# THE IMPORTANCE OF CORPORATE GOVERNANCE IN THE BANKING SYSTEM

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***Abstract.*** *Corporate governance plays an essential role in the stability and efficiency of the banking sector, ensuring transparency, risk management and protection of stakeholders' interests. This article analyzes the importance of corporate governance in banks, with a focus on international regulations and particularities in Romania and Europe. It highlights the benefits of effective governance, such as increased financial stability and improved economic performance, but also the risks of weak governance, such as loss of trust and vulnerability of banking institutions. It also outlines mechanisms for improving governance, including transparency, internal control and ESG integration.*

***Key words:*** *corporate governance, banking sector, transparency, financial risk, banking regulation, sustainability.*

***JEL Classification Codes: G32, G34***

## 1. INTRODUCTION

Corporate governance is a set of principles and mechanisms by which organizations are governed and controlled, with the aim of ensuring transparency, accountability and fairness in dealing with all stakeholders. In the banking sector, rigorous application of these principles is essential given the central role of banks in the economy and their impact on financial stability.

In the banking sector, corporate governance is essential because banks play a crucial role in the economy, managing systemic risks and having a direct impact on financial stability. Organizations such as the OECD (2021) and the Bank for International Settlements (BIS, 2015) emphasize that effective governance includes:

1. Board structure - Responsible for overseeing executive management and setting the bank's overall strategy.
2. Risk Management and Compliance - Implementation of clear policies to manage financial, operational and compliance risks.
3. Transparency and Accountability - Clear communication of financial information and strategic decisions to shareholders and other stakeholders.
4. Regulation and Supervision - Compliance with standards imposed by authorities such as the European Central Bank (ECB) and Basel III to prevent excessive risk-taking.

According to Laeven & Levine (2009), a sound corporate governance system in commercial banks can prevent financial crises, minimize conflicts of interest, and ensure the stability of the global banking system.

Corporate governance in banks involves structures and processes that ensure proper direction and control of financial institutions. Fundamental principles include:

- ✓ Transparency: Clear and full disclosure of relevant information to stakeholders.

- ✓ Accountability: Clarification of roles and responsibilities within the organization.
- ✓ Fairness: Fair treatment of all shareholders and stakeholders.
- ✓ Accountability: Taking responsibility for the consequences of decisions and actions taken.

Unlike other companies, banks manage depositors' funds and have a systemic impact on the economy, which requires higher standards of governance. International regulations such as Basel III and OECD recommendations emphasize the need for sound governance practices in the banking sector.

An empirical study by Mocanu (2019) analyzed the relationship between corporate governance and financial performance in Romanian banks, with the objective of identifying the influence of these practices on financial performance. The study is based on 2015-2019 data from 10 Romanian banks and uses an econometric model. The study suggests a negative relationship between corporate governance and banks' financial performance, which in some respects contradicts good governance assumptions. The author discusses the possibility that this result is influenced by banks' internal structures and other contextual factors specific to the Romanian market. The conclusion emphasizes the need for reforms in bank governance. However, we consider that the study uses an econometric model based on the data of only 10 Romanian banks, which may limit the representativeness of the results at the level of the entire banking sector. An expansion of the sample or the inclusion of additional variables could have provided more comprehensive results. The negative relationship between corporate governance and financial performance raises questions about the governance model used by Romanian banks. Overly strict or bureaucratic management is likely to hamper flexibility and innovation, which are essential for performance. It is also important to further investigate the specific Romanian market context, which may be different from other European economies. While the study provides an observation on the need for bank governance reform, it does not detail concrete solutions or specific steps to improve governance in the Romanian banking sector. Such recommendations would have been valuable for a practical application of the research. Overall, the study raises a relevant issue but could be improved by broadening the perspective and deepening the analysis of the causes for the negative relationship found.

A more relevant study is the one conducted by Bojan Andreea-Mădălina in 2020 which analyzes the relationship between corporate governance and the financial performance of Romanian companies, especially those listed on the Bucharest Stock Exchange (BVB). This research is significant given the context of emerging economies and the impact that corporate governance can have on the long-term stability and performance of companies.

