

The Impact of Regulatory Pressures on Governance

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Contributor: Simon Grima

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Findings: The general trend in the banks was that profitability and efficiency decreased drastically in the post regulatory period, contrary to liquidity, which increased, as higher capital buffers were imposed on banks.

Practical Implications: This study is important because the burden of regulations is detrimental to the performance of public banks in the EU Mediterranean region. There are several arguments that the burden of compliance is becoming very costly and this is negatively affecting their profitability and efficiency.

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The Impact of Regulatory Pressures on Governance on the Performance of Public Banks' with a European Mediterranean Region Connection*

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Glen Gauci^[1], Simon Grima^[2]

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1. Introduction

In recent years, regulators have been increasing their focus on corporate governance practices within banks. This is due to the increase in the number of bankruptcies which they deemed was the cause of absent or poor corporate governance regulations. Kirkpatrick, (2009), reported that the global financial crisis can be blamed on deficiency and vulnerability in corporate governance practices. U.S. Securities and Exchange Commission Chairman, Schapiro (2009), argued that: *"many of the problems leading to our economic crisis can be laid at the door of poor corporate governance. Too many boards failed in their primary function of diligently overseeing management. As a result, too many managers took on too much risk and made decisions that were too focused on the short-term."*

The Basel Committee reports that good corporate governance is important for a sound financial system. Refining corporate board structures, with respect to their size and setting, has been one of the primary issues in the corporate governance framework, developed by international authorities in recent years (EU Commission Communication, 2003; Basel Committee, 2006). These changes in corporate governance raise questions on, for example, what type of ownership or board size are better for banks to improve performance (Grima, 2012). Heidrick and Struggles (2014) reported that although it is extremely important to follow corporate governance practices it should not be the main and only focus of an entity and thus not allowing enough time for the board and management to strive to achieve better performance. While Lux and Piechock (2015) argued that, the burden of compliance and reporting is becoming too time-consuming.

Therefore, in this paper we aim to provide an insight on the regulatory reforms on corporate governance, brought about, by its ineffectiveness in the global financial crisis. We focus on EU since it has been involved in a severe sovereign debt crisis that puts at risk even the very existence of the Union and its currency in their current forms (Andor, 2014). In fact, a study on EU governance carried out by Heidrick & Struggles (2014), suggested that many European companies need to move from pure compliance to create dynamic and flexible governance. More specifically, our focus is on Public Banks within the EU Mediterranean region group of six southern European Union member states Italy, Greece and Spain, France and Cyprus and Portugal, which although not in the Mediterranean is closely related. This specific area is selected because these were the EU countries that were mostly affected by the crisis.

1. Literature Review

• Corporate Governance

Basel Committee on Banking (BCBS) defines corporate governance as:

“a set of relationships between a company’s management, its board, its shareholders and other stakeholders which provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance (BCBS, 2010).

The main aim of corporate governance is to lay down guidelines to ease decision making in line with the objectives. It even defines the roles, duties and responsibilities of the directors and investors. Furthermore, corporate governance is strengthened through incentives (explicit and implicit) provided in executive contracts to align the interests of shareholders with the managers of an entity (Leech, 2003). A shareholder is entrusting his assets in someone else’s hands, hoping to receive back those assets together with an extra return for the risk taken.

• History of Corporate Governance

Early corporate finance textbooks mention the formation of corporate governance with the development of the East India Company, the Hudson’s Bay Company and other dominant companies launched in the 16th-17th century (Cheffins, 2012). It was then seen as the share of ownership patterns, entailing processes of managerial accountability, shareholders’ rights and board structure conveyed through Corporate Governance (Morck, 2005).

Post-World War II, the U.S economy was experiencing a boom and companies were benefiting from a rapid growth. However, corporate governance was not being followed because managers led and took decisions and the directors and shareholders followed. The Federal Securities and Exchange Commission (FSEC) started to treat managerial accountability as part of a regulatory requirement in 1974, after Penn Central went bankrupt due to directors failing to discover misconduct by managerial executives (Schwartz, 1976). Later in the 1990’s awareness on governance increased after further managerial failures in companies.

The 2008 Global Economic Crisis increased the efforts to strengthen corporate governance and incentivised corporate managers to strive to earn interest for shareholders. After the subside of Bear Stearns, Countrywide and Lehman Brothers, the U.S president Barack Obama (2009), in one of his speeches, said that the U.S economy is severely compromised due to irresponsibility and greed of some people. The Dodd-Frank Act was founded in 2010 to “*restore public confidence by increasing accountability and transparency between shareholders and corporate managers*”. This was done by imposing restrictions on managers and clearly set out executive compensation schemes (CEBS, 2009).

Schapiro (2009) argued that the main cause of our economic crisis is poor corporate governance, where the board failed in diligently overseeing management and due to this, high risk and bad decisions were made. Similarly, an OECD report by Kirkpatrick (2009), deduced that the financial crisis is a pure example of failures and weaknesses in corporate governance frameworks.

• Importance of Governance in Banks

Corporate governance is an important concept in a financial institution as it dictates how authority is spread. Additionally, it is also vital for the suitable functioning of the banking sector and the economic growth (Levine, 1997). Corporate governance also allocates authority and states the responsibilities that regulates how the bank carries out its commerce and activities that are controlled by the board of directors and senior management. Supervisors are there to ensure sound corporate governance practices. Thus ensuring the ability to meet objectives keeping within the risk appetite of the board and thereby attaining better performance.

