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# Table of Content

# Executive Summary

"Corporate Governance is the set of rules that define the relationship between stakeholders, management, and board of directors of a company and influence how that company is operating. At its most basic level, corporate governance deals with issues that result from the separation of ownership and control. But corporate governance goes beyond simply establishing a clear relationship between shareholders and managers". (OECD Principles of Corporate Governance, 2004)

Corporate governance is about how companies make decisions, how they organize and arrange themselves and how they communicate with shareholders and the rest of the world. Normally, corporate governance deals with concerns such as the way of choosing the board of directors and the executives, what obligations and responsibilities boards and executives have, whether shareholders have any privilege to participate in specific types of business decisions through voting and, if they have these rights, what form they take.

Many companies are aware of that good corporate governance and risk management is great business practice, great business strategy and what many companies are concentrating on to enhance their business, predominantly in the emerging global marketplace where companies are continuously trying to surpass each other to make their business more operative and to attract new investors. For those companies that reject or fail to apply good corporate practices, this failure can have undesirable impacts not only for the business but for investors and the community at large.

Failures of corporate governance and risk management can have after-effects that reach further than the company itself and lead to complete harm for national economies, as recently happened in Cyprus

with the failure in banking system and the demise of the two main banks in Cyprus, the Bank of Cyprus and the Marfin Laiki Bank. The banking system of a nation is one of the most vital in an economy. If banks fail it is likely that the whole economic system will fail. That is why historically, governments and Central Banks have been acting as guarantors or lenders of last resort. Therefore, it is obvious that the collapse of Cyprus Banking System seriously harmed the economy of the island.

As corporate governance remains an area of focus for most businesses, regardless of whether they are involved in international operations, there are many inquiries and concerns that firms still struggle with:

What is good corporate governance and why is it so significant?

Why are so many businesses and governments encouraging improved techniques in corporate governance?

What are those techniques and finest practices?

Is there indication that these reforms and strategies are useful for businesses in stimulating transparency, sustainability and the assurance of global markets and investors?

Why governments are interesting in forming new regulatory frameworks for businesses to enhance their corporate governance?

What is the association between corporate governance and risk management?

How the risk management influences the wealth and prospective of a business?

This paper will go through all these questions. I will attempt to give answers to these questions by referring to specific examples of companies, foreign and domestic, that failed to continue their operations due to the lack of corporate governance and weak risk management. A deep analysis of the causes that led these companies to demise will be carried out by referring to the historical events that led them to the crisis. Finally, I am going to make some recommendations in order to avoid such problems in the future.

# CHAPTER 1: Introduction

The most countries in the world are now in a recessionary period, economic crisis has touched every single person whether is a politician, entrepreneur or an ordinary householder. Cyprus was not an exception and has suffered a disastrous experience of recession. In response to the recent events that took place in Cyprus through this paper the roots of the problem will be found and analyzed and techniques of preventing such situations will be provided.

Cyprus, an island country in European Mediterranean and a member state of the European Union, have been in the spotlight in Spring of 2013, everyone was speaking about Cyprus and its financial situation.

The Republic of Cyprus joined the European Union in 2004 and adopted the Euro as its national currency in January 2008. Not unexpectedly, this has revealed to be a choice that could not be considered as an ideal choice for the island, however it was one of the requirements of European Union and its members were obligated to follow the instructions. The financial crisis started at the same time Euro was adopted, unfavorably touching both the financial stability of the country and the Euro itself as the currency of the Eurozone. Initially, Cyprus was in a good position and was achieving to ride out the crisis fairly well, so as a result it suffered not as much of severe contrary effects as the rest members of the European Union up until 2012 and developed more rapidly than neighboring countries during that time.

Unfortunately, Cyprus, as a small island with economy that is mainly based on the country’s tourism, did not manage to sustain this economic stability and financial crisis of Eurozone did not spare it. All began when Greece turned out to have serious problems. Most of Cyprus population is of Greek origin, and Cyprus has been historically tied with Greece and its culture, however, it shares not only durable cultural relations with Greece but strong financial ties as well. Specifically, Cyprus was a big holder of Greek government and corporate bonds, so the severe decline in the value of those assets had a predominantly sharp negative influence on Cypriot banks. Actually, Cyprus Banks decided to write down the value of Greek debt as part of the bailout deal for Greece and this decision can be considered as a starting point of Cyprus Economy collapse since this decision meant that Cyprus was basically in a situation where it needed a bailout itself. Cyprus Marfin Laiki Bank and the Bank of Cyprus, two of the core financial bodies in the country, could not endure their losses and requested Cyprus government for aid. The government, in sequence, decided to nationalize Cyprus Marfin Laiki Bank. Unluckily, this action did not resolve the actual problem, for the reason that the Cypriot government could not in fact meet the expense of the bailouts that it had legislated. Hence, the government of Cyprus was in the unpleasant position to ask the European Central Bank, the European Commission, and the International Monetary Fund for assistance.

# CHAPTER 2: Background

There is no need for any introduction about The Financial Crisis in this paper. The scale of the breakdowns around the world and the consequences for the rest of the worldwide economy are well acknowledged in many other places. The question that arises here is whether the cumulative downfall of shareholder value across the globe is the failure of Corporate Governance or not. This is not simply a considerable question: following the cases of Enron, Lehman Brothers and others in the United States, the Sarbanes-Oxley Act initiated some foremost modifications to US Corporate Governance. On the other hand, in response to more isolated examples somewhere else, such as the breakdown of Marconi (2001) in the United Kingdom, top analysts debated that this should not be seen as a failure of Corporate Governance since the collapse was predominantly due to a misleading tactic, rather than a communal board letdown. Resulting this logic, one might well debate that the Financial Crisis was not so much a setback of Corporate Governance but rather a "Perfect Storm" inside the international financial industry, something that boards of directors could neither be expected to predict or to respond to rapidly enough to make a considerable alteration.

Such opinions, which are usually made in order to confute the need for modification in Corporate Governance regulations, may be misdirected in that way that they can lead to unexploited occasions for improvement. Therefore, we could conclude that the failure to reform the UK Corporate Governance regulations in response to Enron and other scandals, in no small part is due to an established opinion, expressed by many that "breakdown on such a massive scale could not arise over here". Unfortunately, it evidently has taken place and it is obligatory for us to examine all of the contributing aspects which either initiated the difficulties or banned them from being managed in as efficient manner as possible, right round the international economy.

