Corporate Governance in the Banking Sector

Edited by
Piotr Urbanek

FACULTY OF ECONOMICS
AND SOCIOLOGY
UNIVERSITY OF ŁÓDŹ

Corporate Governance in the Banking Sector

40 LAT
WYDAWNICTWA
UNIWERSYTETU
ŁÓDZKIEGO

Corporate Governance in the Banking Sector

Edited by
Piotr Urbanek

FACULTY OF ECONOMICS
AND SOCIOLOGY
UNIVERSITY OF ŁÓDŹ

Łódź 2013

Piotr Urbanek – Department of Institutional Economic, Faculty of Economics and Sociology
University of Łódź, 90-214 Łódź, Rewolucji 1905 r. 41/43 Str.

REVIEWER
Sławomir J. Bukowski

TYPESETTING
Tadeusz Wejchert

COVER DESIGN
Barbara Grzejszczak

First Edition. W.06376.13.0.K

Łódź University Press
90-131 Łódź, Lindleya 8
www.wydawnictwo.uni.lodz.pl
e-mail: ksiegarnia@uni.lodz.pl
phone (42) 665 58 63, faks (42) 665 58 62

ISBN (wersja drukowana) 978-83-7525-976-6
ISBN (ebook) 978-83-7969-176-0

Table of Contents

Piotr Urbanek[*]

INTRODUCTION

CORPORATE GOVERNANCE IN THE BANKING SECTOR: LESSONS FROM THE FINANCIAL CRISIS

The financial crisis, symbolized by the collapse of the Lehman Brothers Bank, once again gave rise to discussion about the standards of corporate governance. This has been explicitly included in the preamble to the Shareholder Bill of Rights Act of 2009, adopted by the United States Senate, which states, *inter alia*, that: "... among the central causes of the financial and economic crises that the United States faces today has been a widespread failure of corporate governance." [The Library of Congress, 2009]. Hawley et al. [2011, p.3] support such opinion arguing that "…the current financial crisis has, as a part of its origins, a variety of corporate governance failures".

However, it seems that such a categorical assessment of the causes of the current crisis is debatable. There are several threads in the current debate on the subject. First, it is emphasized that in the early twenty-first century, in response to pathological practices and corporate crimes occurring in major U.S. and European corporations, major reforms of corporate governance have been undertaken. Among the areas of corporate governance in which far-reaching changes have been introduced one finds: the standards of financial reporting and financial audit, remuneration policy for corporate management, principles for the functioning of company boards, the requirements for high transparency, better protection of the rights of minority shareholders, the guidelines for institutional investors, the new regulations relating to the corporate market control, and many others. These changes have created a solid foundation which has significantly raised the quality of intra-corporate relationships and improved the functioning of the external market governance mechanisms. Such corporate governance reforms have fostered attitudes towards enhancing accountability and responsibility. In this context, the implementation of existing standards may be the most important issue of the efficiency of corporate governance.

[*] University of Lodz

There are also opinions that the new standards and institutions of corporate governance developed in this period have proved ineffective in face of the threats that have emerged in the financial services sector. They ask: Why have financial institutions turned out to be resistant to the new regulations of corporate governance? How did it happen that, in light of the financial crisis, banks have been involved as both actors and victims? Why some financial institutions have been deeply affected by the crisis while others have not? The reforms of early in this century were based on the assumption that the new mechanisms of governance should be versatile enough that their application should extend to all corporations, regardless of their specific characteristics and the sector in which they operate. The crisis has shown that they are not suitable for the control and monitoring of the new business model of banks, where risk management and corporate governance are becoming key factors and governance efficiency should be assessed to a greater extent from the perspective of the financial stability of the sector as a whole than from the perspective of the efficiency of the institutions within the sector.

There are also more radical views [Sun et al. 2011, p.4]. The proponents of this approach believe that the weaknesses of corporate governance lie not only in the fact that existing effective standards are not properly implemented and are not adapted to the sector's specificity, but that the current financial crisis and the failure of corporate governance prove a fundamental systemic failure of the paradigms of the invisible hand of market and of the visible hand of management. If this statement is correct, one should restore some basic foundations of market economy, such as shareholder primacy, profit maximization, rational self-interests of human behaviour, efficient markets for corporate control, etc.