Banks are very important for the economy since they act as financial intermediaries between savers and borrowers. That is by distributing excess resources from savers to borrowers, in return earning interest on capital borrowed and therefore encouraging economic growth. The bank’s financial stability is vital, since serious problems, including defects in the governance framework could threaten the financial system of the whole economy (OECD, 2006).

Morgan (2002) argued that the issue of information asymmetries between investors, depositors and senior management still exists in banks. Furthermore, lack of transparency in banks increases the agency problem. For instance, shareholders and depositors would not be able to monitor the banks managers, having less information in hand. The significance of banks in the development and the prosperity of an economy, make it critical for the governments, globally, to force regulatory requirements on banks. This process can be considered as a supplementary corporate governance mechanism (Levine, 2004).

During the financial crisis governance mechanisms gained higher importance (Kirkpatrick, 2009). The Board of directors, in banks, play a key role in clinching effective governance. Members on the board supervise managers' decisions and behaviour to guide them on strategy planning and execution as well as allocate essential resources to the entity. The role of the board, in the banking industry, takes on special importance since higher complexity, opacity, regulation and greater asymmetric information exists (BCBS, 2017).

- **Regulations Before Crisis in EU**

Pre-Global Financial crisis, corporate governance was very limited. Examples of such a framework in EU countries was the restrained concentration of bank ownership. Such restrictions were vague for example, purchasing a large percentage of shares without government's approval was prohibited (Fernandes *et al.*, 2016).

The OECD Principles (1999) were the main project tackled by an inter-governmental organisation, to enhance the predominant factors for a good corporate governance system. Since 2000, the tasks of the EU have, in general, concentrated on designing a system in which accountable and effective firms report to accountable shareholders. It was, therefore, inclined to nurture shareholders' rights and responsibilities. This was implemented through Basel I. Also, BCBS had laid out a regulation regarding the number of independent directors on the board. Additionally, the Sarbanes - Oxley act of 2002, required that the boards of audit committees should only be made up of independent, external directors.

The 2003 Green Paper, (Appendix I) was a substantial revaluation of corporate governance and proceedings of legal harmonisation that were derived from the High-Level Group of Company Law Experts (2002) report bespoke by the European Commission in 2002. It aided in encouraging distinct regulatory initiatives, such as the 2004 Transparency Directive and the 2007 Shareholder Rights Directive (Appendix I) as well as European Commission Recommendations on remuneration and board formation and roles. The one-tier board structure was the most common in European countries. It related to one single board comprising of both executive and non-executive directors. All the directors had the same aims and objectives and they were accountable for all the activities of the bank. The one-tier board structure was dominant in UK, Spain, Ireland, Portugal, France and Italy (Maassen, 2002). The directors made sure that control systems and financial reporting agreed with the law (Weil *et al.*, 2002).

Another regulation was the leadership structure, were in the unitary board system, the role of the CEO and the chairman of the board was performed by the same individual (Hagendorff *et al.*, 2013). France, for example, required that leadership should be combined. The law was changed, allowing entities to choose between combining or separating the roles of CEO and the chairman in the unitary board (Vienot, 2002). In contrast, the most common practice in both Italy and Spain was to combine the duty of leadership structure thus balancing the potential of the CEO and the chairman (Weil *et al.*, 2002).

However, such regulatory framework was not enough as banks managed to find loopholes in the system in addition to taking excessive risks. This was a proof that the regulations on governance at that time were impotent. The massive debt crisis and later the collapse of the financial system, pointed towards the need for further regulations (Erkens *et al.*, 2012).

- **Regulatory Pressures After the Crisis in EU**

The Global Financial Crisis and Great Recession led to the inception of the G20, IMF reform, and Basel III (Eichengreen, 2011). Most of the regulatory reforms focused on disclosure and compliance. The EU launched several policies that tackle distinct issues, including the following:

- Enhancing board effectiveness;
- Enhancing corporate transparency;
- Building shareholder stewardship and engagement;
- Protecting shareholder rights (Dallas and Pitt-Watson, 2016).

The main goal was to improve financial supervision after the crisis. European financial supervision (EFS) reform emerged in October 2008. A high-Level Expert Group on EFS was set up to scrutinize the creation of a more integrated and efficient system of financial supervision for Europe, as well as strengthening collaboration between European supervisors and their international peers (European Commission, 2008). After a series of recommendations based on the De Larosier Report, the European Systemic Risk Board (ESRB) was to be led by the European Central Bank (ECB). The idea was to analyse threats to financial stability, discharge warnings and observe their utilization. The European System of Financial Supervisors (ESFS), had supervisory responsibility on different parts of the financial system, in order to gather a micro insight from diverse areas in financial supervision (European Commission, 2009).

Following the crisis's excessive risk-taking, followed by many bankruptcies, many investors lost confidence and pulled out their money from banks. EU wanted to gain back the confidence lost in the market, so the Institute of International Finance presented a prospectus on developing compensation policies to mitigate excessive risk-taking and keeping transparency in the market (IIF, 2008). The compensation incentives are to be aligned with shareholders and profitability of the entity. However, this self-regulation effort to gain back confidence came too late and the impact of the crisis hit badly.