Having this in mind, it is useful to revoke the purposes of Corporate Governance and what does a good Corporate Governance means. The Financial Reporting Council (FRC) interprets the purpose of Corporate Governance as follows:

“Good corporate governance should contribute to better company performance by helping a board discharge its duties in the best interests of shareholders; if it is ignored, the consequence may well be vulnerability or poor performance. Good governance should facilitate efficient, effective and entrepreneurial management that can deliver shareholder value over the longer term.”
(FRC, Combined Code, June 2008)

This view is supported by the prologue to the OECD’s Principles of Corporate Governance, which determines clearly the significance of Corporate Governance in the following declaration:

“The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. As a result, the cost of capital is lower and firms are encouraged to use resources more efficiently, thereby underpinning growth.”
(OECD Principles of Corporate Governance, 2004)

Simultaneously as Corporate Governance propels a positive system which is favorable for the economy as a whole, there is also a component which looks at the necessity for boards of directors to have a role in guaranteeing that there are operative “detective” controls, which assists to discover deficiencies and failures, and general monitoring of corporate accomplishments. This interpretation of Corporate Governance goes back at least as far as the Cadbury Report:

“Had a Code such as ours been in existence in the past, we believe that a number of the recent examples of unexpected company failures and cases of fraud would have received attention earlier.”
(The Financial Aspects of Corporate Governance, The Cadbury Report, 1992)

Given the massive downfall of market value during the recent Financial Crisis, comprising in some circumstances the total elimination of banks as self-regulating concerns, a number of aspects of these declarations have obviously been breached:

- Company presentation, by any principles, has been poor. Even banks with the best performance have seen vast declines in their profitability and in their trade value.

- The confidence that is needed “for the effective running of a market economy” has been extensively corroded in so far as inter-banking loaning is still at very low ranks, and reliance is not being effortlessly reestablished.

- Shareholder value, far from being carried over the long term, has been wrecked on an massive scale, and in many cases eradicated.

- The cost of capital has enlarged to the extent that the sole suppliers of capital for the reformation of many banks have been either national governments or independent wealth treasuries.

Summarizing, there are two contradictory theoretical opinions: the first, or what might be labeled as Corporate Governance-lite method, is as follows:

Corporate Governance is there to empower boards to perform and complete their responsibilities as best they can in the light of prevailing circumstances, but if the circumstances are not satisfactory, then the board should not be held responsible because procedures were outside their control. In the situation of the present Financial Crisis, the Perfect Storm has ascended and many financial establishments have given in as a result. No-one, within organizations or within the governing or political environment predicted the complications, and as a result, no matter how good the Corporate Governance preparations were, no different aftereffect could have been projected.

The second, conflicting argument would run as follows:

Boards have an obligation to detect and comprehend the circumstances within which their organizations are functioning, to guarantee that there is arrangement between long and short term policy, to guarantee that remuneration strategies are in line with the long term plan, that moral values, risk management and pledge practices are suitable so as to classify potential problems as soon as possible. Regardless of the Perfect Storm, boards should have been trimming their sails to match the emerging situations and should have been aware of their duties to a wider concept of society.

The discussion so far has demonstrated that an accurate explanation of corporate governance should not just refer to directors' responsibilities towards shareholders. Various countries have diverse ideas as to what establishes good practices in corporate governance, therefore any acceptable definition, to be appropriate to an up-to-date, international company, must combine best practice from the principal economic controls into something which can be applied across all most important republics. In principle, good corporate governance involves a system of organizing, functioning and monitoring a company in order to accomplish the following:

- a culture centered on a foundation of sound business ethics
- achieving the long-term strategic objective of the proprietors while taking into account the anticipations of all the key shareholders, and in particular: deliberate and care for the benefits of personnel, previous, current and upcoming work to preserve exceptional relations with both clienteles and dealers take account of the requirements of the environment and the local community
- upholding proper obedience with all the appropriate legal and governing requirements under which the business is carrying out its operations.

A well-run corporation must be organized in such a way that all the above requirements are supplied for and can be seen to be functioning effectively by all the interest groups concerned.

# CHAPTER 3: Corporate Governance

## 3.1 Corporate Governance and its significance

With globalization enormously growing the scale of trade and the magnitude and complexity of organizations and the officialdoms created to attempt to regulate it, the significance of corporate governance and internal regulation has been intensified as it becomes progressively more difficult to control externally. Four issues will be explored bellow which are key to recognizing the significance of corporate governance:

- The matter of integrity: are the boards and management of corporations operating in an ethical way?
- The bonus culture: could enhanced corporate governance in financial establishments and their remuneration strategies have banned the credit crux and occasioning financial crisis?
- The regulatory framework: familiarizing additional regulation has clearly miscarried - nations need improved regulation which guarantees businesses distinguish the significance of corporate governance as an fundamental part of management
- The significance of corporate governance in Directors' training: prolepsis is better than a remedy, so comprising awareness of the values and practice of corporate governance in mainstream director training is indispensable

## 3.1.1 The Matter of Integrity

The central concern nowadays in the field of corporate governance is not whether most registered businesses abide with the various requirements of the Sarbanes-Oxley, Combined Code, etc. The main point is whether the top management of big organizations particularly, but actually businesses in general, is seen as possessed of integrity in the eyes of the society at large. This is the inner self that gave funding to the commencement of setting up the Cadbury Committee*, not just a craving to lay down some regulations on the financial aspects of corporate governance to obviate acquitted fund managers being deceived by avaricious directors. And it is this integrity - supposed and actual - which emphasizes the significance of corporate governance, as it is the instrument by which integrity can be stimulated, measured and planned.

## 3.1.2 The Bonus Culture

The present financial crisis has conveyed into sharp concentration the system of bonuses and remuneration functioned by financial establishments. It is debated that it stimulated extreme risk

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** Cadbury Committee: The committee was chaired by Sir Adrian Cadbury and had a remit to review those aspects of corporate governance relating to financial reporting and accountability. The final report 'The financial aspects of corporate governance' (usually known as the Cadbury Report) was published in December 1992 and contained a number of recommendations to raise standards in corporate governance.*

taking and negligent loaning. Combined with the multifaceted financial mechanisms that the typical institutions constructed to move the risk off their accounts, this - highly simplistically stated - was, some say, what gave rise to the so called 'credit crunch'. What is definitely true is that there was extreme risk and negligent loaning and this led to the collapse of some of the world's principal moneylenders and in turn the brokers insuring that risk.

The significance of corporate governance in this situation is indisputable. A healthier system of checks and balances would have helped the organizations to receive the warning massages that many people were sending about the fact that the level and standards of lending was getting risky.

The OECD have published lessons from the financial crisis, which also deduce that:

"The financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements which did not serve their purpose to safeguard against excessive risk taking in a number of financial services companies."

