

# Governance, Conduct Costs and Equity Performance in Financial Services

## Recent Evidence of Large Financial Institutions

Edward Bace

Middlesex University Business School, London, UK

Email: [e.bace@mdx.ac.uk](mailto:e.bace@mdx.ac.uk)

### **Abstract**

Studies correlating corporate governance and equity values of public companies yield varied conclusions, depending on industry, business cycles, and other factors. Few have examined financial services in mature (and yet volatile) markets, specifically around conduct costs as corporate governance indicators - the purpose of this preliminary study. Conduct costs are monetary fines or redress demanded by regulators and legislators, and publicly reported by institutions. Despite recent events, a clear correlation of these costs with equity value is not obvious, and banks' role in the economic crisis begs further scrutiny of this relation, which theory suggests should be negative (high conduct costs lower returns, and thus shareholder value). Lower costs, reflecting effective governance, lead to superior returns - the initial result of this study of ten banks over the last six years. High conduct costs have negative impact, albeit small, on returns and value. This further reinforces benefits of proper governance to shareholders, managers, regulators and all stakeholders in financial services.

### **Introduction**

Internal determinants of company equity value have been the subject of numerous studies, which have yielded useful insights into important factors such as profitability, solvency and asset quality. Internal determinants are defined as factors that are influenced by a bank's management decisions. Although good quality management is seen to lead to good bank performance, it is difficult, if not impossible, to assess management quality directly. It is explicitly assumed that such quality will be reflected in operating performance. As such, it is not uncommon to examine a bank's performance in terms of financial variables found in the financial statements.

Aspects of corporate governance, another internal determinant, have also been identified as additional influences on firm value (Adams and Mehran, 2008; Agoraki et al., 2009). Corporate governance encompasses a wide range of mechanisms intended to mitigate agency problems, by limiting opportunistic behaviour of management, and reducing information risk imposed on shareholders (Ashbaugh et al., 2004). Prior studies have examined indicators such as board composition, board and executive compensation, and internal audit quality, largely indicating that good corporate governance does have a positive impact on firm value, including that of banks. Another primary governance indicator, not yet examined in detail, is that represented by conduct costs, the money that banks and other firms pay out in the form of fines or redress levied by regulators and legislators. These costs may also include other forms of payments, such as sums paid in settlement of either regulatory proceedings or litigation based on allegation of a firm's misconduct. Amounts paid for the

repurchase of securities from the market at the behest of regulators, eg, because they were mis-sold, are also included. Therefore, practices such as mis-selling of payment protection insurance, benchmark manipulation and breaching of money laundering rules all fall under the definition of conduct costs (McCormick, 2014). Many large banks have set aside meaningful provisions for these costs in recent years.

### **Research Problem, Objectives and Plan**

This paper investigates the extent to which conduct costs, effectively a failure of corporate governance, affect market and value among a group of ten large banks over the past six years (2008-2013), for which data are readily available. Conduct costs are measured by reported annual penalties paid by banks up to the end of 2013. Data preceding this period remain sketchy, hence the focus on the last six years, which also coincides with the financial crisis, when external determinants played a significant role, not included in this study. The prediction is that the level of annual conduct costs, as a percentage of bank pre-tax income, is negatively related to banks' equity returns (ie, higher conduct costs result in lower returns). Conduct costs by their scale and uncertainty represent an additional risk to shareholders, resulting in an erosion of value (Garmaise and Liu, 2005). If, on the other hand, higher conduct costs are associated with higher returns, perhaps through benefits of greater transparency, or have no discernible impact, another explanation for this relationship is to be sought.

It should be noted that conduct costs recorded up to now for ten big banks, even on a cumulative basis since 2008, still account for a small proportion of the banks' total assets (from 0.3% to over 5%), but an increasing percentage of their market capitalization (from 4% up to 36% for the ten banks, including year-end 2013 provisions). The effect of conduct costs could become more meaningful over time, given current trends.

Since conduct costs are only one of a number of factors affecting value, and potentially small at that, it is appropriate to consider another important factor driving value. In considering the main drivers of bank returns and value, evidence indicates that investors are focused on risk and profitability expectations (European Central Bank, 2010), therefore a key parameter is a risk metric such as levels of impaired assets. The prediction is that returns and value should be negatively correlated with asset quality, as measured by impaired loans to gross loans.