The argument behind the failure of governance was inadequate compensation systems and transparency. In April 2009, the Financial Stability Forum (FSF), in the G20 summit developed nine principles for Sound Compensation Practices addressed to national regulators in the European countries (FSB, 2010). These principles revolve around effective governance compensation focusing on the duties of the board in planning and monitoring adequate compensation systems, with a task for independent input from risk management experts inside the entity (United Nations, 2010). These principles were followed by a set of Implementation Standards, issued by the Financial Supervisory Board (FSB) to give clear guidelines on implementation of compensation governance, disclosure to stakeholders and structure. These are transposed into:

- Effective and independent board oversight of remuneration policies and application;
- The need to maintain a sound capital base, whilst delivering fair compensation based on the overall performance of the firm;
- Risk and compensation structure alignment, including vesting, clawback arrangements and deferral;
- Restrictions on guaranteed bonuses;
- Intensify public disclosure and transparency of compensation; and
- Augment supervisory oversight of compensation, incorporating corrective measures when needed (FSB, 2009).

Corporate Governance rules were also reviewed from BCBS's end. These provided a convention for frequent collaboration between the national Central Banks and the ECB in November 2008. The Basel Committee wanted to enhance the Basel III framework to impose strict rules on risk and capital management. The framework and the management of a bank (Basel Committee on Banking Supervision, 2009).

These are implemented under the Principles for Sound compensation practices. In the EU the Committee of European Banking Supervision (ECBS) required financial institutions to implement these principles by the end of quarter three in 2009. The principles focus on the following areas:

- Aligning individual objectives with the company's;
- Higher transparency with all stakeholders;
- Greater governance on decision-making and oversight;
- Better performance practices;
- Guidance on the structure and form of remuneration (United Nations, 2010).

Basel III was then introduced to improve the regulation, supervision and risk management within the banking sector (Elliot, 2010). The ultimate aim, was to increase the idea of improving corporate governance, more specifically, the capacity of the board of directors to exercise independent judgement, diligence and skills, monitoring management based on fundamental factors, enhancing transparent reporting and ensuring continuous education and training to be implemented inside the bank. (Principles for Enhancing Corporate Governance, 2010).

However, Parker and Gupta (2015) argued that regulators need to be careful as they are putting excessive pressures on banks by trying to solve things in a short-term. This might create a bank drain in the long term. Hagendorff *et al.* (2014), suggested separating the roles of a CEO and chairman, to make a bank more independent whilst reducing conflict of interest. Gender diversity was being given greater importance, as it was considered to lead to better performance when having a mix of gender in the board (European commission, 2012). In fact, France and Spain required that forty percent of the board had to be made up of females by 2017 and 2015 respectively. Italy required that thirty percent of the board was female by 2015 (Davies, 2014).

- **Good Governance**

The Pillars for successful corporate governance are: fairness, accountability, transparency, leadership, assurance and stakeholder management. These are ideal to form strong relationships between stakeholders, which include shareholders, the board, managers, staff, clients and regulators. Gitau (2015) stated that, *"Having a clear understanding of the principles and practices of good governance will enhance the performance of both the individual and the organisation."*

Good corporate governance features also in good credit ratings given by credit rating agencies. Hence, it influences behaviour of management and encourages fair dealing with all stakeholders. Quality of disclosure, affiliate dealings and transparency are some of the qualitative features Fitch Ratings uses in its rating analysis. Stock markets, shareholders and creditors will reward a company that has better governance and higher liquidity. This increases share price premiums (which is the aim of the shareholder) relative to its peers and making more credit available at a lower cost. Ultimately, the cost of capital will be lower for companies with good reputations for fair dealings, all other things being equal (OECD, 2012).

- **Performance**

Performance relates not only to profitability. It is vital to include other aspects such as: the quality of assets, the funding capacity (liquidity) and the efficiency in production (European Central Bank, 2010). The key drivers of a bank's performance are earnings, efficiency, risk-taking and leverage.

- **What is Profitability?**

It is important to distinguish between profitability and performance, as sometimes these two are used interchangeably (Tosetti, 2007). Tosetti (2007), noted that there are four components for profitability to quantify true banking performance. These are: 1) provision for loan losses, 2) tax, 3) profits and losses on financial instruments and other items.

Profitability is the overall efficiency of the company. It is the ability of the business to earn a profit. Analyses of Profitability are done through financial statements, that is, profit and loss account, cash flow statement and statement of financial position. The financial statements give information with respect to efficiency, solvency, market prospects and profitability of the company (CFI, 2018). A bank earns a return by giving out loans, from interest income generated from investments in securities and other financial products and fees or commissions charged to service customers. Furthermore, commercial banks generate additional revenue from foreign exchange activities (Fraser and Rose, 2002).

- **Measures for Profitability**

Previous studies have made use of the Return on Equity (ROE), the Return on Assets (ROA), the Net Interest Margin and Profit before Interest and Tax, to study the performance and profitability of a bank (Stepanova and Ivantsova, 2012). ROE portrays the effectiveness of a bank on turning shareholders' funds into profit. ROE is calculated as net profit after tax to shareholders capital. It measures the profits earned with the shareholders capital (Mashamba, 2018). ROA is calculated by taking net profit after tax divided by the total assets. ROE ignores financial opportunity and risks associated with it (Athanasoglou *et al.*, 2006, European Central Bank, 2010). Therefore, ROE is insensitive to risk. Furthermore, other risk factors such as solvency position and the ratio of risky assets of the entity are not taken into consideration when working out the ratio (European Central Bank, 2010).

