

**Corporate Governance and Performance in TRNC  
Banking Industry**

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Submitted to the  
Institute of Graduate Studies and Research  
in partial fulfillment of the requirements for the Degree of

Master of Science  
in  
Banking and Finance

Eastern Mediterranean University  
August 2012  
Gazimağusa, North Cyprus

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## ABSTRACT

This study aims to analyze the governance and ownership variables with the specific performance variables in order to see the effects of these variables on the profitability of the banks that are operating in TRNC bank market. The data used for financial variables derived from the sample of 23 banks which were operated in the period of 2006-2010 and the data used for governance variables were collected from the directors, shareholder report of the banks for the period of 2002 to 2010. Cross section analysis were run to see the effects of every single variables of governance on the performance variables that were used. ROA, ROE and NIM were the performance variables that were used. PLL, LIQR, EQ and AU were the other financial variables which were used with the governance variables like BA, BS, DS, YS, YKBGS and the ownership variable is the ODUM. For financial variables, risks that were taken by the banks like credit, liquidity, interest rate risks play important roles on the PLL,LIQR, EQ, AU and these affect the correlation of these variables with the ROA,ROE and NIM significantly or ,insignificantly. Last variable was the ODUM which is an ownership variable.

**Keywords:** Corporate Governance, Profitability, North Cyprus

## ÖZ

Bu çalışma yönetim ve performans değişkenleri kullanılarak, bu değişkenlerin KKTC'deki banka karlılığı üzerindeki etkilerini analiz etmeyi amaçlamaktadır. Finansal Değişkenler için kullanılan veri 2006-2010 döneminde faaliyet gösteren örnek 23 bankanın bilanço analizlerinden ve yönetim değişkenleri için kullanılan veride 2002-2010 dönemine ait bankaların direktör ,hissedar raporlarından elde edilmiştir. Yönetim değişkenlerinin her birinin performans üzerindeki etkisini ölçmek için çapraz kesit analiz yöntemi kullanılmıştır. ROA, ROE ve NIM kullanılan performans değişkenleridir. PLL, LIQR, EQ ve AU ise BA, BS, DS, YS, YKBGS GİBİ yönetim değişkenleri ile kullanılan finansal değişkenler olmuştur, yönetim değişkeni ise ODUM'dur. Bankaların almış olduğu kredi, likidite ve faiz oranı riskleri PLL, LIQR, EQ, AU gibi finansal değişkenlerin ROA, ROE, NIM gibi performans değişkenlerini olumlu ya da olumsuz etkilemesi yönünde önemli bir role sahip olmuştur. Sahiplik değişkeni olarak kullanılan ODUM ise kamu bankalarının özel bankalara göre daha karlı olduğunu göstermiştir.

**Anahtar Kelimeler:** Kurumsal Yönetim, Karlılık, Kuzey Kıbrıs



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## LIST OF ABBREVIATIONS

PLL	Provisions for Loan Losses
LIQR	Liquidity Ratio
EQ	Equity Ratio
AU	Asset Utilization
BA	Board Age
BS	Board Size
DS	Number of Changes in Board
YS	Number of board members
YKBGS	Years of the CEO, sitting on the board
ODUM	Ownership Dummy

# Chapter 1

## INTRODUCTION

In recent years, corporate governance has become more debatable subject and be one of the most popular methods that has been handled by the managements. Quick developments, changing technologies and the competitive environments force the management strategies to be sure about having good managements to make right decisions in the competitive environment for more profitability. Since corporate governance is an important issue that has recently been debated by the world, it has started to be discussed in the North Cyprus, too. Although, the North Cyprus has small island economy, especially in banking industry, it has showed an important improvement. A few of the foreign banks have invested in North Cyprus bank market and this causes an increase in the number of the banks operating in the sector. Existing private and public banks with the opening of new ones like foreign and other domestic banks, banking industry of the North Cyprus has been more competitive. In that point, corporate governance has become more important issue that needs to be discussed by the researchers. Most of the studies conducted corporate governance as their topics because, as other countries' banking

industries, North Cyprus Banking industry also needs the good governances in order to exist in the continuous competitive environment with the profitability. Risk is the important factor in governances and it should be governed in correct ways. If risk is governed in correct ways, it brings profitability, at that point corporate governances has become more popular concept to be discussed.

As we decided to discuss the importance of the governance in TRNC banking industry, we need to know the meaning of corporate governance, because it's a wide term and it has been explained in lots of different views .Andrei Shleifer and Robert W. Vishny (1996) made a general explanation for the corporate governance and stated that the corporate governance includes all rules, regulations, systems that are needed by the companies, in order to govern efficiently and make profit. According to another perspective, all companies especially private or non-private banks' should be controlled and governed with a system in order to make right decisions with true actions with the possibility of importance of the existence of corporate governance defended by David Walker (2009).

In all respects, in general, the issues of the good corporate governance have been considered as good instruments for managing the profitability. Importance of the corporate governance increases with the problems that exist in companies such as an agency problem. Managers may not act in the interest of company owners in order

to maximize profit. In this situation, Oliver Hart (1995) indicates that, the corporate governance is a control structure that is needed by the company to allocate resources, use them with transaction costs and provide services truly to maximize company's profit.

Hsueh – Liang Wu (2008) stated that agency problem can be solved by correct board monitoring which takes right decisions and that is possible with the true corporate governance. Board monitoring is the subject of corporate governance. Each company has a different board composition. These board compositions can be categorized as inside directors and outside directors. Inside directors were called by April Klein (1998) as those who are on the board and always act in the best interest of the company similar to family-owned companies which affect the performance of the companies positively. Outside directors are defined by K. V. Peasnell, P. F. Pope and S. Young (2000) as directors that may not deal with the interests of the company and this may cause an agency problem.

On the other hand, Benjamin Maury (2006) states that the family owned firms are listed in a weak corporate governance environment with high efficiencies or inefficiencies. Topics of board independence, board size, board age are important issues to be addressed with the board structure in corporate governance. Most of studies examine these topics to correlate the performance with the corporate governance. A study that was carried out by Pablo de Andres and Eleuterio Valledo



(2008) can be an example which analyzes board size, board composition and board independence to correlate with the bank performance. In addition to this, board monitoring and firm characteristics are examined by Ivan E. Brick and N. K. Chidambaran (2007), in order to make an empirical analysis about the corporate governance. The corporate governance has also an importance for all countries' economies since it affects growth and development.

Literature addresses lots of views and these views are summarized by Stjin Claessens (2006), some of which can be listed as creation for employment by increasing firm value, making more investments, bearing the risk of financial crisis and solving the problems regarding principal-agent.

### **1.1 Aim of Study**

This thesis will analyze the importance of governance in the TRNC banking industry. We will use sample of banks operating in TRNC to evaluate the role of the bank specific performance that is considered. We propose to use size of board and board composition. We will also handle board size, age of members in order to see how they will affect the bank performance. Lastly, this thesis will assess all of these relations with performance variables, measure performance of the banks and analyze effects of the bank ownership, regulatory and institutional differences.

## Chapter 2

### LITERATURE

Board size, board composition, board age, board independence, duality are the common variables which are used in corporate governance studies. Corporate governance plays an important role in profitability of banks, corporations and companies. In this respect, all studies try to measure the effects of these variables on corporate governances.