Directors' remuneration and the bonus culture are often detained upon by special interest groups and the mass media as a single concern, not in the framework of business and society as a whole, and is therefore restricted to the underlying aspects causing and influencing payment. While the latter is an apparent demonstration of good or bad governance it omits the basic fact that companies should be function well and responsibly - in every way, not just in by what method they pay salaries and bonuses. In a well-functioning company, good performance is compensated and rightly so - to appeal talent and people enthusiastic to improve functioning, not merely doing a job.

The OECD, in its Principles of Corporate Governance, identifies that:

"Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring."

Visibly, it is not in the best benefits of the company to lose business and essentially having to either close or be bailed out by governments. Thus it is not the opinion that should be argued here, but the application. As it was said previously, while the board, management and even the shareholders may believe that reward is reasonable, it is obvious that existing corporate policy is not harmonized with public perception.

Therefore regardless of the bonus culture being take over at times to attack business generally, the concern does highpoint the significance of corporate governance and the essential to assess the superiority of the system of checks and balances in all dimensions of company.

### 3.1.3 The Regulatory Framework

The significance of corporate governance could be paraphrased as the significance of good management. Put in that simple way it appears clear, but it can be observed daily cases of a lack of acknowledgement that good governance is in fact just good management and a downfall of governance is a downfall of management. Granting bank and insurance company chiefs with substantial bonuses and pension packages after government bailouts of deteriorating institutions, separately from being a vast public relations gaff is rewarding poor management and therefore poor management itself.

But while reorganization is evidently needed, a reflex response will always has as an outcome of building a sledge hammer to miss a nut. The controllers have responsively acknowledged that they did not understand the complex financial instruments that at the end of the day folded in on themselves and led to the breakdown of the financial system. Building new guidelines to try to regulate situations that have yet to arise - every crisis has diverse origins - is a pointless task. Limiting the range of products existing to address the problem has foremost effects on modernization and consumer choice. More or less of the chain effects of this are that products turn out to be more expensive; large suppliers will not take on specific sectors of society because they are not cost-effective; and niche suppliers providing those inventive products will stop to operate or be closed down by the supervisory bodies. That noticeably characterizes a noteworthy backward step in the financial services marketplace.

The significance of corporate governance in the financial markets is predominantly topical but the resolution to bad governance is general and any system of regulation requires to strike the accurate balance between promising innovation and customer choice and applying a minimum set of canons. Basically, though, it should deliver the motivations to go far beyond these minimum canons and try to show that, by shifting the corporate culture, the long term recompenses are in fact greater.  Just as punishing tax rules encourage avoidance, evasion or relocation, it has been verified that the controlling burden, while in many circumstances adding cost and misunderstanding, has caused people to formulate more and more compound systems to avoid uncovering.

There is, of course, much exceptional directive which has really enhanced the consumers' lot by obliging companies to reveal information, diminish costs and charges and largely perform in a fair way.

### 3.1.4 The significance of corporate governance in directors' training

A consequence to the concentration on corporate behavior and the performance of senior corporate personnel is the attention progressively being paid to the qualification of these senior people to follow their duties. There has never been any official compulsory criterion to operate an organization, and none to be a director, although in latest years organizations has familiarized qualifications such as the Chartered Director to address the concern. Actually, of course, most large and well operating companies will search appropriate professional qualifications in their senior workforce, and there is a growing number of companies offering non-executive director preparation and selection facilities.

In the last ten years or so, specifically after the dot com boom and bust and the breakdown of Enron and WorldCom, the role of direction has finally initiated to be seen as a profession or at least a discipline necessitating particular preparation and growth. It is obvious that it is the significance of corporate governance has been a foremost effect here and the IoD qualifications* specifically state corporate governance as a noteworthy element and advantage.

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**The Institute of Directors (IoD) is a UK-based organization, founded in 1903 and incorporated by royal charter in 1906 to support, represent and set standards for company directors.*

## 3.2 Corporate governance mechanisms in banking sector

The corporate governance mechanisms can be classified in two different systems: endogenous systems and exogenous systems.

### 3.2.1 Endogenic Corporate Governance Mechanisms

Internal corporate governance is about mechanisms for the responsibility, controling, and monitor of a company's management in regards to the use of resources and risk taking (Llewellyn and Sinha, 2000). Internal corporate governance begins with the board of directors.

The board of directors is the dominant governing body of bank. The board is accountable for defining the strategic position of the bank and supervising the risk management policies of the bank. The board of directors is elected by the shareholders of the organization. The board has the eventual responsibility for the way in which the operations of a bank are conducted. Besides board's responsibilities include: appointing superior management, set up functional policies and, above all, taking accountability for guaranteeing the healthy existing of a bank. A board must be powerful, autonomous and actively concerned in the operations of a bank. Despite the fact that a bank's directors may not be proficient in banking, it is crucial that they have the skills, cognition, and practice to enable them to execute their responsibilities effectively. The board supervises and assists management attempts, tests and probes suggestions before approving and confirming them. It should make certain that satisfactory controls and schemes are in place to determine and address business concerns before they turn to major troubles. During bad times, a board that is operational and concerned can help a bank live on if it is able to appraise problems, take disciplinary actions, and when needed, keep the establishment on track (Greuning & Bratanovic, 2003).

### 3.2.2 Exogenic Corporate Governance Mechanism

Ciancanelli & Gonzales denoted in 2000 that in the banking sphere, the regulation and regulator symbolize external corporate governance mechanisms. In the formal literature on corporate governance, the market is the exclusive external governance power with the ability to discipline the agent. The fact that regulation exists means there is an additive external power with the ability to discipline the agent. This power is considerably contrary to that of the market. This entails that the powerfulness of regulation has contrary effects to those caused by markets.

Bank regulation typifies the fact that there are interests different from the personal interests of the company. As a governance power, regulation intents to serve the public interests, especially the interests of the clients of the banking services. The regulator does not have a written agreement either with the company's principal or with the banking organizations because of disagreeing interests from those of the principals (Ciancanelli & Gonzales, 2000)

The position that bank regulators and supervisors have in the corporate governance procedure is principally seen through the laws and legislation that are proclaimed. Such laws refer to capital sufficiency demands, reserve demands and others.

# CHAPTER 4: Risk Management

## 4.1 Association between Corporate Governance and Risk Management

An increase in regulation that associates to the risk management duties of corporate officers and directors has been noticed the last 10 years. Firstly, recent state law jurisprudence connotes that non-achievement to guarantee that the risks faced by the organization are interpreted and managed in the best interest of shareholders could be assumed a failure of accomplishing the duty. Secondly, there is a growing body of law and regulation associated with risk management, such as Sarbanes-Oxley Act of 2002, and other laws and regulations which examine issues such as deceitful behavior by workers, product liability, environmental abidance and health and safety.

