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CHAPTER 5

BANKS IN POLAND IN THE FACE OF NEW REGULATIONS ON EXECUTIVE REMUNERATION

Introduction

Executive remuneration has been the subject of numerous debates over the last two decades, attracting considerable attention not among academics and politicians, but also the general public. In the last few years, with the acceleration of growth in executive pay, the discussions have become even more fervent. Executive pay, in particular CEO pay, has shown a steep upward trend since the beginning of the 2000s. During 2003-2007 CEO total remuneration in the US grew by 45%, whereas the average executive compensation increased by 15%, which seems quite disproportional compared to the 2.7% increase in average worker pay. In 2007 CEO total compensation was 521 times larger than the average wage in the firm sector. In the Western Europe the trend is similar. For example, in the Netherlands CEO total remuneration grew by 192%, executive total compensation by 146%, while the average worker's pay increased by only 2.4%. The CEO total package was 103 times larger than the average wage in the firm sector [Ebert et al., 2008].

The increase in executive remuneration is largely attributable to the increase in the value of stock option grants. In the US, between 2003 and 2007 CEO pay without share-based compensation was 'only' 183 times larger than the average worker wage, whereas the ratio in the Netherlands equalled 71:1. Since the 1990s, stock options have replaced basic salary as the largest component of executive pay. The use of stock options was aimed at increasing the sensitivity between executive pay and corporate performance. The percentage of cash in total executive remuneration has declined during the last years; however the amounts spent on cash compensation have increased rather than decreased.

While US executives are paid more than their international counterparts, their pay levels and structures are gradually converging, in particular with regard to the largest corporations, thanks to the increasing use of share-based instruments.

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During 2003-2007 the share-based compensation of CEOs in the fifteen largest corporations in the Netherlands increased by 5391%. This is a relatively new component of executive remuneration in Europe. In the 1990s stock options (and other long-term incentives) were absent in nine out of 23 countries surveyed, and comprised less than 5% of total pay in thirteen out of 23 countries (Murphy, 1999). In 2007 and 2009, the equity-based compensation, as a proportion of total pay was, significant not only in US but also in European banks, although the value was lower in the latter [Ferrarini and Ungureanu, 2011].

As suggested by the empirical evidence for the US [Tosi et al., 1998, Gabaix and Landier, 2008], Australia [Merhebi et al., 2006], Portugal [Fernandez, 2008], France [Dardour, 2008] and Germany (albeit with mixed results according to Haid and Yurtoglu [2006], and Rang [2006]), executive remuneration increases with company size. However, the size of the company has a diminishing implication [Chalmers et al., 2006]. Pay levels vary by industry; CEOs in electric utilities earn significantly lower levels of compensation than their counterparts in other industries, while CEOs in financial services companies earn higher pay. Barclays' top executive in 2010 earned £4.36m – 169 times the pay of an average British worker – whereas in 1980 it was just thirteen times the average [Groom, 2011].

Recently, much attention has been devoted to executive pay in the financial sector. Not only is the level of executive remuneration questioned as being unfair and inappropriate, but also the multi-year guaranteed annual bonuses granted irrespective of corporate performance, or those using state aid. It has been alleged that prior to the crisis pay practices were inconsistent with firms' capital bases, and pay was insufficiently linked to sound risk-taking. Executive remuneration schemes encouraged the taking of excessive risk in order to enable a company to generate the highest possible results in a short period [OECD, 2009].

Empirical research however has found no evidence so far for the thesis that financial crisis can be, to any great extent, attributed to failures and weaknesses in corporate governance arrangements, in particular with regard to predominantly short-term oriented executive remuneration systems. In the early 1990s in the US, stock options replaced base salary as the single largest component of compensation, allowing for increasing pay sensitivity to corporate performance [Jensen and Murphy, 1990, Core et al., 2003, 2005]. Between 2008-2009, the value of the stock and option portfolio for the medium large bank CEO changed by about $13.4 million per 10% change in the stock price [Core and Buay, 2010]. Thus regardless of whether annual pay declined at the same time, the CEOs were strongly punished for declining stock prices. Fahlenbrach and Stulz [2009] stress that bank CEOs did not anticipate the recent financial crisis. The authors investigated the insider

trading of bank CEOs in 2007-2008 and found no evidence that CEOs attempted to liquidate their equity positions in the period leading up to the credit crisis. Instead, on average the CEOs they sampled lost $30 million in stock and option value in their portfolios, and the median CEO lost over $5 million. Bebchuk et al. [2010] reached similar conclusions in analysing data from Bear Stearns and Lehman Brothers, two large US banks that ran into financial difficulties and went bankrupt. The authors show that disastrous risk-taking decisions were the result of top executives' inability to perceive risks, not their compensation structures.

In firms with high financial leverage like banks, an executive remuneration system based on shareholder maximization value encourages taking excessive risk. High financial leverage makes the conflict between shareholders and other stakeholders, in particular depositors, more significant than in non-financial firms. In addition, deposit insurance generates moral hazard by incentivizing shareholders and managers of insured institutions to engage in excessive risk-taking. Moral hazard is exacerbated when a bank approaches insolvency, because shareholders do not internalize the losses from risky investments, but instead benefit from potential gains. Agency costs between shareholders and depositors, as well as the moral hazard of managers, are higher in banks than in non-financial firms, due to the easier process of asset substitution.