Why is this preliminary study important? Surveys in the UK (Which, 2012) and US (Edelman, 2014) continue to show that banking is one of the professions least trusted by the general public, a view which regulators and other participants are striving to address (Lambert, 2014). There is evidence that, while the first priority of stakeholders in a company is the quality of the company's products or services, the second priority is the trust and confidence that the stakeholders have in the company (Phillips, 2004).

The purpose of finance is to assist people in saving, managing and raising money. Economic globalization has increased the magnitude of finance to a systemic importance, counterbalanced by conduct costs for ten banks alone exceeding £150 billion over a five-year period, well above the annual budget of the UK National Health Service, for example (McCormick, 2014). It is therefore critical to re-build trust in the industry, which involves reinforcing with all stakeholders the importance of good governance, and emphasizing corporate and social responsibility (CSR). Institutions pay a price for misconduct, not only in quantifiable monetary terms, but also in less tangible costs to reputation and franchise.

Good governance and conduct (measured by relative level of conduct costs) should correlate positively with long-term investment performance (measured by annual equity

returns over six years), given that a firm's culture and ultimately value is strongly influenced by the nature

In summary, the effect of conduct costs is documented by linking them to realized equity returns, to support or not the general hypothesis that good governance lowers conduct costs, which thereby improves equity performance.

### **Literature Review**

Much previous research has been done on the relationship between corporate governance indicators of publicly-listed companies and their returns and value. A landmark study was made by Gompers et al. (2003), who looked at a wide sample of European companies over a multi-year period, using a large number of governance criteria. This concluded that good governance in fact resulted in higher value, a finding further reinforced by Bauer and Gunster (2003), although the latter found that this did not always hold in the short term.

Looking specifically at the UK, Shaukat and Padgett (2005) determined that an index of non-compliance with the UK Code of Corporate Governance for a panel of FTSE350 companies over a four year period was negatively related to total shareholder return, implying that more compliant firms have higher returns. On a wider basis, McMurrian and Matulich (2006) concluded that demonstration of business ethics added value for customers and heightened firm performance and profitability. More recently, Abdullah and Page (2009) examined UK non-financial companies, revealing no strong systematic relationship. A similar conclusion was reached by Diavatopoulos and Fodor (2010). Marsat and Williams (2011) actually observed strong evidence of a negative impact of responsible behaviour on corporate market value. Giroud and Mueller (2011), however, found positive correlations between good governance and good market performance, particularly in non-competitive industries, while Lewellen (2012) saw no compelling industry-specific governance factors to explain differences in returns. Huppe (2011) concluded that so-called CSR "alpha" resulted largely from the improved disclosure entailed in implementing CSR. Mouselli et al. (2014) pointed to audit quality as an important governance determinant, recently echoed by CFA Institute (2014). Most recently, scholars associated with the London School of Economics (LSE: McCormick, 2014) have compiled total conduct costs for ten large US, UK and European banks, in terms of total costs incurred 2008-2013 (also along with provisions made for the same as of Dec. 31, 2012 and Dec. 31, 2013, as reported on their balance sheets). While this study did not draw any relationships with equity performance, this is seen as a useful next step.

Casson (2013) has found that explicit reference to principles of proper conduct is largely absent from governance guidance and regulation in the EU. It seems that a firm link is yet to be made that what constitutes proper conduct, reflected in good governance, is good for business, and hence shareholder returns, or that what is improper is negative for returns and value.

High conduct costs ultimately affect the profitability and capital positions of banks (the UK regulator has warned of this recently: Finch, 2014), but the actual extent to which this is observed has polarized opinion. There are admittedly limitations to the use of conduct cost data. For one thing, they are based on figures solely in the public domain which in some cases includes "incomplete information." Hence all data must be regarded as approximate. Initiatives towards establishing a more consistent approach to disclosure of material information in this respect are to be welcomed.