The main aim of the study is to examine the extent to which corporate governance mechanisms influence the financial performance of companies listed on the BVB. The study addresses a wide range of corporate governance variables, such as board structure, directors' remuneration policies, level of transparency and financial reporting, and their impact on financial performance measured by indicators such as return on assets (ROA), return on equity (ROE) and price-earnings ratio (P/E ratio). Bojan analyzes some of the most important governance variables that are correlated with key financial indicators to assess the impact of governance on performance. The study concludes that there is a significant relationship between corporate governance practices and the financial performance of companies listed on the BVB. Key findings include:

- ✓ Transparency and financial reporting: Companies that provide clear and complete financial information tend to perform better because investors can make informed decisions.

- ✓ Board diversity: Boards that are more diverse in terms of experience and skills have performed better financially due to their ability to make informed decisions and assess risks more effectively.
- ✓ Link between pay and performance: The study suggests that a stronger link between directors' remuneration and a company's financial performance can lead to improved long-term financial performance.
- ✓ The study emphasizes that corporate governance plays a crucial role in determining the financial success of listed companies. Effective governance, which includes a well-structured board of directors, remuneration policies properly aligned with performance and a high level of transparency, can contribute significantly to enhancing the financial performance of banks and companies in general.
- ✓ The author also suggests that corporate governance in Romania needs improvement, particularly in terms of transparency and compliance with international best practices. These changes could boost investor confidence and contribute to the development of a more efficient financial market.

Another study, *Corporate Governance Impact on Bank Performance: Evidence from Europe* by Salma Belhaj and Cesario Mateus (2019) analyzes the impact of corporate governance on bank performance in Europe between 2002-2011. The authors examine factors such as board size, gender diversity and CEO role duality. The findings suggest that larger boards with more women have a positive impact on bank performance, and during the global financial crisis, banks with smaller boards and fewer independent directors performed better.

The study *Corporate Governance and Bank Performance: Evidence from Macedonia* (Fidanoski and Mateska, and Simeonovski ,2013) analyzes the importance of corporate governance on the performance of commercial banks in Macedonia. The authors investigate factors such as the size of the board of directors, its composition and the qualities of the CEO, considering that governance systems can directly influence the performance of banks, especially in a developing economy. The results suggest that effective governance contributes to improved bank performance, an important point for emerging economies.

The study *Corporate Governance of Banks and Financial Institutions* (Hopt, 2021) addresses corporate governance in the banking sector, highlighting the differences with other sectors due to the economic role of banks and their specific risks. Hopt emphasizes the need for distinct governance models for banks, given the regulations and influences of creditors and supervisors. The article also explores how governance principles have evolved and the impact of financial crises on them.

Although the results of the literature are not uniform, it is clear that effective corporate governance in banks not only protects financial institutions from risks and scandals, but also contributes to the development of a stable and confident economy.

## 2. CORPORATE GOVERNANCE IN THE EUROPEAN AND ROMANIAN BANKING SYSTEM

### 2.1. Corporate governance in the European banking system

Corporate governance in the European banking system is essential to ensure financial stability and to protect the interests of all stakeholders. Since the 2008 financial crisis, governance regulations and practices have been reviewed and strengthened to respond to new economic challenges and prevent systemic risks.

European banking governance is governed by a strict regulatory framework, with rules set by the European Central Bank (ECB), the European Banking Authority (EBA) and the European

Commission. The main regulations cover transparency, board independence and the alignment of remuneration with bank performance.

The European Union imposes strict rules on corporate governance in the banking sector, the most important of which are:

- ✓ EU Directive 2013/36 (CRD IV) and EU Regulation 575/2013 (CRR) - bank capital and governance requirements
- ✓ European Central Bank (ECB) Regulations on prudential supervision
- ✓ Bank Recovery and Resolution Directive (BRRD) - bank crisis management arrangements
- ✓ Basel III standards - international rules for financial stability

Boards of directors of banks in Europe need to be composed of independent and competent members with diversified experience in areas such as financial management, audit and banking risk. European regulations require a significant proportion of members to be independent to ensure objective decisions and prevent conflicts of interest.

Governance principles in the European banking system are guided by transparency, accountability and sound risk management. Banks must provide detailed information about their financial performance, the risks they take and their remuneration policies. There is also a strong emphasis on internal audit and control systems to prevent abuses and financial instability.