Most authors agree that regulatory intervention concerning executive compensation at banks should be limited in scope, so as to maintain the flexibility of executive pay arrangements. Bebchuk et al. [2010] recommend the regulation of executive pay at banks only to the extent necessary to take into account the interests of depositors and other creditors. Both Bebchuk and Fried [2010] and Bhagat and Romano [2010] point out that the executive remuneration system is a weak link in the corporate governance mechanism, owing to the strong influence of the management team, especially the CEO, on both the board of directors and on the remuneration committee in charge establishing executive pay. Hence they propose focusing more attention on those responsible for the pay-setting process, i.e. the board of directors and its remuneration committee.

Executive compensation practices in banks are not completely flawed. It's true however that they need considerable improvements in terms of increasing their transparency and aligning the interests of shareholders and depositors. Since the onset of the crisis a number of legal reforms have been proposed to develop a risk-aligned system of executive remuneration that would take into consideration to a greater extent the interests of all stakeholders, and thus contribute to financial stability. Some of them were proposed in the form of global benchmarks by international organizations, such as the Financial Stability Board, Committee of

European Banking Supervisors and European Commission. Some initiatives have been undertaken by local regulators, such as the Polish Financial Supervision Authority, making them of a binding nature.

The aim of this paper is to examine the extent to which the current practice of rewarding bank executives in Poland differs from international benchmarks, taking into account the most recent Polish regulations, in force since 2012. The question is whether the new legal rules will have a significant impact on the structure of executive compensation in banks. The paper describes recent recommendations of international organizations on how to regulate executive pay in the financial services industry, and compares them with the legal initiatives introduced in Poland. I also discuss the merits of such regulation in order to assess whether it can achieve the stated objectives. In the following section the findings related to executive remuneration practices in banks in the face of the new regulation will be presented. The final section presents the conclusions drawn.

1. Regulation and best practices on executive remuneration

A number of regulatory initiatives aimed at improving the governance of executive remuneration have been taken since the beginning of the decade. However, prior to the crisis financial institutions were not provided with any regulation or corporate governance codes specific for them. Up until 2008, the major issue that received public attention was the transparency of remuneration policies of public companies, based on the principle of *name and shame* in order to encourage moderation in executive pay levels. Only in the UK (since 2002) and in Poland (since 2005) have legal regulations made it statutory for listed companies to release the level and structure of executive pay, separately for each director, in their annual accounts.

At the EU level, the European Commission issued its Recommendation in 2004 (2004/913/EC) and 2005 (2005/162/EC). Amongst other things, the Recommendation advocated a shareholder vote on remuneration policy (*say on pay*), prior approval of stock option plans by the shareholders, the establishment of a remuneration committee, together with concrete guidelines on its composition and role, and the publication of a remuneration statement with information on remuneration levels, remuneration instruments, and performance criteria.

According to the European Commission report [European Commission, 2009] most of Member States have translated the Recommendation, completely or partially, into their national regulatory frameworks. The analysis of corporate governance codes of the EU27 shows that some countries, such as France, Slovenia,

Estonia, Germany and Portugal, have focused primarily on the transparency of remuneration policy. Others, like Sweden, Austria, Luxemburg, Hungary, the Czech Republic, Ireland and Italy, place more stress on defining the rules of remuneration. In Spain, Belgium, the Netherlands, Finland, Great Britain and Cyprus both issues are treated equally importantly. However, the largest group of Member States either did not discuss at all, or if so only very briefly, executive remuneration practices [Urbanek, 2009]. Among them was Poland, which did not touch upon the disclosure of executive remuneration policy in its corporate governance code, referenced to the EC recommendation of 2004 (2004/913/EC) and 2005 (2005/162/EC). This carries the risk of missing, or only partially applying, good practices, which is confirmed by empirical analysis [Urbanek, 2011].

The financial crisis brought about a sharp increase in the scrutiny of executive remuneration in most of the developed countries. However, only a few of them decided to introduce regulations limiting excessive executive remuneration in banks. The level of executive pay largely remains the responsibility of corporate bodies, so as not to limit the possibility of obtaining the most talented executives in the market. Russia and China were the exceptions [Prossner, 2009]. Most of the new legal initiatives were focused on the structure rather than on the level of executive pay.

Since the beginning of the crisis, regulatory reforms in the national context have focused on the development of 'say on pay' policies, introduced for the first time in the UK in 2006. This involves giving shareholders the right to vote on both the level and structure of executive compensation. In 2009 Germany followed the footsteps of the UK and amended its corporate law (*Aktiengesetz*) accordingly. Similar to the UK, the decision of the shareholder meeting is not binding on the management board. Additionally, in Germany the supervisory board has the right to make cuts in the levels of compensation if the economic situation of a firm worsened. Executive remuneration may not exceed the usual (sector or country-specific) level of pay in the absence of special reasons. Decisions concerning the remuneration of board members must be taken by the whole supervisory board rather than only by the remuneration committee. Executive share options are also regulated in detail. They are not permitted to be exercised until four years after the granting of the option.

