

Predrag Stancić¹, Milan Čupić², Sladana Barjaktarović Rakočević³

INFLUENCE OF BOARD SIZE AND COMPOSITION ON BANK PERFORMANCE – CASE OF SERBIA*

We investigate the relation between board structure (size and composition) and bank performance in 16 Serbian commercial banks with a dominant shareholder in 2006-2010. We analyze this relation using OLS regression analysis on an unbalanced panel dataset of 67 observations. We find no significant relation between proportion of independent directors on the board and bank performance. We find that bank profitability measured by ROA increases as the number of directors on a board decreases.

Keywords: commercial banks; dominant shareholder; board composition; board size; bank performance.

JEL: G21; G32; G34.

Предраг Станчић, Милан Чупић, Сладана Бар'яктаровић Ракочевић ВПЛИВ РОЗМІРУ РАДИ ДИРЕКТОРІВ ТА ЇЇ СКЛАДУ НА ЕФЕКТИВНІСТЬ ДІЯЛЬНОСТІ БАНКУ: НА ПРИКЛАДІ СЕРБІЇ

У статті досліджено відношення між структурою ради директорів (її розміром та складом) та ефективністю діяльності банку на прикладі 16 сербських комерційних банків із основним власником акцій у 2006-2010 роках. Ці відношення досліджено за допомогою застосування аналізу регресії найменших квадратів до незбалансованої панелі даних з 67 спостережень. Значущих зв'язків між часткою незалежних директорів у раді та фінансовими результатами діяльності банку не знайдено. З'ясовано, що прибутковість банку за виміром ROA (рентабельність активів) зростає зі зменшенням кількості директорів.

Ключові слова: комерційні банки, основний власник акцій, склад ради директорів, розмір ради директорів, ефективність діяльності банку.

Форм. 1. Рис. 1. Табл. 4. Літ. 22.

Предраг Станчић, Милан Чупић, Сладана Бар'яктаровић Ракочевић ВЛИЯНИЕ РАЗМЕРА СОВЕТА ДИРЕКТОРОВ И ЕГО СОСТАВА НА ЭФФЕКТИВНОСТЬ ДЕЯТЕЛЬНОСТИ БАНКА: НА ПРИМЕРЕ СЕРБИИ

В статье исследовано отношение между структурой совета директоров (его размером и составом) и эффективностью деятельности банка на примере 16 сербских коммерческих банков с основным держателем акций в 2006-2010 годах. Эти отношения исследованы с применением анализа регрессии наименьших квадратов к несбалансированной панели данных по 67 наблюдениям. Значимых связей между долей независимых директоров в совете и финансовыми результатами деятельности банка не найдено. Выяснилось, что прибыльность банка по измерению ROA (рентабельность активов) растет с уменьшением количества директоров.

Ключевые слова: коммерческие банки, основной держатель акций, состав совета директоров, размер совета директоров, эффективность деятельности банка

¹ PhD, Full-time Professor, Faculty of Economics, University of Kragujevac, Serbia.

² M.Sc., PhD candidate, Assistant, Faculty of Economics, University of Kragujevac, Serbia.

³ PhD, Assistant professor, Faculty of Organizational Sciences, University of Belgrade, Serbia.

* We are grateful to Vladimir Stancic for helpful comments and suggestions.

1. Introduction. This paper is an empirical investigation of the relation between board structure and performance of Serbian banks with a dominant shareholder. We focus on a specific industry in a specific (Serbian) emerging economy for two reasons. First, although some aspects of governance in nonfinancial firms can be applied to banks, the complexity of banking business increases information asymmetry and makes it difficult to shareholders and other stakeholders to monitor bank managers. Banks are also a key element in the payment system, and are subject to more intense regulation than other firms. Second, weak institutional environment and weak protection of investors in emerging economies give rise to conflicts between a controlling shareholder and minority shareholders more often than between managers and shareholders. In this regard, La Porta et al. [13] questioned the uncritical application of Anglo-Saxon business governance practices in emerging markets. This paper builds on several empirical studies on the relation between board characteristics and performance of firms, both financial and non-financial. These studies focus mainly on two board characteristics – proportion of independent directors on a board and board size.

