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CEOs Remuneration in Corporate Governance Codes in EU Member Countries**Abstract**

Over the past two decades corporate governance has become one of the key issues in business and academic debates. The appropriate standards of corporate governance constitute important components of successful market economies. At the same time it is widely emphasized that contemporary mechanisms by which enterprises are directed and controlled are seriously defective. There is a need for profound reforms in corporate governance mechanisms. The growing interest in corporate governance codes among OECD countries is a very important component of these reforms.

The purpose of the paper is to compare regulations in corporate governance codes in 27 EU countries concerning remuneration of top executives. It enables identifying two main mechanisms which are implemented in CG codes – market mechanism based on high level of remuneration transparency and hierarchical mechanism based on setting rules according to which corporate boards establish a formal procedure for fixing the remuneration packages of executives. The paper presents the discussion on determinants of these two mechanisms.

1. Introduction

The extent and manner of establishing CEOs salaries in the biggest corporations has for many years aroused immense interest. It is a popular conviction that extent and dynamics of this remuneration have no relation what so ever with company's economic performance. Numerous financial scandals,

extensively covered and commented by media, deepen the grim sight of the situation in which managers, without any control and supervision on part of owners are in a position to attain incredibly big benefits at an expense of companies and their shareholders.

Today, a natural reaction to this kind of phenomenon involves attempts to normalize this exceptionally sensitive area of corporation performance. It is an element of a broader phenomenon of reforming mechanisms of corporate governance. The corporate governance codes are a result of activities aimed at streamlining standards of corporate order. The first in a series of such codes was the so called Cadbury's Code presented in 1992 by a Commission appointed by British government. Since then the work to create national regulations started in several dozen countries, and in all EU countries. Apart from national codes there are valid documents of a broader than national character, the most important of them the OECD Principles of Corporate Governance.

There are two basic aspects of codes which are the subject of regulation connected with operation of incentive schemes. The first one involves procedures of setting remuneration, its amount and structure. The latter involves paying attention to problems of transparency of information on CEOs salaries.

These two aspects of code regulations indicate similarity to existing in the economy mechanisms of resource allocation described in the theory of transaction costs (Coase 1937). The first one concerns market co-ordination. The effective allocation of resources is implemented first of all by use of price mechanism. Market transactions are concluded between independent „agents”: companies, consumers, government. Market system works itself out. One of the conditions that must be fulfilled so that market allocation is effective is perfect market transparency. The entities operating in the market must possess complete knowledge about provisions at which market transactions are concluded including first of all prices at which the goods, services and production factors are provided.

The market environment is not the only one determinant of entities' behavior. The other mechanism of resource allocation consists in hierarchical co-ordination. This concerns co-ordination within a company. This co-ordination is of organizational character – hierarchical structure acting through planning, control, giving orders, recommendations, issuing bans (Gruszecki 2002, pp. 210-211). The use of this mechanism is indispensable when market co-ordination is ineffective or costs of co-ordination through prices are very high.

Provisions of codes regarding the question of CEOs remuneration indicate analogy to those two mechanisms of co-ordination. Recommendations regarding high transparency of salaries are meant to increase the efficiency of managerial

labour market. This leads to streamlining of such production factors like services provided by managers. Recommendations regarding formal principles and procedures for setting salaries resemble mechanism of hierarchical co-ordination. Off course, in the latter case there is a certain difference in relation to mechanisms described in the theory of transaction costs. Hierarchical co-ordination is not implemented under inter-corporate procedures, but is characterized by external regulations which however, serve similar function. They substitute market mechanism.

In the further part of the study there will be presented proposals of solutions included in the recommendations of European Commission and in national corporate governance codes of EU countries with emphasis placed on these two types of recommendation.

2. Corporate governance codes in EU countries and transparency of CEOs remunerations

Open principles of paying CEOs should constitute a vital element of transparency in public corporations. Questions of compensation, its amount, structure in terms of fixed and variable components, in terms of long and short term elements, incentive schemes for directors participation in ownership, their termination payments, non-cash benefits etc. This concerns persons both managing and supervising companies (Hill 1997; Ward 1998).

We shall start the presentation of principles of remunerating top executives of listed companies, with European Commission recommendation¹⁰. In the document adopted in 2004 the emphasis was laid on transparency of remuneration policy. Listed companies should disclose a statement of remuneration policy of the company (the remuneration statement). It should constitute a part of an independent remuneration report which should also be posted on the listed company's website. The statement should also include explanation of the variable and non-variable components of remuneration, information on the performance criteria on which any entitlement to share options, shares or variable components of remuneration is based; information on non cash benefits. Remuneration of individual directors should also be disclosed

¹⁰ Commission Recommendation 2004/913/EC of 14 December 2004 on fostering an appropriate regime for the remuneration of directors of listed companies [Official Journal L 385/55]

including total remuneration and other benefits granted to them. The information should be disclosed in a separate report.