The 'say on pay' policy has also developed gradually in the U.S. In 2008, firms that owed money to the Troubled Assets Relief Programme (TARP) were legally required to pass a 'say on pay' resolution. In July 2009, the U.S. House of Representatives passed the 'Corporate and Financial Institution Compensation Fairness Act of 2009'. This bill allowed for 'say on pay' resolutions at all public

institutions within the U.S., and also provided shareholders with the right to vote on 'golden parachutes' for executives.

In some countries, the changes in executive remuneration in banks are enforced by a local regulator or by non-public associations of private financial institutions. For example, in the Netherlands it was agreed that bonuses for executive board members should be limited to 100% of annual salaries. In 2009 a decree was passed in France banning stock options and bonuses for bankers for three years. Those financial institutions that do not comply with the rule will be subjected to special scrutiny by the regulator.

Due to the significant differences in the approach to bankers' remuneration between developed countries throughout the recent crisis, there was a need to initiate legal changes in executive pay practice at the global level. This task was taken up by the three international organizations that cooperate with each other: the Financial Stability Board (FSB), the Committee of European Banking Supervisors (CEBS) and the European Commission.

In April 2009 the FSB, an organization made up of 24 central banks, the Ministries of Finance, supervisors of the largest economies as well as the most influential international organizations and committees which set the standards for financial markets, published nine prudential 'Principles' on executive remuneration in financial institutions. They can be divided into three parts. The first part encompasses recommendations that the bank board should be in charge of monitoring and reviewing the compensation system to ensure that it operates as intended. The second part is quite new, as it requires alignment of executive remuneration with prudent risk taking and implementing practices that reduce employees' incentives to take excessive risk. The last part emphasizes the role of regulators in monitoring executive remuneration policy.

Due to the generality of the Principles, in September 2009 the FSB converted them into fifteen detailed, more practically-oriented Standards. They start by addressing areas related to remuneration governance. They specify the functions and the composition of the remuneration committee, whose appointment should be binding. Its members should be independent, competent, and experienced in setting remuneration policy. In addition, the remuneration committee should closely cooperate with the risk committee in evaluation of the incentives created by the compensation system. It should also be required to submit to the regulator a report on executive compensation, which should include a detailed description of the remuneration policy, in particular the rules determining its level and structure. This report should be made available to the public.

The FSB paid the most attention to compensation structure and to the alignment with prudent risk taking. Risk adjustment should account for all types of risk. If necessary, banks should rely on opinions of independent experts on the likelihood of non-transparent risk that is difficult to quantify. It is also highly recommended to use stress tests to examine how corporate performance could and should influence the level and structure of executive remuneration. Capital requirements should not be compromised by the payment of executive compensation. If there is a risk of breaching capital adequacy, the local supervisor should be able to reduce bonuses.

In order to prevent excessive risk and promote long-term value creation, provisions for deferment of executive remuneration have been introduced. The compensation payout schedule should be aligned with the time horizon of risks. A substantial portion of variable compensation payments (40%-60%) should be deferred over a few years, at least three, although the period should increase significantly with the level of seniority and responsibility. Deferred compensation should vest no faster than on a pro rata basis.

A variable element of compensation should constitute a significant portion of total executive pay and be tied to the individual's, business units' as well as firm's performance. The size of the bonus pool should be linked to overall firm performance. Subdued or negative firm performance should lead to a contraction of variable compensation through reclaiming already paid out bonuses (clawbacks) or reducing current payments (malus). In addition to the resignation from guaranteed bonuses and encouragement of the use of conditional instruments and setting variable remuneration, it is also highly recommended to re-examine the severance packages of executive directors, as being a big burden imposed on shareholders. Termination payments should be related to achieved performance, so as not to reward failure. In order to align corporate performance with risk and promote long-term shareholder value creation, a substantial proportion of variable executive remuneration should be awarded in shares or share-linked instruments. At least 50% of variable compensation should be based on shares and should be subject to an appropriate retention policy, as well as a deferment arrangement.

The FSB Standards set forth in detail what should be disclosed. While most of their requirements are not new, their enforcement to date has been largely ineffective. Many companies did not disclose executive remuneration structure in their annual reports. What is relatively new is the necessity to disclose the policy of establishing the deferred proportion of executive pay and vesting policy of those shares that constitute as part of compensation, the ratio of fixed to variable compensation, and an explanation of the relative importance of both components

as well as criteria for risk adjustment. The implementation of the FSB Principles and Standards should be overseen by the local regulator.

Around the same time, in April 2009, best practices on executive remuneration in financial institutions were published by two other international organizations: the European Commission and the Committee of European Banking Supervisors (CEBS). The Commission issued its Recommendation in 2009, which included further stipulations regarding disclosure. Moreover, it also focused on the design of executive remuneration, more specifically variable remuneration (e.g., types of variables to be included, deferral of payout), share-based remuneration (e.g., vesting period, vesting criteria) and severance payments (i.e., limits on such payments). The Recommendation tackles the same issues as the FSB Principles and Standards; however the level of detail provided by the Commission is substantial. For example, it sets a limit of two years maximum on the fixed component of director remuneration in severance pay, and bans severance pay in case of failure. The Commission stresses that the minimum vesting period for stock options and shares must not be shorter than three years, and requires the retention of part of the shares until the end of the employment contract. It also strengthens the role and operation of the remuneration committee through new principles on its composition, the obligation for members to be present at the general meeting where the remuneration policy is discussed in order to provide explanations to shareholders, and avoiding conflicts of interest with external remuneration consultants. It also refers to the role of institutional investors, imposing on them the obligation to attend general meetings, and where appropriate to make considerate use of their votes regarding executive remuneration. Last but not least, EC Recommendation advises Member States to keep a balance between fixed and variable remuneration, and to tie variable remuneration to predetermined and measurable performance criteria to strengthen the link between performance and pay.