The European Central Bank and the European Banking Authority play an active role in overseeing the implementation of governance principles in the banking sector. These authorities impose regulations aimed at protecting financial stability and the integrity of the banking system. The ECB, through the Single Supervisory Mechanism (SSM), monitors euro area banks to ensure compliance with European governance rules.

***A. Comparing the level of implementation in different countries***

- Western European countries (Germany, France, Netherlands, UK): have advanced governance systems with a clear separation between shareholders and management. Banks are subject to strict reporting rules.

- Central and Eastern Europe (Poland, Hungary, Romania, Bulgaria): adopt European standards, but implementation varies according to local financial market development.

- Nordic countries (Sweden, Norway, Denmark): focus on sustainability, digitalization and maximum transparency in governance.

***B. Challenges and gaps in European banking governance:*** Although the European legislative framework is comprehensive, significant challenges remain. Some banks face difficulties in applying regulations uniformly, and conflicts of interest and lack of diversity on boards can undermine the effectiveness of governance. In addition, there are concerns about transparency in financial reporting and systemic risk management.

***C. Lessons learned from the financial crises:*** The 2008 financial crisis highlighted weaknesses in European banking governance. The crisis prompted a regulatory overhaul to strengthen controls and reduce systemic risks. The reform of bank governance also included measures for greater transparency and accountability in decision-making.

***D. Recent reforms and improvements:*** After the economic crisis, the EU introduced a number of reforms to improve governance in the banking sector. These include stricter risk management regulations and increased capital requirements. Stricter rules on the selection and formation of boards have also been imposed to ensure more responsible management and better protection for investors and customers.

Corporate governance in the European banking system has evolved significantly in the aftermath of the financial crises, and the current regulations reflect a stricter and more transparent approach. However, uniform implementation of governance principles remains a challenge and regulators need to continue to monitor and adapt regulations to ensure the long-term stability of the European banking system.

### 2.2. Corporate governance in the Romanian banking system

Corporate governance is essential for the efficient functioning of the banking system, ensuring financial stability and protecting the interests of all stakeholders. In Romania, regulations in this area are designed to promote transparency, accountability and effective risk management. These principles are fundamental to ensuring public and investor confidence in banks, especially in the context of a developing economy and Romania's integration into the European Union.

In Romania, banks' corporate governance is regulated by: Law no. 312/2004 on the Statute of the National Bank of Romania (NBR), Emergency Ordinance no. 99/2006 on credit institutions and capital adequacy, NBR Regulations on prudential management requirements, the Corporate Governance Code of the Bucharest Stock Exchange (for listed banks) and by European legislation. Under NBR regulations, banks must adopt governance structures that include effective, independent and competent boards of directors. These regulations aim to ensure effective internal control and adequate supervision, in line with the European standards established by the European Banking Authority (EBA) and the European Central Bank (ECB).

The boards of directors of banks in Romania are made up of members with expertise in areas such as financial management, risk management and banking regulation. The legislation requires that the majority of members must be independent to prevent conflicts of interest and to ensure objectivity in the decision-making process. A diversity of skills and expertise on boards is also recommended, including financial audit and risk experts.

The NBR also plays a crucial role in overseeing bank governance by imposing strict regulations on transparency and financial reporting. The NBR monitors banks, checking that they comply with rules on governance structure and risk management. Banks are obliged to adopt clear risk policies and report regularly on their financial and risk performance.

Corporate governance principles in Romania are based on transparency, accountability and compliance with ethical standards in bank management. Banks are obliged to adopt transparent practices in their financial reporting and in their communication with shareholders and other stakeholders. In addition, it is important that banks adopt clear policies with regard to directors' remuneration and their alignment with the financial performance of the institution.

***A. Corporate governance challenges in Romania:*** Although the regulations are clear, their effective implementation can be difficult. Some banks in Romania face a lack of diversity on boards and conflicts of interest among members. There is also an ongoing concern about the level of transparency of banks, especially in terms of risk reporting. Financial crises, such as the 2008 crisis and the effects of the COVID-19 pandemic, have shown how vulnerable banks can be when governance is not effectively implemented.

***B. The impact of financial crises on bank governance:*** The global financial crises have highlighted the need for stricter regulation and more rigorous governance practices. In Romania, banks have been subject to bank assessments and restructuring since the 2008 global financial crisis, and bank governance has become a major focus for regulators and investors. These events triggered a wave of reforms to strengthen bank transparency and accountability.