The European Central Bank (2010) suggests that ROA is a more accurate measure on efficiency performance since it adjusts for leverage. Studies suggest that ROE figures of pre-global financial crisis were approximately the same in the period following the crisis. However, some of the banks having high ROEs before the crisis were affected by a greater magnitude. This shows that ROE is a short-term signal which might be an inaccurate indicator of performance, especially in times of crisis. Nevertheless, ROA may be biased since it disregards income from off-balance sheet activities (Flamini *et al.*, 2009). Thus, it is recommended that both indicators should be considered.

• Measure for Liquidity

Saeed (2014), in his paper of liquidity crisis, chose loans to deposit as a measure for liquidity since it shows the financial health of a bank. The higher the LTD means that a bank is relying more on borrowed funds, which sometimes are more costly than other of types of deposits.

• Measure for Efficiency

Efficiency was used for the first time as a performance indicator in the works of Edgeworth (1881) and Pareto (1927) and was initially empirically used in Shephard's (1953) book. Efficiency is defined as the ability to produce the maximum amount of output out of the minimal input of resources. A bank is efficient; if it is able to generate the highest revenues by using the least amount of resources.

The banks' efficiency in this study is measured by means of the efficiency ratio, which is a widely used measure of a banks' performance (Hays *et al.*, 2009). It could be defined as the bank's capability of transforming its resources into revenues. Efficiency ratio is calculated by dividing the bank's total costs, omitting interest expenses, by its total revenue. The lower the ratio, the lower are the costs as a percentage of sales, hence higher efficiency (Hays *et al.*, 2009).

• Governance and Performance

Deloitte (2018) reported that various governance variables have a positive impact on the likelihood of firms' improving their financial and operating performance. The most functional variables of 'good' governance are: 1) board independence, 2) demographic diversity, 3) remuneration, 4) CEO characteristics, and 5) oversight and ownership structure (Table 1).

Table 1. Corporate Governance Variables and their effect on performance

Governance Variable	Impact on Performance
Board Independence	Higher number of independent members on the board increases board's capability to epitomize several points of view. However, when the size of the board increases, it slows down the decision-making process.

Board Diversity	Demographic diversity has a positive relationship with performance. However, being regulated diminishes this relationship effect.
Remuneration	Contributes by aligning interests between shareholders and management boosting performance.
CEO Characteristics	A powerful CEO, positively effects performance but also leads to more risk decisions.
Oversight	Active oversight role of owners and boards has a positive impact on performance. However, there is less attentiveness in times of prosperity.
Ownership Structure	Institutional ownership amplifies the quality of strategic decisions made by the board, by actively adding an outside perspective.

Source: Adopted from Deloitte, 2018.

In their study, Bhagat and Bolton (2008) analysed the relationship between corporate governance and profitability by studying confounding relationships of performance, capital structures, and ownership structure. The outcome showed that when there is good corporate governance, the companies attained better operating performance. Other factors affecting the relationship of performance and governance can relate positively to the legal framework and financial structure of a country. Anderson and Gupta (2009) conducted a cross-country study of financial structure and legal system. They took a sample of 1736 firms from 22 countries and showed that the financial structure and legal system of a country have a joint impact on the relationship.

Ueng (2016) analysed the link between the quality of governance policy and the firm's financial performance. A sample of 3068 entities from a Corporate Library database was used. The outcome was similar to the previous studies, hence better corporate governance policies leads to better performance. JB (2017) analysed the correlation between governance and profitability of financial entities listed on the Nigerian stock exchange. The author found that the overall impact of higher governance on a companies' profitability is negative.

Some other studies analysed the relation between governance and financial performance by taking a closer look on board aspects, more specifically size, board independence and CEO roles. When addressing the number of members on the board and its relationship with performance, there are conflicting results in the literature. Lipton and Lorsch (1992) argued that having a smaller number of members on the board allows for better and more effective decision-making. Based on this theory the authors suggested a proposal to limit the number of members to a maximum of ten. Yermack (1996) revealed that smaller boards are positively related with financial ratios; while to the contrary, Coles et al. (2008) highlight that a higher number of board members is ideal when the entity is large; is operating with high leverage and the board has important advisory roles.

Other studies found a negative relationship between the board size and firm performance. The higher the members in a board, the less efficient an entity is. Leading to higher bureaucratic problems and increase time taken for decisions (Jensen, 1993). Moreover, other scholars argue that when the board becomes too large, it becomes difficult to coordinate, to communicate and to participate. This would lead to a decrease in

Bhagat and Black (2002), find that entities with more independent boards (as post crisis requirements on governance stipulate) are performing worse. Bhagat and Bolton (2008), found a negative association between board independence and firm performance. Bhagat and Bolton (2009), reported that having a higher board independence does not lead to excess performance and could lead to worse performance. Arun and Turner (2002), point out that the inefficiencies associated with bank management, are a major cause of strict regulatory pressures from authorities. Likewise, according to Boot and Thakor (1993), the interests of the shareholders of a bank, mainly the maximisation of the share

Saeed (2014), in his study on post crisis liquidity found that stricter liquidity regulations from the authorities led to banks decreasing drastically the LTD ratio to maintain higher capital buffers. Furthermore, Grima and Spiteri (2019) found that lower leverage led to a 'deposit-war' between banks to attract more customers. This is because banks had to rely mainly on their deposits to perform loans, thus influencing negatively their profitability.