The Recommendation contains several provisions on disclosure. It states that shareholders should be provided with a clear and comprehensive overview of company remuneration policies. This information should include at least the proportion of the variable and non-variable components; the performance criteria to be met for granting share options; the link between remuneration and performance; the main parameters and rationale for annual bonus schemes and non-cash benefits; and the main characteristics of supplementary pensions or early retirement schemes. It is highly advised that shareholders should vote on remuneration policy. The shareholders' vote may be either binding or advisory. Remuneration and other benefits granted to individual directors should be disclosed in detail in the annual accounts (or in the notes to the annual accounts), or in a remuneration report.

In 2010 the European Commission examined the enforcement level of the Recommendation as of 2009, demonstrating that it was neither uniform nor satisfactory. As a consequence, it was decided to issue norms on executive remuneration in financial institutions through a Directive, by including them in the revised Capital Requirement Directive (CRD III). This Directive obliges banks to develop a remuneration policy for risk management purposes and subject it to a regulator's supervisory review. In addition, the CEBS issued guidelines on sound executive remuneration policy in financial institutions in order to facilitate implementation of the Directive. The CRD III goes beyond the FSB Principles and Standards, treating them as minimum criteria, which eliminates Member States deviation and ensures uniformity among European countries. However, some criticism may be raised, arguing that the detailed regulation of executive pay would undermine flexibility of pay instruments.

There are several studies available which analyse the implementation of remuneration reform. The FSB is obliged to annually monitor the progress of national regulators and large financial institutions in implementing the Principles and Standards. Its most recent report, as of 2011, shows that the necessary regulatory actions were taken in most developed countries, supervisory oversight has intensified, and the governance of remuneration has improved. The analysis reveals that two different approaches of the authorities to implementation can be distinguished. The first is called the regulatory approach, which is applied by the European Commission (see Table 1). This approach is characterized by a greater reliance on prescribing detailed requirements. The second approach – supervisory – relies on increased use of the high-level principles that allow more flexibility for banks and a greater role for supervisors.

Table 1. Approach to the implementation of FSB Principles and Standards on executive remuneration

Regulatory approach	Argentina, Australia, Brazil, France, Germany, Italy, Mexico, the Netherlands, Saudi Arabia, Singapore, Spain, Switzerland and the UK.
Supervisory approach	Canada, China, Hong Kong, Japan, Korea and the USA
No specific approach	India, Indonesia, Russia, South Africa and Turkey.

Source: FSB [2011].

There are significant differences among jurisdictions in the proportion of financial institutions subject to the FSB rules. Only a few countries introduced the same regulation on compensation practices for all banks (France and Japan). Some jurisdictions have adopted a tiered approach that differentiates banks on

the basis of their systemic importance (Canada, Germany, Italy, and UK). China only regulates executive remuneration at major or systemic financial institutions. Some jurisdictions, whose national frameworks do not formally distinguish between different tiers or categories of institutions, still appear to have focused their supervisory activities on large, systemically important banking groups (Australia, Hong Kong, Spain, and the US). These countries stress the need for the regulatory framework to take account of differences in the size and riskiness of institutions, as well as differences in their capacity to implement the changes. For small banks the cost burden of implementation is much heavier, as they have low resource capacity.

Most of the countries have implemented, or plan to largely or fully implement, the FSB Principles and Standards, even despite the lack of identification of specific remuneration practices as significant sources of risk within their financial systems. The reasons for a lack of such identification include: ownership of banks by a single majority shareholder or small groups of shareholders (Brazil), low levels of variable remuneration (Indonesia, Italy, Japan), lack of use of equity as compensation (China), absence of a 'bonus culture' and a tendency for employees to spend a long time with a single employer (Japan).

The studies show that most large financial groups have implemented the most significant rule and aligned compensation with risk. Profit after risk charges was the primary metric used for setting bonus pools, and the involvement of the Risk Management function in setting remuneration has also increased. Smaller banks that are not active internationally use mainly traditional measures such as net profit, *tier one capital ratio*, or ROE in order to determine the size of bonuses.

During the implementation process a new term was coined - *material-risk-taker* (MTR) – to indicate that group of people whose professional actions can have a material effect on a bank's risk exposure. For them the ratio between cash payments and share-based remuneration must be adjusted to the level of risk taken. The larger the risk, the less cash they should obtain.

The changes in remuneration structure provide further alignment between risk takers' incentives and the bank's risk profile. Most of the large international financial institutions reported a significant fraction of the variable compensation component, reaching up to 90%. This fraction depended largely on the size of the bank, its country of origin, and the approach to implementation of the Principles and Standards of the FSB. Some regulators raised the issue that large international banks may be forced to reduce variable compensation due to current or future capital concerns.