Further, some have argued that a political agenda lies behind the scale of the reported conduct costs, which are not solely driven by bank managements themselves. JP Morgan, for

instance, stated that 80% of the misconduct covered by its \$13 billion settlement for toxic mortgage-backed securities stemmed from Bear Stearns and Washington Mutual, both taken over by Morgan in 2008. Given the bank's strong market position, some commentators claim it was pressured by the US government to acquire troubled banks in order to help stabilize the US economy (Benedict, 2014). In this regard, greater transparency is also to be expected of governments and regulators in their actions.

As also pointed out by Benedict (2014), this cost analysis highlights different reporting and regulatory standards across different jurisdictions, which potentially emphasize deficiencies in national corporate accountability and transparency. One of the purposes here is to attempt to analyse firm-specific, rather than jurisdictional, failings with the ultimate goal of encouraging healthy competition among banks from a stakeholder perspective. For instance, the study excludes banks domiciled in the Asia-Pacific region, and Canada, where conduct costs tend either not to be reported or not incurred. The extension of the LSE project to more banks around the world, currently under way, is a welcome initiative.

Some have observed a drag on asset value associated with conduct risk (Worship et al., 2013), based on shorter-term market movements. There is often a price decline associated with a large liability, but sometimes also a price increase due to greater investor certainty going forward. Other analysts have noted a "multiplier effect" of conduct costs on bank valuations greater than that associated with "normal" trading losses (Moynihan et al., 2013). Decreases in market capitalization relating to conduct losses have been observed to be typically 2-8x greater than the size of the underlying loss event. Of greater interest perhaps are the longer-term effects of elevated conduct costs on profit and market value.

### **Developing the Research Model and Hypotheses**

To help rebuild trust in the financial system, it is important to better align the interests of managers and stakeholders, a primary group being shareholders in financial institutions. If it is observed that well-governed companies provide superior value, by not incurring excessive conduct costs, this can send a strong message to boards and managements that good governance contributes to enhanced wealth creation, thus providing further incentive to strengthen and maintain good governance and conduct. This should drive greater transparency, management accountability and responsibility, and ultimately greater trust in institutions from investors and the general public, who are the customers of these institutions. The objective of this research is to show how strong a link exists between measures of corporate governance and misconduct in large financial companies and their returns over a multi-year period. The research plan involves examination of market returns of a sample of large financial institutions over the past six years (2008-2013), contrasting that with conduct costs paid as publicly reported by these companies, and as analysed by others. In considering events since 2009, when the UK Walker Report was published, followed by the 2010 UK Combined Code and Corporate Governance Code (updated in 2012), it seems appropriate and timely to re-visit this relationship relative to this small but very prominent group of US, UK and European financial firms. Do mature markets now generally assume a level of adequate governance and conduct, implicitly reflected in returns, or do differences still exist, after the financial crisis, in which large finance institutions played a significant role?

As stated, conduct costs relate to money that banks have paid out in the form of regulatory fines or redress demanded by regulators. They may also include other forms of payments, such as:

- a) Sums paid in settlement of regulatory proceedings (whether or not there is any admission of wrongdoing)

- b) Sums paid in settlement, or at the conclusion, of litigation that is based on an allegation of a bank's misconduct or that of its officers (although it is not intended to cover all litigation costs, whatever the nature of the claim)
- c) Sums paid for the repurchase of securities from the market (because they were mis-sold) at the behest of regulators
- d) Egregious losses caused by a bank employee's serious misconduct and/or attributable to poor risk management.

Therefore, practices such as the mis-selling of payment protection insurance, benchmark manipulation and breaching money laundering rules fall under the definition of conduct costs (McCormick, 2014).

These recorded conduct costs, as one independent variable, are then compared against the historic market returns of the banks, in order to gauge their effect on returns. Given the relatively small sample of ten banks, a cross-sectional panel regression approach is used, incorporating other variables. Return information is correlated against actual conduct costs paid, as a percentage of pre-provision income, along with a proxy for profitability, which is reported return on equity, another for solvency risk, which is reported equity to assets, and another risk proxy for asset quality, which is the reported level of impaired loans as a percentage of gross loans.