Many establishments, including banks, perceive the corporate governance standpoints of risk management as a paper pushing exercise that adds a little value. It is obvious that risk management should move beyond the mundane procedures and needs to become part of the culture of organizations. Putting differently risk management needs to be about delivering a prospective to the management of intricate issues in complex organizations. Risk management is not about avoiding the risk, it should be about the management of risk. It should help to categorize by priority the work in a fast moving environment with an approach that is healthier than unsophisticated intuition and which assists better communication among people. Risk management should become a way of thinking, and should undoubtedly not be a simple paper following. Establishing a risk intelligent organization necessitates boards to realize the maturity of their risk management operations right across the organization.

Boards of directors should bear in mind four aspects that need to be appraised on a regular basis:

1. Manager and personnel attitudes to risk, governance and control: according with the experience of working with a large number of different customers in various sectors, attitudes to risk, governance and control are apprehended differently in different departments of any organization. It is obvious that it is essential the board to have an overall comprehension of these attitudes so that it can evaluate what further steps are necessary to create the overall culture of risk management.

2. Whether the organization is inclined to catastrophes: there is plenty of stuff in the risk management written material to determine signs of the disaster-prone organizations. Banks might well have been able to hold a mirror up to themselves and determine many of the indications of such firms, for instance blame cultures, excessive complexity, over-confidence and so on. Boards are essential to undertake this exercise round all departments of the organization to find out whether any corrective action needs to be taken.

3. Attitudes to corporate moral values and manners: a lot of organizations pay little more than lip-service to corporate moral values. Studies have revealed that a high proportion of personnel have seen possibly illegal or inappropriate performances in others that they in turn are not ready to state in the company. Enabling appropriate corporate moral values with an emphasis on open and honest disclosure is essential to a balanced methodology to risk management.

4. Determine how personnel will respond in times of pressure: a lot of risk management schemes hypothesize a standard pace of life for the organization. These schemes then crash when immoderate pressure is applied for the reason that managers and personnel move into a diverse model of management, which outcomes in the necessity for what might be termed as Fast Clockspeed Risk Management. Fragment of this valuation is also about realizing the heuristics that managers and personnel use to manage risk. Supreme informal risk management is completed by means of the “unrecorded guidelines of the game” – detecting and understanding the consequences of those unrecorded guidelines are both vital.

At this point in time, risk and risk management denote diverse things to diverse people. In the passage of one day of its debates the Treasury Select Committee detected risk in:

- Acquisitions
- The sales culture
- Financial instruments and
- Dependency on wholesale funding.

Furthermore the well acknowledged problems of illegal trading at Société Générale characterize an additional expression of risk, as do the sub-prime loaning problems in the US and the entire demolition of trust subsequent to the downfall of Lehman Brothers which led to the desiccation of inter-bank loaning.

## 4.2 Diversity of Risks

This multiplicity of risk leads to substantial complications in concentrating all of the risk elements together, and all types of business, not just banks, have a tendency to obsess about some rudiments of risk management and to neglect others from its group thinking about risk. Figure 1 determines one potential way of thinking about the range of risk management and guaranteeing that all aspects are well-thought-out.

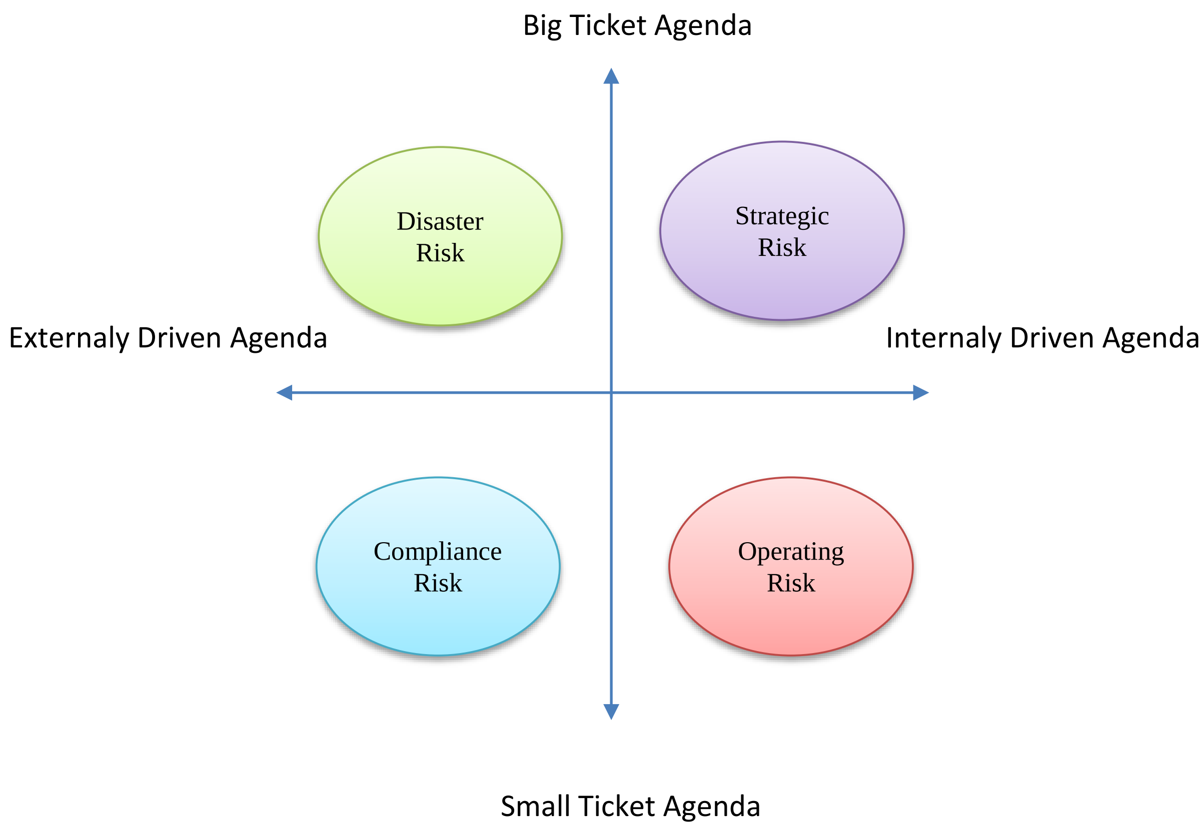


*Figure 1. Scope of Risk Management*

Turnbull focused on the top right hand quadrant, without cognizing the constituent parts, and Sarbanes-Oxley on the bottom left hand quadrant, without considering the bigger picture. Frightening risks are regularly those that interchange swiftly from the bottom of the scale to the top and turn into big ticket concerns – for instance funding procedures from the wholesale market at Bank of Scotland (HBOS) possibly started as an operating risk, but advanced into a foremost strategic concern which eventually brought the bank to its knees. A lot of organizations flunk to appreciate these shifting risks coming at them for the reason that they are culturally adjusted to an on-going level of activity that offers fabricated well-being. A good risk management context will address all of these extents.