Different arguments have been introduced for the relationship of board size with the corporate governance. From Khaled Elsayed (2011) points of view, board size is handled with duality and the results showed that the managers who have a position inboard of directors affects profitability negatively. Shijun Cheng, John H. Evans and Nandu J. Nagaraju (2008) carried out two hypotheses; one of them shows that positive relationship between the larger boards and the profitability and the latter shows the resultwith the smaller boards providing more control with the profitability. Brian K. Boyd (2006) also tested board size by using cross-section analysis in sample of 193 firms andfound that board size is not related with the profitability. Moreover, U.S firms aretested with panel methods by Theodere Eisenberg, Stefan Sundgren and Martin T Wells (1998) in order to see the negative

correlation between the size and performance.

Although, the preceding studies found an inverse relationship between the board size and profitability, Yermack (1996) defends that higher performance is possible with larger boards because board size has an effect on firm value in a possible direction. Board composition, is a more broad term for affecting board effectiveness. In literature, directors are categorized as inside directors and outside directors. For the reason of inside directors are thought as incentive groups for providing benefits the firms, most of the views argue that inside directors have positive impact on performance whereas outside directors don't. Structure and roles of the boards were examined by Klein (1998) and inside directors are found more efficient for the firm's investment policies. Correspondingly, compensation of the boards are analyzed with cross-section analysis and results showed that inside directors earn more than outside directors.

From this aspect, John E. Core, Robert W. Holthausen and David F. Larcker (1999) defend that outside directors are less efficient due to having low salaries. Moreover, Barry D. Baysinger and Henry N. Butler (1985) emphasized the importance of inside directors because of providing valuable information to the outside directors for performance. In contrast to these studies, some of them defend that the outside directors are more valuable to the firms' performances. For instance, Samuel R. Gray (1997) states that, risk is an important factor for long-term efficiencies and this

is possible with outside directors. In addition to this, outside directors are thought by Yung Sheng Lee, Stuart Rosenstein and Jeffrey G. Wyatt (1999) as more efficient especially for smaller banks which have no ability to take risk. BonnI, Yoshikawa and Phan P. H. (2004) categorized directors as inside, outside and female, male directors to see the relationship between the board age, gender, board size and profitability. Their study resulted with negative relationship among the board age and profitability.

Lastly, board independence and duality are important issues that are discussed in the corporate governance. For instance, Helen Wei Hu, On Kit Tan and Monica Guo-Sze Tan (2010) provide data for good governances in corporations. Moreover, Robert Barontini and Stefano Bozzi (2011) did an overall study using the 56 Italian IPO's with different ownerships over the period of 1999-2005 and found that the Board independence affects performance positively. Positions that are placed in the company also affect the firm performance. In this respect, duality is being an important issue that has been discussed. 1.883 firms are tested by Renato Giovannini (2010) to see how the separation of ownership and control affects profitability. In that point, although some results showed that the duality is important factor on profitability, some incentives indicate that the duality is not an important factor on performance.

In the literature, most of studies used regression method in order to see the effects of board size, board composition, board age, board independence and the duality on the

performance. Taking into account all these previous studies, some of views defended there is a positive relationship between the corporate governance and the profitability whereas some views defended there is no significant relationship between the corporate governance and profitability. Amienyaru Enobakhare (2010) conducted a study to determine the matter of profitability with the corporate governance. Independent variables like board independence, board structure, board leadership, board composition, board size and board diversity which are types of ownerships were tested with dependent variables like ROA and non-performing loans ratio. The research showed that most shareholders take large numbers of interest in the profitability of the banks and cause an increment in the banks' non-performing loans. In addition to this, foreign ownership influenced bank's profitability positively. Christopher and Mo Fung Yung (2009) also carried out a similar study analyzing the effects of corporate governance like board size or board composition using the panel regression methods. The results were conducted for the good performance. Banks have negative relationships between the size of the board , of directors and the level of related-party loans. The size of the bank has a positive impact on banks' performances, that is; with a larger size, bank is called as more profitable. Mousa F. Al Manaseer, Riyad Mohamad Al – Hindawi, Mohamad Abdulrahim Al – Dahiyad and Iaad Issa Satawi (2012) have also found significant relationship between the corporate governance and performance. They pooled data during the period of 2007-2009 from the Jordanian Banks and tested the effects of

board size, separation of ownership on the banks' profitability. The study was conducted by linear regression analysis. ROA, ROE, PM and EPS were performance variables which were used in the methodology.

Lack of the true corporate governance in the banking industry causes crisis. In that point, Renee B. Adams and Hamid Mehran (2008) used 35 banks between the period of 1986-1996 and tested them to emphasize the importance of corporate governance in the banking industry. Results found showed that bank size have a positive effect on the performance of banks. They used financial variables like Tobin's Q, ROA and investigated the relationship between board structure and performance.

Another similar result was found by Adel Bino and Shroug Tomar (2009) who used a linear regression analysis and tested sample of 14 banks, in order to see the importance of corporate governance in the performance of Jordanian banking industry. They found the ownership structure and board composition are important variables to have the valued performance. Moreover, board size is found as a non important variable related with the profitability. Mohamed Belkhir (2008) also studied 174 banks during the period of 1995-2002. Tobin's Q and ROA were the elements of investigation and he that although banks have similar corporate governance problems like firms, there is no important effect on the ownership concentration and the bank performance. Moreover, the sample of 107 banks from Russia and 50 banks in Ukraine were tested by Inessa Love and Andrei Rachinsky

(2003) to evaluate the relationship between ownership, corporate governance and operating performance in banks, ROA, ROE, asset growth, capital growth, non-performing loans, reserves, dividends, net interest income, interest income, interest expense were the performance measures whereas size, capital, loans, owners, shareholders were the control variables. They used panel regression methods and this study presents no significant relationship between the governance and operating performance. They found that the ownership is more important than the corporate governance in Ukraine and Russia.

Another study was conducted by Papanikolaou Ermina and Patsi Maria (2009). They analyzed 79 banks and examined relationship between the bank's profitability and corporate governance. ROA, ROE, investment return were used as dependent variables and statistical results showed there is no significant correlation with the corporate governance. In summary, the relationship between the corporate governance and profitability may be affected by different conditions which are handled by the researchers.

Agency cost hypothesis was another perspective to the corporate governance. For instance, Allen N. Berger (2003) has a different perspective and tested the agency cost hypothesis cause which increases firm value and encourages the governance to be more efficient. Moreover, Eahab Elsaid, Wallace N. Davidson and Yiacin Wang (2011) found that the good governance reduce the principal-agent problems by affecting asset utilization of the firm which results with the efficiencies.