1. Methodology

To carry out this study we used financial ratios and industry statistics. Panel data of ratios were collected for the period before and during the latest financial crisis(2006-2010)andfortheperiodafterregulationshavebeenimplemented(2014-2018).

A non-probability purposive sampling, using five independent/control variables for performance (profitability, liquidity and efficiency), were collected. We also followed this up with twenty-two interviews conducted with chief officers and executives from the banking sector within the region under study. The period chosen wasregardedasidealsinceitwouldcapturethedifficultiesoftheeconomyandwouldbebeneficialtodetermine the difference in performance, since the post 2008 Global Financial Crisis, when more stringent requirements were being placed onCorporateGovernancePrinciples.

However, we decided to skip four years since during those years, most regulations were being amended and new ones were being enacted. Therefore, most entities were had not yet applied these requirements. As already noted, our focus was specifically on Public Banks within Spain, Italy, France, Cyprus, Greece, Portugal and Malta. 100, banks in total were found to be relevant to our research however only 61 of these provided the relevant data required. This met the minimum sample size required at 95% confidence level (Qualtrics, 2018) which was computed as 53.

Table 2. Sample

Country	Number of Public Banks
Cyprus	2
France	16
Greece	6
Italy	19
Malta	4
Portugal	1
Spain	5

The data was collected using Thompson Reuters and from annual reports of the banks downloaded from the Banks' websites or from the registrar of companies. This yearly data was then transferred onto Microsoft Excel and SPSS to enable analysis. We used three ratios to measure profitability:

1. The Return on Assets (ROA) to measure the return on investments and retained
2. The Return on Equity (ROE) which measures performance by dividing net income by the closing equity value of shareholders.
3. Net profit margin (NPM) to determine whether the management are returning adequate profit from sales and if total expenses are being efficiently catered for (Todorovic, 2017). The above three ratios were taken as measures for

The Loan to deposit (LTD) ratio is used as a measure of a bank's liquidity. An ideal loan to deposit ratio for a healthy banking system is between 80% and 90% (Murphy, 2019). The Efficiency ratio was taken as a control variable for a bank's efficiency. It relates to the efficacy of the management to generate the highest return by the lowest possible costs.

We decided to take both ROA and ROE even though they are both a measure of profitability, since ROA has been widely used to analyse profitability in models, however ROE has now gained higher distinction in recent studies. In this study, ROA was taken as a measure for operational profitability and ROE represented financial profitability. The structured interview was designed to tackle the following key areas of discussion with the following open-ended questions:

- How do you perceive corporate governance to affect performance?
- Do you believe the requirements imposed on banks to be harsh?
- What in your opinion can be done to implement efficient governance practices?

The interviews were transcribed into MS word and later analysed using the thematic approach as proposed by Braun *et al.* (2006). Moreover, we carried out the following tests on all the individual control variables (i.e. ROE, ROA, Net Profit Margin, Efficiency Ratio, and Loan to Deposit).

Control Variables: H_0 : No difference between the periods.

H_1 : A decrease between the periods.

Once data was collected, an average was derived for both periods i.e. Period one, being the pre and during crisis and Period two being the period post-crisis described above. Then the t-test was computed, using SPSS, to study the significance of the results.

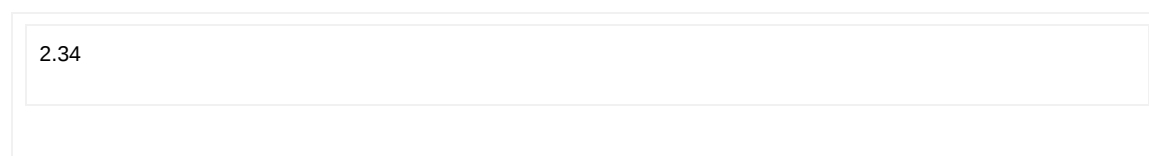
The second test computed, was the Wilcoxon signed-rank test. It is a test used for smaller sample sizes, mainly because this test assumes that with a small sample, the assumption of normality is violated (Spiteri, 2019). As such, this test was computed for each country for each variable.

1. Results and Discussions

4.1 Profitability

(a) Return on Assets (ROA)

Figure 1. Average yearly % Return on Assets in the EU Med Region.



The computed t-test resulted significant with a t-test statistic of 4.35 and a p-value < 0.05. Therefore, H_0 can be rejected, meaning that a negative trend in operational performance exists between the two periods.

(b) Return of Equity

There is a huge drop from period one to period two. In fact, the computed mean ROE in the first period was 20.15% and that of period two was 4.69%. This means that in period two the management of the banks were less able to generate cash internally from the shareholders capital. The computed t-test result of 2.43 is significant with a p-value < 0.05. This

lies outside the acceptance region (using the ± 2 rule of thumb). We can therefore reject H_0 , meaning that the two periods are not the same and a downward trend in financial performance exists between both periods.

(c) Net Profit Margin (NPM)

NPM also decreased on average from period one to period two. Again, one could notice (in figure three) a boom in net profits in the year 2007 (39.13%) followed by a decline to 11.14% in the following year. The computed average of net profit margin for period one was 21.83%, while that during period two was 10.78%. This means that in period two banks had a lower NPM as a percentage of sales. Hence, banks in period one was more profitable and more effective at converting revenue into actual profit.