Numerous studies indicated that a strong board can protect the interests of minority shareholders and improve company performance in countries with weak legal protection of investors. For example, [6; 8] and [9] stress that a strong board can offset the market value discount in firms with a dominant owner, much more in a country with weak than in countries with strong legal protection of investors. Similarly, majority of the studies on bank governance find positive relation between board independence and bank performance. For example, [2] find significant positive linear relation between board independence and bank performance, but suggest that an optimum combination of executives and non-executives can contribute to value creation more than excessively independent board. On a sample of Turkish banks, [4] find curvilinear relation between board composition and bank performance, but their results imply that boards composed of a majority of either inside or outside directors contribute to high performance of banks. On a sample of Thai banks [17] find a statistically significant positive relationship between proportion of independent directors on a board and bank performance. Based on the results of these studies, we have formulated the first hypothesis as follows: The dominant shareholder of a bank operating in Serbia could improve bank performance by increasing the proportion of independent directors on a board.

Although some authors [7; 11] suggest that larger boards may be beneficial because they increase the pool of expertise available to an organization, the majority of authors find that excessive boards lead to problems of coordination, control and flexibility in decision making. For example, [6; 10; 21] find a statistically significant negative relationship between board size and performance of nonfinancial firms. However, studies on bank governance usually show positive relation between board size and bank performance. For example, [1] find that large boards have no negative impact on bank performance, while [2] find that increasing a board contributes to improving bank performance but only to a certain level (19 board members in their research), after which performance, measured by Tobin's Q, starts to decrease. Contrary to the findings of majority of the studies on bank governance, [17] and [19] find that bank performance is negatively related to board size, while [4] find no sig-

nificant relationship between board size and return on assets of Turkish banks. Following the results of the studies on bank governance, the second research hypothesis states: the dominant owner of a bank operating in Serbia could improve bank performance by increasing a bank's board.

2. Banking industry in Serbia. Serbian economy is very bank-oriented, and bank loans are the most important source of finance for companies. At the end of 2010 banks participated in total assets of Serbian financial sector with 91.8%, insurance companies with 4.2%, finance leasing companies with 3.6%, voluntary pension funds with 0.36% and investment funds with 0.04% [15; 18]. The most important item within the assets of banks are loans and they count for 63.8% of the banking sector total assets (approximately 15 bln. Euros). From the total amount of loans 55% are corporate loans and 30% are retail loans. Some key information about number, ownership structure and financial performances of the banks in Serbia are presented in Table 1.

Table 1. The main characteristics of Serbian banking sector

	Number of banks	Assets (in millions of €)	Capital (in millions of €)	Profit (in millions of €)	Number of employees
Foreign banks	21	18,380	3,820	211	20,886
Domestic banks	12	6,710	1,470	37	8,758
State	8	4,600	890	18	7,287
Private	4	2,110	580	19	1,471
Total	33	25,090	5,290	248	29,644

Source: National Bank of Serbia, Banking Supervision: Third Quarter Report 2011, Belgrade, Serbia.

The capital adequacy ratio in Serbia has been set by regulators to a higher level than the Basel 8%, and equals a minimum of 12%. For the banking sector in Serbia this ratio has been around 20% for the last few years, and in the third quarter of 2011 it was 19.7%. During the first a months of 2011 the banking sector in Serbia was profitable. Earnings before taxation were 248 mln. Euros, an increase by 21.2% compared to the previous year. In the same period, return on assets equaled 1.3%, while return on equity equaled 6.5%. 10 banks reported losses, and these banks represent 17.8% of the total bank assets in Serbia. The total amount of overall bank losses was around 68 mln. Euros [16]. Figure 1 presents the structure of Serbian banking sector balance sheet.



Figure 1. Ownership concentration of Serbian banking sector

Source: www.nbs.rs

No person may acquire direct or indirect ownership in a bank which carries over 5% of voting rights, without the prior consent of the National Bank of Serbia. Accordingly, all the banks in Serbia, except one, have 3 or less owners who have more than 5% of voting rights. Domestic banks have a more dispersed ownership structure in relation to the banks that are in foreign ownership. In the group of the first 10 largest banks, by total assets, 8 have foreign dominant owner, and 2 have domestic dominant owner. Figure 1 describes the level of ownership concentration of Serbian banking sector.

When founding a bank, the National Bank must be provided with data on the bank's founders, all persons who will participate in a bank and the basis of their participation, as well as with the names of the proposed members of directors' board and executive board, and information regarding their qualifications, experience and business reputation. The law clearly defines the organization of a bank as well as the method of governing a bank (see [12]). Arising as a potential problem of this law is the fact that it emphasizes that shareholders with 1% or more of voting rights cannot be prevented from directly exercising their voting rights. The question coming up is what happens with the shareholders who have less than 1% of ownership in the bank – they, therefore, have less rights, because the law implies that they can be prevented from exercising their voting rights.