## **Chapter 3**

# **GENERAL OUTLOOK OF THE NORTH CYPRUS ECONOMY AND THE BANKING INDUSTRY**

### **3.1 The North Cyprus Economy**

The North Cyprus Economy is characterized by small island economies and has adopted a free market economy by using Turkish Lira as a legal currency. TRNC does not possess its own monetary policy because of the Turkish Lira of mainland Turkey. In the recent years, economy of the Turkey has a growth. These positive improvements in the economy of Turkey were also influential in North Cyprus' economy. Exports and the imports is the key indicators of the economies and due to being an unrecognized country, North Cyprus has low exports and most of products are imported from Turkey. The principal reason for this condition is the economic blockade faced and the fact that the productive base of the country is inadequate. TRNC has embargoes and isolations. EU countries do not recognize the North. They recognize only the South because Greek Cypriots joined the EU and have been represented in the whole island. TRNC's ports are called illegal. Because of this reason, TRNC cannot sell its products to the EU countries directly and generally TRNC



exports its goods to other countries via ports in Turkey. In addition to this, having limited resources and technology with lack of recognition cause high costs of production. Although TRNC can use ports in Turkey and can make the exports via Turkey, when we compare the costs with the EU, TRNC has low quality with high prices.

This makes TRNC's exports uncompetitive in EU markets. Moreover, lack of privatization is another problem for being a nonproductive country and affects the TRNC's economy negatively. Political problems create an uncertainty in, economy and decreases the demand for the private sectors.

Information technologies are important in the productivity because they have been used in determining customer needs and preferences. This provides high quality at low costs and increase the productivity. However, because of nonimprovement in private sector, the public sector has existed with Turkey encouragement for the productivity is low in the economy of North Cyprus. Although country has lots of embargoes and isolations, it's a good investment place among European countries because it provides low tax rates on corporate income for companies and it has also a strategic location.

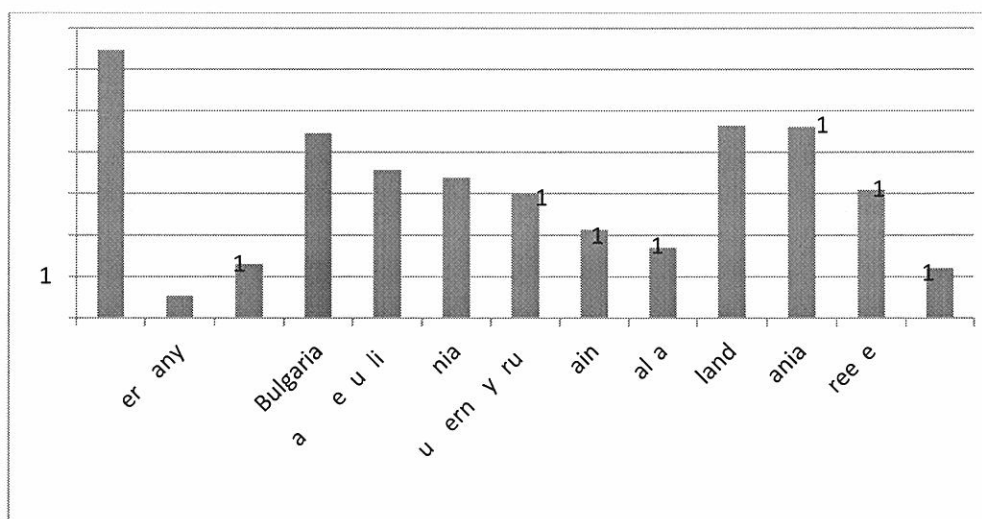


Figure 3.1: Annual Average Growth Rate (2003-2009) in EU Countries and Northern Cyprus (%)

Source: Eurostat & SPO

According to the graph which is illustrated above, TRNC has the fastest annual average growth rate between the period of 2003 and 2009 by 6.47% among European countries.

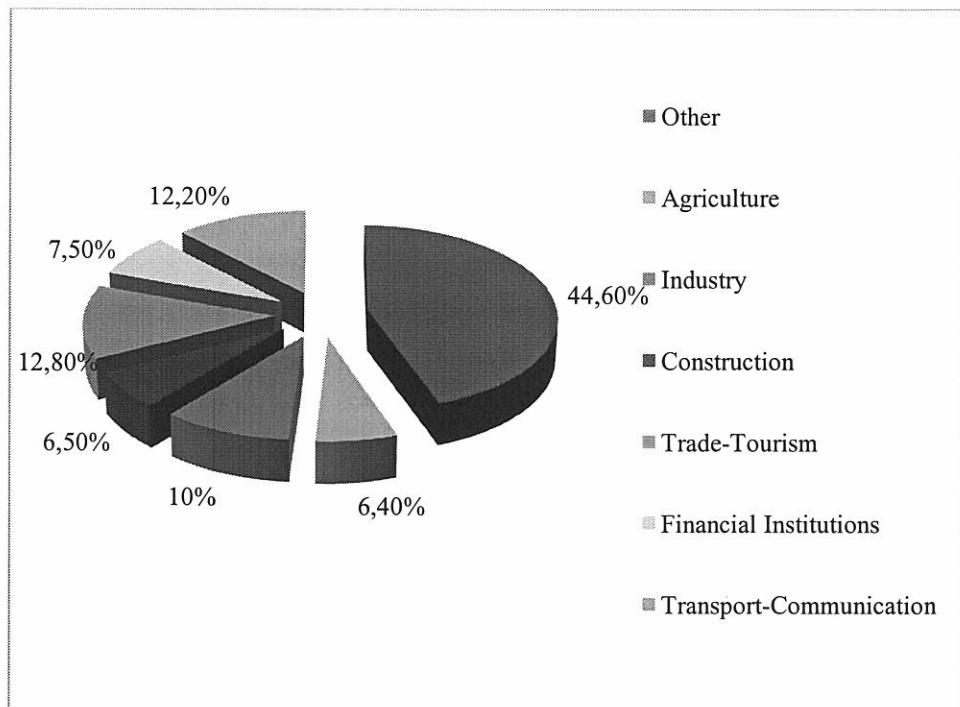


Figure 3.2: GDP According to the Sectors (2009)  
 Source: Cyprus Turkish Investment Development Agency

As displayed in the figure, because of low productivity, the economy is based on trade-tourism, transport-communication, financial institutions and the others. The contribution of the industry sector has allocations in the economy as 10% by industry, 6.5 % by construction, 12,8 % by trade-tourism 7,5 % by financial Institutions where as agriculture has a figure of 6,4 %.

Key indicators of Northern Cyprus's economy are shown below:

Indicator / Year	2009
Gross Domestic Product (GDP) Million US\$	3,324
Gross National Product (GNP) Million US\$	3,349
GDP Per Capita Income US\$	13,253
GNP Per Capita Income US\$	13,354
GDP Growth rate %	- 6.1
GNP Growth rate %	- 6.3
Bank Deposits Million US\$	6,505
Bank Credits Million US\$	3,976
of which Public	1,341
of which Public %	33.7
Foreign Trade total (Million US\$)	<u>1,313</u>
Export	71
Import	1,241
Net Tourism Income (million US\$)	450
Arrivals	800,376

Figure 3.3: TRNC Main Economic Indicators

Source: Cyprus Turkish Investment Development Agency

The figure showed that the growth rate of the GDP of North Cyprus was 6,1 whereas growth rate of the GNP was 6.3 %. This means that the products and services which are based on North Cyprus were less than the product and services that come from other countries. Moreover, number of arrivals was 800,376 which is considered as the main tourism indicator and have the importance for the tourism sector. As can be

seen in the table exports were less than the imports that means economy of the North Cyprus has not had a good production. Bank credits and deposits had also important role in the improvement.

