The Impact of Board Size and its Independence on Financial Performance in Banking Industry

Research & Advisory Report

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Abstract

In September 2008, world’s financial system was almost brought down by a struggling global banking industry (The Economist, 2013). Banks, as major creditors and in some countries as major equity holders, play an important role as its complexity makes it different from the other industries. The complexity of banks has made it subject to more intense regulation than other firms (Andres and Valellado, 2008). However, the challenges in regulating the banking industry in turn lead to an initiative to deregulate banking industry, which was believed to let financial institutions, such as banks, to come back in the competition. However, this increase in freedom also had a significant downside, namely the increasingly speculative, high-risk activities of the financial sector, or in other words, financial sector failure. The failure of financial system brings out awareness of banks corporate governance, in which board of directors is one of the elements. An effective board of directors is expected to support the monitoring function of corporate governance in banking firms. Board of directors has several factors that can support its effectiveness, such as board size and independence. Research believed the independence of boards can be identified by two sub-factors which are the existence of independent directors and CEO role duality. Despite of the importance of board of directors in banks, the waves of regulation and deregulation of banks corporate governance throughout the years has left us with the question whether board of directors is really effective in controlling financial performance. Thus, the main question arises: "What are the influences of board size and its independence on banks financial performance?" Using literature review method, it can be concluded that two influencing factors that particularly become the focus of this study, board size and independence, which is identified by the existence of independent/outside directors and CEO role duality, do have both positive and negative relationship towards banks financial performance.
Preface

All praises and glory for the Precious Savior, Jesus Christ, for His favor lasts a lifetime. The writer would also thanks family and friends for their continuous supports and love during the writer's study in the Netherlands. In addition, the writer gives sincere gratitude for both of the supervisors, Ms. Bettine Bergmans and Mr. Frank Gruben, for their guidance, supports, and recommendations during the process of writing. Without them, this paper would not be completely written.
# Table of Contents

I. Introduction .......................................................................................................................... 5  
1.1 Problem Description ........................................................................................................ 5  
1.2 Main Research Question and Sub Questions ................................................................ 8  
1.3 Methodology .................................................................................................................. 9  
1.4 Research Objective and Study Contribution ................................................................. 10  
1.5 Paper Outline ................................................................................................................. 10  

II. Theoretical Framework ...................................................................................................... 11  
2.1 Introduction ..................................................................................................................... 11  
2.2 Definitions ....................................................................................................................... 11  
2.2.1 Corporate Governance .............................................................................................. 11  
2.3 Underlying Theories ........................................................................................................ 15  
2.3.1 Agency Theory .......................................................................................................... 15  
2.3.2 Resource Dependence Theory .................................................................................. 17  
2.4 Board Size and Banks Financial Performance ............................................................. 18  
2.5 Board Independence and Banks Financial Performance .............................................. 22  
2.5.1 General Independent / Outside Director and Banks Financial Performance ..22  
2.5.2 CEO Role Duality and Banks Financial Performance ............................................ 25  
2.5 Conclusion ..................................................................................................................... 28  

III. Conclusion ......................................................................................................................... 29  
3.1 Problem Description ....................................................................................................... 29  
3.2 Theory ............................................................................................................................. 29  
3.3 Influencing Factors .......................................................................................................... 30  

IV. Policy ................................................................................................................................ 33  
4.1 Suggestions ...................................................................................................................... 33  
4.2 Limitations ....................................................................................................................... 35  

Reference List ......................................................................................................................... 37
I. Introduction

1.1 Problem Description

In September 2008, world’s financial system was almost brought down by a struggling global banking industry (The Economist, 2013). The Economist (2013) also mentioned that after several years, the insight of major factors are getting clearer. For instance, irrationally confident Anglo-Saxon investors, who claimed to have found a way to banish risk when in fact they had simply lost track of it. Central bankers and other regulators were also to blame, for it was they who tolerated this ignorance. Some research also implicates European banks, which borrowed greedily in American money markets before the crisis and used the funds to buy dodgy securities (The Economist, 2013).

Banks, as major creditors and in some countries as major equity holders, play an important role (Caprio et al., 2007). Research has proven that the banking industry has several characteristics that make it different from the other industries. What makes it unique is its complexity. As in comparison to non-bank financial institutions, banks are highly leveraged firms taking a wide range of complex risks in their daily operations, including credit, liquidity, interest rate, operational and market risk. In addition, banks are also special with respect to their crucial position in the financial system whereby liquidity or solvency problems have a direct and severe adverse impact upon the overall financial system. This is because banks can constitute as the main or even the only source of finance (Staikouras, 2007).

The complexity of banks has made it subject to more intense regulation than other firms (Andres and Valellado, 2008). One standard rationale for this is that shareholders and creditors lack sufficient mechanisms for establishing sound governance over extraordinarily complex and opaque banks (Caprio et al., 2007). However, according to Andres & Valellado (2008), regulation, in turn also presents several challenges in the field of corporate governance, especially when regulation imposes bank ownership restrictions, or when it reduces operations allowed to banks and applies coefficients that lessen competition in the industry, or when it designs a deposit insurance that restricts depositors’ supervision.

Existence of such challenges in turn lead to an initiative to deregulate banking industry, which was believed to let financial institutions, such as banks, to come back in the competition. Competitiveness is effective in the way of giving incentive for
banks to expand production. To support this argument, Belkhir (2009) found that in a business environment characterized by increased competition and higher threats from the market for corporate control, the effectiveness of internal governance systems in protecting shareholders’ interests has become more relevant than ever before (Belkhir, 2009).

A concrete example of where this deregulation took place in order to create more competitiveness was for instance in the United States. The rising of neoliberal capitalism in United States was followed by financial deregulation which attempts to free banks and other financial institutions to pursue whatever financial activity would bring the highest profits, which had not been allowed under the pre-1980 highly regulated financial structure (Kotz, 2009).

However, this increase in freedom also had a significant downside, namely the increasingly speculative, high-risk activities of the financial sector, or in other words, financial sector failure. In pre 2008 financial crisis period, U.S. financial institutions created trillions of dollars in risky mortgage-backed securities, derivatives, and other types of securities, before finally collapse and directly responsible for the financial crisis (Kotz, 2009). In respond to 2008 crisis, the best attempt of governments of the wealthiest nations in the world is only to resort to extensive bail-out and rescue packages for the remaining large banks and financial institutions (Shah, 2013).

Similar case also occurred in South East Asia. During the early 1990s, financial liberalization programs were implemented across the region, which intended to increase the competitiveness of national banking sectors. The result actually resembles the previous example where financial liberalization ends with bank restructuring programs beginning almost immediately in 1997 and not ending until the early 2000s (Williams and Nguyen, 2005).

Besides distressing effects in the individual countries, crises themselves often have contagion effects. This means the crisis does not only impact the country experiencing the crisis, but it can also affect other countries (Baig and Goldfajn, 1998). Baig and Goldfajn (1998) found discernible patterns of contagion during the East Asian crises. The crises suggest that during a period of financial market instability, market participants tend to move together across a range of countries. Shocks originating from one market continually transmitted to other markets becoming a source of substantial instability (Baig and Goldfajn, 1998). As a
consequence of the latest financial crisis that spread all over the world, corporate governance has become one of the most debated subjects, especially in banking environment (Stefanescu, 2011).