***C. Recent reforms in banking governance in Romania:*** In recent years, corporate governance in the Romanian banking system has made significant progress. The Romanian authorities have introduced additional measures to ensure stronger and more accountable governance. These include stricter regulations on risk management, transparency in financial reporting and internal control. In addition, incentives have been introduced for greater board diversity and more efficient management of financial resources.

Corporate governance in the Romanian banking system has evolved significantly in recent decades, being regulated by the National Bank of Romania and in line with European standards. However, the implementation of these regulations may face challenges and banks need to continuously improve transparency and risk management to ensure stability and trust in the banking system. Recent reforms suggest a commitment by the authorities to strengthen governance in the banking sector, but it remains essential that banks actively adopt best practices to prevent financial crises and support Romania's economic development.

**Table 1. Comparison between Romania and Europe in terms of corporate governance**

| Criteria | Romania | West Europe | Central and Est Europe |
|---|---|---|---|
| **Regulations** | Adopt EU standards, but with delays | Strict regulations, effective implementation | Moderate adoption, implementation difficulties |
| **Transparency** | Rising, but problems at small banks | Very high | Average, by country |
| **Internal control** | Needs improvement | Very well structured | Variable, some countries have shortcomings |
| **Protection of minority shareholders** | Still vulnerable | Well protected | Less developed than in the West |
| **Board independence** | In some banks influenced by majority shareholders | Clear independence | Differences between countries |
| **Sustenability (ESG)** | Still in its infancy | Strongly regulated | Growing but variable |

Source: made by the authors

## 3. THE BENEFITS OF EFFECTIVE CORPORATE GOVERNANCE IN BANKS

Effective corporate governance in banks brings multiple benefits for both financial institutions and the economies in which they operate. Major benefits include:

- Increased trust and transparency: A clear and well-structured governance system ensures transparency in decision-making and banking, which increases the confidence of customers, investors and regulators.
- Reducing financial risks: By implementing rigorous risk management practices, effective corporate governance helps banks to identify and minimize financial and operational risks, thereby safeguarding the stability of the institution.
- Promoting accountability: A well-defined governance system helps establish clear accountabilities within the bank, which reduces the risk of fraud, corruption or irresponsible management.
- Maximize shareholder value: Effective corporate governance ensures that decisions taken are in the long-term best interests of shareholders, leading to better management of resources and increased profitability of the bank.
- Regulatory compliance: Sound governance helps banks comply with international financial rules and regulations, avoiding sanctions and keeping their reputation intact.

- Improving overall performance: By promoting competent management and a good relationship between management and boards of directors, effective corporate governance can improve the bank's operational and strategic performance.
- Creating a healthy organizational culture: Corporate governance promotes integrity, ethics and transparency within the bank, which contributes to a positive organizational culture, motivating employees and improving employee retention.

## 4. THE IMPACT OF WEAK GOVERNANCE IN THE BANKING SECTOR

Poor governance in the banking sector can lead to multiple risks and problems. Here are some further details on its effects:

- Inadequate financial risk management: Without effective governance, banks can make risky financial decisions, ignoring market signals or regulatory rules, which can expose them to liquidity and solvency risks.
- Fraud and corruption: Lack of a robust internal control system can create opportunities for fraud and conflicts of interest. These can be difficult to detect and can cause significant financial losses, affecting not only the bank, but the entire economy.
- Poor financial performance: Poor governance leads to inefficient allocation of resources and can inhibit the growth and development of the institution. For example, negligent management may decide to invest in risky projects or projects that are inappropriate for the bank's strategic goals.
- Loss of confidence and capital withdrawals: Investors and customers lose confidence in a bank with weak governance. This can translate into massive deposit withdrawals, falling share prices and a continued deterioration of the bank's reputation, making it more difficult to attract new investors.
- Legal and regulatory consequences: Banks that fail to comply with financial regulations are vulnerable to sanctions and penalties from regulators. For example, breaches of consumer protection rules or reporting standards can attract substantial fines and can lead to the restriction of the bank's activity in international markets.
- Failure to innovate: Weak governance can lead to a rigid organizational culture where change and innovation are slowed or even blocked. This is dangerous in a dynamic banking sector, where new financial technologies and methods are essential to remain competitive in the marketplace.
- Systemic instability: If several banks in an economy operate with weak governance, this can lead to systemic instability. Such instability can affect the entire financial market, causing economic recessions, rising unemployment and widespread losses for all economic actors.