### **3.2 The North Cyprus Banking Industry**

The North Cyprus banking industry is the developing industry among other industries. It takes an important place in the North Cyprus economy. Banking is an essential function for healthier economies by providing money flow. At that point, Deenar Khathake and Klaus Walter Riechel (1980) defend that banking is a system that provides financial resources, types of products credits and instruments for growth that play important roles in developing countries' economies. In North Cyprus, number of banks increases from day to day and the effects of a good corporate governances on the bank performances is being discussed with the importance of banking sectors just as in other developing countries. North Cyprus banking industry has 22 banks which include 3 public banks, 12 private banks and 7 foreign banks. According to the Central Bank reports there is 2519 people who are working in that sector. This shows that the banking sector creates an important amount of employment to the North Cyprus economy.

YEARS	2005	2006	2007	2008	2009	2010	2011	Mar-12
Public Banks	2	2	2	2	2	4	3	3
Private Banks	15	15	15	15	15	12	12	12
Foreign Banks	6	6	7	7	7	7	7	7
<b>Total</b>	<b>23</b>	<b>23</b>	<b>24</b>	<b>24</b>	<b>24</b>	<b>23</b>	<b>22</b>	<b>22</b>

Figure 3.4: Improvements of the Number of Banks

Source: Central Bank of Cyprus

According to the figure 3.4, the number of banks operating in the TRNC banking sector remained the same until the end of 2009, in 2010 there were some differences in the number of public and private banks. In addition to this, from 2010 to March 2012, the number of public banks declined and the number of private banks and foreign banks remained unchanged.

<b>YEARS</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>Mar.12</b>
Public Banks	23	23	24	27	29	34	35	35
Private Banks	83	83	95	111	120	118	117	117
Foreign Banks	25	28	30	32	35	40	44	44
<b>Total</b>	<b>131</b>	<b>134</b>	<b>149</b>	<b>170</b>	<b>184</b>	<b>192</b>	<b>196</b>	<b>196</b>
<b>in Percentage</b>								
Public Banks	17,56	17,16	16,11	15,88	15,76	17,71	17,86	17,86
Private Banks	63,36	61,94	63,76	65,3	65,22	61,46	59,69	59,69
Foreign Banks	19,08	20,9	20,13	18,82	19,02	20,83	22,45	22,45

Figure 3.5: Improvement and Distribution of the Number of Branches

Source: Central Bank of Cyprus

Looking at the distribution of the number of branches, in the period of March 2012,

In total, 59.69 % of branches are privately-owned banks. Foreign banks have the second place with the 22.45 % which is more than the public banks. North Cyprus banking sector is divided into three groups as public banks, private banks and foreign banks. In the following graph, we can see the assets share of the banks that have a role in sector.

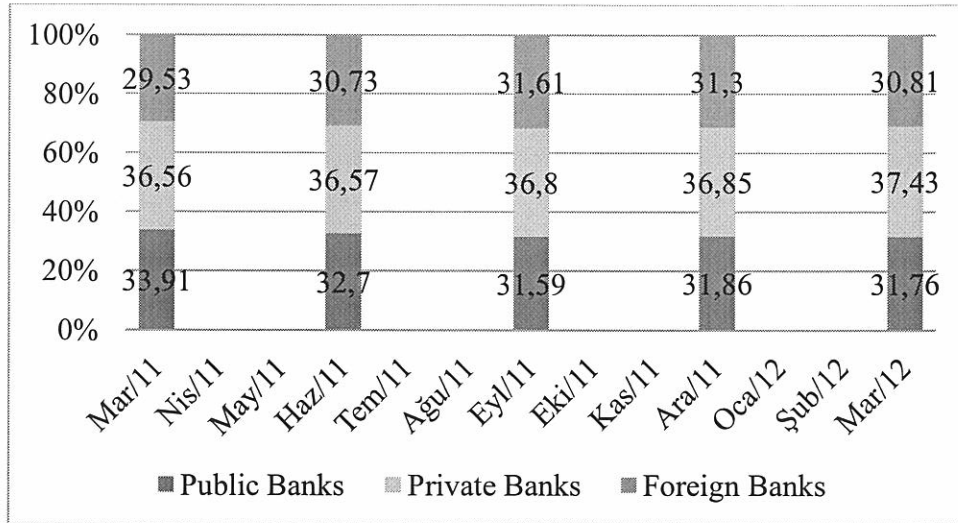


Figure 3.6: Assets Share of the Banks in Sector

Source: Central Bank of North Cyprus

The graph illustrates that in the second quarter of 2011, private banks had the 36, 85% roles in the sector and this percentage decreased to 37,43 % in the first quarter of 2012. On the other hand, when we look at the foreign banks, there was an increment from 31,3 % to 31,80 % in the first quarter of 2012. Moreover, in contrast with the both foreign and private banks, the number of public banks declined from 31,86 % to 31,76 % .

Banks act as a financial intermediary, therefore, loans created to the market, deposits that is collected from the people and the equity that is owned are important factors of the North Cyprus banking industry like other developing banking industries.

Following graphs show that the places of loans, deposits and equity in the sector.



	<b>Mar-11</b>	<b>Jun-11</b>	<b>Sep-11</b>	<b>Dec-11</b>	<b>Mar-12</b>
<b>Total Loans</b>	4.404,2	4.670,5	4.953,0	5.402,3	5.361,4

Figure 3.7: Number of Loans (in Millions)

Source: Central Bank of North Cyprus

If we look at the place of the loans in the sector, we can say that from March 2011 to December 2011, the number of existing loans increased. There was a highest increment with the rate of 9.14 in 2011, September. Although there was an increment until the September of 2011, in March 2012 loans decreased by a figure of 0.44 .