In our opinion the second view in the above debate is the most reasonable. New standards of corporate governance have effectively reduced inefficient business practices occurring earlier in the largest corporations. At the same time, one can point to several factors that have hindered or prevented their implementation in the financial sector institutions. An important cause of dysfunction of governance has been the lack of precision of many standards, which made it possible for the financial institutions to interpret them too broadly. Often, the use of the standards was only of a purely formal nature and lacked the methods to assess their actual implementation. The responsibility of the institutions supervising and monitoring the financial markets with respect to their implementation of the standards has not been specified. In many countries, the new standards of corporate governance have not taken the form of normative acts, mandatory for all entities, but rather the form of recommendations of international institutions and sectoral regulations - codes of good practice - applicable only to public companies. Above all, there were no provisions designed specifically for the financial sector, especially for banks, i.e. no provisions which would take into account the specific nature of corporate governance in the banking sector.

This was the result of many factors: systemic risk, the scale and nature of operations, relationships between entities in the banking sector, innovative financial instruments, the complex ownership and control structure in large financial groups, and rapid changes in the business models of financial institutions. The "agency problem" found in private corporations concerns, in the case of banks, the specific relationships and conflicts of interest between shareholders and depositors. This creates an additional dimension when compared to other corporations, because banks are institutions of public trust. The relationship between the entities of the financial sector and the complex ownership and control structures in large financial groups increase the systemic risk associated with the operations carried out in the banking sector. One consequence is that the market mechanism of corporate governance, involving the removal of inefficient entities by the mechanism of mergers, acquisitions, and bankruptcies, is less effective in the case of large financial institutions. Another distinguishing feature of governance in the banking sector is the duality of the roles of banks, which may at same time be shareholders and lenders for the same entities. This can lead to a situation where the interests of banks, as lenders, are contrary to the interests of other shareholders and companies. The specificity of corporate governance in banks is also conditioned by the very nature of the banking business. This is reflected in the components, structure, and risk of banks' assets, as well as in the sources of their funding.

One can identify many areas of banks' operations in which gaps in the procedures of corporate governance became particularly evident. These include: remuneration policy for managers, supervision performed by the boards of banks, passive shareholders, and the activities of credit rating agencies. There are relationships between these areas, but the dysfunctionalities associated with risk management constitute the most important bond that unites them. Risk management in banks determines their economic results and their chances for commercial survival and development.

The key issues include constant identification, assessment, measurement, and monitoring of risks. Risk management is so important in managing banks that the solution to this problem cannot be limited to the internal bank procedures that make up the internal mechanism of corporate governance. Legal and environmental standards, set by international institutions supervising the financial sector and by national regulators, should constitute a complementary mechanism supporting the risk management process.

The book you are holding in your hands can be regarded as a voice in the debate about the search for effective standards of corporate governance in the banking sector. Its dominant theme is the current financial crisis, presented primarily from the perspective of developments in the financial markets and the consequent implications for efforts to reform corporate governance mechanisms. Particular attention is devoted to the analysis of corporate governance in the Polish banking sector, which was among the least affected by the global financial crisis. The financial stability of Polish banks was not threatened and direct intervention by the state was not necessary. There was no loss of confidence in the financial market, which could have resulted in liquidity problems. This relatively good situation of the Polish banking sector raises the natural question about the causes which led to its position. If one of the main causes of the current crisis was banks' failure to comply with the principles of corporate governance, it seems interesting to assess the quality of supervisory procedures applied by Polish banks.

The book consists of nine chapters. In the first chapter Cz. Mesjasz and W. Rogowski define the concept of financial stability in terms of key research issues in the book. As they point out "... it is commonly agreed that relatively unambiguous and precise definitions and interpretations of the concept of financial stability have not been elaborated yet ...". And further that "It may be treated as a paradox that so many institutions and people emphasize the significance of the term, which is so poorly defined ...". The authors do not usurp the right to effectively fill in this research gap. At the same time they conclude that "…the definitions (of financial stability) can be decomposed into dimensions reflecting characteristics of the markets and criteria of their assessment, characteristics of the institutions and criteria of their assessment, and relations between the markets and the institutions – norms and activities…". Such an approach can significantly facilitate the examination of the relationships between different concepts of financial stability and corporate governance.