Figure 2. Average yearly % Return on Equity in the EU Med Region.

They seem to have had better control over their costs in period one compared to period two. This presents a higher risk for investors who invested in the banks in period two since they required higher margin of safety. The paired two-sample test shows a t-test result of 2.51 and a p-value < 0.05 . We can therefore reject H_0 , meaning that the two periods are not the same and a downward trend in financial performance exists between both periods.

Figure 3. Average yearly % Net profit Margin in the EU Med Region.

4.2 Liquidity: Loans to Deposits

From the liquidity perspective, we can see a downward trend for Loans to deposits (LTD) in period two as opposed to period one. This was due to the revision of higher Liquidity Coverage ratio recommended in Basel III and transposed into the requirements for EU banks (Capital Requirement Directive). This requires EU banks to maintain a higher liquidity cover for unforeseen circumstances. In 2008 and 2009, the LTD ratio exploded to a level of 207% and 204% respectively meaning that for every euro held in deposit, public banks in the EU Mediterranean region lent €2.07 and €2.04 respectively. This put banks into a serious liquidity problem, which led to the Liquidity and Credit Crisis. In period two LTD ratio was less than 100% meaning that banks were lending from their deposit accounts, without borrowing additional funds (Grima *et al.*, 2019; Camilleri *et al.*, 2019; Mazreku *et al.*, 2018)

Grima *et al.* (2019), in their study, found that this led to a 'deposit-war' between banks to attract customer deposits. Besides, this had a negative impact on their profitability. The average for period one was 156.8%, while for period two it decreased to 90.8%. This clearly shows that banks maintained higher liquidity in period two. The evaluated t-test resulted as 1.92 (the t-test is very close to the ± 2 rule of thumb) with a significant p-value < 0.05 . The H_0 is therefore rejected meaning that in period two the liquidity is higher.

Figure 4. Average yearly % Loans to Deposits in the EU Med Region

4.3 Efficiency: Efficiency ratio

The Efficiency ratio relates to the ability of management to turn inputs into sales with the lower possible costs. As can be seen from figure 5, the efficiency ratio increased from period one to period two in the EU Mediterranean region. This meant that banks were less efficient in period two when compared to the previous period. Precisely the mean efficiency ratio in period one was 60.8% while in period two it rose to 69%. In other words, it can be said that costs as a percentage of sales were higher in the period where regulations were revised. This went hand in hand with the issue that Lux and Piechocki (2015) explained. That is, that the burden of compliance and reporting is becoming too time-consuming, hence making banks perform less efficiently. An ideal efficiency ratio would have been 50%, however in banks this value tends to be higher.

The t-value of -4.56 lies in the rejection region as it is greater than the critical value and is significant at a p-value < 0.05. Hence the H_0 is rejected. Therefore, we can conclude that between period one and period two a strong difference exists. Efficiency has thus decreased significantly from the first to the second period.

Figure 5. Average yearly % Efficiency Ratio in the EU Med Group

4.4 Analysis by Country

1. a) Cyprus

In Cyprus, all of our control variable taken for profitability show a decline between period one and two [ROE (-10.80%), ROA (-0.87%) and NPM (-26.69%)]. On the other hand, Liquidity improved as was expected prior to analysing results, due to higher liquidity requirements imposed by regulations. The LTD ratio decreased to 82% in period two, as opposed to the huge 646% in period one - meaning that in period one public banks in Cyprus lent €6.46 for every euro of deposit held in account. The banks gave out loans by borrowing with high interest rates in the hope of earning high rates from giving out loans.

The Efficiency ratio also increased, meaning that costs as a percentage of sales were higher in period two. Thus, it can be concluded that in period two public banks in Cyprus were less efficient as a result of the regulations imposed. Although results were all as expected, the p-values resulted to be insignificant ($p=0.18$). This may be due to the small sample extracted for public banks in Cyprus. Therefore, we cannot reject the null hypothesis.

1. b) France

ROE decreased from 10.35% in period one to 8.04% in period two. Operational Performance also decreased from 1.09% to 0.90% as represented by the ROA. NPM, however, went against our expectations since in period two it increased to 22.47%. This means that in period two public banks in France managed to control their costs better despite higher regulations imposed. All the above-mentioned results have strong z-tests and are all highly significant at all levels considering that their p-values are almost equal to zero. The null hypothesis (H_0) is disregarded, hence failing to reject the alternative hypothesis (H_1).

Liquidity also improved in period two. This is because fewer loans were given for every euro of deposit held. In period two, €0.89 loans were given for every €1 held. This was €0.10 less loans given for every euro held in period one. The magnitude of the z-test (-2.844) calculated by the Wilcoxon sample paired test is higher than the rule of thumb. The negative sign of the z-stat shows that in period two the LTD ratio was lower when compared to the benchmark period. The p-value of 0.004 is considered as highly significant at all levels (99%, 95% confidence intervals). The null hypothesis is rejected and hence there is a negative trend of LTD ratio between the periods.

The efficiency ratio also met our assumption by increasing in the second period, resulting in lower efficiency. This result is highly significant at all levels with a p-value of 0.002 and a z-score of -3.154, which shows a strong statistical test. The alternative hypothesis (H_1) is accepted, i.e. efficiency worsened following regulatory pressures on governance.