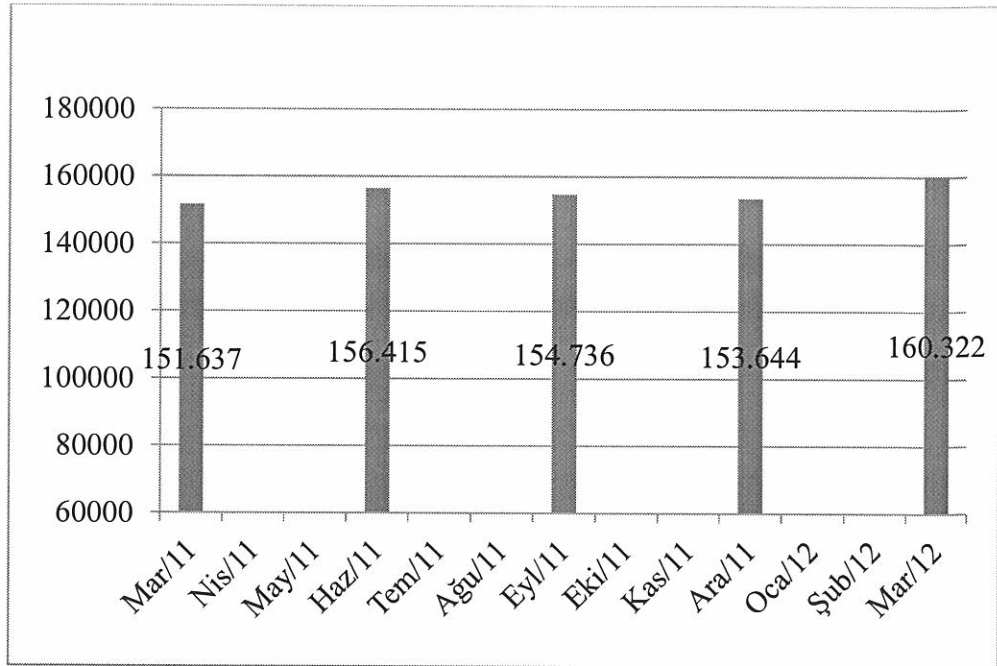


Figure 3.8: Number of Loan Customers  
Source: Central Bank of North Cyprus

According to the figure3.8, from the first quarter of March 2012 to the second quarter of March 2012 the number of loan customers increased by 6,678 and reached 160,322 people. In addition to this, If we look at the overall graph from March 2011 to March 2012, there was an increment by 8,685 people.

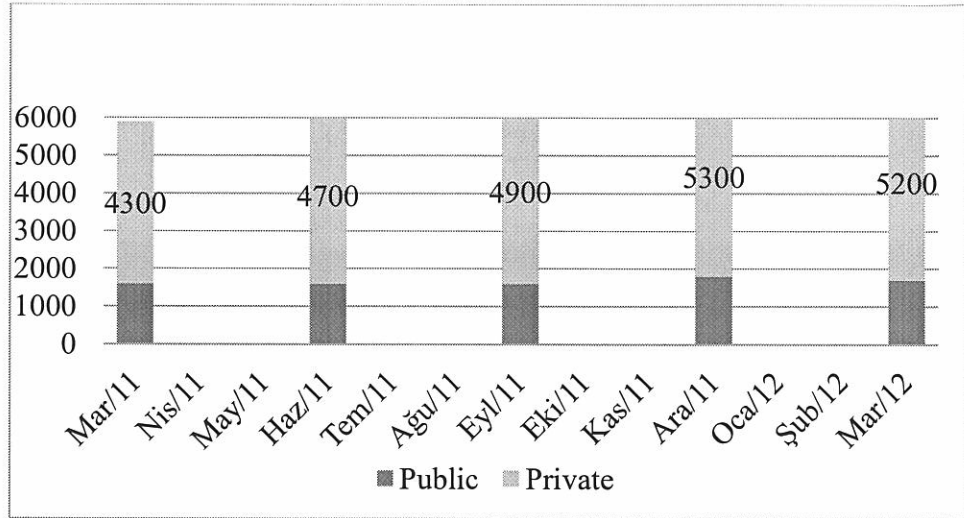


Figure 3.9: Distribution of Public and Private Sector Loans (in Millions)  
Source: Central Bank of Cyprus

The graph illustrates that the 68,96 % of the loans were given to the private sector and the rest was given to the public sector. The public sector loans were increased from 1,516 million to 1,664 million between the period of December 2011 and March 2012. In the same period, private sector loans were also increased from 2,887.8 million to 3,697.4 million. Deposits are the most important source of the fund in the banking industry. Following graphs show that the numerical data from the TRNC banking industry.

	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
<b>Total Deposits</b>	7.365,3	7.658,4	8.118,1	8.402,9	8.274,4

Figure 3.10: Number of Deposits (in Millions)

Source: Central Bank of North Cyprus

Figure 3.10 shows that the number of deposits had an increase until the December 2011 and then they was a decrease to 8,274.4 in the March 2012.

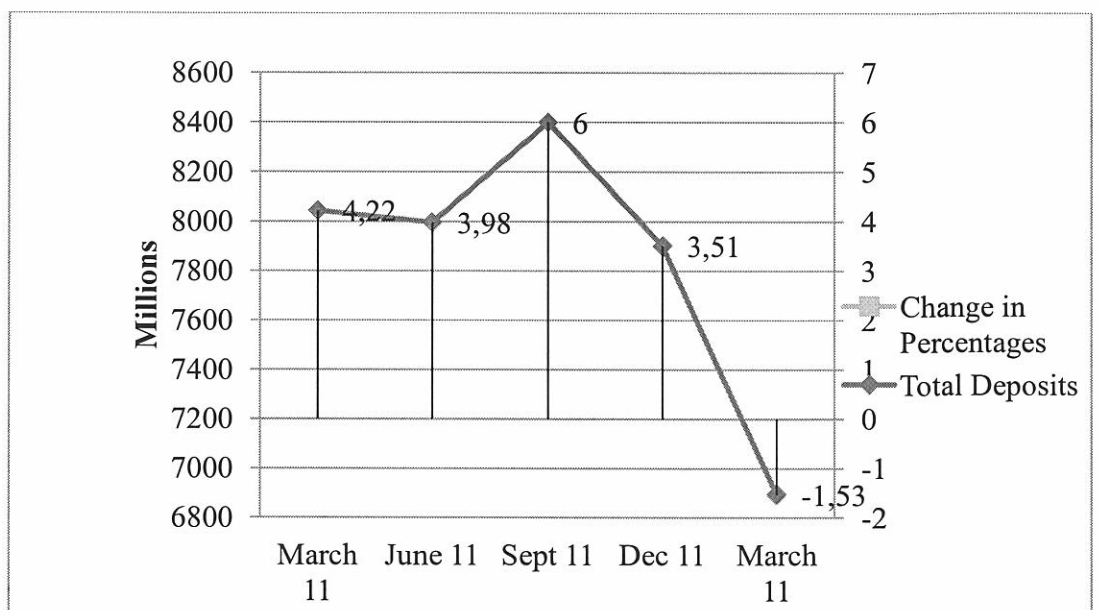


Figure 3.11: Improvement of Deposits by Percentages %

Source: Central Bank of North Cyprus

According to the graph from March 2011 to December 2011, number of deposits increased. However, in the first quarter of March 2012 it decreased by 1.53%. Last, but not least; equity is another important element of the improvement and the stability of the countries' banking industries.

	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
<b>Total Equity</b>	907,9	1.012,2	1.077,3	1.097,0	1.092,3

Figure 3.12: Improvements of Equities (in Millions)

Source: Central Bank of North Cyprus

As can be seen from the figure 3.12, equity showed the highest improvement in December 2011 with a number of 1,097 million. From the period between the March 2011 and September 2011, there was an increment month by month. Although the table showed equity had an improvement in the year of 2011, there was a decreasing figure in the first quarter of 2012. Loans, deposits and equity which are mentioned above have important places in the banking industries and the tables that were illustrated show that the TRNC's banking industry has that have place in the North Cyprus economy.

## **Chapter 4**

### **DATA AND METHODOLOGY**

#### **4.1 Data**

In order to examine the role of corporate governance in bank performance, we have taken a sample of 23 banks in North Cyprus banking industry. Data which were used in performance variables were collected from the bank's annual financial reports for the period of 2006-2010 and the data which provides to analyze governance variables were collected from the directors and shareholders report of the banks from 2002 to 2010. For the evaluation, we created single values which were the average of nine years for the directors and shareholders report and the average of five years for the financial reports of the banks.

