining disclosure requirements encompassing capital sufficiency and distribution, as well as risk exposure and valuation, with the aim of encouraging market discipline (Mülber, 2009).

Second, unlike generic firms, a bank’s core business is to accept a disparity in the term structure of its assets and its liabilities and charge creditors a premium for accepting a maturity mismatch (Mülber, 2009). Hence, a bank’s profit is directly proportional to its lending volume and an increase in leverage will increase its default and insolvency risk premia (Cooper, 2009), thus amplifying the term structure disparity and its susceptibility to creditor runs (Mülber, 2009).

Third, banks are highly leveraged institutions with little equity in their capital structure compared to non-financial entities. Bank deposits are mostly protected by government-backed deposit insurance and make up a large proportion of the liabilities, thus creating an industry-specific moral hazard that inhibits shareholders’ motivation to monitor management (Cooper, 2009).

Fourth, banks are subject to government regulation because of their systemic consequence and their vulnerability to runs (Mülber, 2009). Banking regulation curtails the magnitude of risk a bank may take to ensure the safety and soundness of financial institutions. According to Mülber, Pillar 1 of Basel II curtails bank risk-taking by stipulating risk-adjusted minimum capital requirements, and limiting a bank’s exposure to creditors. Regulators are currently evaluating the benefits of introducing a supplementary backstop-ceiling that would limit a bank’s total leverage to an arbitrary multiple (Mülber, 2009).

The characteristics and significance of the banking sector to the economy makes their corporate governance issues and their coping mechanisms highly specific (De Andres & Vallelado, 2008). Hence, prescribing a one-size-fits-all governance solution to banks is not recommended, even though key aspects of governance are applicable to the sector. The sector’s unique nature warrants the development of governance policies that would accommodate this uniqueness without undermining the value creation strategy in the process.
Levine (2004) argues that bank-related crises are chiefly a result of weak bank governance and that well-managed banks operate more efficiently compared to non-financial entities. The main areas of governance problems in financial institutions as stated by Sahut and Bouleme (2010) are: definition of strategy, risk management and the internal control system, the independence and competence of board members, and executive and trader compensation. They warn that adopting governance reforms in those problem areas requires a coherent and subtle balance between hard and soft laws to deflect the value-creation trap.

Instances where governance mechanisms can be counter-productive are seen when regulation limits bank operations and applies coefficients that lessen competition in the industry, or when it designs a deposit insurance that restricts depositors’ supervision, or when it imposes bank ownership restrictions (Becher and Campbell, 2004; Booth, Cornell, and Tehranian, 2002; De Andres and Vallelado, 2008; Hagendorff et al., 2007). Moreover, new agency problems could arise when the regulator’s objective, which is to diminish systemic risk, conflicts with that of shareholders, which is to increase share value (De Andres & Vallelado, 2008).

Such cases inevitably restrain the impact of governance processes, diminish the coping effectiveness of other mechanisms, weaken ingrained monitoring mechanisms that protect shareholder interests, and mute the market for corporate control as a disciplinary device for management inefficiency (Becher and Campbell, 2004; Booth et al., 2002; De Andres and Vallelado, 2008; Hagendorff et al., 2007; Pathan and Skully, 2010). Thus, the standard rules or guidelines to reform board governance would become counter-productive and inhibited within the context of banking (De Andres & Vallelado, 2008; Pathan and Skully, 2010).

On the other hand, governance mechanisms if implemented prudentially can curtail economic setbacks and avert unfavorable government budgetary consequences (Ben Naceur & Omran, 2011). In addition, sound mechanisms can reduce bank’s cost of capital, limit expropriation of its resources, and enable it to oversee its investments efficiently, thus, increasing investor confidence, and enhancing market valuations (Caprio, Laeven & Levine, 2007).

Furthermore, in a highly competitive banking industry, stringent capital requirements, continuous monitoring and inspection of licensed foreign banks, and bank closures, tend to amplify the entry barriers facing low-quality banks (Beck, Laeven, Levine & Pennac, 2008), thus decreasing occurrences of sectorial collapses and financial catastrophes (Ben Naceur & Omran, 2011). Moreover, according to Barth, Caprio and Nolle (2004) and others, regulations and policies that foster private sector monitoring enhance the integrity of bank-firm relations.

3. Board leadership structure and methodological approaches

Since Jensen and Meckling’s (1976) treatise on the theory of the firm, board leadership structure remains to be one of the most topical and controversial corporate governance mechanisms. Board structure may be unitary (single-tier) or dual (two-tier) depending on the country (Mallin, 2007). Unitary board structure is the practice of combining the functions of the chief executive officer (CEO) and chairman of the board, otherwise known as CEO duality. While a dual structure is the practice of separating ownership (chairman) from management (CEO).