A deferred compensation structure was in place in most countries under FSB oversight. Substantial fractions deferred, at least 60%, were common in the large, internationally active firms. For small banks that cannot be considered as international players, this fraction was smaller and was associated with the smaller fraction of variable pay in the total pay, and applied to a small number of employees. In the EU countries, typically half or more of deferred pay was in the form of equity or other performance-linked instruments, which were subject to a retention period, with the other half in cash or cash-like instruments that were also subject to a malus. Outside the EU, the most common award structured all deferred pay in equity-linked instruments.

At most large international financial institutions maluses or clawbacks are in use. Maluses usually operate by affecting the quantity of deferred compensation at vesting, for example by reducing the number of shares received on the vesting date. Clawbacks require the executive to return to the firm a specified amount of money already in his/her possession. Maluses act as the reverse of bonuses, and can be used after the end of the deferral period. Clawbacks can apply to both deferred and upfront payments and can be applied beyond deferral or retention periods. Both were in place in the international financial institutions for malfeasance, misstatement, or other violations of internal policy. In some banks they were activated by significant downturns in financial performance, such as the realisation of material losses at either the firm, business, or individual level. They are applied on a discretionary basis, often by the remuneration committee, which in large financial institutions is comprised of solely independent board members.

The FSB review shows that the trajectory of change has been positive as compensation reform has been implemented. However, some unintended consequences have begun to emerge. Clawback or malus provisions appear difficult to implement in some jurisdictions, such as Argentina, Spain, and Switzerland, due to other labour law provisions. In some countries 50% of executive remuneration in share-based instruments may pose a challenge due to underdevelopment of the domestic equity market. Additionally, shares and share-like instruments cannot be used as an instrument of variable remuneration for unlisted financial institutions. Also, there appear to be some differences with regard to the criteria used to identify Material Risk Takers. Most jurisdictions have already adopted a way to identify individual MRTs, but the methods used and sets of employees involved tend to differ. This leads to competition between jurisdictions. Some banks in the EU draw attention to the potential loss of employees associated with the implementation of executive remuneration reform with respect to competitors from other countries with more lax regulation, or from other sectors, making the banking in-

dustry a less attractive employer. Lastly, the disclosure requirements for executive remuneration vary significantly from country to country, which may prevent the comparison of different banks.

3. Overview of the new regulations in Poland

In Poland the stimulation to reform executive remuneration policy arose from the implementation of CRD III. Poland was one of the last Member States of the European Union to take legislative steps to adapt to the new Directive, by amending the Banking Act, the Act on Capital Market Supervision and the Act on Trading in Financial Instruments. Accordingly, the new supervisor named in Polish law – the Polish Financial Supervision Authority (PFSA) - is in a position to determine the variable remuneration policy for executive board members in banks by issuing a resolution. Its authority increases when a bank is obliged to develop a remedy plan. When such a plan proves to be insufficient or improperly conducted, the supervisor can order a reduction or suspension of variable remuneration, but only covering a period not longer than the last three years. Clawback clauses are not provided.

On the basis of the aforementioned provisions of the new regulations. the PFSA passed a resolution setting out rules for determining the variable executive remuneration in banks. In accordance with CRD III, executive remuneration is nowadays aligned with long-term value and prudent risk taking. The resolution applies not only to all executive board members regardless of bank size, but also to all managers who have material influence on a bank's risk profile (MRTs). A list of Material Risk Takers should be created, maintained, and provided to the supervisor. Furthermore, banks have to convey, by 31 January of each year, a list of employees whose total remuneration in the previous year exceeded 1 000 000 Euro, together with information on the position held and the value of the main compensation components.

The FSB Principles and Standards are to large extent implemented in the new Polish regulations. Firstly, 40% of variable pay is subject to mandatory deferral for the period from 3 to 5 years, and in the case of particularly large amounts, up to 60%. Secondly, at least 50% of variable remuneration must be based on shares or corresponding non-cash instruments that reflect the quality of credit institutions. Besides, banks should have a share retention policy in place. The deferral of 40% of variable remuneration, and the requirement to pay at least half of variable remuneration in non-cash instruments, means that no more than 30% of variable pay

can be paid immediately in cash. This value is further reduced to 20% for those with higher incomes, for whom 60% of variable pay is deferred. Moreover, the size of the deferral may be re-examined if the corporate results are not achieved due to taking higher risks than planned. Unlike in some European countries, in Poland the new regulatory scheme does not determine the ratio of fixed to variable pay. It is only required that the fixed component of remuneration should constitute a significant part of the whole package, insofar as is possible to conduct a flexible remuneration policy. Thirdly, there is no possibility of granting guaranteed bonuses. Finally, it was decided to ban the use of personal hedging and insurance strategies for executive remuneration.

In the PFSA resolution severance payments, which in 2010 represented a very important component of executive remuneration in a few large banks operating in Poland, are not discussed in great detail. However, the need to resign from guaranteed severance payments was stressed. In addition, their payment should be dependent on long-term performance, at least for the three preceding years, and financial institutions should not allow for granting severance payments to employees for dismissals based on unsatisfactory performance.