(c) Greece

Greece was one of the most severely hit by the crisis. The Greek-government debt crisis in 2009 led to a serious drop in the Gross Domestic Product (GDP) of the country. Greece continues to suffer from this depression even today, in the form of high debts. With respect to profitability, public banks in Greece, suffered a huge drop in the mean % values of period two. ROE recorded a mean of 4.35% in the second period dropping from a mean 21.87%. ROA declined below zero, meaning that public banks in Greece experienced negative returns on assets in the second period.

NPM followed the same trend as ROA, by registering a negative score (-10.64%). ROA's results are significant with a p-value of 0.046. However, this cannot be said for ROE and NPM since their p-values are greater than 0.05. In this case the null hypothesis (H_0) cannot be rejected, hence we cannot distinguish between period one and period two. Public banks in

Greece loaned out €1.40 for every euro held in deposits during the first period. This diminished to €0.79 for every euro held in period two, showing an improvement in their liquidity by almost 50% in the second period.

Moreover, there was a registered increase in the efficiency ratio between the periods. The second period recorded an efficiency ratio of 63.26%. When compared to the first period, the costs as a percentage of sales were approximately 14% higher in period two. However, for both liquidity and efficiency, the computed z-score and p-value shows statistical insignificance for these results. Again, this insignificance is most probably the result of a small sample.

1. Italy

During the crisis, Italy experienced an 8% drop in GDP in 2008 (3% more than the euro zone). This led to the EU authorities to keep a close eye on the Italian banking system. Italian public banks faced diminishing profitability averages. ROE averaged 28.63% in period one. This value diminished to an average of 1.66% in the second period. This shows that the management of banks were less capable to generate cash from shareholders' equity in period two. ROA in period one was 1.78% and in the second period, this decreased to -0.30%. Both ROE and ROA are statistically significant with p-values of 0.018 and 0.011 respectively ($p < 0.05$). Z-scores for both ROE (-2.374) and ROA (-2.535) show that period two was lower than period one (represented by the negative sign) and the size is higher than the rule of thumb. Therefore, we reject the null hypothesis (H_0) and accept the alternative (H_1).

Although NPM registered a decrease in the second period, this result is not statistically significant at the 0.05 confidence level ($p = 0.126$). On the other hand, the LTD ratio decreased in period two, from 114.52% to 98.61%. This shows that the Italian public banks in the second period gave out less loans for every euro held in account, as a result of the revised regulations. This improved the liquidity position of banks in period two. This result is highly significant at all levels with a p-value of 0.003 and z-score of -3.018 ($z > 2$). Therefore, the alternative hypothesis (H_1) (i.e. that liquidity improved after regulatory pressures on corporate governance) cannot be rejected.

The Efficiency ratio increased in the second period making the banks less efficient in this period. That is, as a result of revised regulations on governance, costs as a percentage of sales increased. This result is significant with $p = 0.009$.

1. Malta

ROE decreased from 21.56% to 7.26% and ROA followed the same direction, with a drop in period two to 0.52%. The p-value = 0.068, which is statistically significant at ($p < 0.1$) (Cowles and Davis, 1982). NPM declined by a lower magnitude. Hence, there was no difference between the periods. The p-value = 0.465. The loans to deposits ratio show that in Malta, public banks were giving lower loans for every euro held on account during period one (€0.72 for every euro). However, in period two banks lent €0.85 for every €1 held on deposit accounts. This meant that banks in Malta were more cautious in period one and the regulatory pressures after the crisis enabled Maltese public banks to give out more loans for every euro held on account. The p-value = 0.715, which makes it insignificant.

Efficiency in Maltese public banks also plunged. This was seen in the increase in the efficiency ratio, which in period one was 58.68% and increased to 74.74% in period two. This increase in efficiency ratio portrayed an increase in costs as a percentage of sales after authorities in the EU revised regulations on governance. The p-value of 0.068 is significant at a p-value < 0.01 .

1. Spain

Public banks in Spain experienced a decrease in profitability from period one to period two. ROE decreased from 18.09% to 10.53%. This decrease is significant with a p-value of 0.043. Z-score is computed as -2.023, which magnitude is greater than our rule of thumb ($+2$) and the sign represents the drop in period two when compared to period one. We therefore reject the null hypothesis (H_0), meaning that ROE decreased from period one to period two. Although ROA and NPM declined in period two, these results are not significant at p-value = 0.138 and 0.345 respectively. To this effect, we could not reject the null hypothesis (H_0). This means that there is no difference between both periods.

LTD decreased during the second period to 94.49% from 401.31% in the first period. This represented a higher liquidity position of the banks. This value is statistically significant with a p-value of 0.043. Therefore, the alternative hypothesis (H_1) can be accepted. Thus, liquidity in period two was better than in period one.

In addition, the Efficiency Ratio soared from 59.82% to 68.60% during the periods. This denoted that public banks in Spain performed less efficiently in period two. This increase is significant with a p-value of 0.043 and a z-test of -2.023. The null hypothesis (H_0) can be rejected, meaning that efficiency was worse in period two.

1. Portugal

Here only one bank was deemed to be fit this study. To this effect, all outcomes are insignificant $P\text{-value} > 0.1$. However, with regards to profitability and liquidity, Portugal followed the same trend, similar to the other countries in this study.

Despite this, the same cannot be said with regards to efficiency ratio. This is because this bank seemed to be more efficient in period two (period 1 - 63.98% and period 2 - 60.32%).