The contention surrounding leadership structure revolves around the question of where and under what circumstances do the unitary and dual board structures lie on the value destruction-creation continuum.

Schmid and Zimmerman (2008) found that CEO duality tends to be non-existent in countries that have dual board predominance, while in Egypt and most of the other Arab countries it is almost taken for granted. However, the banking sector tends to be an exception to this generalization, because of their functional and economic differences from other firms. As a result banks are subject to rigorous and prudential regulation of their capital and risk (Müller, 2009). Even though some countries might not explicitly recommend the separation of the CEO-chairman functions, their banking regulation might mandate such separation as seen in Switzerland (Schmid & Zimmermann, 2008). Recently, the Central Bank of Egypt issued a governance code that left the separation of the CEO-chairman functions to the discretion of the bank. In case a bank’s board elects to combine those functions, its reasons for doing so have to be clarified in its annual report; on the other hand, if the bank decides to separate the CEO-chairman functions, their roles, responsibilities and specializations have to be documented and approved by the board of directors (Central Bank of Egypt, 2011).

Through scanning the extant literature on leadership structure-firm performance relationship, the authors noted the following.

Firstly, studies tend to exclude financial institutions from their samples, because of the different regulatory environments that govern the banking sector, as well as the sector’s fundamentally different capital structures, cash flow and accrual processes, and operations (Ben Naceur and Omran, 2011; Bliss, 2007; Francis and Stokes, 1986; Huafang and Jianguo, 2007; Mashayekhi and Bazaz, 2008; Tsui, Jaggi, and Gul, 2001).
Secondly, the number of empirical studies that investigate the relation between CEO duality and bank performance is limited in comparison to those focusing on non-banking sectors (Table 1 lists studies that address the banking sectors).

Thirdly, irrespective of the sector, two distinct commonalities are found in the empirical work on leadership structure. First, a binary variable is used as a proxy for CEO duality that takes the value of one if the CEO is also chairman of the board and zero otherwise. Second, before the introduction of technical efficiency as an alternative performance measurement; bank performance has always been proxied by market and accounting measures. In recent years, the use of technical efficiency in determining the effectiveness of corporate governance has been gaining considerable interest (Garcia-Sanchez, 2010). Technical efficiency refers to the ability of a firm to produce maximum output given its current inputs. According to Agoraki, Delis, and Staikouras (2010), simple accounting ratios as measures of bank performance are inadequate. In addition, Barth, Caprio and Nolle (2005) as well as, Hill and Snell (1989), pointed out that financial ratios and Tobin’s q are extremely sensitive to differences in accounting methods or accounting profit manipulation and thus their use as a performance measurement has pitfalls (Garcia-Sanchez, 2010). Hill and Snell (1989) found technical efficiency to be a more precise measurement of firm performance.

Fourthly, in search for evidence of a substantive and systematic relationship between firm performance and leadership structure, researchers have attempted a variety of methodological approaches and sophisticated analytical techniques which were tested along different time horizons. Empirical methodologies have ranged in complexity from correlations to data envelopment analyses (DEA) and stochastic frontier frameworks. Among these, Abdullah (2004), Cooper (2009), Harjoto and Jo (2008), Kiel and Nicholson (2003), Kula (2005), Li and Tang (2010), Mahmood and Abbas (2011), Pathan (2009) and Valenti, Luce, and Mayfield (2011) used a correlation matrix. Whereas others employed different regression techniques: panel data regression (Adnan et al., 2011; Al Farooque et al., 2007; Baliga, Moye, and Rao, 1996; Chaganti and Sherman, 1985; Cheung et al., 2006; Cooper, 2009; Daily and Dalton, 1993; Daily and Dalton, 1992; Dalton et al., 1998; Garcia-Sanchez, 2010; Griffith et al., 2002; Kesner, Idalene, and Dalton, 1986; Weir and Laing, 2000; Valenti et al., 2011).

In accordance with Agoraki et al. (2010), Aguilera, Filatotchev, Gospel, and Jackson (2008), Dalton and Dalton (2011), Pathan and Skully (2010) and others, the findings indicate mixed empirical evidence as to the relationship between CEO duality and firm/bank performance. The following sections summarize the survey conducted by the authors on empirical findings according to the significance of the relationship: insignificant, positive, or negative.

3.1. Insignificant effect of duality on performance.

Most of the available empirical research concluded that CEO duality had no significant impact on firm performance (e.g., Adnan et al., 2011; Al Farooque et al., 2007; Baliga, Moye, and Rao, 1996; Chaganti and Sherman, 1985; Cheung et al., 2006; Cooper, 2009; Daily and Dalton, 1993; Daily and Dalton, 1992; Dalton et al., 1998; Garcia-Sanchez, 2010; Griffith et al., 2002; Kesner, Idalene, and Dalton, 1986; Weir and Laing, 2000; Valenti et al., 2011).