Corporate governance deals with mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected (John & Senbet, 1998). One of the mechanisms is board of directors. Importance of board of directors also applies in banking industry. In his research, Pathan et al. (2007) stated several reasons of the importance of bank board governance. First, bank directors are accountable not only to shareholders, but also to depositors, clients and regulators. Second, banks’ high leverage and mismatch between term structure and liquidity of their assets and liabilities makes banks’ role in the economy even more important. Third, the agency problems are particularly crucial for banks as they are opaque largely because of information asymmetries. For instance, in banking, loan quality is not readily observable and can be hidden for long periods in such a way that banks can readily hide problems by extending loans to clients that cannot service previous debt obligations. Not surprisingly, research finds that bond analysts disagree more over the bonds issued by banks than by nonfinancial firms (Levine, 2004). Fourth, deposit insurance makes the situation worse by ameliorating the ‘moral hazard’ problem among bank shareholders and debt-holders. In a world with deposit insurance, insured depositors will not demand a risk premium because they know that the government will insure their deposits up to the legal limit, regardless whether the bank makes the loan. Thus, deposit insurance gives banks incentives to take added risks - either by increasing their leverage or investing in riskier assets - thereby increasing the government’s exposure to losses (McCoy, 2007). Finally, bank corporate governance is particularly important because it reduces the risk of taxpayer funds being used in mitigating a crisis and helps restraining connected lending (Pathan et al., 2007).

Despite of the importance of board of directors in banks, the waves of regulation and deregulation of banks corporate governance throughout the years has left us with the question whether board of directors is really effective in controlling financial performance. Many research have been conducted to reveal the effectiveness of board of directors based on its mechanisms. This study, however, will take focus on the internal control mechanism of board of directors, as explained by Praptiningsih
(2009). There are basically two factors incorporating the internal control mechanism, they are board size and board independence. Following Stefanescu (2011), this study identifies board independence through two sub-factors, which are existence of independent/outside directors and CEO role duality.

Board size and board independence become the focus of this research because: First, there have been many issues discussed in previous research about both of the factors. Nevertheless, the results vary among different research. This study hence attempts to review the previous research and reveal how or when board size and independence will positively or negatively influence the financial performance of banking industry. Second, the waves of regulation and deregulation of banking industry also delivers this study to focus on the optimum size and independence of banks board of directors, which can be useful to be incorporated in rules or standard for banks corporate governance. Third, there is an apparent departure of the current practice of corporate governance from the legal provisions, which suits the board control over management. As John & Senbet (1998) stated, the basic principle of corporate governance is that the shareholders elect the board of directors who in turn select top management. The common practice, however, is for the board to be elected by the shareholders from the lists approved by the top management. Therefore, following John & Senbet (1998), this study sees board size and independence important as they determine the effectiveness of the board of directors in monitoring the management (John & Senbet, 1998).

**1.2 Main Research Question and Sub Questions**

Based on the findings from previous research, this research study has come up with main question: “What is the influence, according to the literature, of board size and board independence on bank’s financial performance?” This question aims to find relationship between board size and its independence on financial performance in banking industry.

To follow up the main question, this research also takes into account the following sub question: “What are the reasons to expect a relationship between board size and its independence on bank’s financial performance?” Another sub question that this study needs to convey is: “What are the evidence, based on literature, on the relationship between board size and independence on bank’s financial performance?”
The literatures found are expected to provide evidences to prove board size and its independence as the factors that can influence banks’ financial performance.

1.3 Methodology

Literature review methodology is applied in conducting this research. This method is believed to be the basis of both theoretical and methodological sophistication, thereby useful in improving the quality and usefulness of subsequent research (Boote and Beile, 2005). On-topic materials supporting this research include articles from journals, as the main resources, and also websites, theses and dissertations of professionals.

Journals that supply the articles used as resources of this research consist of:

- Journal of Organizational Management Studies
- Journal of Economics and Finance
- Journal of Banking and Finances
- Journal of Financial Intermediation
- International Review of Economics and Finance
- Financial Management
- Journal of Managerial Finance
- Strategic Management Journal
- Journal of Corporate Finance
- Managerial Auditing Journal
- Social and Behavioral Sciences
- Journal of Accounting in Emerging Economies
- Policy Research Working Paper
- Review of Radical Political Economics
- The Business Lawyer
- American Economics Association
- IMF Working Paper
- Educational Researcher
- Social and Behavioral Sciences
- Journal of Accounting in Emerging Economies
- Policy Research Working Paper
- Review of Radical Political Economics
- The Business Lawyer
- American Economics Association
- IMF Working Paper
- Educational Researcher
- Social and Behavioral Sciences
- Journal of Accounting in Emerging Economies
- Policy Research Working Paper
- Review of Radical Political Economics
- The Business Lawyer
- American Economics Association
- IMF Working Paper
- Educational Researcher
- Social and Behavioral Sciences
- Journal of Accounting in Emerging Economies
- Policy Research Working Paper
- Review of Radical Political Economics
- The Business Lawyer
- American Economics Association
- IMF Working Paper
- Educational Researcher
- Social and Behavioral Sciences
- Journal of Accounting in Emerging Economies
- Policy Research Working Paper
- Review of Radical Political Economics
- The Business Lawyer
- American Economics Association
- IMF Working Paper
- Educational Researcher

All resources are obtained from the internet by processing following relevant keywords: corporate governance, board size, banks, financial industry, financial sector, board structure, board characteristics, profitability, efficiency, governance system, financial crisis, financial deregulation, financial institution, ownership structure, financial liberalization, Asian crisis. While the search engines used to retrieve the resources involve:

- Google Scholar
- Science Direct
- Elsevier
- JSTOR
- Emerald Insight
In order to select appropriate article, the abstract of each article is read thoroughly. Then, the articles that have no relation to specific scope of bank industry are eliminated. Other than articles from journal, relevant sources like formal article from websites, theses and dissertations are also reviewed. Process of obtaining those other resources is conducted through internet search using Google Scholar.

1.4 Research Objective and Study Contribution

This research is conducted with aim to contribute to policy formulation regarding the governance structure in banking industry, particularly in board size and board independence. By finding the relationship of board size and independence on banks financial performance, the result will suggest in how banking industry should form its optimal board size, how many outside directors can present in the board and in what condition CEO can or can not have dual role as both CEO and board chairman. Regulator then can advantage from this contribution in order to set the standard with regard to appropriate size of banks’ board of directors, appearance of outside directors and absence of CEO role duality.

1.5 Paper Outline

The rest part of this paper is organized as follows. Chapter 2 presents the theoretical framework of this paper, which will comprise the definition of corporate governance, the underlying theories, and also evidences of relationship between board size and independence on bank’s financial performance found in literature. Chapter 3 concludes the relationship between board size and independence on bank’s financial performance. Chapter 4 presents the suggestions related to the topic and the limitations of this study.
II. Theoretical Framework

2.1 Introduction
This chapter presents the core of this study. There are three big sections discussed in order to answer the main research question and the sub-questions. First, definition of the big topic, which is corporate governance, is explained along with the variables of this study, which are board size, outside/independent directors, and CEO Role Duality. Second, the theories that underlie the analysis of this study are elaborated in the next section, which are agency theory and resource dependence theory. Then, the next section amplifies the findings of this study that will answer the main research question, which is the relationship between three variables mentioned before with banks financial performance, as the angle of research. The last part concludes and gives closure of the chapter.