The banks that were used in the analysis were given in table 4.1 below.

Table 4.1: List of the Banks

K.T KOOP MERKEZ BANKASI LTD. TÜRK BANKASI LTD. LİMASOL TÜRK KOOP BANK LTD. ASBANK LTD. KIBRIS İKTİSAT BANKASI LTD. ARTAM BANK LTD. KIBRIS ALTINBAŞ BANK LTD. YAKIN DOĞU BANK LTD. ŞEKERBANK (KIBRIS) LTD. AKFİNANS BANK LTD. YEŞİLADA BANK LTD. UNIVERSAL BANK LTD. KIBRIS CONTINENTAL BANK LTD. VİYABANK LTD. KIBRIS FAİSAL İSLAM BANKASI LTD. T.C. ZİRAAT BANKASI A.Ş. TÜRKİYE HALK BANKASI A.Ş. HSBC BANK A.Ş. TÜRKİYE İŞ BANKASI A.Ş. OYAK BANK A.Ş. (ING BANK A.Ş.) TÜRKİYE GARANTİ BANKASI A.Ş. KIBRIS VAKIFLAR BANKASI LTD. TÜRK EKONOMİ BANKASI A.Ş.
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## 4.2 Methodology

Most of the previous studies were conducted by panel regression methods in order to see the effects of the importance of the corporate governance on the profitability. In this research, because of having single observations for single periods at the end of the valuations that came from financial reports of the bank and the directors and shareholders reports, cross section analysis was preferred to use to analyze single variables to see the effects on performance. Variables which were used to measure performance were divided into two groups as dependent and

independent variables and include financial and governance variables as other governance studies.

#### **4.2.1 Variable Measurement**

##### **Financial Variables**

###### **ROA**

Return on Assets shows the ability of management about how they can use their assets efficiently to generate earnings. It is calculated by the net income divided by the total assets.

###### **ROE**

ROE is the return on equity which measures the returns of the banks' shareholders' profit when they invest their funds at risk and expect some profits. Calculation of the ROE is the net income over total equity.

###### **NIM**

Net interest margin shows the ability of management to control their earning assets with the cheapest sources of funding. When the spread between revenues and interest costs are large; it means that the management is able to achieve profit. It is calculated by the difference between the interest revenues and interest expense divided by the total assets.



ROA, ROE, NIM are the most known ratios that are used in the measurement of profitability and efficiency. In this study these measurements were used as dependent variables, ROA was the primary measure to see the profit which comes from total assets of the banks, the ROE followed this measurement to calculate the rate of return over the equity of the banks and the NIM provides data to see the effect of good managements in order to keep the growth of banks' profitability.

#### Liquidity Ratio

Liquidity is an important factor of the functioning of the banks, it provides information about the power of the assets of the banks which can be converted easily into cash in order to cover the bank's debts. Liquidity issue is directly related with the performance of the banks, because if banks do not cover its short term debt obligations in some situations bankruptcy is seen. Formula of the liquidity ratio is the liquidity over total assets.

#### Asset Utilization

Asset utilization provides an idea about how banks use their resources efficiently in order to generate profits. For instance, banks can arrange their pricing of services or minimize their tax liabilities. Pricing of services and tax liabilities

are important issues for the bank performance because these policies affect their assets positively or negatively. It gives a detailed picture of how well a bank governs these issues, so it is important in the measurement of corporate governance. The formula is conducted by the total revenues over total assets.

#### Equity Ratio

This measurement shows the capacity of the banks for using to finance their assets. Equity ratio is an important indicator because it gives an idea about the financial strength of the banks in order to absorb their losses and make profit by using assets efficiently. It also reduces the cost of accounting by making funding with the powerful contribution of the equity which brings higher profits. The formula is the equity over total assets that is used to see the effects of the equity on the performance of the banks.

#### Provision Loan Loss Ratio

It shows the small percentage of the total loans that the banks have to hold in order to prevent the failure which occurs in credit risk with loan losses. It is calculated by dividing provision loan losses to total loans.

LIQR, AU, EQ and PLL were the other financial variables that were used in the analysis as independent variables in contrast to other financial variables like

ROA, ROE and NIM which were used as dependent variables. These variables also affect the performance but they do not directly affect it like ROA, ROE and NIM. These give ideas about the risks related to liquidity, credit ,interest rate risk which may cause failures.

### **Governance Variables**

#### **Board Size**

It's a size of people who are on the management of the bank. Larger board size causes good governances because of the variety of the ideas but sometimes, larger board size causes conflict between the board members and prevents to make right decisions for good governances.

#### **Board Age**

Board age indicates the effects of the management that take places in decision making process. Years which the board has been in place in management can be shown as an experience to make rightdecisions and be more profitable. On the other hand, boards that have been in charge for a short time,are sometimes referred as more efficient to the banks because they bring new ideas to the management and they are more risk takers.

DS

It shows the number of people that have been changed in management and it can be a measurement related with the board age. In order to find the board age, DS provides observations about how many people work for how many years. This indicator brings a question that if board members changed frequently, does this mean more profitable firms.

YS

YS shows that the number of people who are sitting on the board of the banks continuously. This may mean that, these people can be more active in decision making process and take more actions because of their knowledge and the experience. This can affect the performance directly. In order to measure the YS, we used directors and shareholders reports of the banks and put a time limit to show the average of minimum years and multiplied this value with the board age. In addition to this, we put forward the argument that the result should be greater in order to be YS or not.

YKBGS

YKBGS is a measurement about the number of years that the chairman has held in his position within the management and have high performances. For instance, most

of the banks have one chairman who works for many years. At that point, the argument is whether a chairman should work for many years or not. BS, BA, DS, YS and YKBGS are the other independent variables which give ideas about the governance of the banks that will affect the profitability.

### **Ownership Variables**

#### **ODUM**

A dummy variable that takes on if the ownership is public. It provides means to separate ownership of the banks as private and public. The idea then to argue is if private ownerships can be referred as more profitable or not. ODUM was the variable that was used as independent variable in order to see the effects of the types of ownerships on the performance.

## **Chapter 5**

### **ANALYSIS AND EMPIRICAL RESULTS**

#### **5.1 Analysis**

This study used cross section analysis research method to analyze the effects of the corporate governance on the TRNC banking industry. In analysis, we created single values, which are the average of nine years for each dependent and independent variables.

Although most of the studies conducted panel regression analysis, we preferred to run cross section analysis to the overall of the study because of single values for the governance variables. In order to assess the influences of corporate governance on bank performance, we used two equations named as basic and advance equations.