The law specifies that governing bodies of a bank are the board of directors and executive board. The National Bank of Serbia prescribes the requirements and qualifications that a person must possess in order to be elected as a member of the directors' board or executive board. A board of directors must have at least 5 members, including the bank president. At least 3 members of the board of directors must have adequate experience in the field of finance, while at least one third of the bank's board of directors must be the persons who are independent of a bank. The bank executive board consists of at least two members, including the president of executive board who represents and acts on behalf of a bank. A bank must establish a committee for monitoring bank operations (audit committee), a credit committee and assets and liabilities management committee. Such provisions in the domestic law are consistent with the Basel Committee recommendations for strengthening of bank governance.

The National Bank of Serbia, as the regulator and supervisor of the banking sector of Serbia, has passed a series of regulations that set the basis for adequate bank governance, as well as easier control by the supervisor. All regulations concerning the banking sector of Serbia enclose the basic elements of good bank governance, which are contained in the Basel Committee recommendations for the strengthening of bank governance, as well as in the Basel standards. What should be changed or introduced is regular control and improvement of corporate governance in Serbian banks. So far not even once has been performed overall control of corporate governance principles in banking sector of Serbia.

Special attention should be given to the structure of compensation schemes in banks and this would be very important for the overall process of corporate governance in these institutions. It could be expected that in accordance with new provisions and principles of adequate roles of boards of directors, new improved compensation system will enhance corporate governance in banks. Also, it is expected that

new law on consumer protection will set up corporate governance in Serbian banks on higher level, especially considering stakeholders protection.

3. Sample and variables. Our sample comprises 16 publicly traded commercial banks with a dominant owner in Serbia. We assemble data on ownership, board structure and financial performance for 2006–2010 period, available in the banks' annual reports or proxy statements and on company websites, as well as in the reports of key financial institutions in Serbia (National Bank of Serbia, Securities and Exchange Commission, Belgrade Stock Exchange). To identify the bank population in Serbia we use a list of banks reported by the National Bank of Serbia (NBS). We exclude banks whose shares are not publicly traded, banks with only one owner and banks without a dominant shareholder. Like [13], we believe that a company has a dominant shareholder if a shareholder has more than 10% of direct and indirect voting rights in a company.

We identify all the shareholders with at least 10% of the banks voting rights. In banks with more than one such shareholder, the dominant shareholder is the one that has the largest share of direct and indirect voting rights. In banks with few shareholders who have more than 3% of voting rights, we check to determine whether two or more of these shareholders are affiliated, so that the percentage of their joint ownership of voting rights exceeds that of the largest individual shareholder. In such cases, joint owners are treated as the single largest shareholder (dominant shareholder).

Using the presented sampling procedure and sources of information, we identified a sample of 16 banks, representing 48.48% of the total population of banks, or 35.83% of the banking assets and 38.92% of the deposits in Serbian banking sector. We build an unbalanced panel data of 67 bank-year observations.

Governance variables. We use the criteria similar to those developed by [6] to determine the proportion of independent directors on a board. We believe that a director is affiliated if he or she is: 1) the dominant owner, 2) employee of a bank, 3) employee of any company or subsidiary of any company that is positioned above the sample bank in the ownership tree, 4) employee of another firm in which the dominant shareholder has at least 10% of voting rights, regardless whether this company is in the same ownership tree, 5) politician or employee of a government agency, when the dominant shareholder is the government, or 6) employee of a company domiciled in the same country as the dominant shareholder when a dominant shareholder is a foreigner. Directors who are not affiliated with the dominant shareholder are considered independent.

The proportion of independent directors on the board (labeled INDEP) is the number of independent directors divided by the total number of directors on the board. In all the banks in our sample CEO and Chairman of the board are different persons, i.e. all the banks have clear two-tier board structure with separate supervisory and executive body. Like in some other studies on bank governance [5; 14; 20], board size (labeled SIZE) is defined as the number of board members, including only the members of a supervisory board.

To account for potential principal-principal conflict, we also include ownership concentration into our analysis since this variable may have implications for firm performance and board structure [13]. The ownership concentration ratio (labeled OWN) is determined as the percentage of shares owned by a dominant shareholder.

Financial data and control variables. In governance studies, Tobin's Q and return on assets (ROA) are the two most frequently used performance indicators [4]. Since the majority of banks in our sample is not regularly traded on Belgrade Stock Exchange, Tobin's Qs of these banks are not a reliable performance measure, so we use ROA as a performance measure. We calculate ROA as of the end of years 2006, 2007, 2008, 2009 and 2010 as the ratio of earnings before taxes to the book value of assets.

We also include bank specific control variables in the analysis. Bank specific variables are the factors influenced by bank's management decisions and policy objectives. These are book value of assets as a proxy for bank size (labeled TA), the ratio of loans to total assets as a proxy for differences in banking business (labeled LA), and the capital ratio as a proxy for capital structure (labeled CAR). We also use time (year) dummies.