4.5 Perspectives of Interviewees

The interviewees (22/22) agreed that, 1) failures in Governance were a significant cause of the crisis; 2) performance related pay instead of decreasing the agency problem, actually encouraged higher short-term risk taking; 3) boards and senior management failed to understand the complexity of banking transactions example derivatives and the high exposure that their entity was running into. They highlighted that most board members did not provide the necessary oversight or control over management. Shareholders, in turn, pressured for higher share prices, which led to banks taking excessive risks. Regulators failed to capture low probability-high severity incidents example credit rating of collateralized debt obligations (CDOs). Moreover, regulators failed to supervise how financial information was produced and measures to safeguard integrity were not enough.

Particularly, (10/22) interviewees argued that *"Regulations on governance have become excessive. We moved from one extreme to another"*. Prior to the crisis, the regulatory frameworks focused on profitability while ignoring severity. Presently the emphasis is on the severity and overseeing profitability. This means that nowadays depositors are overprotected (deposit guarantee schemes, higher capital buffers) to detriment of banks losing a large proportion of investors (since they opt to invest elsewhere, in a less regulated environment).

Regulations have become fixed for all banks, whether large or small, without the application of the principle of proportionality enacted in the Lisbon Treaty of 2007. Other interviewee (15/22) argued that *"in the aftermath of the crisis, regulatory changes in the field of corporate governance in particular, were pretty drastic and may not have been as proportional as desired"*. To this effect, banks incur a fixed and significant compliance cost. Hence, a bank needs to have the necessary critical mass in business activity to cover for these costs. Therefore, the impact on smaller banks is very high and sometimes business activity becomes unfeasible. Performance has been adversely affected by higher regulatory costs. In the short-term there is a trade-off between profitability and liquidity, however, in the long-term these two converge.

Lack of liquidity would eventually lead to lower profitability and a company that is not profitable in the end, would find it difficult to raise the necessary funding. High liquidity buffers are eroding away the opportunity of reaping higher returns. Efficiency has decreased because banks are putting more attention (resources) on who their customers are, through a series of controls such as customer due diligence. These processes take time and time is money for every entity, this is why the costs as a percentage of sales are getting out of control.

Moreover, all the interviewees (22/22) agreed that the regulations should follow the principle of proportionality and deliver the right balance with a fair and safe return to investors in accordance to their appetite and tolerance levels.

Sixteen interviewees (16/22) in fact noted that; *"too much regulation will just drive business from regulated entities to newly formed but unregulated entities"*. This is because the increment in costs are transferred to the client. Furthermore, they note that effectiveness is achieved through the integrity and collective effort of those involved. It is useless having strict regulations to have a robust corporate governance framework without appraising the people involved.

They highlight that to appraise the human element in corporate governance; one needs to keep in mind the following two adages: (1) the past is not a mirror of the future and (2) not all that glitters is gold. Hence, the main objective of a bank is to deliver adequate training together with remuneration of good personnel to obtain the desired levels of efficiency, which ultimately leads to better performance.

5. Conclusions

Using panel data of ratios of 53 banks from seven different countries in the EU Mediterranean region over the period between 2006-2010 (regarded as pre and during crisis) and between 2014-2018 (taken as the period post regulatory pressures on governance), we studied the key regulations imposed on governance and their effects on the performance of public banks. Italian, French, Greek, Portuguese, Spanish and Cypriot banks have been involved in an economic depression and credit crunch and many parties blame this on the ineffectiveness of governance. European authorities have therefore intervened by issuing new regulations on governance, whilst updating flaws in the existing.

This had some repercussions on the overall performance of public banks in the EU Mediterranean region. As one could see, from the data analysis above, profitability decreased significantly from period one to period two. Thus, one can conclude that profitability was negatively affected with corroborates to the findings in the studies carried out by Bhagat and Bolton (2009) and JB (2017).

In the year of the crisis (2007), one could notice a high profitability trend. In addition, however, 2014 was one of the worst years in terms of profitability for public banks in the EU Mediterranean region. This was exactly after the implementation of new governance requirements. When we looked at the individual countries, we noted a downward trend in profitability in most of the cases.

Interviewees supported our findings by arguing that the regulators are being too strict, and regulations imposed have moved from one extreme to another impacting adversely banks' profitability. However, nowadays, banks know their customers and are making profits supposedly without the risk of losing their reputation. Liquidity improved after the regulatory pressures and the LTD ratio decreased significantly in the second period. This corroborates to the findings of Saeed (2014) and Grima et al. (2019), who reported that stricter liquidity regulations led to banks decreasing drastically the LTD ratio, to maintain higher capital buffers. Interviewees claimed that this high liquidity coverage ratio is one of the main causes of decreasing profitability as it is making banks lose the opportunity to earn higher profits.

Efficiency plummeted significantly in period two. This theory followed what Arun and Turner (2002), reported in their paper, suggesting that the inefficiencies associated with bank management, is a major cause of strict regulatory pressures. This is also due to higher compliance costs incurred as a percentage of sales. This finding also corroborates to the works of Lux and Piechocki (2015), who reported that the burden of compliance and reporting is becoming too costly and time-consuming.

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[1]University of Malta, Graduate, Faculty of Economics, Management and Accountancy, glenngauci1996@gmail.com

[2]University of Malta, Senior Lecturer, Department of Insurance, Faculty of Economics, Management and Accountancy, simon.grima@um.edu.mt

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