As pointed out above and in Figure 1, it is not unusual for risk management to denote diverse things in different departments of an organization. Characteristically there is a diverse meaning of risk management for each of governance, risk sectors and internal audit. This can have as a consequence a great misunderstanding, to people failing to recognize contrary duties, considering that they are being settled elsewhere and to important risk issues falling among organizational holes and among risk silos.

## 4.3 Banks and financial risk

Banks have been defined as being in the business of managing risks. Bank risks may be characterized in a number of ways. One interpretation is that bank risks fall into four main classifications: operational risks, event risks, business risks and financial risks (Greuning & Bratanovic, 2003).

Operational risks are associated with a bank's general structure and running of internal systems, comprising computer-related and other technologies, obedience with bank policies and processes, and actions against unprofessional conduct and fraud.

Event risks consist of all categories of exogenous risks which, if they were to emerge, could put in danger a bank's procedures or destabilize its financial situation and capital capability.

Business risks are related to a bank's business environment, comprising macroeconomic and policy apprehensions, legitimate and controlling factors, and the whole financial sector organization and payment methods.

Financial risks can be further separated into two categories of risks – speculative risks and pure risks. Speculative risks may outcome in a profit or loss. The key types of speculative risks are currency, interest rate, and market price risks for example financial derivatives. Pure risks can only outcome in a loss for the bank. Pure risks comprise of credit, liquidity, and solvency risks.

Capital Risk. Capital states the amount of equity owners have invested. Nearly every aspect of banking is either directly or indirectly subjective to the obtainability of capital. The position that capital has in banking business is so essential that in a lot of authorities, rules and regulations are established for upholding a least possible capital adequacy ratio.

Capital is one of the crucial factors to be well-thought-out when the security and wellbeing of a bank is considered. A satisfactory capital base assists as in security net for a diversity of risks. Capital engrosses potential unforeseen losses, and therefore delivers a basis for preserving depositor self-reliance in a bank. Capital also is the definitive determining factor of a bank's loaning competency. A bank's balance sheet cannot be prolonged beyond the level prescribed by its capital adequacy ratio. The obtainability of capital accordingly defines the maximum level of assets called equity multiplier.

The miscarriage of a bank may let its shareholders with none of the capital they devoted to the organization. Additionally, account holders who didn't insure their accounts also are under the risk of losing a considerable percentage of their funds. When stakeholders have faith in that a bank has an amplified chance of deteriorating, the market value of its capital stock starts to fall. Correspondingly, depositors and creditors start to hurry for their money. That's why, the prices of traded equity and high earnings on uninsured deposits, can function as early cautionary signs of soundness problems.

Credit risk is represented as the prospect that some of a bank's assets, particularly its loans, will decrease in value and perchance become of no value. For the reason that banks hold little owners' capital comparative to the cumulative value of their assets, only a small proportion of total loans require to go bad to drive a bank to the edge of catastrophe. Therefore, management of credit risk is very essential and vital to the well-being of a bank and without a doubt the whole financial system.

As banks make loans, it is essential to make forecasts for loan losses in their accounts and balance sheet. The higher this forecast grow into, comparative to the proportion of total loans, the riskier a bank come to be. A raise in the value of the forecast for loan losses comparative to total loans is a denotation that the bank's assets are coming to be more challenging to gather.

Liquidity Risk. Liquidity is essential for banks to reimburse for projected and unforeseen balance sheet rise and fall and to make available funds for progress. Liquidity signifies a bank's aptitude to efficiently accommodate the redemption of securities and other liabilities and to deposit growths in loan and investment portfolios.

Liquidity risk management ranges at the focus of confidence in the banking system, as banks are highly leveraged organizations. The significance of liquidity exceeds the individual organization, since a liquidity short-fall at a single organization can have system wide consequences. It is in the nature of a bank to convert the term of its liabilities to various maturities on the asset side of the balance sheet. Since the revenue curve is normally upward sloping the maturity of assets normally have a tendency to be longer than that of liabilities. A bank may as a result experience liquidity incongruities, making its liquidity strategies and liquidity risk management key to persistence.

# CHAPTER 5: Literature review

## 5.1 Global Recession

In order to better understand the recent financial crisis in Cyprus it is essential to look back in history and analyze other similar situations in world. The most notable event that shocked the entire world was the global recession of 2007 2008. In 2008 the world economy faced its most dangerous crisis since the Great Depression of the 1930s. The infection, which began in 2007 when sky-high home prices in the United States finally turned conclusively descending, spread rapidly, first to the entire U.S. financial sector and then to financial markets abroad.

The wide-spread global recession has its roots in real estate and the supreme lending crisis. Real estate boom began in the 1990s and was increasing continuously for nearly a decade, commercial and housing properties values were increasing. Increases in properties prices concurred with the investment and banking industry dropping lending principles to market mortgages to unreserved buyers permitting them to take out loans whereas at the same time government deregulation merged the lines among traditional investment banks and mortgage lenders. In order to disperse risk bankers tried to spread the real estate loans in the form of collateralized debt obligations and other multifarious derivatives throughout the financial system which are comparatively safer because they have principal priority on the collateral in the case of default. Despite the fact that bankers tried to diminish the risk exposure, when housing prices failed to increase and property owners did not manage to keep up with their payments and they proved to be unable to meet their obligations regarding their mortgages , banks were forced to confess massive write downs and write offs. These actions turned out to be catastrophic for several financial institutions and many of them were forced to raise capital or go bankrupt.

## 5.2 Lehman Brothers Collapse

The major shock came on one of the biggest banks in the world based in the U.S. the Lehman Brothers, whose operations included all types of banking and investment activities. The Lehman Brothers was a successful business with huge annual revenues; its directors were earning millions of dollars in bonuses every year which were based on the annual performance of the bank. These bonuses can be considered as the major reason of bank's collapse. During the real estate bubble the bank invested heavily in real estate loans, especially to those described as higher risk higher return loans to buyers of houses that would not normally qualify for such loans. Directors of the bank did not considered the high risk of those investments and obviously this was done by purpose, since by investing in real estate the profitability of the bank had rapidly gone up and consequently the bonuses directors were earning was rising accordingly.

Observably, in the case of The Lehman Brothers Corporate Governance was totally absent. Directors were acting in prospective personal benefits and not for the welfare of the company and its owners as according to Corporate Governance they should have done. Here it is also notable that the members of risk management committee have not done their job properly as well, since they did not stop such high concentration of the bank's funds into high risk projects.