2.2 Definitions

2.2.1 Corporate Governance
Over recent years, corporate governance has become a major and highly contentious issue in all advanced economies, as well as in developing countries. Driven by a wave of corporate scandals mainly owed to self-dealing, fraud and poor quality management decision-making, corporate governance has attracted international attention as a means to address the agency problem, thus promoting corporate efficiency, which will be discussed later on in this chapter (Staikouras et al., 2007).

Besides corporate scandals, lack of awareness of the importance of good corporate governance in some countries, particularly developing countries, also drives establishment of corporate governance code (Arouri et al., 2014). For instance in 2008, the corporate governance survey of Gulf Cooperation Council (GCC) countries by the Institute of International Finance and Hawkamah, the Institute of Corporate Governance, found that corporate governance practices across the GCC countries are lagging behind international standards. This survey found that not a single publicly listed company in the region followed best practice of corporate governance, and only three percent of surveyed firms followed good practice. Most firms mentioned that they did not have better practices because it was not required (Arouri et al., 2014).
Starting to realize the importance of corporate governance, research has made their attempts in defining corporate governance from different perspectives. According to Zingales (1998), corporate governance is interpreted as a group of mechanisms used by stakeholders to ensure that directors efficiently manage corporate resources (Andres & Vallelado, 2008). Emphasizing on rules and principles, Praptiningsih (2007) follows Brigham and Erhardt (2005) definition of corporate governance as the set of rules and procedures that ensures managers employ the principles of value-based management. The essence of corporate governance is to make sure that the key shareholder objective, which is wealth management, is implemented (Praptiningsih, 2007). Moreover, presenting a broader accountability to the whole of society, future generations and the natural world, Solomon & Solomon (2004) defines corporate governance as the system of checks and balances, both internal and external to companies, which ensures that companies discharge their accountability to all their stakeholders and act in a socially responsible way in all areas of their business activity.

At the same time, regulatory body such as Organization for Economic Cooperation and Development (OECD) express corporate governance as a set of relationships between a company’s management, its board, its shareholders and other stakeholders and also provides the structure through which the objectives of the company are set, and the means of achieving those objectives and monitoring performance are determined (Staikouras et al., 2007). Consistently with the OECD definition, the Basel Committee on Banking Supervision set out a definition from the perspective of banking industry, according to which corporate governance involves the manner in which the business and affairs of individual institutions are governed by their Boards of Directors and senior management, which affects how banks: set corporate objectives, run day-to-day operations of the business, meet the obligation of accountability to their shareholders and take into account the interests of other recognized stakeholders (Staikouras et al., 2007). The last definition therefore becomes the reference for this study, since this study takes the viewpoint of banking industry.

Praptiningsih (2009) reveals four monitoring mechanisms of corporate governance, namely ownership monitoring mechanism, internal control monitoring mechanism, regulatory monitoring mechanism, and disclosure monitoring mechanism
altogether with the sub-elements. However, this study will specifically focus on internal control mechanism, comprising of board size and independence, which comprises of existence of independent/outside directors and CEO duality role.

Chen (2006) defines board size as the number of directors within the board. While board of directors itself is regarded as one of corporate governance mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management, who control the key decisions of corporation, such that their interests are protected (John & Senbet, 1998; Solomon & Solomon, 2004). However, the board of directors is presumed to carry out the monitoring function on behalf of stakeholders, because the stakeholders themselves would find it difficult to exercise control due to wide dispersion of ownership of common stock (John and Senbet, 1998). Therefore, it can be concluded that there should be two independent parties instituting board of directors. One of the parties refers to managing or executive directors, which is delegated to day-to-day management. While the remaining is non-executive directors or supervisory directors, which serves as monitors for the work of executive directors (Staikouras et al., 2007). Despite of the term ‘non-executive/supervisory directors’ introduced by Staikouras et al. (2007), this study use ‘independent/outside directors’ because non-executive/supervisory directors perceived to be independent of executive directors and thus have more incentive to do their role more effectively (Cadbury Committee, 1992 in Al-Saidi & Al-Shammari, 2013).

Focusing on banking industry, Bassel Committee (2015) follows Financial Stability Board (2013) in defining independent directors, as members of the board who do not have any management responsibilities with the bank and are not under any other undue influence, internal or external, that would impede the board member’s exercise of objective judgment. In addition, Pathan et al. (2007) also makes a clear distinction between the term independent and outside directors. An ‘outside director’ is a non-executive director on the board whereas an ‘independent director ’is an outside director with no ‘material’ relationship with the firm except for the board directorship. However, as many research uses the term independent directors and outside directors interchangeably, this study will consider outside directors to have the same meaning as independent directors.
In his research, Pathan et al. (2007) also found there are three basic characteristics required for a board member to be identified as an independent director:

- is neither an official nor an employee of the company, its subsidiaries nor part of the same conglomerated
- does not own directly or indirectly more than 0.5% of equity share and
- does not have any direct or indirect special relationship with insiders of the banks that may obstruct their impartiality.

The role of outside directors has been viewed as particularly critical, because in addition to providing expert advice to management, outside directors are expected to represent the interests of shareholders by mitigating agency problems between management and shareholders (Subrahmanyam et al., 1997). Therefore, supporting the argument of the importance of outside directors existence, Jensen (1993) conveys, that for the board to be effective, it is important to separate the CEO and chairman positions. He believes that the function of the chairman is to run board meetings and oversee the process of hiring, firing, evaluating, and compensating the CEO (Jensen, 1993). This role, most closely aligned with agency theory, requires the board to monitor and evaluate the CEO and his or her top management team and company performance in general, as well as protect shareholders’ interests (Dalton et al., 1998).

Such corporate governance mechanisms are also applied for banking industry. Only there are some differences between corporate governance mechanism between banking firms and the non-financial corporation since they operate under different environments. Praptiningsih (2009) presents one of the evidence as an issue of moral hazard in banking firm operational, such as transfer pricing, asset stripping, hiring family members, and an improper credit allocations that result negative impact on bank’s performance (Praptiningsih, 2009). Such issue encourage good governance practice particularly in banking industry, as Caprio et al. (2007) believes, sound governance mechanism enhances banks to efficiently mobilize and allocate funds, lowering the cost of capital to firms and accelerates capital accumulation and productivity growth. Moreover, also emphasizing banks efficiency, Pathan and Faff (2011) stated that well-governed banks can not only contribute to, but in fact also be critical agents for the proper functioning of many non-financial sector firms, thus, collectively promote a more efficient allocation of resources across the economy. For
those reasons, sound governance in banking industry has drawn attention of general public and professionals, as Stefanescu (2011) stated, financial crisis made a controversial economic concept, bringing it as well to the attention of media and academic environment, and thereby becoming the most challenging topic of worldwide research.

2.3 Underlying Theories

2.3.1 Agency Theory

Mizruchi (1998) defined agency theory as a control-based theory in that managers, by virtue of their firm-specific knowledge and managerial expertise, are believed to gain an advantage over firm owners who are largely removed from the operational aspects of the firm (Dalton et al., 1998). It is separation of ownership and control, as characteristic of the modern corporation, which potentially leads to self-interested actions by those in control (managers) (Al-Saidi & Al-Shammiri, 2013; Dalton et al., 1998).