Most national codes include recommendations to disclose remuneration policy that applies to chief executive officers. First of all, it concerns principles of relation between fixed and variable components of compensation, performance criteria on which variable components of remuneration are based; performance bonuses, the reasons why non-performance criteria have been applied, principles of supplementary pension schemes, information on compensation paid to directors in connection with termination of their activities. Companies which use share-based remuneration schemes should additionally present description and explanation of setting performance criteria for shares, share options, the names of the participants in the schemes, conditions and frequency of schemes use, discounts and bonuses applied.

The total amount of salary and fees paid to directors is a very important element of remuneration transparency¹¹. We see here several levels of transparency. The most aggregated data show total salaries and fees received by persons managing and supervising companies.¹² The more specific data refers to disclosing total amount of salary and fees paid to individual directors. One can talk about real transparency only when companies publish individual data with reference to particular components forming remuneration scheme: basic salary, performance bonuses, postponed remuneration (shares, share options), pension schemes, termination payments. Such information should be presented for several consecutive periods since on this basis the tendency of company's remuneration policy can be assessed.

Supplementary non-cash benefits play an important role in incentive schemes for members of managerial bodies. The benefits involve company's car, free air-flights, telephone calls, cellular phone, business flats, private medical plans, medical insurance and examinations, professional development, paid holidays, payment of legal and financial counseling costs, low interest loans and many other. Only in 4 countries the companies are obliged to disclose such components, assessing their value. A lot of controversy is aroused by termination payments granted in situations in which for many reasons the manager is dismissed. Severance pays usually involve several components: paying several years' worth of salary, granting share option or shares, granting

¹¹ In certain countries the requirement to disclose information about remuneration has not been put into provisions of corporate governance, but there are references to other regulations, in Great Britain it is „*Directors' Remuneration Report Regulations 2002*” as a part of Company's Act.

¹² This type of recommendation was included into Polish Code for Corporate Governance of 2002.

supplementary benefits (insurance scheme, life insurance, supplementary pension scheme) (Borkowska 2001, pp. 474-475). Severance packages enable „smooth landing” out of a company so the literature calls them „golden parachutes” (Singh, Harianto, 1989). Eight codes include recommendation to disclose principles of calculating termination payments and costs, which the companies may face in the case of terminating contracts with present management.

Company’s transparency is a function of not only the range of disclosed information but also of the form of its disclosure. Only in 7 countries there is a recommendation to publish this type of information in the form of an independent remuneration report being a part of annual report.

Table 1. presents comparison of national regulations with respect to transparency of information about directors’ remuneration in 7 fields:

1. Description of remuneration schemes
2. Description of long term share-based incentive schemes
3. Remuneration of individual managers
4. Components of remuneration
5. Severance payments
6. Non-cash benefits
7. Standard form of presentation

Table 1. Corporate governance codes – transparency in the field of executives compensation

Country	Area of transparency						
	1	2	3	4	5	6	7
EU	yes	yes	yes	yes	yes	yes	yes
Austria		yes	yes	yes			
Belgium	yes	yes	yes	yes	yes	yes	
Bulgaria							
Cyprus	yes		yes	yes			yes
Czech Republic	yes						
Denmark	yes		yes				
Estonia			yes	yes	yes	yes	
Finland	yes	yes	yes	yes			
France	yes	yes	yes	yes	yes	yes	yes
Germany	yes	yes	yes	yes			yes
Great Britain	yes	yes	yes	yes	yes		yes
Greece							
Hungary	yes		yes				
Ireland		yes					
Italy							
Latvia		yes	yes				
Lithuania							
Luxembourg	yes		yes				yes
Malta							
The Netherlands	yes	yes	yes	yes	yes	yes	
Poland							
Portugal		yes	yes	yes	yes		
Romania			yes	yes			yes
Slovakia			yes				
Slovenia	yes	yes	yes	yes	yes		
Spain	yes	yes	yes	yes	yes		yes
Sweden	yes						

Source: own work based on corporate governance codes.

3. Corporate governance codes in EU member countries and rules of compensating managers

A vital feature of European Union recommendation is that there are no specific guidelines for procedures of setting remuneration. The most important recommendation is the one about share-based remuneration. Schemes under which directors are motivated in shares, share options and right to buy shares must be approved by general meeting of shareholders¹³.