The collapse of The Lehman brothers brought about the beginning of one of the worst economic recessions in the world and was clearly the result of the lack of Corporate Governance. Directors of Lehman Brothers were trying to maximize their own self-interests through earning enormous bonuses on the basis of large short-term profits. The core target of the directors should have been the maximization of shareholders' interests on a long-term basis, i.e. a reasonable long-term level of profitability based on low level risk taking. However, directors of Lehman Brothers and of many other banks in United States and Europe did the absolutely opposite, they were investing in high risk projects with short-term high level of profitability In order to maximize their own benefit. Firstly, directors as mentioned above were earning huge bonuses which were based on the annual bank's performance. Furthermore, many of the bank's directors were holding shares of the company that have been offered to them by shareholders as bonuses, so there was another reason for directors to invest in high risk projects in order to show high level of short-run profitability that would have as a result the increased share price. Most of directors who hold shares of the bank was trying to sell them by the time the share price were at its highest bid. Finally, another reason for directors to discard the established Corporate Governance rules was the reputation and the craving for improved curriculum vitae (CV).

## 5.3 Enron Scandal

Finally, another reason of 2008 melt-down was the independence of auditors that has it roots in earlier Enron Scandal that took place in September 2001. Besides the fact that after the Enron scandal, which has as a core problem the independence of its external auditors, new ethical guidelines were issued and were seriously restricting the auditors activities this did not prevent the same mistake to happen again. The collapse of Lehman Brothers and so many other banks around the world, brought back the major issue of auditors independence and their ability to sincerely act as protectors of shareholders. Banks were too big clients and auditors could not go against the wishes of management since their earnings from the banks were huge and obviously they did not want to lose their main source of funding.

Therefore, the near catastrophe of the banking and financial system in United States and following in the entire world, was the result of complete nonexistence of established corporate governance system and the lack of appropriate risk management system

# Chapter 6: Cyprus Banks' demise

## 6.1 Events that led Cyprus to demise

Banking is of crucial importance to Cyprus. Contrasting to countries which have alternative sources of funding one of those can be considered the investment markets; Cyprus depends almost completely on its banks for monetary intermediation. The country's worldwide specialized services business also involved a large amount of overseas banking business. Before the current crisis, the banking industry was an essential funder to the economy, accounting for a considerable percentage of the labor force and the GDP. Therefore, it is obvious that the demise of the Cyprus Banking system had critically affected every single person in Cyprus and not only.

The most significant internal cause was a failure at the national policy level to comprehend that running a large banking industry comprises not only reward but also risk. The community believed that the banks were doing a respectable job of contributing and sustaining economic growth and that the global business they brought enhanced the nation's welfare. The fact that the banks were acting incautiously and that the global business was resulting in serious internal imbalances was unlikely paid a little and insufficient attention. Furthermore, little attention was paid to how any probable shocks might be controlled. There is also a possibility that the neglect of these risks might have been a possibly subconscious desire for some persons who had personal benefits form these agreements. This revealed a general environment in which little priority was given to managing banking risks, and to controlling the banks themselves. Additionally, the government's failure to manage the budget generated a major economic crisis which at the end of the day led Cyprus to be excluded from international financial markets and that intended that no funds were existing when the banks needed to be saved.

The core problems started with the scandalous Greek PSI and the instant loss of about €4 billion from the banking sector and Cyprus economy generally, since Cyprus was linked with Greece with strong financial ties when problems in Greece started to reveal it was obvious that Cyprus was in trouble. The banks involved in impulsive lending both internally and through their rapid spreading out overseas, predominantly in Greece and East Europe, all these wrong moves were due to poor lending practices and resulted in failure in risk management systems.

Cyprus main Banks took an inappropriate and eventually fatal €5.7bn exposure to Greek Government and Corporate Bonds, ultimately Greek government proved to be unable to repay and meet its obligations regarding those bonds. Having no expertise in lending also followed at the co-operative banks and the reason was mainly the weak corporate governance and internal controls. Co-operative banks have as a result to suffer tremendously large loan losses. The overall result was that the indebtedness of private sector in Cyprus came to reaching extremely high level percentage of GDP, and it was considered as the highest level in the European Union, with most of this secured on assets that was diminishing in value.

Business methods used by Cyprus Banks were one of the reasons for collapse. Two characteristics of Cyprus' banking approaches contributed to the bad loan problem (non-performing loans) at the heart of the recession. One of the Cyprus Bank mistakes was the practice of forwarding loans, mainly to real estate sector, in contradiction of collateral and personal guarantee, with insufficient attention paid to cash flow and ability to pay back. Even though, this method looks practical, it can only be successful if the value of the real estate is constant and sustained on the same level or, if not, it could also succeed if the banks are in position to take hold of the collateral or request on the guarantee in the event of nonpayment. The downfall of real estate prices and property value as well serious legal system problems in Cyprus can be considered as obstacles that stood in the way of banks recovering their lends. The second was the significance of personal and political relations in Cyprus banking sector. Familiarity was the factor that stood a barrier for making objective credit judgment more difficult despite the fact that some bonkers was of idea that familiarity offers comfort to lender. Therefore, a considerable scramble in Cyprus Banks' non-performing loans resulting in the rapid weakening in the economy of the island was due to banks' vast exposure to the real estate sector in Cyprus, which consequently resulted in a real estate bubble.

As a result to all these problems that the banks were fronting, the banks have incessantly been downgraded by the credit rating agencies such as Moodies and Standard & Poor, which automatically implies loss of confidence from investors and increase in the cost of borrowing. That got Cyprus excluded from the international markets, the Cypriot government was no longer in a position to borrow money from international markets and obviously with the passing of time government would lose its ability to act as a lender. It should be noticed though that the reasons for the banks' or sovereign downgrades (as expressed in the rating agencies' reports) is not solely a result of the banking crisis, but also due to the economic problems that Cyprus government confronted and the structural problems that its economy is facing and need to be resolved.

## 6.2 Deep Understanding Of Banks' Collapse

Finally, the main questions that arises here is why was the management of the two banks able to behave in such a catastrophic way? Where were the shareholders? Where were the supervisory authorities? What was the government doing? And most importantly, where were the Board of Directors of both banks? The answer is one - weak bank governance, which played critical role in Cyprus banks' future. These careless undertakings were made likely by the failure of the directors of the banks to put liberated checks on the motivations of strong – willed chief executives and to guarantee that their banks had risk strategies and controls that were imposed. Contrary, the board lived by a culture of deference which was fostered in some cases by loans and supply agreements.