Agency theory starts with recent modern corporations situation that has been challenged by the separation between management and ownership. Research agrees that separation between ownership (shareholders) and control (managers) of corporations will lead to the agency problem. A crucial agency problem is the ability of controlling shareholders to expropriate corporate resources legally (Staikouras et al., 2007; Caprio et al., 2007). However, there is a problem with aligning the interests of dispersed shareholders with that of management, leading to conflict of interests (Arouri et al., 2014). Managers, who are delegated with the task of running the firm on behalf of ultimate owners, have interests, such as high levels of remuneration and social status, which differ and often conflict with those of shareholders, which is maximization of their investment in the form of increased dividends and capital value (Staikouras et al., 2007).

In addition to the conflict of interests between shareholders and management, there are at least three additional agency problems, the first two of which are addressed by Liang et al. (2013). First, is the manipulation of stock price. Peng & Roel (2008) found some recent works that present a standard principal-agent framework in which managers are incentivized to provide value-creating effort by basing their pay on the stock price. The implication of this model is that managers
tend to be motivated to influence the stock price in the short run by devoting time and effort to investor relations. Second, is the expropriation of minority stockholders as issues commonly happen especially in firms with concentrated ownership. Williams & Nguyen (2005), using pyramiding technique model, found that concentrated ownership can create an entrenchment agency problem, and majority owners can expropriate against outside owners. The pyramid concept allows majority owners to spread their influence into entities further down in the group structure without requiring any fresh injection of capital. The third, addressed by Andres & Vallelado (2008), is regulation made by the regulator. The main aim of the regulator, which is to reduce systemic risk, might come into conflict with the main goal of shareholders, which is to increase share value. The conflicting goals introduce a new agency problem (Andres and Vallelado, 2008).

The implication for corporate governance from an agency theory perspective is that adequate monitoring or mechanisms need to be used to protect and reduce the conflicts of interest between shareholders and management, among shareholders, and between debt-holders and firms as such conflicts lead to agency costs (Fama and Jensen, 1983 in Al-Saidi & Al-Shammiri, 2013). According to agency theory, then, effective boards will be comprised of outside directors. These non-management directors are believed to provide superior performance benefits to the firm as a result of their independence from firm management (Dalton et al., 1998; Solomon & Solomon, 2004: 69). In addition, agency theory also suggests that the number of directors on the board has an effect on the extent of a company’s monitoring, controlling, and decision-making. Prior studies have argued that a small board size is more effective with a greater diversity of knowledge and experience and preferable on the grounds of easy coordination, cohesiveness, and communication (Jensen, 1993; Yermack, 1996; Al-Saidi & Al-Shammiri, 2013; Staikouras et al., 2007; Arouri et al., 2014).

Gorton & Schmid (1999) modeled agency problem as one of the efficiency wages. Where agency problem exists, firm owners must design a managerial compensation contract to induce effort and monitor performance. This argument is preferred especially when the employee can not rely on the promise of performance-based compensation. Such a promise may not be credible because it may be difficult to assess the performance of the employee objectively, creating a moral hazard on the
THE IMPACT OF BOARD SIZE AND ITS INDEPENDENCE ON FINANCIAL PERFORMANCE IN BANKING INDUSTRY

part of the principal since there is then an incentive to deliberately underrate the performance of the agent (Gorton & Schmid, 1999).

Efficiency wage theory predicts that a decrease in the intensity of monitoring will result in an increase in the optimal efficiency wage. However, the agency costs, in terms of the required efficiency wages, rise and firm performance declines. Gorton & Schmid (1999) applies this theory in modeling agency problem within cooperative banking. They consider the wages of all the employees of a cooperative and ask whether there is a link between the ownership structure (the degree of free-riding as measured by the number of members) and the level of efficiency wages (Gorton & Schmid, 1999).

Cooperative banking is a setting where the efficiency wage view is most appropriate, because the owners of these banks cannot reasonably be viewed as insiders who are able to judge the employees’ performance on objective grounds. Their model argues that when the number of cooperative members increases, the costs of monitoring rise due to free riding because the higher the number of cooperative members, the lower the intensity of monitoring (Gorton & Schmid, 1999). By receiving the higher wages, the employees of a bank with a higher number of cooperative members have the same incentive to perform as their colleagues in a bank with fewer members and hence, more intensive supervision. However, since higher wages translate into higher operating costs, bank performance deteriorates (Gorton & Schmid, 1999).

2.3.2 Resource Dependence Theory

Resource dependence theory, as Boyd (1990) found, asserts that the board is an integral component of the effective firm. In this model, the board is used to gain access to scarce resources and information, consistent with Hillman & Dalziel (2003) argument that the board of directors has ability to bring resources to the firm. The ‘resources’ here means anything that could be thought of as a strength or weakness of a given firm (Wernerfelt, 1984: 172 in Hillman & Dalziel, 2003). Hillman & Dalziel (2003) also discovered that there is an expectation from organization that when it appoints an individual to a board, it expects the individual will come to support the organization, will concern himself with its problems, will variably present it to others,
and will try to aid it. Therefore, through its resources provision, there are four benefits presented by boards:

1. advice and counsel
2. legitimacy
3. channels for communicating information between external organizations and the firm, and
4. preferential access to commitments or support from important elements outside the firm (Pfeffer & Salancik (1978) in Hillman & Dalziel, 2003).

Specifying implication of resource dependence on outside directors, Dalton et al. (1998) found that resource dependence perspective views outside directors as a critical link to the external environment. Such board members may provide access to valued resources and information as well as facilitate inter-firm commitment (Dalton et al., 1998). It has also been argued that this resource dependence role of directors may be particularly notable in protecting the organization from adversity, as Dalton et al. (1998) found in Pfeffer and Salancik (1978: 168), ‘one would expect that as the potential environmental pressures confronting the organization increased, the need for outside support would increase as well’ (Dalton et al., 1998). While in regard to board size, Haniffa and Hudaib (2006) and Pearce and Zahra (1992) argued that a large board size is more likely to provide companies with more expertise to not only monitor managers, but also secure critical resources.

2.4 Board Size and Banks Financial Performance

Many literatures found the existence of the relationship between board size and financial performance in the banking industry. The importance of board size is presented by the finding of Staikouras et al. (2007) in the 2005 Basel Committee Consultative Document on corporate governance for banks. The document reinforces and further explicates corporate governance practices in the matter of duties of care and loyalty that should be fully respected by board of directors. It mentioned size of the board should allow for efficiency and real strategic discussion. According to the committee, board size is then one of the most prevalent corporate governance issues, attracting wide theoretical attention (Staikouras et al., 2007).

Specifically in banking industry, both negative and positive influence are identified from different authors. Al-Saidi & Al-Shammiri (2013) found studies arguing that big larger boards are better for corporate performance because they allow
for more effective monitoring by reducing the domination of the CEO within the board, with the result of reducing agency costs, allowing for representation of different shareholders on the board, protecting shareholders’ interests, and having a greater range of expertise and resources to help make better decisions (Al-Saidi & Al-Shammiri, 2013).