Let us now turn to description of selected regulations adopted in national codes.

A standard solution which occurs in almost all countries is a recommendation to set up a remuneration committee which should consist of only or mainly of independent directors (countries with one-tier governance system) or independent members of the board (countries with two-tier governance system). The codes with a recommendation to set up a committee usually involve defined obligations. The most important task of a committee is to table a recommendation regarding remuneration policy of chief executives to company's board. The general rule is that none of the directors should be involved in undertaking decisions about their own remuneration.

An issue which raises a lot of controversy is the obligation to obtain shareholders' approval for long term incentive schemes for managers including first of all the option to buy shares. Such rigorous formal regulations imposing on companies obligations of this type did not exist earlier. The situation changed radically in the beginning of 21st century. It was a result of many factors. On the one hand a rising opposition could be seen on part of shareholders against application of such instruments of remunerating managers and on the other hand ever more companies adopted these solutions and benefits gained by managers on this account have many times outnumbered their remuneration in cash.

Most national company codes include recommendations for long term incentive schemes for managers. First of all the companies are obliged to table such incentive schemes for voting by shareholders. In the case of remuneration in form of share options discount should not be applied. The price must result from market share price and there have even appeared demands that it should be

¹³ Commission Recommendation 2004/913/EC of 14 December 2004 on fostering an appropriate regime for the remuneration of directors of listed companies [Official Journal L 385/55 of 14.12.2004] section IV, point 6

higher. There are time limits imposed on the implementation of options – usually 5 years from the start of a programme or till the end of employment in a company. Enforcing rights resulting from option schemes should be dependent upon company achieving specific indices that cannot be modified whatever the trends in the capital market.

Several codes name components which should be included into remuneration of chief managers. Usually it is postulated to use a mechanism linking remuneration and overall performance of a company. Sometimes the parameters for assessment of performance are given¹⁴. None of the codes gives recommendation as to the individual remuneration of managers. The committees responsible for the determination of remuneration when taking such decisions should take into consideration not only company's performance and assessment of individual managers but also average managerial salaries in the market, and remuneration paid to directors in comparable companies. Several codes involve limitations of termination payment paid to directors to a fixed sum or to total yearly remuneration.

Table 2 presents comparison of national regulations with respect to setting managers' remuneration in 7 fields:

1. Appointment of a committee responsible for the determination of remuneration.
2. Members of a committee.
3. Tasks of a committee.
4. Approval by shareholders of long term share-based incentive schemes.
5. Rules for setting these schemes.
6. Components of remuneration scheme.
7. Criteria of setting components of remuneration scheme.

¹⁴ The Irish Code for example, postulates to use such criteria as earnings per share (EPS), the Dutch Code suggests market share price.

Table 2. Corporate governance codes – regulations in the field of executives compensation

Country	Area of regulations						
	1	2	3	4	5	6	7
EU				yes			
Austria					yes	yes	yes
Belgium	yes	yes	yes	yes			yes
Bulgaria						yes	
Cyprus	yes	yes		yes			
Czech Republic	yes	yes	yes				
Denmark				yes			
Estonia				yes			
Finland	yes	yes	yes				
France	yes			yes			
Germany						yes	
Great Britain	yes	yes	yes	yes	yes		
Greece	yes			yes			
Hungary	yes	yes		yes			
Ireland	yes		yes	yes			yes
Italy	yes	yes	yes				
Latvia	yes						
Lithuania	yes						
Luxembourg	yes	yes	yes	yes			
Malta	yes	yes					
The Netherlands	yes	yes	yes	yes	yes		
Poland							
Portugal	yes					yes	
Romania							
Slovakia	yes		yes				
Slovenia						yes	yes
Spain	yes		yes			yes	yes
Sweden	yes	yes		yes		yes	

Source: own work based on corporate governance codes.