## 5.2 Empirical Result

### Basic Equation

Basic equations were created separately for the ROA, ROE and NIM which were run by the cross section analysis. These basic equations were as the following:

$$\text{ROA} = \beta_0 + \beta_1 (\text{PLL}) + \beta_2 (\text{LIQR}) + \beta_3 (\text{EQ}) + \beta_4 (\text{AU}) + \beta_5 (\text{BA}) + \beta_6 (\text{BS}) + (\text{DS})$$

$$\text{ROE} = \beta_0 + \beta_1 (\text{PLL}) + \beta_2 (\text{LIQR}) + \beta_3 (\text{EQ}) + \beta_4 (\text{AU}) + \beta_5 (\text{BA}) + \beta_6 (\text{BS}) + (\text{DS})$$

$$\text{NIM} = \beta_0 + \beta_1 (\text{PLL}) + \beta_2 (\text{LIQR}) + \beta_3 (\text{EQ}) + \beta_4 (\text{AU}) + \beta_5 (\text{BA}) + \beta_6 (\text{BS}) + (\text{DS})$$

Running cross section analysis, we get the results that show the effects of independent variables on the dependent variables which were placed on the following table. These results provide information to evaluate the impact of PLL, LIQR, EQ, AU, BA, BS and DS on the ROA, ROE and the NIM in order to have an idea about how corporate governance affects the performance of the TRNC banking industry.

Table 5.1: Basic Equation

<b>Basic Equation</b>			
<b>Dependent Variables</b>	<b>ROA</b>	<b>ROE</b>	<b>NIM</b>
<b>Independent Variables</b>	<b>Coefficient</b>	<b>Coefficient</b>	<b>Coefficient</b>
PLL	0.439	0.602***	0.491***
LIQR	-0.017*	0.047**	-0.074*
EQ	0.103	-1.785*	0.132
AU	0.128	1.857	0.284
BA	-0.001*	0.007*	-0.006*
BS	0.000*	0.012**	0.004*
DS	0.000*	0.004*	-0.001*
<b>R-squared</b>	0.869	0.448	0.938
<b>Adjusted R-squared</b>	0.786	0.097	0.836
<b>F-Statistic</b>	10.467	1.278	9.206

Note: \*, \*\*, \*\*\* denotes the significance level at  $\alpha=0.01$   $\alpha=0.05$   $\alpha=0.10$

Liquidity was the independent variable which was used in basic equation and as can be seen from the table there is a significant effect on our dependent variables which are ROA, ROE and NIM. Cross section analysis gave the outcome of liquidity to be significant at the  $\alpha=0.01$  level for the ROA,  $\alpha=0,05$  for the ROE and  $\alpha=0,01$  level for the NIM. ROA, ROE and NIM are the measurements of performance and the liquidity shows the capability of the bank to have sufficient cash. When banks have sufficient cash to meet customer withdrawals and demands, it means that these banks are performed well and there is no failure risk because of liquidity risk. As a result of these, we can say that, liquidity is directly related with the performance variables which are ROA, ROE and NIM. We are expecting an inverse relationship with the ROA and LIQR because assets can be converted into cash in order to have liquid. LIQR had -0,017 of coefficient on the ROA as can be



seen in the table 5.1. When we compare LIQR with the ROE, there was a positive effect on it. This can be explained as the bank can use their assets by converting the cash to use it to finance with its equity to get profit. In this respect, results of the ROA and ROE were significant. NIM had also -0,074 of coefficient on the LIQR which can show that the bank used their liquids to bear the interest rate risk in the financial leverage.

The analysis for the basic equation resulted in no impact between EQ and ROA, NIM. ROA shows the banks' ability to use their assets efficiently and turned them into profit. On the other hand, NIM is related with how the interest rate risk affects banks' performances. In contrast of these measurements, EQ has a positive relationship between the ROE, because it is directly related with the financial leverage and shows how banks used their assets to support their equity capital. Higher EQ means banks have stronger equity to cover losses in their assets. Research of the Adel Bino and Shoroug Tomar (2012) found also positive correlation among the capital and the ROE because banks that have more capital can be referred as more risk takers, which brings more returns.

According to the table5.1, there is no effect of AU on ROA. Normally, there shouldbe a positive relationship among the asset utilization and return on assets because asset utilization shows how management uses their assets efficiently and the ROA measures the returns from the assets that the banks have. However, analysis was resulted with no effect of the AU on ROA. The reason can be both of the ROA and AU give the same ideas about the performance of the banks but their functions are different. AU is related with how the bank used their total assets to reflect their total operating revenues and this reflects decision making processes. It causes to use

assets in correct ways by taking right decision in the portfolio managements. When the management make right decisions, this can result with returns and cause an increase in ROA. AU had also no impact on ROE and NIM because functioning of the ROE and NIM is not directly related with the functioning of AU.

In cross section analysis, basic equation also provides an understanding of the effects of governance variables like BS, BA and DS on the performance of North Cyprus Banking industry.

As can be seen in the table 5.1, BA is statistically significant on ROA, ROE and NIM at the level of  $\alpha=0,01$ . BA shows the years that the boards are in the management. If years are long, this means that the bank has been operated efficiently. The result was logically with the ROE, ROA and NIM which also showed the efficiency of the banks. BS was the other governance variable and result of the analysis showed BS has an effect on the ROA and NIM. We are also expecting significant relationship on the ROE because expected outcome was to have the strongest equity occurring in larger board size but the analysis resulted with no impact on ROE. ROA and NIM can be related with the BS because higher ROA means assets of the banks were turned in return and NIM shows bank is strong to bear the interest rate risk. These can be thought as possible with larger boardsizes because with different board views, making right decisions is more expected and if these boards are larger, it can provide conditions to make healthy decisions in order to make profits.

Khaled Elsayed (2011) made a similar study with our research but he brings out a different perspective by handling the BS with duality. He emphasized that structure of management carried importance with the board size, especially CEO and the

members of the board at the same time when considering the duality, board size affected the profit negatively and had negative impact on the performance. Moreover, most of the studies that analyzed the effect of board size on the performance by using the same techniques in the study of Theodore Eisenberg, Stefan Sundgren, Martin T. Wells (1998) and Christopher Kasener, Benjamin Moldeshaver (2008) found the result that there is no significant correlation among the board size and performance which contradicted with our findings.

Results of DS were significantly related with the performance of the bank. Although most of views have defended if DS were high, performance would be low because of non-experienced director. The analysis showed that performance is correlated with the DS are at the level of  $\alpha = 0.01$ . This can be explained that perspectives of the board members have important role in decision making processes and new members can be more risk takers with new ideas which may lead to high returns.

The study was analyzed by two equations which were basic and advance equations. We completed the section of basic equation. Next step was advance equations. We created advance equation by adding YS, YKBGS and ODUM variables to the independent variables on ROA, ROE and NIM.

#### Advance Equation

In advance equation, we add the new governance and ownership variables to the basic equation, in order to see the importance of governance in TRNC banking industry from a wider governance perspective. As basic equation had been created for ROA, ROE and NIM separately, advance equation was also created separately.