Remuneration policy, with respect to its variable components for all Material Risk Takers, should be approved by the supervisory boards following receipt of the remuneration committee's opinion. However, the management board is in charge of its implementation. In addition, a bank's internal audit department is obliged to review the policy and provide a separate report to the supervisory board. Approved and implemented terms of remuneration policy, in particular with regard to the method for setting variable remuneration and performance criteria, as well as the composition of and tasks assigned to the remuneration committee, should be disclosed. Banks are required to include detailed information on the level of executive remuneration on an individual basis, including the deferred pay component and the value of share-based compensation, in their annual reports.

The new law will certainly strengthen the role of the remuneration committee. A remuneration committee should be established in all banks that fulfil at least one of the following conditions: are listed on the stock exchange, have an asset share or a deposit share in the banking sector of at least 1%, or its share of own funds of the banking sector is at least 1%.

The Polish Financial Supervision Authority has not provided banks operating in Poland with detailed guidelines for implementing the new legislation, specified the transitional period, nor supplied references to other legal acts, such as the Labour Code. The regulator's approach is quite general, which leaves room for different interpretations of the resolutions issued. Some of them have been set

out in a letter submitted to the banks at the end of December 2011. For the first time the regulator has highlighted the importance of the proportionality rule in the application of the new regulations. It also referred to the share-based compensation in banks that are not listed on the stock exchange or are not joint stock companies. A bonus may be settled in cash, but in conjunction with the price of the shares (phantom) or by other instruments reflecting the value of the institution. To summarize, the legal reforms on executive remuneration in banks have quite a limited scope, since the law refers solely to the variable competent. In addition, a quite peculiar definition of the variable component is adopted, since there is no provision referring to Long-Term Incentive Programs (LTIPs).

4. Methodology of the research

This section presents a description of the research design, sample, and data collection procedures. I analyse the remuneration policy applied by the largest Polish banks prior to the entry into force of the new regulations, which were a response to the European Commission's CRD III. In this analysis the following issues, which were of interest to the FSB as well as European Commission, were examined: level and structure of executive pay, remuneration governance, severance payment policy, and disclosure of remuneration policy. The latter was introduced in 2010 as norm I5 to the corporate governance code, binding in Poland. The study shows the remuneration practice for both the CEO position as well as for the entire executive team.

The sample of interest for the study is composed of all banks listed on the Warsaw Stock Exchange at the end of 2010. Three banks were excluded from the survey as the problem of corporate governance at that time was not relevant to them and their annual reports did not provide adequate information on executive remuneration policy, probably due to very low free-float (less than 1% of all shares). Their combined share in the capitalization of the banking sector on the Warsaw Stock Exchange was below 0.01%. One of them was withdrawn from the stock exchange shortly thereafter.

According to Polish law, detailed information on executive remuneration in listed companies should be disclosed in annual reports. The information should include the value of each pay component for each director separately. Despite this requirement, identifying the size of bonuses poses significant difficulties in some banks, as they reveal just one figure, comprised of both basic salary and annual bonus for each director. In addition, due to inconsistencies and gaps in the dis-

closure of equity incentive plans, I could not analyse the total value of the bank's LTIPs. In order to estimate the value of the equity-linked component of CEO's pay packages I referred to the value of the shares they owned in 2010, as obtained in the framework of LTIP.

5. Analysis of remuneration practices of listed banks in Poland on the eve of the new regulations

The results of the analysis show that in 2010 the average total cash remuneration of bank CEOs in Poland represented 738 times the wage of the average worker (see Table 2). With respect to CEOs, remuneration was dominated by cash payments, which ranged from 86% to 100% of total pay. Basic salary represented the most important component of cash compensation in the largest banks operating in Poland. On average it constituted more than half the total cash compensation. Two other components of cash compensation had a similar average weight: CEO bonuses constituted 18% of total cash compensation, while other benefits constituted 15%. For most banks, it was difficult to demonstrate the fraction of pay in the form of bonuses as only three banks disclosed that component, and two others had not paid out it in 2010. During the financial crisis, when the levels of bank's executive remuneration and the method of their calculation triggered public outrage, some banks in Poland, whose financial situation was the most difficult, decided not to pay annual bonuses. However, there was one bank that had a completely opposite executive remuneration policy, as basic salary and bonus constituted only 36% and 27% respectively of total CEO cash compensation. The remainder of the cash compensation (37%) came in the form of other benefits. Share-based remuneration was an absolutely minor component of total executive pay (median equal to 2%). Only one bank had a different approach, paying out 31% of total remuneration in shares. This prevailing situation was quite the contrary to that of developed countries, where equity pay was the single largest component of CEO compensation for both banks and non-financial firms, with the proportion of equity payments being the greatest among large banks (Core and Guay, 2010). Hence, share-based compensation did not contribute much to the variable component of executive remuneration, which on average comprised 21% of the total pay package.