Effective governance is essential to prevent these risks. This includes transparent and accountable management, rigorous risk control, regulatory compliance and the creation of an organizational culture based on ethics and accountability.

## 5. MECHANISMS TO IMPROVE CORPORATE GOVERNANCE IN BANKS

To improve corporate governance in banks, there are several detailed mechanisms that are essential for the efficient and accountable functioning of financial institutions. These include:

- ✓ Robust internal control: Implementing a well-structured internal control system is crucial to identify and manage risks, both financial and operational. This system should include policies and procedures for internal and external audits to quickly detect any deviations from the rules. Rigorous supervision helps prevent fraud and management errors, which can have devastating effects on the bank and the economy.

- ✓ Transparency and accountability in reporting: Transparency in financial reporting is a fundamental element of corporate governance. Banks must publish comprehensive and accessible information about their financial performance, risks, strategies and market developments. This enables all stakeholders (investors, regulators, customers) to objectively assess the bank's financial health and make informed decisions.
- ✓ Diversification and professionalization of the board: A board of directors diversified in terms of skills, experience and perspective is crucial for informed strategic decision-making. Board members should have a strong background in areas such as financial management, banking regulation, risk management and corporate governance. Diversification can contribute to a better understanding of diverse markets and risks.
- ✓ Establish a clear ethical framework: Clear ethical policies that set standards of behavior for all employees are essential to maintaining an integrity-based work environment. These include clear rules on conflict of interest, transparency in financial decisions and acceptable behavior. Promoting ethics throughout the organization contributes to a culture of accountability and respect for legal regulations.
- ✓ Continuous training of management and staff: Investing in the continuous training of managers and staff is essential for banks to adapt to new regulations, technologies and economic trends. Banks must ensure that their leaders are prepared to meet economic challenges, apply best management practices, and respond quickly to changes in the financial environment.
- ✓ Active stakeholder involvement: Corporate governance should not be an internal process but one that actively involves external stakeholders. Shareholders, employees, regulators and even customers should be able to influence the decision-making process through consultation and dialog mechanisms. This will better align management decisions with the expectations and interests of these stakeholders.
- ✓ Improve risk management: Another vital mechanism for effective governance in banks is rigorous risk management. Banks should adopt proactive strategies to identify, assess and mitigate risks (including financial, operational, reputational and regulatory risks). These strategies include the use of advanced risk models and the creation of a dedicated risk management department.
- ✓ Performance evaluation and continuous feedback: An effective management and employee performance appraisal system, combined with continuous feedback, contributes to continuous governance improvement. On a regular basis, not only the financial performance of the bank should be assessed, but also how ethical and governance principles are being adhered to. Bonus and reward systems should be aligned with the bank's long-term objectives to prevent speculative or risky behavior.

Thus, the implementation of these mechanisms contributes to the creation of a robust governance structure that not only minimizes risks and ensures compliance, but also improves the operational efficiency of the bank, allowing it to maintain a stable and reliable position in the market. These changes require constant commitment from the bank's management and all stakeholders.

## 6. CONCLUSIONS

Corporate governance plays a key role in ensuring the stability and integrity of the banking system. The implementation of sound governance practices not only protects the interests of stakeholders, but also contributes to the prevention of financial crises and enhances public confidence. To achieve these objectives, it is essential that banks adapt governance arrangements to their context.

Romania has made significant progress in aligning with European standards, but further reforms are needed to improve the transparency and independence of bank governance.

Western Europe offers a strong corporate governance model with strict rules and effective implementation.

Countries in Central and Eastern Europe, including Romania, need to improve regulatory enforcement and reduce the influence of politics and controlling shareholders in banks' strategic decisions.

Recommendations for Romania

- Strengthen the independence of boards - eliminate external influence on managerial decisions.
- Increase financial transparency - improve public reporting and communication with investors.
- Adopt clearer risk management strategies - including cyber and financial risks.
- Align with ESG trends - promoting sustainable and socially responsible banks.
- Develop digitalization for increased efficiency and transparency.

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