Much of the impulsive behavior by the two main banks in Cyprus, the Marfin Laiki Bank and the Bank of Cyprus, through this period can be credited to an absence of effective governance. Abiding the rules of corporate governance is vital for a healthy business, especially one such as banking which depends heavily on public confidence. It is evident that the boards of directors of both banks failed in their responsibility to guarantee that their institutions had accurate processes to screen and control risk, and to arrange for the required checks on the executive. Chief executives progressively ignored their boards of directors and avoided what controls did exist and the reason was culture of deference. This was principally dangerous in the case of the two leading banks which were driven by powerful rivalry and, over time, by a continuously increasing desperate need to generate returns to funding their significantly expanded processes, and come across with their bonus targets. Some directors had power conflicts of interest which banned them from exercising the compulsory independence, as when they received huge loans from the bank or were settled supply agreements.

According to the Corporate Governance Code the directors of any company are hired by its shareholders in order to manage their company and serve their interests, so they must be completely independent of self-interests, have an unbiased judgment during the exercise of their duties and work for the company's welfare. Furthermore, the Board of Directors should comprise a satisfactory number of Non-Executive Directors and with appropriate abilities, knowledge and experience; as a result their opinions convey substantial weight in the Board's decision making. Non-Executive Directors do not earn a salary but only a fee for the time they spend at the board meetings and most importantly they do not gain any bonuses, thus their independence is sufficient to trust their opinion. For this reason it is essential to have at least one third of the company's Board of Directors to be Non-Executives. Executive directors are full time employees and therefore they earn a salary and more than often bonuses, so their income is completely depended on the profitability of the company. Summarizing, executive directors are not as much independent as Non-Executives and is important to have non-executives on the board in order to be sure that the decisions made are serving company's interests.

Here arises the agency problem, because both principals and agents are trying to maximize their own utilities and self-interests. The principals are the shareholders and agents are the directors who have been elected by the shareholders, so the directors are expected and have a legal obligation to look after the interests of those who have hired them.

Jensen and Meckling (1976) represented agency theory as an interpretation of how the public corporation could operate and survive, bearing in mind the assumption that managers are self-seeking, and an environment in which those managers do not bear the full wealth effects of their choices and decisions. This was the first adequate interpretation of the public corporation since Berle and Means

(1932) indicated some of the central problems built-in the disjunction of ownership and control. The fact that agency theory is popular in governance research is probably due to two factors. First, it is an extremely unsophisticated theory, in which sizable corporations are decreased to two players—managers and shareholders—and the interests of each are acknowledged to be both clear and constant. Second, the concept of humans as self-interested and broadly reluctant to immolate personal interests for the concerns of others is both age old and widespread.

All these factors mentioned above have not been paid significant attention by the boards of both leading Cyprus banks. Directors were acting incautiously and by considering their own benefits, instead of looking after the interests of the shareholders, invested the money of shareholders and depositors of the banks to high risk projects. As the directors were earning not only fixed salaries but also bonuses based on the annual performance of the banks, in their attempt to increase their bonuses they took very high risks by investing billions of euros in Greek Government Bonds as it gave high interest and as a result high short-run profitability. Besides that, to earn high bonuses directors were continuously investing bank funds by allowing mortgages and loans, mainly into the real estate sector.

Eventually, these actions brought Cyprus to the real estate bubble; the majority of the borrowers proved to be unable meet their responsibilities regarding their obligations. The high level of non-performing loans and a large concentration of banks' investments in a single type of investment meant to be a starting point for Cyprus Banking System collapse. All these activities were against all basic principles of portfolio theory and risk management.

Another important factor that have not been followed and led the island to already known situation is the fact that all the members of the board of directors and various committees should be qualified, to have a perfect knowledge of their field and to have enough expertise in order to deal with diverse problems and situations that company is continuously confronted with and help it to withstand. Directors of the Bank of Cyprus and of the Marfin Laiki Bank had poor lending practices and failed to monitor and control the whole situation, despite the fact that they obviously had knowledge of the 2008 recession and its causes that used to be the extremely high concentration of funding in real estate sector.

Finally, the role of external auditing has been ignored in supervision of two banks which is essential in running any business and especially a banking institution. External auditors are third-party professionals who execute an independent reassessment of an organization's financial records. External auditors' main obligation is to supervise the Board of Directors and then to express an independent opinion about the true and fair view of the financial statements provided by the directors. The report of the auditors can be considered as the main shield of protection that shareholders have against possible manipulation of reported information by the directors. Since the external auditing has been neglected by the Cyprus Banks' authorities, directors were out of control and at some point were acting in the way that was beneficial for them and not for the shareholders. Besides that, external auditors are obligated to express their opinion as to whether there weaknesses in the system of the company and whether they view the company to be a going concern, i.e it will be able to continue operating in the predictable future. Unlikely, external auditing concept was not entirely adopted by the banks of Cyprus and they lost the possible rescue for the companies.

# CHAPTER 7: Rules of Best Corporate Governance Practice

With all said above, we can conclude that corporate governance is an essential tool to sustain a smooth operation of any type of business.

In the chapter below summarized rules of best corporate governance practice are presented - key concepts in accepting good corporate governance and best practices in business. Accepting these ideologies will mean the company's culture and consequently public appearance will shine out as an illustration of an open, well and objectively operating organization.

The public appearance of a company will quite accurately mirror the culture of that body. Consequently then, we can summarize that good corporate governance has to be in the bones and bloodstream of the corporation since this in turn will be mirrored in the culture. To convey the parallel further, in the same way that healthy blood and bones are mirrored in the naturally healthy look of a person, so a company whose internal operations are healthy will naturally look so from an external viewpoint.

## 7.1 Principles of good corporate governance

From the above illustrations, we can draw some assumptions and construct a short set of rules concerning best corporate governance practice. The principles on which these rules are based on are the following:

1. ethical approach - society culture,; organizational model
2. decision-making procedure in place - giving due weight to all interested parties

3. responsibility and transparency - to all interested parties
4. well-adjusted objectives - correspondence of goals of all stakeholders
5. identical concern for all interested parties - although some have superior weight than others
6. each party plays his role - roles of key players: owners, management, personnel

Therefore, with due esteem to Milton Friedman who is cited as considering that the social accountability of business begins and finishes with growing profit, it is contended that functioning the business productively is not simply about market power and shareholder value.

Best corporate governance practice is not merely about a conflict between distant, unfaithful institutional shareholders and materialistic directors but about the beliefs of the organization and accomplishing its clearly approved objectives.

These objectives may be agreed by the entrepreneur who initiates the business, but they are acknowledged by all parties as being principled and in everyone's benefits. This is nevertheless the fact that some parties have superior stakes and some advantage more than others. And, obviously, various parties want various things from the company. There has to be, for that reason, a procedure of detecting the different requirements and, as much as possible, coordinating them. This is the initial point for the smooth operating of the business. Once disagreement in the common objective trails in the threat of the standard of corporate governance worsening rises gradually.