Table 2. Structure of CEO remuneration in banks listed in Poland

Bank	1	2	3	4	5	6
PKOBP	NA	NA	N	NA	NA	NA
Pekao (*)	1012.4	NA	NA	NA	5%	NA
BRE(*)	589.8	86%	79%	13%	8%	25%
INGBSK	707.5	99,9%	NA	NA	28%	NA
BZWBK	940.7	98%	48%	49%	2%	51%
Millenium	527.4	100%	99%	0%	1%	0%
Handlowy (Citi)	1150.4	94%	0%	NA	5%	NA
Kredyt	592.6	100%	64%	0%	36%	0%
BPH	980.6	95%	36%	27%	37%	31%
BOS	366.2	100%	NA	NA	NA	NA
Noble Bank	509.8	31%	NA	NA	NA	NA
Mean	737.7	89%	54%	18%	15%	21%
Median	650.1	98%	56%	13%	7%	25%

1- ratio of CEO remuneration to the average wage in the national economy; 2- percentage of cash remuneration in total executive pay; 3 - percentage of basic salary in total cash remuneration; 4 – percentage of bonus in total cash remuneration; 5 - percentage of other benefits in total cash remuneration; 6 - percentage of variable components in total executive pay.

NA – data not available.

(*) information for an acting president of the board in 2010. (**) average monthly wage in the firm sector in 2010 equalled 3,224. 98 PLN.

Source: Own calculations based on financial reports and data from the Central Statistical Office

For most banks the most detailed remuneration structure was presented for the entire management board (for accumulated figures, see Table 3). Cash compensation for all executives constituted on average 95% of their total pay (whereas the median was 98%). The proportion of basic salary to total cash remuneration was higher for all executives than for a bank's CEO (median 65%). The second most significant component of executive cash remuneration for all executives was the bonus. There are slightly larger discrepancies between banks with regard to the size of bonus awarded to the executive members. The fraction of other benefits in total remuneration was smaller for the average executive than for the a bank's CEO. Share-based remuneration was also negligible, as in CEO pay. On average it was 5% of the total executive package and the median was close to 2%.

Table 3. Structure of the management team remuneration in banks listed in Poland

Bank	1	2	3	4	5
PKOBP	100.0	NA	NA	NA	NA
Pekao	89.0	NA	NA	3%	NA
BRE	90.8	91%	13%	9%	21%
INGBSK	99.5	NA	NA	32%	NA
BZWBK	98.4	48%	41%	11%	42%
Millenium	100.0	84%	0%	16%	0%
Handlowy (Citi)	96.1	57%	37%	6%	39%
Kredyt	100.0	72%	0%	28%	0%
BPH	97.2	50%	33%	17%	35%
BOS	100.0	NA	NA	NA	NA
Noble Bank	73.6	NA	NA	NA	NA
Mean	95.0	67%	21%	15%	23%
Median	98.4	65%	23%	13%	28%

1- fraction of cash remuneration in total executive pay; 2 - percentage of basic salary in total cash remuneration; 3 - percentage of bonus in total cash remuneration; 4 - percentage of other benefits in total cash remuneration; 5 - percentage of variable components total executive pay.
NA – data not available.
Source: Own calculations based on bank financial reports.

The study shows that banks operating in Poland had a quite differentiated approach to the development of executive remuneration packages. However, most of them pursued conservative policies in setting the executive remuneration structure. This means that the fixed component, in particular basic salary, constituted the largest share of total executive compensation. CEO compensation was structured more aggressively, as the fraction of basic salary and other benefits was smaller. On average, other benefits represented quite an important component of bank's executive remuneration, larger than in other countries [PwC, 2011]. This may be evidence of the violation of minority shareholders' rights, as highly concentrated ownership allows for granting excessive executive remuneration. There are some banks where, in 2010, other benefits were the second largest component of total remuneration after basic salary. Such benefits encompassed life insurance, contributions to an investment fund, and medical care. In addition, a few banks reported that 'other benefits' also consisted of additional salary to foreigners, as well as payments for housing, school fees for children, and family allowances. A minority of banks did not reveal what kind of perks they granted. All in all, banks operating in Poland, even though almost all of them are subsidiaries of large financial holding corporations, conducted a conservative executive remuneration

policy in comparison with banks from Western Europe. In the EU15 basic salary constituted relatively small fraction of the total compensation package (around 25%), and variable compensation, in particular LTIP, was the dominant component of total pay. [PwC, 2011].

In Poland, LTIP is still of minor importance in the entire executive compensation package, including in its variable component. The analysis shows that in 7 out of 11 banks executive directors participated in a management share option plan. In four cases the plan was linked to company shares, and in three cases management board members were entitled to exercise stock options for the parent company's stock. The management share option plan was the only element of bank's executive remuneration based on shares. For three out of the four banks that revealed all components of total remuneration, the share-based compensation represented 4-10% of variable pay. The fourth bank reported a significantly higher fraction, equalling 44%. With respect to CEO compensation, share-based compensation as an element of variable pay was higher than for an average executive. Banks which included their executives in long-term incentive programmes paid more generously. In the two banks where the state had a controlling stake, the management share option plan was not in place.

According to the survey conducted in 2011 by PricewaterhouseCoopers (PwC), banks' executive remuneration in Poland was lower in 2010 than in 2007 or 2008. The five largest banking institutions - in terms of asset size - listed on the stock exchange paid their executives an average 30% higher cash remuneration than the five listed banks with the lowest asset size. The level of executive remuneration was also related to stock market capitalization. Banks that are included in the major indexes - WIG20, mWIG40 or sWIG80 - paid their executives on average 40% higher remuneration than banks that were not included in the indexes. The lowest executive compensation was paid by banks controlled by the state. Three quarters of the banks listed on the stock exchange offered their executives higher remuneration. The results of this study confirm the observation, reported in PwC's analysis, that in 2010 the executive packages in the two banks where the state held a significant equity stake were substantially lower than those in the private banks.