Studying financial performance of bank holding companies, Adams & Mehran (2005) also found a positive influence of board size towards banks financial performance. They assert that banks structure and activities may make a larger board more desirable. For example, the regional expansion of banking activities may be associated with an increase in banks board size due to the need to coordinate subsidiary boards located in different states. They find that board size is significantly related to characteristics of banks structure and that banks structure may explain part of the relationship between board size and financial performance (Adams & Mehran, 2005). This finding is supported by Pathan & Faff (2013) research that found this positive relation depends upon a firm’s economic environment. For instance, firms with greater advising needs, such as diversified and heavily debt-financed firms, may benefit from large boards (Pathan & Faff, 2013).

This is in accordance to resource dependence theory, applying which Arouri et al. (2014) also found positive relationship between board size and banks financial performance. They found that larger boards enhance performance because they have valuable business experience, expertise, skill and social and professional networks that might add substantial resources (Arouri et al., 2014). Similarly, another finding also claims that increasing the board size generates added value due to growing complexity of banks over time and so require a better manager supervision and bringing more human capital to advise managers (Dedu & Chitan, 2013; Liang et al., 2013).

Similarly, investigating the relationship between board size and performance in United States banking organizations during the period 1995-2002, the study by Belkhir (2009) reveals that there is a positive relation between board size and measures of performance, one of which is known as return on assets. The alternative explanation for the documented positive correlation between board size and performance in banking is that the effect goes from performance to board size and not the opposite (board size affects performance). In other words, the evidence suggests
that boards expand in response to an increase in bank total assets (Belkhir, 2009).

But overall, research believes that the consensus in the economic literature is that an increase in board size will have a negative effect on firm performance (Adams & Mehran, 2005). As Jensen (1993) found, when boards get beyond seven or eight people they are less likely to function effectively and are easier for the CEO to control, because smaller board will be most likely to allow directors to get to know each other well, to have more effective discussions with all directors and to reach a true consensus contributing from their deliberations (Lipton & Lorsch, 1992). Andres & Vallegado (2008) reinforce the argument, only with a difference number, which are 19 directors. They argue that the inclusion of more directors should benefit the monitoring and advisory functions, improve governance, and raise returns, but still within a limit beyond which the coordination, control, and decision-making problems outweigh the benefits (Andres & Vallegado, 2008).

This argument is supported by the finding of Eisenberg et al., (1998) that there are at least two main sources of the board size effect: increased problems of communication and coordination as group size increases, and decreased ability of the board to control management, thereby leading to agency problems stemming from the separation of management and control (Eisenberg et al., 1998; Dedu & Chitan, 2013; Andres & Vallegado, 2008). Therefore, the effect of board size on bank value is a trade-off between advantages (monitoring and advising) and disadvantages (coordination, control, and decision-making problems) (Andres & Vallegado, 2008).

In addition, through findings in their research, Boone et al. (2007) mentions factors, which support the determinant of board size. The first hypothesis implies that board size is driven by the scope and complexity of the firm's operations. This hypothesis is called the scope of operations hypothesis. Through this hypothesis they predict that larger or more complex processes will lead to larger and more hierarchical firms (Boone et al., 2007). The second hypothesis, referred to monitoring hypothesis, implies that board size is determined by the specific business and information environment, in which the firm operates. The monitoring hypothesis does not imply that larger or more independent boards should be related to firm performance. Rather, it implies that the tradeoff between the costs and benefits of adding a board member depends on the firm’s characteristics (Boone et al., 2007). It is presumed that the net benefits of extra monitoring increase with managers’ opportunities to consume private
benefits, but decrease with the cost of monitoring. Thus, optimal boards will employ large numbers of outside directors, and be larger in overall size, when managers’ private benefits are high and the cost of monitoring is low (Boone et al., 2007). And the third hypothesis implies that board composition results from a negotiation between the firm’s CEO and its outside board members. They call this the negotiation hypothesis. The negotiation hypothesis implies that the proportion of outsiders on the board will be negatively related to the CEO’s influence and positively related to constraints on the CEO’s influence (Boone et al., 2007).

Based on those three hypothesis, Boone et al. (2007) found the forces which shape corporate boards are such as: (i) larger, more seasoned, and more diverse firms have larger and more independent boards; (ii) firms in which managers’ opportunities to consume private benefits are large, or in which the cost of monitoring managers is small, have larger boards; and (iii) firms in which managers have substantial influence and in which the constraints on managerial influence are weak, have less independent boards (Boone et al., 2007).

Whereas in banking industry, Pathan & Faff (2013) explains the negative influence of large board size influence is because directors on large boards could face greater difficulties in expressing their opinions in the limited time available during board meeting, reducing an individual director’s incentive to acquire information and monitor managers, and therefore CEOs will find larger boards easier to control (Jensen, 1993: 865 in Pathan & Faff, 2013). Still in the same direction, Liang et al. (2013) found strong evidence that board size have significantly negative impacts on bank performance and loan quality in the case of Chinese banks. The results suggest that small boards tend to be more efficient in supervising and advising functions (Liang et al., 2013). Similarly in Thailand, statistically significant negative relation between Thai bank board size and performance has consistent result. This result suggests that smaller boards are more effective in monitoring bank managers because larger boards are susceptible to increased agency problems as well as ‘free-riding’ problems (Pathan et al., 2007). In addition, Staikouras et al. (2007) results on of 58 large European banks over the period 2002–2004 reveal that bank profitability is negatively related to the size of the board of directors when using several criteria such as ROA and ROE as performance measurements. In the same way, Al-Saidi & Al-Shammari (2013) also found negative influence of board size towards Kuwait banks
financial performance.

There are also some other research, with similar measurement, that found insignificant influence of board size towards banking financial performance, such as Stefanescu (2011), Arouri et al. (2014) and Praptiningsih (2009). Arouri et al. (2014) take Gulf Cooperation Council (GCC) countries bank as the research object and conveys that one possible reason of insignificant result could be that boards in GCC countries are still at an emerging stage, whereas Praptiningsih (2009) took evidence from South East Asian countries comprising Indonesia, Thailand, Philippines and Malaysia.

2.5 Board Independence and Banks Financial Performance

This section elaborates two influencing factors with regard to board independence. The first explains about how the existence of outside director in general can influence effectiveness of board of directors that will lead to a better banks financial performance. While the second one explains that dual role of one person as both CEO and board chairman can influence the performance of the board affecting banks financial performance.

2.5.1 General Independent / Outside Director and Banks Financial Performance

While in regard to independence of directors, previous studies mention a firm’s degree of independence is measured by the presence of outside directors, who are perceived to be independent of executive directors and thus have more incentive to do their role more effectively. Executive directors are full-time employees of the company and should have clearly defined roles and responsibilities as they manage the day-to-day operations, while outside directors are not employees of the company or affiliated with it in any other way (Al-Saidi & Al-Shammiri, 2013).

In a further research, Al-Saidi & Al-Shammiri (2013) also found that outside directors are unlikely to work with executive directors against the interests of the shareholders. Therefore, more outsiders on bank boards improve the supervision and reduce the agency problem by monitoring and controlling the opportunistic behavior of management to ensure that they pursue shareholders’ interests (Al-Saidi & Al-Shammiri, 2013; Andres and Valletlado, 2008; Stefanescu, 2011; Liang et al., 2013; Belkhir, 2009). The implication is that the presence of outside directors can make executive directors feel evaluated and under pressure and hence, will affect quality of directors’ consideration of making decisions and provide strategic direction and
improvement in performance (Al-Saidi & Al-Shammiri, 2013; Staikouras et al., 2007; Cornett et al., 2009 in Dedu & Chitan, 2013).