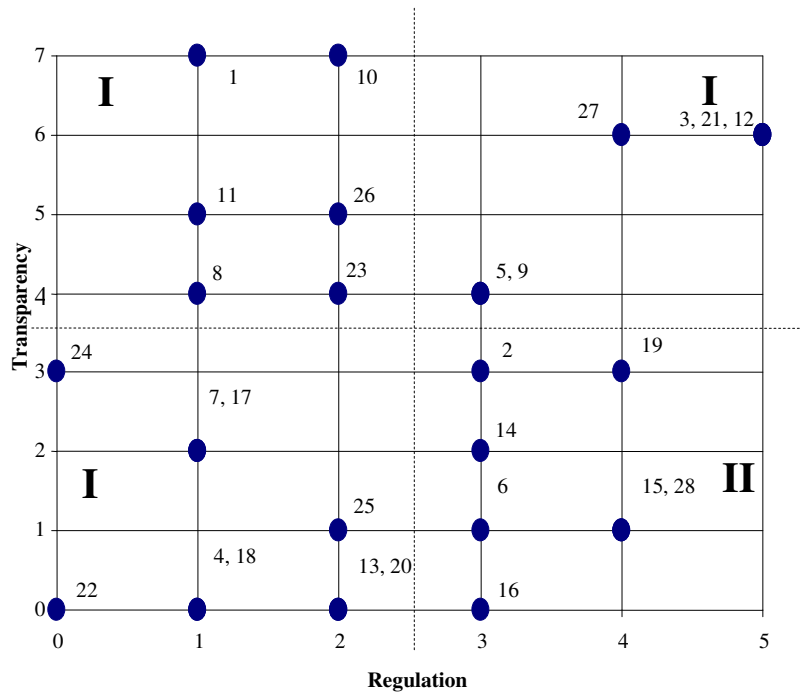
4. Comparison of national codes

While assessing guidelines for setting directors' remuneration and scope of disclosure of information on remuneration presented in European Commission and national codes of corporate governance one can point out

several regularities. Particular emphasis is laid by EU recommendations on issues of transparency of information on remuneration, allowing companies to decide about procedures of setting remuneration. Only in one country in France the scope of disclosed information is similar to European Commission recommendations.

On the other hand we observe certain specific patterns of relations between scope of regulation and transparency. Chart 1. positions particular countries on a seven – tier scale in reference to national codes. Fields of regulation named in Tables 1. and 2. were taken into consideration when building the chart.

Chart 1. Regulate or disclose - the comparison of national rules



EU – 1, Austria – 2, Belgium – 3, Bulgaria – 4, Cyprus – 5, Czech Republic – 6, Denmark – 7, Estonia – 8, Finland – 9, France – 10, Germany – 11, Great Britain – 12, Greece – 13, Hungary – 14, Ireland – 15, Italy – 16, Latvia – 17, Lithuania – 18, Luxembourg – 19, Malta – 20, Netherlands – 21, Poland – 22, Portugal – 23, Romania – 24, Slovakia – 25, Slovenia – 26, Spain – 27, Sweden – 28.

Source: own work based on corporate governance codes.

The drawing illustrates several features specific for groups of countries. Clusters I and III involve countries for which analyzed mechanisms are considered as alternative. In France, Slovenia, Estonia, Germany and Portugal transparency of information plays decisive role. In Sweden, Austria, Luxemburg, Hungary, the Czech Republic, Ireland and Italy more importance is given to issues of defining the rules of remuneration.

Cluster II involves six countries: Spain, Belgium, the Netherlands, Finland, Great Britain and Cyprus. We observe extensive range of regulation in these two areas.

Most countries (9) can be found within cluster IV, which is characterized by the least range of recommendations both in respect to guidelines for setting remuneration as well as to transparency of remuneration. It is symptomatic that economies of most of these countries undergo process of systemic transformation.

It is difficult to clearly interpret the results of national code regulations distribution. The distribution seems to be conditioned by many reasons: market capitalization, ownership concentration, institutional and legal solutions of governance, development of national economy.

The increased capitalization of stock exchange gives rise to a demand for transparency of listed companies on part of home and foreign investors. The demand is also affected by structure of sources of financing companies. Financing institutions have sufficient means of securing payment of liabilities by adequate definition of credit terms. Where company financing is based mainly on capital markets and shareholders are to a large extent dispersed, high transparency of public companies starts to be a key instrument of effective governance. Among six countries which place in the cluster III four of them exceed 30% market capitalization. None of the IV cluster countries exceeds this factor.

Ownership concentration determines system of corporation control. High concentration (specific for insider system) allows investors more direct control mainly through participation in governance bodies. Under outsider system with dispersed ownership control over corporation activities is carried out through external market mechanisms, mainly through capital market. The type of control over corporation does not explain the distribution results. Into the cluster II found their way countries with relatively high concentration (Belgium 56%, Holland – 43.5%), as well as countries with low concentration

(Great Britain – 9.9%, - Spain 34.5%)¹⁵. Similar dispersion of results can be found in remaining clusters.

Also institutional and legal solutions of corporate governance – one-tier or two-tier systems – do not really affect code recommendations adopted by particular countries.

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¹⁵ Concentration of ownership measured by median of the first block of shares.

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