A new regulatory tool, which is beginning to play an important role as a factor stabilizing the financial system, is so-called 'soft law', i.e. codes of good practice. E. Klepczarek indicates in her article that soft law instruments are commonly used in business practice and have a significant impact on the functioning of entities in the financial system. Codes of good practice contribute to systematizing, organizing and clarifying requirements in terms of ethics, enhancing mutual trust between market participants. In this way they enforce the use of higher standards in services rendered by the banks. In addition to the many advantages of this regulatory solution, her article also highlights the risks involved with it, including in particular the use of them as a purely an image-building move rather than a real attempt to implement pro-consumer attitudes.

The systemic failure in the supervision of banks, exposed by the current financial crisis and ensuing attempts to reform the system, form the subject of M. Marcinkowska's considerations in the chapter on the new corporate governance in banking. She adopts the thesis that "... the financial system is as strong as its governance practices, the financial stability of its institutions, and the effectiveness of its market infrastructure. The creation and application of good governance practices is the joint responsibility of market regulators and market participants…" This indicates that the core elements of an improved, stable and responsible financial system should include an effective regulatory regime, which must be supported by high management standards and values as a part of banks' corporate culture.

This research topic is continued by K. Misiołek in the subsequent paper. He examines corporate governance in banks from two perspectives. First, banks are public institutions which require effective legal, institutional, and customary foundations. But modern banks also take into account in their actions the social and financial models of corporate operations. These models must be followed by proper organizational structures and procedures, supported by an adequate corporate culture ensuring appropriate standards and by incentives for professional and responsible conduct, which is essential for good governance.

Executive compensation policy in the financial sector institutions is often regarded as one of the key factors that led to the current financial crisis. The systemic dysfunctions in financial corporations revealed by the current financial crisis have shown the need for far-reaching reforms. In the subsequent chapter of this monograph, A. Słomka-Gołębiowska compares recent recommendations of international organizations to regulate executive pay in the financial services industry with legal initiatives introduced in Poland. In the second part of her article she assesses whether the new legal rules have a significant impact on the structure of the executive compensation in Polish public banks.

The independence of supervisory board members is an institutional solution which significantly affects the executive compensation policy in banks. The obligation to appoint such persons to serve on the board results from, among others, codes of good practice. A. Wieczorek analyzes the extent to which the banking companies listed on the Warsaw Stock Exchange (WSE) observe the regulations concerning the appointment of independent supervisory board members. She also tries to determine whether the independent board members are appropriately educated and have the proper qualifications to perform their tasks on supervisory boards.

There are two key features of the Polish banking sector. First, ownership and control of banks in Poland are very concentrated, and second, most banks are controlled by foreign strategic investors which are owned by global financial groups. K. Postrach raises the question, formulated in the next paper, whether the current ownership structure of banks operating in Poland is beneficial for the Polish economy and whether there is an alternative solution to this situation. He concludes that, "…it would be advisable to request relevant institutions (the Polish Financial Supervision Authority, the National Bank of Poland, and the government) to increase the share of locally controlled banks in the assets of the Polish banking sector. This process can be described as the domestication of banks."

One of the major causes of bankruptcies is dysfunctions in ownership supervision, including insufficient use of an early warning system. Business practice provides a lot of evidence in this regard, but the latest international financial crisis is a real laboratory, full of examples of the lack of such supervision. P. Masiukiewicz indicates in his article that receivership management is an effective legal and managerial tool for the rehabilitation of banks, but regulations in this field are insufficient in Poland.

The last chapter of the book presents the main bank system, which determines relationships in the process of corporate governance between companies and institutions in the financial sector in Japan. M. Jerzemowska in her article points to the origins and main characteristics of this specific institutional arrangement, which differs substantially from the Anglo-American model. The confrontation of these two different models of corporate governance does not lead to a clear-cut assessment concerning which of them ensures better efficiency of corporate governance.