Even though, Andres and Valvelado (2008) result regarding outside members of board shows that the optimal proportion of outside directors also has a limit. To avoid or lessen the conflict of interest among stakeholders (in particular between regulator and shareholders) and fulfill the functions of monitoring and advising in an efficient manner, these directors should be a majority on the board. Thus, it is important to note that an optimum combination of executive and non-executive directors is more adequate to create value for the firm than excessively independent boards. Efficient boards would require the presence of executive directors, whose knowledge of the bank could complement the non-executive director ability (Andres & Valvelado, 2008).

From the resource dependence point of view, non-executive directors add value to firms by providing expert knowledge and monitoring services. Non-executive directors are supposed to be guardians of the shareholders’ interests through monitoring, or, in some cases, substitutes for other types of monitoring mechanisms (Staikouras et al., 2007). Independent directors are widely believed to be better monitors of managers as they strongly value maintaining their personal reputation in the directorship market (Dedu & Chitan, 2013; Fama and Jensen (1983b) in Staikouras et al., 2007; Pathan et al., 2007).

Nonetheless, the empirical findings are mixed on the direct relation between independent directors and financial performance of banking firms. In Pathan & Faff (2013) research, they found authors arguing that an independent board might lower the cost of debt financing, might increase a firm’s credit rating or might lower its idiosyncratic risk, systematic risk and cost of equity. They also found that independent directors are also important for banks, as they tend to help improve earnings quality and provide compatible compensation incentives to managers (Pathan & Faff, 2013). Moreover, non-executive directors may contribute to the value of firms through their evaluation of strategic decisions and through their role in the dismissal of inefficient and poorly performing management (Staikouras et al., 2007; Andres & Valvelado, 2008).

However, Adams & Mehran (2005) found that the proportion of outsiders on banking holding companies board is not significantly related to performance,
consistent with their prior findings for manufacturing firms. They argue this result is possible because the legal mandate of directors in bank holding companies is essentially the same as that in non-financial firms, which is to create value for shareholders (Adams & Mehran, 2005). Presenting similar result, Belkhir (2009) argues that increasing the proportion of outside independent directors at banking companies does not improve performance and it may even negatively affect performance (Belkhir, 2009). Consistent with the two previous results, other research, such as Staikouras et al. (2007), Stefanescu (2011), Al-Saidi & Al-Shammari (2013) and Praptiningsih (2009) also found that the impact of independent board is in most cases insignificant because, as it concerns the banking sector, in consequence of regulatory requirements, directors do not emphasize value maximization over the safety and soundness of the institution (Staikouras et al., 2007).

Pathan & Faff (2013) findings also present evidence of a negative association between board independence and performance. Likewise, in regard to information asymmetry, they believe that banks with high information asymmetry may benefit from more inside directors, as they have greater firm-specific knowledge. This is important for firms operating in more uncertain environments, namely those that have a greater need for specialized knowledge. Therefore, banks with high information asymmetry should not depend solely on monitoring by outside directors, because inside directors add to the board information that outside directors would find difficult to gather (Pathan & Faff, 2013; Andres & Valletlado, 2008). Besides, executive directors facilitate the transfer of information between board directors and management. In other words, an excessive proportion of non-executive directors could damage the advisory role of boards since it might prevent bank executives joining the board. This indicates a trade-off between the advantages and disadvantages in the proportion of non-executive directors (Andres & Valletlado, 2008).

Considering financial performance based on abnormal returns, Subrahmanyam et al. (1997) found a negative relation of the proportion of independent directors in bidding banks. They interpret this result as an indication that independent directors could be selected for reasons other than maximizing shareholder wealth. One possible explanation for this result is that because banks differ substantially from non-financial corporations in the nature and degree to which their operations are regulated by the
states in which they do business and the federal government. For example, Baysinger and Zardkoohi (1986) predict that the boards of regulated utilities, in contrast to those of unregulated firms, should have a smaller proportion of monitors and a greater proportion of "public relations" members, directors who promote the social image of these firms among regulators, legislators, and other constituencies (Subrahmanyam et al., 1997).

A second possibility is that antitrust and banking laws combine to prevent those who are most knowledgeable about banking from serving as outside directors since intense regulation and severe penalties might have discouraged qualified and experienced directors from serving on bank boards. This conjecture is supported by the result that outside directors' expertise, as measured by the number of other boards on which outside directors serve, is positively related to bidder abnormal returns (Subrahmanyam et al., 1997).

More research discussing negative influence of independent directors is presented by Dedu & Chitan (2013). He found authors arguing that during the financial crisis independent board members will decrease ROE because banks were pushed by management to maximize shareholder wealth before the crisis and took risks that were understood to create wealth, but later turned out poorly during the credit crisis. They also found that negative influence might happen due to independence-associated costs and lack of company-specific knowledge, which potentially leads to suboptimal decisions (Coles et al., 2008 in Dedu & Chitan, 2013; Liang et al., 2013).

### 2.5.2 CEO Role Duality and Banks Financial Performance

As the leader of management board, CEO is a full-time person responsible for the company’s day-to-day operations and, as such, is responsible for the company’s performance. In contrast, the chairman of board of directors is normally a part-time employee primarily responsible for ensuring that the board operates effectively. Combining both of the functions mentioned previously, CEO role duality refers to the situation when one person holds the two most powerful positions on the board of directors – namely, CEO and chairman (Al-Saidi & Al-Shammiri, 2013). Clearly, the CEO cannot perform this function apart from his or her personal interest. Without the direction of an independent leader, it is much more difficult for the board to perform
its critical function (Jensen, 1993). Therefore, Jensen (1993) recommends for the independent chairman should, at a minimum, be given the rights to initiate board appointments, board committee assignments, and, jointly with the CEO, the setting of the board's agenda (Jensen, 1993).

Research also suggests absence of CEO role duality within board, as Al-Saidi & Al-Shammiri (2013) found in Fama and Jensen (1983), because concentration of decision management and control in one person reduces boards’ effectiveness in monitoring. In addition, Jensen (1993) argues that the CEO-Chairman duality or the dual appointment of chairman and CEO, gives too much power to the individual, which could cause decision-making not to be in the best interests of minority shareholders. Yermack (1996) provides support that the CEO-chairman duality reduces board independence. Even though, at last Al-Saidi & Al-Shammari (2013) research reveal positive influence of CEO role duality affecting bank performance, which is opposite of their hypothesis (Al-Saidi & Al-Shammari, 2013).

Dalton et al. (1998) emphasize the scale and complexity of the firm in discussing CEO double role as both top management executive and chairman of the board. As it is known that banking industry has tendency to have more complexity in its governance, thus it can be argued, to be in accordance with agency theory, that duality role of CEO promotes CEO entrenchment by reducing board-monitoring effectiveness, or even reduce indirectly the reliability of accounting information (Dalton et al., 1998; Al-Saidi & Al-Shammiri, 2013; Belkhir, 2009; Stefanescu, 2011). Focusing in banking industry, Praptiningsih (2009) finding supports this argument as she found the CEO duality is significant in a negative relationship explaining the ROA as banks financial performance in four South East Asian Countries. The plausible argument is that high compensation and prestige go with the position on the board of a major company, so board seats are prized possession, being potential in reducing independence of a CEO holding double role as board chairman (Praptiningsih, 2009).