Kiel and Nicholson (2003) found that CEO duality is positively correlated with Tobin’s q, yet insignificant in relation to ROA. Belkhir (2009b) found the impact of internal corporate governance controls (i.e., CEO-
chairman duality, board size, block-holder ownership, proportion of outside directors) on banks’ performance to be insignificant. Bektas and Kaymak’s (2009) results indicated that board size and duality do not significantly influence the returns on assets of Turkish banks. Bektas and Kaymak (2009) stated that there are many external factors (e.g., economic conditions, interest rates, and political instability) that are beyond an individual’s control which affect bank performance much more than the disproportionate power assigned to a single individual. Even though the results are not significant, Bektas and Kaymak (2009) cautioned that these governance mechanisms should not be disregarded, as prior studies have found these variables to be significant.

In addition, Cooper (2009) found no relation between the CEO serving as chairman of the board and bank performance using Tobin’s q, EVA, or MVA. He added the inability of the market to discipline the CEO is another mitigating aspect that may be manipulating the results. Griffith et al. (2002) stressed that wearing both hats has no significant impact on performance because the added responsibilities do not significantly add to the CEO’s capacity to affect performance. They further added that, “in commercial banks, management entrenchment may offset the effects predicted by Jensen and Meckling’s (1976) convergence-of-interest hypothesis” (p. 171). Therefore, both convergence of interest and entrenchment impact performance, but the marginal impact of these factors varies with the level of CEO ownership (Cooper, 2009).

Furthermore, Garcia-Sanchez (2010) and Nanka-Bruce (2011) concluded that CEO duality does not have a negative effect on bank efficiency; Adnan et al. (2011) found that CEO duality has no significant impact on technical efficiency. Finally, Valenti et al. (2011) found that none of the performance change variables (ROA, ROE, return to shareholders and P/E) were significantly related to CEO duality.

3.2. Positive (for duality) effect on performance.

The earliest empirical evidence supporting CEO duality was in 1991. Rechner and Dalton (1991) in a study of the US firms over the period of 1978-1983 found that performance was significantly lower for firms that had a dual leadership structure, while those having a unitary structure unfailingly outperformed the CEO duality firms (Donaldson and Davis, 1991). Pi and Timme (1993) provided evidence that banks with dual leadership had lower costs and higher accounting returns (returns on assets) than those with unitary leadership structures, while Brickley et al. (1997) indicated that CEO duality is not associated with mediocre performance. They argued that the monitoring benefits of CEO non-duality (i.e., separating CEO and chairman positions) may be counterbalanced by the costs of upholding such leadership structure and as such, banks with high monitoring costs, i.e., with high information asymmetry, could profit from CEO duality.

Simpson and Gleason (1999) pointed out that banks with CEO duality are less likely to face financial distress. They suggested that banks with CEO duality may have superior internal control systems reducing the probability of financial distress in the bank. By studying Chinese publicly listed companies, Tian and Lau (2001) found a positive and significant relation between performance and CEO duality. Kiel and Nicholson (2003) also found a positive and significant correlation between Tobin’s q and duality in their correlation analysis. Harjoto and Jo’s (2008) evidence suggested that CEO duality positively affects Tobin’s q, industry-adjusted Tobin’s q, ROA, and operating profit after accounting for the endogenous treatment effect, indicating that the stewardship theory dominates the agency explanation when CEO is also the chairman of the board. Belkhir’s (2009) analysis of 174 banks and savings-and-loan holding companies, over the period of 1995-2002, found a significantly positive relation between duality and ROA, as well as, between duality and Tobin’s q.

Pathan (2009) measured the impact of duality on five measures of bank risks: total risk, systematic risk, unsystematic risk, assets return risk, and insolvency risk, by running correlation, regression, and robustness tests on 212 large US bank holding companies over the period of 1997-2004. A negative relationship was found between duality and bank risk-taking. In addition, Cheung et al. (2006) found that CEO duality is negatively correlated to undertaking connected transactions, value-destroying connected transactions, and joint venture stake sales. Boujelbène and Nabilà (2011) used static panel and GLS random effect regressions on a panel of 10 Tunisian commercial banks listed on the Stock Exchange of Tunisia over the period of 1995-2007 to measure the effect of CEO duality on bank risk (total risk, insolvency risk, and beta). Their study showed that there is a significant inverse relation between CEO duality and bank risk-taking. Moreover, Nanka-Bruce’s (2011) study revealed a marginal positive difference between the effects of CEO duality versus separation on technical efficiency.