The book that we would like to recommend to you refers to current developments observed in both the Polish and global economy. It is one of the first titles on the Polish market dedicated to assessment of the role of mechanisms of corporate governance in the banking sector. These developments increase the need for reliable, systematic knowledge on the subject. We hope that the articles in this book illustrate, in an original way, many of these developments. Where it was not possible to formulate clear assessments and answers, the threads elaborated in this book may be a valuable contribution to further in-depth discussion between academia and business.

References

1. Hawley, J.P., Kamath, S.J., and Williams, T. 2011, *Corporate Governance Failures. The Role of Institutional Investors in the Global Financial Crisis,* University of Pennsylvania Press, Philadelphia.
2. Sun, W. Steward, J. , and Pollard D. 2011. *Corporate Governance and the Global Financial Crisis. International Perspectives,* University Cambridge Press.
3. The Library of Congress 2009. *Shareholder Bill of Rights Act of 2009*, S. 1074.

Czesław Mesjasz[*],
Wojciech Rogowski[**]

CHAPTER 1

DEFINITIONS OF FINANCIAL STABILITY

"Stability, that much overburdened word with unstabilized definition"[1]

Introduction

Any survey of the literature in finance and banking leads to a conclusion that a state of affairs described as "financial stability" is undoubtedly an important idea for the theory and practice in those areas. At the same time, it is commonly agreed that relatively unambiguous and precise definitions and interpretations of the concept of financial stability have not been elaborated yet.

It may be argued that, with a few exceptions, the works by F. Mishkin [1991, 1999], and first and foremost, Schinasi [2004], plus several more recent works by M. Čihák et al. [2006, 2012], those who discuss financial stability do not have any clear vision what that term may mean. The utterance "financial stability" is usually applied as an interpretation of some results in purely "technical" considerations, when the term "risk" alone seems to be irrelevant or not too fashionable [Beck, 1999; Luhmann, 1991][2]. At the same time financial stability is applied as a kind of "mantra" or "trendy buzzword" in the language of grand theories and in policy making. It may be treated as a paradox that so many institutions and people emphasize significance of the term, which is so poorly defined.

This observation can be strengthened by the fact that in majority of considerations on financial stability no links are made to the meaning of such ideas as equilibrium and stability in economics, and in finance, not mentioning systems thinking. In addition, such issues as predictability/prediction and possible control

* University of Economics, Cracow, Poland.
**Economic Institute of National Bank of Poland, Warsaw School of Economics, Warsaw, Poland, Allerhand Institute, Cracow, Poland.

[1] See: Bellman [1953]; Ashby [1963, p.73].

[2] Applications of the term "risk" in the "Risk Society" require separate considerations due to multitude of its interpretations, also in quantitative formal considerations.

of financial systems/markets/phenomena are absent in most of the works in which the notion "financial stability" is referred to.

The explanation of such a situation is stemming from the fact that the term financial stability should be treated as metaphor and/or analogy. Knowing the patterns how the meaning of the metaphor of financial stability is "emerging" in economic discourse, it should be possible to make an attempt to define it in a way which could be helpful both for possible further operationalizations and for more precise interpretations in theory and in policy making.

Applications of analogies and metaphors taken from physics, natural sciences and engineering have been an important factor in development of social sciences and economics. First and foremost, they are used to describe phenomena in one area with concepts drawn from another discipline e.g. the equilibrium of various physical systems – mechanic, thermodynamic, serving as a foundation of the concept of economic equilibrium. If they are employed as a tool for analysis, i.e. to describe causal relationships, predictions, or as predictive or normative categories, they always have to be defined in a more precise way than it is required for descriptive purposes. The importance of this challenge becomes even more vital when such concepts enter the language of policy making.

The disagreement and the absence of precision in defining may lead to the situation that the term "financial stability" becomes a carrier of many positive and, at the same time, declarative features of finance at national and international level, but with a very low cognitive value translating into a limited applicability. Considering the above, the concept of financial stability gains a very positive connotation, although it may have different meaning for theorists and for practitioners in day-to-day practice. This may cause the distortions in the communication processes between the various institutions investigating the problem area. Furthermore, it may restrict the usefulness of the term "financial stability", if not undermining the very reasons for its use in theory and policy making. .