Drawing on data gathered from the annual reports for the year 2010, it appears that severance payments were a significant component of executive remuneration in the Polish banking sector. Termination contracts specified that cash remuneration, not dependent on any performance criteria, would be paid for a period ranging from 2.5 months to 24 months. Seven of the 11 analysed banks provided information on the process of establishing the terms for severance payments.

With respect to remuneration governance, eight banks reported that a remuneration committee was established and aimed to strengthen the work of the supervisory board. This situation was unchanged in comparison to 2009 [Słomka-Gołębiowska, 2010; Urbanek, 2011]. Seven banks reported that at least one member of the committee was independent, and in three cases he or she held the position of committee chairperson. Only four banks followed the FSB Standards and enabled cooperation between remuneration and risk committees through interlocking mandates.

Table 4. Composition of the Compensation Committee in listed banks in 2010

Bank	1		2		3	4
	2009	2010	2009	2010	2010	2010
PKOBP	No	No	ND	ND	ND	ND
Pekao	Yes	Yes	1	1	No	No
BRE	Yes	Yes	2	2	No	Yes (4)
ING BS	Yes	Yes	2	2 (5)	Yes	No
BZWBK	Yes	Yes	2	2 (3)	No	No
Millenium	Yes	Yes	2	2(4)	Yes	No
Handlowy (Citi)	Yes	Yes	2	2(4)	Yes	Yes (1)
Kredyt	Yes	Yes	1	1	No	Yes (2)
BPH	Yes	Yes	0	0	No	Yes (2)
BOS	No	No	ND	ND	ND	ND
Getin Noble	No	NO	ND	ND	ND	ND

1 - Is there Remuneration Committee?
2 - What is the number of independent members on the Remuneration Committee?
3 - Is the Chairman of Remuneration Committee independent?
4 - Are there any Risk Committee member sitting on the Remuneration Committee? (number of members)?
NA – data not available.
Source: Own calculations based on bank financial reports.

The disclosure policy regarding executive remuneration is not new, as it was introduced into the corporate governance code in 2010 as binding for all listed banks. The new regulation increases the disclosure requirements by describing in detail what kind of information should be revealed with respect to executive remuneration policy. Up until 2011 banks listed in Poland were to follow recommendation I5, using the comply or explain principle. This recommendation compels a company to have a remuneration policy and rules defining the policy by which the form, structure, and level of remuneration of executive directors are determined. The corporate governance code does not give more detailed guidance,

but it advises following the European Commission Recommendation of 2004 and 2009. The thorough analysis of annual reports revealed that only five banks had a remuneration policy and rules for defining the policy. They briefly described a compensation policy, but without a justification of the levels and payment mechanisms of remuneration components, and without providing any criteria for payment of the variable component of remuneration. Three other banks just declared adherence to the Recommendation, without yet having an executive remuneration policy.

Conclusions

The analysis, based on data gathered from banks listed in Poland, shows that newly introduced provisions, binding since 1 January 2012, are aimed at forcing changes in the approach to executive remuneration policy in the banking sector. Firstly, long-term incentive programs (LTIPs) should gain in importance because of the need to defer a large part of the variable compensation component and the use of instruments other than cash. The small percentage of share-based compensation that is deferred means that risk was not taken into account as a significant variable when shaping the structure of a bank's executive remuneration in 2010. This component also accounted for only a small part of variable pay. In 2010, some listed banks rewarded managers solely in cash. Approximately 80% of variable compensation was comprised of bonuses that were paid without deferral.

The changes in the regulations may have less impact on banks characterized by a conservative executive remuneration policy, where the basic salary is a dominant component, than on banks pursuing an aggressive policy by granting a high annual bonus as fraction of total pay. The introduction of new regulations that refer solely to the variable components of executive remuneration may be associated with an increase in basic salary. A trend toward increasing the fixed component, relative to the variable one, appears to have taken place in some countries as a compensating mechanism for the deferred bonus payment [FSB, 2011]. Hence, a bank can alter a policy of aggressive executive remuneration into a more conservative approach. To prevent this scenario, laws should require a balanced structure of remuneration between fixed and variable components, as is the case, for example, in Denmark.

It seems that implementation of the CRD III provisions may be more costly in Poland than in developed countries, due to limited use of own share-based compensation. Adherence to the new regulations on remuneration governance has not posed a problem so far. Regulating the organization and procedures of a superviso-

ry board is less intrusive than intervening directly in remuneration arrangements. There remains a lot of resistance toward the implementation of any best practice that is not included in the hard law. The analysis shows that banks listed in Poland do not adhere to FSB Principles and Standards that have not been incorporated into the Polish regulatory regime. This is evidenced by the fact that remuneration committees do not cooperate with the risk committees. Additionally, the Polish regulations do not highlight disclosure, which has been weak to date, as evidenced by the fact that legal provisions on disclosure of all components of executive pay separately for each director are ineffectively enforced. That may conceal noncompliance with some rules related to remuneration structure or governance.

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