3.3. Negative (against duality) effect on performance.

Worrell, Nemec, and Davidson (1997) tested stock price reactions to CEO duality and found it to have a negative impact. A cross-sectional data analysis of established commercial banks in Turkey, by Kaymak and Bektas (2008) investigating the association of board independence, CEO duality, board size, and board tenure with bank performance in Turkey resulted in findings proving that duality has a negative impact on return on assets. As such, the presence of duality increases the risk of principal-principal conflict (Kaymak & Bektas, 2008). Applying an econometric model within a stochastic frontier framework, Agoraki
et al. (2010) found that two-tier board structures improved efficiency, by contrast to increased ownership concentration which had no significant effect. In addition, Agoraki et al. (2010) reported a negative relationship between bank efficiency and amplified managerial power. After controlling for individual CEO, firm, industry, and geographic location, Li and Tang (2010) in their survey of Chinese firms found that CEO duality increases CEO hubris and therefore, increasing firm risk taking. Furthermore, a correlation analysis of 21 leading banks of Pakistan during 2006-2009 indicated that CEO duality is negatively related to ROA and ROE (Mahmood and Abbas, 2011). While, Rachdi and Ben Ameur (2011) noted that performance metrics are more negative when firms shift away from dual structures.

Discussion and conclusion

Justifications for inconsistency. The mixed evidence in the empirical literature has led researchers to propose justifications for this inconsistency. Aguilera et al. (2008) attribute it to samples coming from different institutional environments. Elsayed (2007) ascribes it to differences in industries, while Davis et al. (1997) and Ramdan and Van Witteloostuijn (2010) credit it to the different psychological attributes of the sampled managers and/or the different characteristics of the sampled organizations. In addition, Ben Naceur and Omran (2011) warn that existing “empirical work on determinants of bank’s profitability could potentially suffer from three sources of inconsistency: highly persistent profit, omitted variables, and endogeneity bias” (Poghosyan and Hesse, 2009, p. 6). Endogeneity in empirical corporate governance research can mislead researchers in seeing a non-existent relationship and failing to find an existing one (Denis, 2001).

Despite the voluminous empirical attention and justifications, there is still no conclusive evidence illustrating the leadership structure-financial performance relationship (Dalton et al., 1998; Dalton, Hitt, Certo, and Dalton, 2008; Dalton and Dalton, 2011; Dey, Engel, and Liu, 2009; Faley, 2007; Kim, Al-Shammari, Bongjin, and Lee, 2009; Lyengar and Zampelli, 2009; Peng, Zhang, and Li, 2007; Schmid and Zimmermann, 2008). Dalton and Dalton (2011) admit that they have not come across any topic in corporate governance where null results persist with such consistency as in the case of the effect of leadership structure on firm performance. In spite of researchers’ efforts to broaden their understanding of leadership structure effect on performance, the extant empirical evidence in the literature remains “inconclusive”, which leads to question the wisdom of conducting future research in this area? Even though researchers have considered broader perspectives on theory, employed varied methodological approaches, and applied broader set of techniques, the outcome has not changed. As such, why should we assume that it will change in future?

The authors suggest that CEO duality might be a suboptimal choice/mechanism for banks seeking sound corporate governance and that inconclusive evidence may be attributed to the inadequacy of analyses relied on to examine the leadership structure-bank performance relationship; an inadequacy that might be constructively addressed by focusing on alternative governance mechanisms, namely, the functions of the board’s audit committee.

Banks’ audit committee versus dual board structures. Typically, a bank’s board audit committee has the following responsibilities, powers, authorities and discretion (HSBC Egypt, 2008):

1. Monitor the integrity of the financial statements of the bank and reviewing significant financial reporting judgments contained in them.
2. Review the bank’s internal financial controls and its internal control and risk management systems.
3. Review and monitor the external auditor’s independence and objectivity and the effectiveness of the audit process and to ensure that a timely response is provided to the issues raised in the external auditor’s management letter.
4. Provide the board with additional assurances as it may reasonably require regarding the reliability of financial information submitted to it.
5. Review the effectiveness of the bank’s risk management framework.
6. Study the regulator’s remarks as set forth in the inspection reports carried out on the bank, and its remarks on the bank’s financial statements and report them to the board of directors.
7. Develop a crisis management plan.
8. Recently, audit committees evolved from a role of enforcing compliance to a higher-value role of evaluating the control framework and assessing the effectiveness of management control.
9. Audit committee continued to develop its methodological innovations such as risk-based auditing and themed audits to get the maximum benefit in order to carry out its roles efficiently.

These responsibilities allow board audit committees to perform a very important role in maximizing the economic value added of a bank through the supervision of the efficient management of the assets-liabilities of the bank. A dimension that is absent in the literature of bank governance mechanisms and had little attention by banks’ performance analysts and deserve thorough investigation to discover the correlation between board audit committee responsibilities and bank’s performance and the maintenance of good bank governance.

The authors recommend pursuing research in the area of the role of the board’s audit committee and its impact on bank performance and value creation.
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