4. Results of the analysis. Descriptive statistics. Table 2 shows the descriptive statistics for the bank boards, ROA and bank specific variables. The average ROA is 1.14%, and is slightly higher than the median ROA. The mean of OWN is about 60% which is considerably more than mean percentage voting rights of dominant shareholders reported for non-financial firms by [6], and mean equity holdings of 3 largest shareholders of firms in emerging economies (51%), and developed economies (41%) as reported by [22].

Mean and median of board size (labeled SIZE) are 5.91 and 5 directors, which is close to 8.04 and 7 directors on the board of Turkish banks as reported in [4]. This is, however, considerably less than the average board size reported in some other studies on financial [1; 2] and non-financial firms [3; 6; 21]. These studies report that the average size of a bank board is 16-18, and average size of a board in a non-financial firm is 7-12 directors. In 58.21% of bank-year observations in our study there are 5 directors on boards, which is equal to minimal requirement of Serbian Law on banks.

On average, independent directors account for 38.37% of directors on boards, which is again considerably less than the average proportion of independent directors (around 80%) reported for banks [1; 2; 4] and average proportion of independent directors (at least 38%) reported for non-financial firms [3; 6; 21]. In only 28.36% of bank-year observations in our study there is a majority of independent directors on the board. The median bank board comprises 5 directors, which are 2 independent and 3 affiliated directors.

Table 2. Descriptive statistics for sample banks

	Obs.	Mean	Median	Standard deviation	Min.	Max.
ROA (%)	67	1.14	1.02	5.77	-9.65	23.35
OWN (%)	67	60.42	58.79	32.95	10.91	99.99
SIZE	67	5.91	5.00	1.40	5	11
INDEP (%)	67	38.37	40.00	19.13	0.00	85.71
TA (in millions of €)	67	492.70	258.74	563.84	26.82	2,425.33
CAR (%)	67	28.80	23.72	15.49	7.52	68.99
LA (%)	67	51.73	53.29	12.60	24.83	74.42

Source: Own calculations.

Table 3 presents Pearson correlation matrix. There are very few significant correlations between the variables. Only CAR shows slightly higher correlation with the

ROA, but the correlation coefficient is way below the level that could cause problems with multicollinearity.

Table 3. Pearson correlation matrix

	ROA	INDEP	SIZE	OWN	LnTA	CAR	LA
ROA	1.000						
INDEP	0.146	1.000					
SIZE	-0.105	-0.113	1.000				
OWN	-0.328***	-0.469***	-0.171	1.000			
LnTA	-0.027	0.061	0.312**	-0.067	1.000		
CAR	0.562***	0.186	-0.031	-0.222*	-0.492***	1.000	
LA	0.090	0.179	0.085	-0.011	0.408***	0.055	1.000

Notes: Statistically significant at 1% (***), 5% (**) and 10% (*).

Source: own calculations.

Regression analysis. In this section we analyze the relation between bank performance and board structure (size and composition). We rely on some earlier studies of this relationship [1; 2; 4; 21]. In order to select the model to analyze the data, we also rely on several papers of the relationship of board structure and performance in non-financial firms [3; 6]. We analyze the relation between bank governance variables (board structure and ownership concentration ratio) and bank performance using OLS regression analysis on a panel dataset. We also include bank specific variables as control for endogenous variables and time (yearly) dummies as control for unobserved macroeconomic effects. Our dependent variable is ROA as our proxy for bank performance. The equation takes the following form:

$$ROA = \beta_0 + \beta_1 INDEP_{it} + \beta_2 SIZE_{it} + \beta_3 OWN_{it} + \beta_4 LnTA_{it} + \beta_5 CAR_{it} + \beta_6 LA_{it} + \beta_7 year_t + \varepsilon_{it}, \quad (1)$$

where i goes from bank 1 to bank 16 and t takes the values of the years from 2006-2010. Year stands for time dummy. β parameters are the estimated coefficients for the constant and each of the explanatory variables included in the model, and ε stands for disturbance with the unobserved bank-specific effect and the idiosyncratic error.

Table 4 presents OLS regression estimates of the relation between bank performance proxied by ROA, and governance variables using our sample of commercial banks from Serbia in 2006-2010. We report 3 alternative models of the regression equation labeled I, II, and III. Model I includes governance variables and ownership concentration ratio, model II also includes bank specific control variables, and model III also includes time dummies. Combination of independent variables statistically significantly predicts ROA in all the regression models, and the adjusted r^2 is relatively high, especially in models II and III.