Consistent with agency theory predictions, Dalton et al. (1998) found that firms with the separate board leadership structure outperformed those firms with the joint structure when relying on return on equity, return on investment, and profit margin as measurement of performance (Dalton et al., 1998). Furthermore, advocating separation of the leadership roles is considered to increase independence
of the board, eliminating a very real source of conflict and therefore improves the board’s effectiveness in management monitoring that also could lead to improved performance (Sanda et al., 2003 in Arouri et al., 2009; Al-Saidi & Al-Shammiri, 2013; Praptiningsih, 2009).

This argument is in accordance with The Cadbury Committee (1992) recommendation to separate the two roles to ensure a clear division of responsibilities and thus combining the two roles is a key indicator of bad corporate governance (Al-Saidi & Al-Shammiri, 2013). Moreover, CEO duality provides the CEO with the power to negotiate with the board, which may help the CEO to pursue self-serving interests, makes the board inadequate and powerless in the face of a strong CEO (Al-Saidi & Al-Shammiri, 2013; Arouri et al., 2009).

A conflicting view argues that separating the roles of chairman and CEO can create problems in decision-making if the two powerful positions do not agree on strategies (Liang et al., 2013). Similarly, Adams & Mehran (2005) find evidence that CEOs also holding the chairman title appear to hold greater influence over corporate decision-making (Liang et al., 2013). The implication is that the combination of the CEO and chairman of the board into one position reduce the probability of financial distress in the firm. A manager with significant control over both operations and the board would not be as susceptible to the influence of outside directors, and other monitors, that would cause the interests of management to be more closely aligned with shareholders (Simpson & Gleason, 1999).

However, prior research also concludes that CEO duality has no impact on bank performance (Griffith et al., 2002). Griffith et al. (2002) argued that CEO duality has no significant impact on bank performance. There are several possible explanations. First, holding both positions has no significant impact on performance because the added title and added responsibilities do not significantly add to his or her ability to affect performance. Second, the CEO’s ownership drives performance, not his or her title. Finally, when he or she is only CEO, the chairman’s monitoring has little impact on his or her performance (Griffith et al., 2002). Supporting this, Arouri et al. (2009) research on banks in GCC countries found similar result because, they argue, the additional responsibilities do not significantly add to the CEO’s capacity to affect performance (Arouri et al., 2009).
2.5 Conclusion

By reviewing several research on corporate governance in banking industry, it can be concluded that board of directors do have both positive and negative relationship towards banks financial performance, depending on the influencing factors. The influencing factors that become the main angle of this study are board size and independence, which consist of independent/outside directors, and CEO role duality. The relationship of each influencing factor on banking financial performance apparently brings out mixed results of positive, negative, and neutral relationship, which will be elaborated more in the next chapter.
III. Conclusion

3.1 Problem Description
Many research believe that banking industry has big impact towards global financial system (Caprio et al., 2007). Characterized by its complexity, banks are often associated with strict regulations, which is also common to even lower the competition among banks (Andres & Vallelado, 2008). Therefore, accompanied with the developing capitalist system in most countries, financial liberalization was introduced again in order to get the banking industry back in the game. Competition in financial deregulation was presumed to provide more incentive for banks to increase their productivity (Belkhir, 2009; Kotz, 2009). However, the freedom brought by the more liberal system also had its downfall, namely the increasingly speculative, high-risk activities of the financial sector, which can turn out in financial crisis (Kotz, 2009; The Economist, 2013).

Due to the financial sector failure, corporate governance, especially in banking environment, has become a big concern (Stefanescu, 2011). Corporate governance mechanisms include board of directors, which also comprise of sub-elements such as board size and independence that become the focus of this study. Moreover, referring to Stefanescu (2011) study, this study identifies board independence into two more specific factors, which are the existence of independence/outside directors and CEO role duality.

3.2 Theory
Based on such background, this study makes an attempt to analyze the effectiveness of board of directors in affecting banks financial performance using agency theory and resource dependence theory. Agency theory is based on the recent development form of governance structure in most corporations, in which there is conflicting interest between two separate bodies, which are principal (supervisory board) and agent (management board) (Staikouras et al., 2007; Caprio et al., 2007; Arouri et al., 2014). The conflicting interest leads to what is known as agency problem. In accordance to agency theory, adequate monitoring mechanism will affect the mitigation of the agency problem, which can be realized through board of directors (Fama and Jensen, 1983).
However, monitoring function of board of directors is diminished when explained using efficiency wage theory, which predicts that a decrease in the intensity of monitoring will result in an increase in the optimal efficiency wage (Gorton & Schmid, 1999). The theory argues that where agency problem exists, firm owners must design a managerial compensation contract to induce effort and monitor performance. Nonetheless, the agency costs, in terms of the required efficiency wages, rise and result in declining firm performance (Gorton & Schmid, 1999). Therefore, it can be concluded that this theory presents the same result as agency theory in terms of banks financial performance, since the lower monitoring function will also lower banks financial performance.

On the other side, resource dependence theory argues that board of directors actually provides additional resources, which can be advantageous for companies. For instance, outside directors are important because they may provide access as a critical link to the external environment (Dalton, et al., 1998). Furthermore, in opposed to agency theory, this theory suggests board of directors to be in a large size, because it enables companies to involve more expertise to not only monitor managers, but also secure critical resources (Haniffa and Hudaib (2006); Pearce and Zahra (1992)).

3.3 Influencing Factors

After reviewing available journals and books, it can be concluded that two influencing factors that particularly become the focus of this study, board size and independence, which is identified by existence of independent/outside directors and CEO role duality, do have both positive and negative relationship towards banks financial performance. Some research found board size to have positive influence with argument that larger board allow for more effective monitoring by reducing the domination of the CEO within the board therefore helping make better (more independent) decisions (Al-Saidi & Al-Shammiri, 2013; Arouri et al., 2014), support regional expansion of banking activities due to the need to coordinate subsidiary boards located in different states (Adams & Mehran, 2005) and beneficial for firms with greater advising needs, such as diversified and heavily debt-financed firms (Pathan & Faff, 2013; Dedu & Chitan, 2013; Liang et al., 2013). Also finding positive correlation, Belkhir (2009) found evidence with reverse direction of relationship suggesting that boards expand in response to an increase in bank total assets (Belkhir, 2009).
While on the other side, general consensus on economic literatures believes that an increase in board size will have a negative effect on firm performance (Adams & Mehran, 2005). Jensen (1993) mentions specifically that the limitation of effective board is the one that consists of seven or eight people. Research supporting this consensus argue that board size have negative influence towards banking financial performance, because directors on large boards could face greater difficulties in expressing their opinions in the limited time available during board meeting, reducing an individual director’s incentive to acquire information and monitor managers, and therefore CEOs will find larger boards easier to control (Jensen, 1993: 865 in Pathan & Faff, 2013; Liang et al., 2013; Pathan et al., 2007). Meanwhile, there are also research that found insignificant influence of board size towards banking financial performance, such as Stefanescu (2011), Arouri et al. (2014) and Praptiningsih (2009).