Panel data are commonly used because of the following reasons. First, it has the advantage of giving more informative data as it consists of both the cross sectional information, which captures individual variability, and the time series information, which captures dynamic adjustment. In short, panel modelling helps identify a common group of characteristics while at the same time taking account of the heterogeneity that is present among individual units.

The consensus from the literature is that the appropriate functional form of analysis is the linear one. This in this study a linear model is used to analyse the cross-section time series data to isolate the equity performance determinants of the banks.

The basic regression equation is as follows:

$$\text{Returns} = \alpha + B1\text{conduct\_cost/pretax\_income} + B2\text{impaired\_loans/gross\_loans} + e$$

Equity market return is the dependent variable, the independent ones being relative level of conduct costs (to pre-tax income), and impaired loans to gross loans.

Panel data models are usually estimated using either fixed effect or random effect techniques. If the number of time series data (T) is large and the number of cross-sectional units (N) is small, there is likely to be little difference in the values of the parameters estimated by the two models. Since there are only ten cross-sectional units that involve six years' data in this study, the regressions in our study are estimated by the fixed effect model. The bank-specific variables examined in this study are derived from both the income statements and the balance sheets of the publicly reported financial statements of the banks. The data cover a six-year period from 2008 to 2013, with a sample of ten different banks. All of the accounting information is consolidated on 31 December of each year.

The hypothesis put forward is that good governance and conduct (measured by relative level of conduct costs) correlate positively with long-term investment performance (as measured by annual equity returns over six years), given that a firm's culture and ultimately value is strongly influenced by the nature and quality of leadership shown by the board and executive management.

Conduct cost information is publicly available from the reports of these firms over the period, as well as from further external analysis. Metrics focus on actual conduct costs

incurred and paid per year, as a percentage of pre-tax income earned in that year. These data are compared with asset quality of the firms (using Bankscope as an information source), in order to correlate conduct costs with historical returns, largely following the methodology of previous related studies (Cordeiro and Vilayath, 2003). Such an investigation ultimately lends itself to wider samples and longer time periods, but initial indications suggest that equity investors are rewarded by good governance, as manifested in lower relative conduct costs, which help them to make positive investment decisions based on transparency, robust risk management and service to stakeholders.

### **Hypothesis**

This study considers whether the following deductive hypothesis, constructed based on the literature review – after Garmaise and Liu (2005) and Peni and Valhalmaa (2012) - can be applied to banks, and thus can result in recommendations for future research.

**H1:** that banks incurring high conduct costs as a percentage of their pre-tax income exhibit lower market returns on average, and lower valuations, due to the consequences of inadequate governance.

### **Research methodology**

The author has conducted a quantitative approach of deductive reasoning to the hypotheses, employing a secondary quantitative statistical analysis of data following prior research methods.

Secondary conduct cost data was used for ten banks over the period 2008-2013, as compiled by the LSE Conduct Costs project (McCormick, 2014). Other primary market and accounting-based data were drawn from Bankscope and the annual reports of the ten banks.

### **Bank features**

The sample of ten banks included four based in the UK, four in the US, one in Switzerland, and one in Spain. All have had meaningful operations in the UK over the period of the observation. All rank among the world's thirty largest banks by market capitalization, and among the top fifteen in the US and Europe by the same measure. All have a presence on the London Stock Exchange.

### **Data analysis**

The hypotheses were tested using pooled time-series cross-sectional regression analysis. This procedure deals with data sets that consist of time series observations (in our case the six years from 2008-2013 inclusive) on each of several cross-sectional units (in our case, the 10 banks). Our pooled time-series cross-sectional regression (implemented using the regression function in Excel) uses a general model of the form:

Returns = f(conduct costs/pt income, impaired/gross loans)

The basic regression equation is as follows:

Returns = alpha + B1conduct\_cost/pretax\_income + B2impaired\_loans/gross\_loans + e

Equity market return is the dependent variable, the independent ones being relative level of conduct costs (to pre-tax income), and impaired loans to gross loans.

The empirical evidence on the determinants of bank's equity returns is based on balanced panel data, where all the variables are observed for each cross-section and each time period. In this study, a single econometric specification is estimated, including only the bank-specific variables. The estimations are performed by the generalized least squares (GLS) technique, which is especially suitable for data sets where serial correlation and/or heteroscedasticity might be present.