Evidently external regulation can only perform a restricted part in confirming that such a deep-seated and advantageous culture as that pronounced above exists. Correspondingly clearly, however, the mission of confirming this required state and obeying to best corporate governance practice have its place to the various interested parties, who can and should, through their appropriate contribution, bring this about.

## 7.2 Five Rules

A complete approach by which a business can make sure that a state of good corporate governance is existent, or is brought into being if its existence is indeterminate. It takes the interpretation that there is an over-riding ethical aspect to operating a business and that the standard of governance will be governed by the ethical complexion of the process. Therefore the approach settled is based on the opinion that:

the business ethics or morality must pervade the complete process from top to bottom and embrace all interested parties best corporate governance practice is an fundamental part of good management practice also pervading the complete process, and not an esoteric concentration addressed by auditors, lawyers and sociologists.

The main beliefs of this approach are therefore enclosed in relation to the conservative way of viewing at how a business should be accurately run.

The Five Summarized Rules of best corporate governance practice are:

1. Ethics: a visibly ethical foundation to the business
2. Strategic management: an operative strategy procedure which includes stakeholder value
3. Make even Business Goals: proper objectives, arrived at through the formation of a appropriate interested party decision making model
4. Organization: an organization appropriately regulated to consequence in good corporate governance
5. Reporting: reporting schemes designed to deliver transparency and responsibility

This methodology distinguishes that the benefits of different investors carry different weight, but it does not, by any means, propose that those with a foremost interest count and the rest don't. Quite the opposite, best corporate governance practice orders that all interested parties should be treated with equivalent concern and respect.

For understandable reasons, even though the methodology is proposed includes taking major stakeholders into greater account when conveying strategy, it is intended to create all round sustenance because of the fact that every investor, no matter how small, is given the chance to express an opinion, through the constant watching of stakeholder views. It is key to the methodology that organizations actually esteem the minority benefits.

## 7.3 Best corporate governance practice = best management practice

The monitoring methodology to the subject would concern governance as something on its own, to do with guaranteeing a stability between the various stakeholders in a company's activities, or more principally a way of ensuring that the chairman or chief management is under control, generating transparency in reporting or restraining over-generous compensation packages. This certainly is what the Cadbury recommendations and the following reports and code are all about.

The core of success in business is:

- having a clear and realizable goal
- having in place a reporting scheme to guide development
- forming an organization suitable to deliver
- having an achievable strategy to realize it.

Best corporate governance practice is about accomplishing the stakeholders' objective, and carrying success in a moral manner. Therefore it follows that it must involve a complete application of good management.

To represent the entirety, and the necessity for a holistic approach, an illustration displaying the pressures on a large organization is presented below.

### Pressures on a Company

It is essential that a wide-ranging viewpoint is taken when bearing in mind corporate governance because we cannot lay emphasis too strongly on our belief that good management practices, as reported in the rest of this chapter, will provide good corporate governance. Obedience with checklists of guidelines and codes, in the setting of bad management or a lack of commitment to good management, will not provide good corporate governance. The longer term concerns of this externally-applied controlling approach will be a enlightened introduction of more and more regulations which are held in less and less concern, and which produce less and less result.

The outcome aids neither business nor its clienteles, and has only assisted to spawn a developing industry of professional consultants in corporate governance and lobby groups. It has also miscarried to stop more and bigger corporate catastrophes. Thus while the most of the provisions of the different Codes of Conduct could definitely be deliberated as best corporate governance practice - or no less than good corporate governance, if they are enforced externally and not actually bought into by every part of the business and its stakeholders, and supervised successfully, there will constantly be those who attempt - and are successful - in hiding from or twisting the instructions.

The big benefit of the shareholder model over the stakeholder model in management standings is the simple objective it displays: maximize shareholder value. No such simple goal attaches to the stakeholder methodology, and yet without a clear objective, directors face an unbearable task in trying to do their job correctly.

The governance, the objectives and the strategy of a corporation must be harmonious, and there must be correspondence between the anticipations of the different interested parties. Noticeably, in describing best corporate governance practice, this implies that:

- there is a shared opinion as to the ethic by which the business is directed
- the opinions of all interested parties are taken into consideration when determining the objective
- an suitable weighting is given to those opinions to reach at a assumption as to how to accomplish the greatest good
- a strategy is generated to reach the selected objective which takes account of the expected actions of the different interest groups
- an implementation program is formulated which makes the required organizational preparations to achieve the strategy and to guard the interests of different interested parties
- the implementation program involves reporting schemes which guarantee transparency and systematic feedback on factors which affect them to the different interested parties

# CHAPTER 8: Conclusion

Summarizing all the facts mentioned above the conclusion is that there are many weaknesses in Cyprus financial system that resulted in the collapse of Cyprus Economy. One major mistake of Cyprus was that Cyprus was blind sighting themselves since they had a knowledge of previous recessions that took place in 1930 and 2008 but the failed to pay attention to the reasons of the crisis's, especially of that of the 2008 that is considered to be the worst global recession.

Initially, considering extremely high reliance on its banking system for financial services, and the prospective of the monetary services industry to generate foreign incomes, Cyprus should implement a domestic financial services strategy to guarantee its constant development. Therefore, it is essential to clearly understand the consequences of a high reliance on banks, and of the risks that go along with the revenues from international banking business.

Cyprus should give significance to enhance the independence of the banking industry, and strengthening it with different people, new innovative ideas, and worldwide sources for assistance. This kind of cultural change is likely to transform the banking system in all the necessary ways in order to improve and deliver healthier governance and gain greater trust globally.

The crucial cause behind the banking crisis in Cyprus was the weaknesses in corporate governance in Cyprus' banks. In order to advance the standard of governance in the banks firstly the quality of directors should be improved, this can be achieved by appointing directors qualified professional and with international experience. It also could be attained by providing training for directors, and perform regular assessment of board performance, reinforce board actions to make sure that board members are entirely up-to-date of the bank’s concerns. Another way to raise the governance is to increase the number of non-executive directors on the board to counter-balance the executives, this will improve the decision making process and the judgments would be more independent and objective.

Finally, the quality of bank accounting and auditing in Cyprus should be enhanced as the weakness in auditing was one of the crucial reasons for Cyprus banks’ collapse. Board committees should be improved, predominantly in the areas of audit and risk, in order to deliver independent monitoring and control.

In general, there is the need to enhance the role and structure of boards of directors, advance and sustain the quality of the knowledge of directors, and provide critical oversight over areas that are crucial for the banks such as internal and external audit as well risk management.

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