Table 4 shows that proportion of independent directors on the board is negatively related to bank performance. This means that the dominant shareholder of a bank operating in Serbia could increase bank performance by appointing fewer independent directors to the board. However, this relation is not statistically significant. This finding is consistent with some studies on bank governance [1; 19], but is surprisingly given the conclusions from some previous studies on governance issues in countries with weak legal protection of investors (e.g. [6]) and majority of studies on bank gov-

ernance (e.g. [2; 4; 17]), which show significant positive relation of firm performance and board independence. Board size is also negatively related to ROA. This relation is statistically significant in models II and III, that is after controlling for endogenous variables and unobserved macroeconomic effects. This means that a dominant shareholder of a bank operating in Serbia could increase bank profitability by appointing fewer directors to a board. This finding is consistent with [19], a study on corporate governance in large European banks, but is different from the results of most studies on bank governance.

Ownership concentration ratio is also negatively related to bank performance. This means that banks with less concentrated ownership structure are better performing than banks with more concentrated ownership structure. This relation is statistically significant in all the regression models. Table 4 also shows that natural logarithm of banks total assets is positively and significantly related to ROA in our sample. This means that larger banks with dominant shareholder operating in Serbia are more profitable than smaller banks. We find no significant relation between bank activity, measured by loans to asset ratio, and ROA, although this relation is negative in all the regression models. On the other hand, capital structure is always positively and significantly related to ROA. This means that banks with a dominant shareholder with more capital perform better.

Table 4. Regressions of ROA on SIZE, INDEP, bank specific variables and time dummies

Model	I	II	III
INDEP	-0.054 (-0.395)	-0.155 (-1.413)	-0.147 (-1.330)
SIZE	-0.176 (-1.445)	-0.278*** (-2.724)	-0.307*** (-2.986)
OWN	-0.383*** (-2.798)	-0.249** (-2.251)	-0.235* (-2.132)
LnTA		0.465*** (3.504)	0.492*** (3.699)
LA		-0.093 (-0.853)	-0.076 (-0.685)
CAR		0.761*** (6.392)	0.724*** (6.017)
Y2006			0.176 (1.493)
Y2007			0.013 (0.108)
Y2008			0.070 (0.605)
Y2009			-0.073 (-0.624)
Const.	0.101 (2.239)**	-0.416*** (-3.182)	-0.444*** (-3.375)
F-rat.	3.318**	9.802***	6.429***
Adj. R ²	0.095	0.445	0.451

Notes: t-values are in parentheses. Statistically significant at 1% (***) , 5% (**) and 10% (*).

Source: Own calculations.

5. Conclusions. We investigate the relation between board structure (size and composition) and bank performance on the sample of 16 Serbian banks with a dominant shareholder in 2006-2010. We find that the proportion of independent directors on a bank board and the size of a bank board are small if compared to the statistics reported from the samples of nonfinancial and financial firms in developed countries. The implication of this finding is that dominant shareholders tend to appoint small and weak boards, which can lead to serious conflicts between dominant and minority shareholders. In addition, the majority of banks in our sample have only 5 directors on the board, which is equal to requirement of Serbian Law on banks, and the majority of affiliated directors. Consequently, in absence of strong boards, policy

makers in Serbia should develop better legal and institutional mechanisms for protecting minority shareholders.

We find negative, but statistically insignificant relation between proportion of independent directors on the board and bank performance. This means that our first hypothesis cannot be accepted. We find significant negative relation between board size and bank performance, proxied by ROA. This means that dominant shareholder of a bank operating in Serbia could increase bank profitability by appointing fewer directors to a board. This result is statistically significant after controlling for endogenous variables and unobserved macroeconomic effects. This means that our second hypothesis is rejected. We conclude that Serbian banks with dominant shareholders should put limits on board size, which is in line with the argument that excessive boards lead to problems of coordination, control and flexibility in decision making. The relation between bank performance and ownership concentration ratio is negative and significant.

The bottom line of our findings is that dominant owner of a bank operating in Serbia could increase bank performance by appointing fewer directors to a board. Our findings are similar to those of [19] who conducted the analysis on the sample of European banks, but differs from [1] who conducted the analysis on the sample of US bank holding companies. However, one should bear in mind that our study is specific because it focuses only on banks with dominant shareholder. We perform the analysis in emerging country with civil-law legal system and weak protection of investors. Also, the 2006–2010 period marked with world financial crisis may have influenced our findings. In connection to financial crisis, we would expect banks with more capital to perform better, which is confirmed in this paper.

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Стаття надійшла до редакції 18.01.2012.