The results of the regression analysis are given in table 1.

**Table 1: Determinants of Equity Returns - regression**

<i>Bank characteristics</i>	Predicted sign	
Intercept	?	0.09699
Conduct costs/pre-tax income	-	-0.02515** (0.013625)
Impaired loans/gross loans	-	-10.7881** (5.04957)
R square		0.11584
No. of observations		60

Notes:

(i) The regression is based on fixed effect estimation and is estimated using GLS estimation pooling bank level data across ten banks for the 2008-2013 period.

(ii) Standard errors are given in parentheses. \*\*indicates significance at the 0.05 level.

### **Analysis and Discussion**

**H1: that banks incurring high conduct costs as a percentage of their pre-provision income exhibit lower asset returns on average, and lower valuations, due to the consequences of inadequate governance.**

R<sup>2</sup> shows how well this combination of variables can predict market returns, and in this sample R<sup>2</sup> at 0.12 shows that 12% of the variation in returns is attributable to the variables of conduct costs to pre-tax income and impaired to gross loans, thus suggesting that other elements may play a larger part in predicting overall returns.

However, as indicated in table 1, the negative coefficient of conduct costs indicates better returns for well-governed banks, which result in lower costs of conduct.

The inverse relationship also between returns and impaired to gross loans supports earlier findings (Staikouras and Wood, 2003) that asset impairments reduce the market return and value of banks. Though banks tend to be more profitable when they are able to undertake more lending activities, yet due to the credit quality of lending portfolios, a higher level of impairments occurs. Such a high level in fact depresses banks equity returns significantly

The analysis has yielded a couple of key findings. First, a negative association is observed between conduct costs as a proportion of pre-tax income and the sample banks' equity market performance. Second, it is documented that conduct costs relative to pre-tax profit have some limited explanatory power for banks' equity returns after controlling for risk proxy of asset quality. The observation that banks with relatively low conduct costs have superior equity returns adds to the literature on the financial information characteristics valued by the market. This result also provides insight into how governance is priced in that it is observed that conduct costs and asset risk are partial determinants of firm value. These findings lend support to Garmaise and Liu (2005), who model firms' exposure to risks as a function of the quality of firms' governance.

### **Limitations of the study**

The scope of this short paper limits consideration of the many variables that can contribute to differing outcomes, but the author has statistically considered the variable of asset quality in addition to conduct costs to deepen results. The literature review has been

limited to post-2003 studies and has also not considered external determinants of bank returns, which during the sample period could have a significant effect.

The author has presupposed that the banks considered have similar characteristics. Results from previous literature indicate that a variation of results may be dependent on study size.

Due to length restrictions and data availability considerations, basic regression analysis has been undertaken, although more complex statistical analysis may have produced different results.

### **Summary and Conclusions**

This paper explored the link between bank conduct costs, a key governance indicator, and their equity returns. High conduct costs can affect equity returns through their impact on profitability and capitalization of the bank. Promoting high standards of conduct and reducing conduct costs enhances profitability and capital, and provides management with a transparent long-term planning horizon. All of these could be perceived positively by shareholders, resulting in enhanced equity performance.

These arguments were tested on ten large international banks over the period 2008-2013, measuring reported conduct costs as a percentage of pre-tax income against market returns over that time frame. The results suggest that returns are negatively associated with conduct costs, in other words, that banks incurring high conduct costs yield lower equity returns relative to their peer group.

Since good governance is intended to reduce agency costs, the level of conduct costs should also have an effect on banks' cost of equity capital. A contribution is made to the existing literature on the determinants of value and return by identifying another factor that explains value and return beyond factors traditionally used to explain them. Consistent with prior research, it is documented that the level of conduct costs is negatively related to banks' equity performance.

There are several potential directions of future research that this study would suggest. One direction would be to study the effect of conduct costs on other cost of capital measures, such as the cost of debt capital. Another potential extension would be to use more refined measures of conduct costs and to study their effect on overall cost of capital. This line of research would help to develop a clearer picture of the relative benefits of lower conduct costs, since ultimately one of the primary reasons for the existence of effective governance mechanisms is the reduction in the cost of capital.

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