Different from basic equations, advance equations are as the followings:

$$\text{ROA} = \beta_0 + \beta_1 (\text{PLL}) + \beta_2 (\text{LIQR}) + \beta_3 (\text{EQ}) + \beta_4 (\text{AU}) + \beta_5 (\text{BA}) + \beta_6 (\text{BS}) + \beta_7 (\text{DS}) + \beta_8 (\text{YS}) + \beta_9 (\text{YKBGS}) + \beta_{10} (\text{ODUM})$$

$$\text{ROE} = \beta_0 + \beta_1 (\text{PLL}) + \beta_2 (\text{LIQR}) + \beta_3 (\text{EQ}) + \beta_4 (\text{AU}) + \beta_5 (\text{BA}) + \beta_6 (\text{BS}) + \beta_7 (\text{DS}) + \beta_8 (\text{YS}) + \beta_9 (\text{YKBGS}) + \beta_{10} (\text{ODUM})$$

$$\text{NIM} = \beta_0 + \beta_1 (\text{PLL}) + \beta_2 (\text{LIQR}) + \beta_3 (\text{EQ}) + \beta_4 (\text{AU}) + \beta_5 (\text{BA}) + \beta_6 (\text{BS}) + \beta_7 (\text{DS}) + \beta_8 (\text{YS}) + \beta_9 (\text{YKBGS}) + \beta_{10} (\text{ODUM})$$

At the end of the cross section analysis, with these advance equations, we get the different results than basic equations. These findings are displayed in the Table 5.2 as the following:

Dependent Variables	ROA	ROE	NIM
Independent Variables	Coefficient	Coefficient	Coefficient
PLL	0.226	-4.048 *	0.071 ***
LIQR	-0.034*	-0.165 *	-0.041*
EQ	0.264	-0.804 *	0.112
AU	0.041**	2.447	0.395
BA	0.002*	0.041 **	-0.003*
BS	-0.003*	-0.071 *	0.005*
DS	-4.740*	0.012 **	0.000*
YS	0.006*	0.162	-0.002*
YKBGS	0.000*	0.060 ***	0.002*
ODUM	0.022*	0.409	0.001*
<b>R-squared</b>	0.918	0.602	0.907
<b>Adjusted R-squared</b>	0.781	-0.06	0.849
<b>F-Statistic</b>	6.719	0.909	15.496

Note: \*, \*\*,\*\*\* denotes the significance level at  $\alpha=0.01$   $\alpha=0.05$   $\alpha=0.10$

management should directly affect the overall performance as the results showed in Table 5.2. Governance variables which were added to the advance equation were not all the same with the basic equation. Some of them showed differences with the basic equation as can be seen in the table 5.2. BA were the same in advance equation and resulted with the positive impacts on the ROA, ROE and NIM with different coefficients and being significant like 0.002 for the ROA at the  $\alpha=0,01$  level, 0.041 for the ROE at the  $\alpha=0,10$  level and -0.03 for the NIM at the  $\alpha=0,01$  level. BS was significant and the coefficient of the BS by -0.071 at the  $\alpha=0.01$  level. Sometimes banks need larger boards, in order to make right decisions about how the assets should be financed efficiently with the bank's equity. Meanwhile, results showed expecting relationship between the BS and ROE. DS also showed the same result with

the basic equation, only the significance levels were changed. Higher DS was thought as more new perspectives were to take more risk with higher returns. YS was an independent governance variable which was directly affecting the ROA and NIM.

The table 5.1 showed that, YS has no effect on ROE. ROA is an indicator of overall operating efficiency and the NIM showed if bank is strong to risk a failure in the changing of interest rates. In order to be successful in both of them, YS has an important role in decision making processes. Normally, ROE should also be related with the YS because when YS increases ROE is expected to rise. However, as a result of this analysis ROE was found not have any impact on YS. Moreover, YKBGS and ODUM were other new variables which were added on the advance equation and results showed that the both of YKBGS and ODUM related with the performance significantly. Sometimes, if the yearsof the chairman, who is in the management is long, this bank can be referred as non risk taker. In the result of analysis, in contrast to this, the years of the chairman that is in the management were directly and positively related with the performance.

At the end of the analysis, ODUM was the last variable that was used in table 5.2. ODUM resulted in the public ownerships affected performance significantly. In such situations; private ownerships are thought to be more profitable in comparison with thepublic ownerships because their capital is higher than the capital of public ownerships.

In literature most of the studies found that the private ownerships can be referred as more profitable but our findings resulted with the opposite. Public ownerships are more profitable as Gerard Caprio, Luc Leaven, and Ross Levine (2007) found. The same result occurred in analyzing the ownerships of the 244 banks in 44 countries

and large proportion of these banks showed the same result with our findings. As a result of cross section analysis, the public ownerships were stronger than the private ownerships in the North Cyprus banking industry as it is illustrated in the table 5.1.

## **Chapter6**

### **CONCLUSION**

#### **6.1 Summary of the Study**

This thesis examined the importance of the role of corporate governance in the TRNC banking industry. ROA, ROE and NIM were the performance variables that were used with the governance variables and other financial variables in order to see the effects of governance on profitability. The comprehensive results were derived from two equations, basic and advance equations, by using cross section analysis. Other financial ratios were the PLL, LIQR, EQ, AU whereas governance variables were BA, BS, DS, YS, YKBGS and ODUM. Based on cross section analysis approaches, the impacts of governance and financial variables on profitability were investigated by employing the data collected from the sample of 23 banks of North Cyprus banking industry.

#### **6.2 Summary of Empirical Results**

For each bank, cross section analysis represented different results because of different evaluations of the banks' balance sheets. The general finding reveal that BA,BS, DS, YS, YKBGS, ODUM which are the governance and ownership variables and the PLL,LIQR, EQ, AU which are financial variables have impact on the performance of the banks directly. This study proved that governance variables are a key factor of banks' profitability. Effects of the PLL, EQ, and AU on the ROA were negative



whereas they were positively related with the ROE and NIM. Most of the results were found as expected. However, some results like PLL, EQ, AU which were the financial variables had negative impact on the ROA. Although, they have negative impact on ROA, results showed that the PLL had positive impact on the ROE and the NIM. These results for the PLL can be possible when banks showed their loan loss provisions as low and the banks' capital will be overstated on the balance sheets because of the understating of the loan losses. Non significant effects of the ROA showed that the assets of the banks are not strength to cover failures because of credit risk. Moreover, EQ doesn't have any impact on the ROA unexpectedly. Strength of the bank equity depends on the strength of the bank's assets because equity is related how banks finance their assets to make profit. Lastly, AU was expected to be related with the ROA but the results showed that the AU doesn't have an impact on ROA. This can be explained by the different functioning of the ratios. The governance variable, ODUM, indicated an unexpected result which shows public ownerships can be referred as more profitable. Results showed that the concept of the governance is important in the TRNC's banking industry like in other developing countries.

### **6.3 Limitations and Further Research**

Limitations of this research were related with the data which were collected from the directors and shareholders report of the banks. Most of the banks have lots of shareholders, because of this reason we can't get the information from these reports in order to evaluate the amount of shares of the holders and see the effects of these on profitability of the banks. These created some difficulties in the number of observations that we used. In addition to this, although we tried to find the dual role

of the general managers and the board of directors, we can't get information from the foreign banks which are opening branches in TRNC. Moreover, board composition is an important element of the governances and in order to see the effects of the board composition on performance we need to find the insider and outsider of the banks. Although, we tried to find the insider and the outsider of the banks, we had some problems with the foreign banks. Panel regression method was the most common research method of governance studies but because of lack of panel values, we had to use cross section analysis. Estimation of the panel regression analysis gave more detailed results than the cross section analysis, nevertheless, we used average values and observations which gave meaningful results with the cross section analysis. Further research can be replicated by gathering more detailed data and by increasing the variables in order to see the importance of the governance on profitability.

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