Results on board independence can be identified by looking at the existence of independent/outside and absence of CEO role duality (Praptiningsih, 2009). Independent/outside directors is believed to have significant impact towards banks financial performance because its presence is considered successful to increase the effectiveness of management board’s monitoring function in such a way that the management board would feel to be under supervision of the outside directors (Al-Saidi & Al-Shammiri, 2013; Staikouras et al., 2007; Cornett et al., 2009 in Dedu & Chitan, 2013). But on the other side, excessive amount of independent directors can imply in lack of advisory role of boards since it might prevent bank executives, who are assured to have better knowledge about the banking firms, to join the board (Pathan & Faff, 2013; Andres & Vallelado, 2008). While insignificant results were found by the other authors such as Adams & Mehran (2005), Staikouras et al. (2007), Stefanescu (2011), Al-Saidi & Al-Shammari (2013) and Praptiningsih (2009).

CEO role duality is mostly believed to lower the board performance, impacting in lower banks financial performance. The argument is that if one person holds important position as both CEO and chief of the board of directors, level of independence of that person can be decreased (Sanda et al., 2003 in Arouri et al., 2009; Al-Saidi & Al-Shammiri, 2013; Praptiningsih, 2009). However, as opposed to the joint role, other findings believe that separating the role can cause a dissent between the CEO and the chairman of the board (Liang et al., 2013; Adams &
Mehran, 2005). Despite all of the results, there are also some research that comes across with insignificant relationship results for the relationship between board of directors and banks financial performance (Griffith et al., 2002; Arouri et al., 2009).

To sum up, there are two influencing factors that can affect monitoring function of board directors they are board size and board independence, which is identified by the existence of outside board members and CEO role duality. After finding the influencing factors, a guideline for regulator, shareholders, and managers are conducted as a suggestion towards a better monitoring function of board of directors on banks financial performance in the next chapter.
IV. Policy

4.1. Suggestions

This study mainly investigates the relationship of board of directors, as one of corporate governance mechanisms, on banks financial performance. The factors of board of directors are more specifically broken down into board size and board independence, while board independence itself comprise of the existence of outside directors and CEO role duality.

The previous studies showed that complexity of banks corporate governance and its impact towards the financial system stability support specific bank regulations. Such regulations, however, carry out challenges to banking firms that are potential to obstruct monitoring of managers or even lead to the appearance of new conflicts of interest between regulator and stakeholders. Therefore, well-functioning board of directors in banks is entailed as they hold the duty to monitor managers as the representatives of stakeholders.

This study has found evidence that there are relationship between board of directors and banks financial performance. Based on the findings, all influencing factors (board size, outside directors, and CEO role duality) are found to have both negative and positive influence on banks financial performance. Those factors can be the consideration for a board to be well functioning. Thus, it can be said that well-functioning board can be supported by the optimal size and board independence. To achieve it, suggestions are provided to regulator and banking firms in order to improve mutual understanding and to improve the performance of banks board of directors.

Optimal board size

Following the general consensus of economic literature about board size, this study would like to suggest that a small size board is good in creating effective and efficient coordination among board members. Research mentions particularly the optimal size of board is within seven to eight people (Jensen, 1993). However, this argument applies for more general case and for banking industry, it might be different case. A bigger size of board might be needed due to growing complexity of banks over time requires a better manager supervision and bringing more human capital to advise managers (Dedu & Chitan, 2013; Liang et al., 2013). Andres & Vallelado
(2008) support the argument stating that the inclusion of more directors should benefit the monitoring and advisory functions, improve governance, and raise returns. However, there is a limit beyond which the coordination, control, and decision-making problems outweigh the benefits. According to Pathan & Faff (2013) this limit is around 19 directors. Bank regulators can benefit from these findings in constituting policy regarding the maximum amount of banks board by considering the requirements of being a bank director to make the bank director market more competitive and actively encourage qualified directors to compete in the market (Pathan & Faff, 2013).

**Outside / Independence Directors Limitation**

Based on the literatures, appointment of outside directors should be incorporated in the codes of good governance practices. Moreover, outside directors are also important to take the majority of seats within the board in order to avoid or lessen the conflict of interest among stakeholders (in particular between regulator and shareholders) and fulfill the functions of monitoring and advising in an efficient manner (Andres & Vallelado, 2008). Nevertheless, to be majority member of boards should not later make an excessive independent directors presence becomes excessive. Because it can imply in lack of advisory role of boards since it might prevent bank executives, who are assured to have better knowledge about the banking firms, to join the board (Pathan & Faff, 2013; Andres & Valletlado, 2008).

Thus, an optimum combination of executive and non-executive directors is more adequate to create value for the firm than excessively independent boards. In order to create an efficient boards, regulators should require the presence of executive directors, whose knowledge of the bank could complement non-executive director ability (Andres & Vallelado, 2008). The concrete example is like how it is done in New York State, it is required for the banks to maintain boards of seven to 30 directors (when their capital stock, surpluses and divided profits are in excess of $50 million), while two-thirds of these directors should be non-executives (outisders) (Pathan & Faff, 2013).

In this connection, Lipton (1992) recommends that each board establish, and update annually, the criteria to be followed in selecting candidates for nomination as a director of that company. As a practical matter this is the only way in which a board can replace a director who no longer meets his or her responsibilities. Following
Korn/Ferry Consultant (1992), he recommends that each board should also establish a mandatory retirement age for the independent directors. The average tenure for directors was reported at 10 years (Lipton, 1992). However, Lipton (1992) addressed the suggestion for general industry and not for specific banking industry.

**Absence of CEO Role Duality**

As already concluded, most literatures found argue that CEO holding position as a board chairman is not likely increasing board independence. This argument has already recommended by formal organization for corporate governance practice such as The Cadbury Committee (1992). Following their recommendation, this study suggests separating the two roles will ensure a clear division of responsibilities and thus combining the two roles is a key indicator of bad corporate governance. Considering the opposite argument that separating the role can cause a dissent between the CEO and the chairman of the board, it is then suggested for banking firms that considering common vision is important in selecting holders of both positions. In such a way, conflicting argument between different persons holding the positions can be avoided.

Moreover, in the case of inevitable CEO role duality, Lipton & Lorsch (1992) propose that each board select a leader from among the independent directors. The person in this role could be rotated on an annual or biannual basis and may be a particular committee chairperson, the director with the most seniority, or the one who is most respected. They believe that the CEO-chairman should consult with this lead director on the following matters: the selection of board committee members and chairpersons; the board’s meeting agendas; the adequacy of information directors receive; and the effectiveness of the board meeting process (Lipton & Lorsch, 1992).

**4.2. Limitations**

Some limitations are acknowledged occurred during the conduct of the study. First, short-term duration of the study causes lack of time to review all of the information in the available journals. This time limitation is potential to influence the accuracy of the findings. Second, this study does not take angle on specific countries. The literatures reviewed were research conducted in different countries all over the world, lessen the focus of the study result. Therefore, it is suggested for the next
research to take specific angle on particular countries so that the result will be validly applicable in that country.
Reference List


THE IMPACT OF BOARD SIZE AND ITS INDEPENDENCE ON FINANCIAL PERFORMANCE IN BANKING INDUSTRY