The aim of the paper is to elaborate a preliminary survey of definitions and interpretations of financial stability. It may be asserted that it will never be possible to elaborate more precise explicit, "working" definitions of "financial stability". Perhaps some operationalizations can be achievable. Instead, it is only possible to make an inventory of applications and interpretations of the term financial stability in the language of theory and policy making in finance at the macroeconomic level. Having such an inventory it will be possible to elaborate a typology of interpretations of financial stability and study in depth the diverse meanings of that utterance.

1. Stability in economics and social sciences

1.1. Stability in systems thinking

The concepts of equilibrium and stability were introduced firstly in mathematics and later were transferred to other areas – physics, biology, automatic control, etc. Subsequently, they have also become the key concepts of economics and social sciences. As to achieve the broadest possible scope of the applications of the concepts of equilibrium and stability, a reference to systems thinking can be proposed[3].

It must be also underlined that the concepts taken from systems thinking can be used in economics and in social sciences either as mathematical models of different scope of relevance to the real situation or as metaphors and/or analogies.

The concept of stability is always analyzed in reference to an idea of equilibrium. In traditional systems thinking based upon first order cybernetics and/or theory of automatic control systems only the stable equilibria are predominantly valuable subject of investigation.

Mirroring the aforementioned areas of existence of equilibrium, in the discussion on system stability two important issues have to be distinguished:

- stability of equilibrium (equilibria),
- stability of the system treated as an entity.

The origins of discussion on stability in systems thinking can be traced in the works of Bellman whose concepts, developing the ideas of Lyapunov and Poincare proved applicable in mathematical modelling of automatic control systems [Bellman, 1953]. In cybernetics stability is regarded as positive state even as an increased plausibility of survival, although with some exceptions [Ashby, 1963, p. 81]. Methods used to analyse stability are based upon differential equations and difference equations, depending whether the phenomena are of continuous or discrete character.

It can be thus summarized that in any definitions of stability relating to a system understood as a "set of elements standing in interaction" the following issues should be taken into account:

1. System identified by an observer described with a set of characteristics (parameters).
2. Patterns of macro- and microscopic of dynamics of the systems described with the use of the characteristics.
3. Influence of the dynamics of the parameters upon the entire system.

[3] Broadly defined system thinking includes also cybernetics and complex systems studies. Relations between systems thinking and cybernetics were discussed in Mesjasz [1988]; Mesjasz [2010].

4. States of equilibrium for the parameters
5. Mechanisms (internal or external) of restoring equilibrium, i.e. mechanisms of achieving stability of parameters.
6. Relation between stability of parameters and of the entire system.

It is obvious that the links between stability of characteristics and stability of entire system may have a very complex character. However, in some cases a limited set of parameters and sometimes even a single representative parameter, which permit to describe macroscopic dynamics of entire system, e.g. entropy in thermodynamics.

1.2. Stability in economics

The term stability used in social sciences and in economics, including obviously financial stability, is applied either as a metaphor, metonymy, simile or analogy. In order to simplify the considerations it can be assumed that stability can be treated as a metaphor and other forms of transfer of meaning should be also considered in some cases[4.] Therefore it can be viewed as an idea brought to social sciences and economics from natural sciences, predominantly from physics. Such a phenomenon is not rare in history in economic thought [Mirowski, 1989; Mirowski, 1994].

Metaphors in social sciences can be used for the following approaches: descriptive, explanatory, predictive, normative, prescriptive, regulatory, retrospective, retrodictive. The notion stability can be associated with mathematics and physics, or in a somehow broader sense, with systems thinking, systems approach, whatever we may call it. It can be also easily traced in history of economic thought that analogies and metaphors taken from "science" (systems thinking) acquire a specific normative sense. Due to their origins in „rationalist" disciplines - mathematics, physics, chemistry and biology they are treated as objective and scientific in a rationalist sense. Thus their applications, in addition to enhanced explanative validity, by definition obtain supplemental, „sound", normative - predictive and prescriptive, legitimacy in any debate on social issues. Consequently, in those applications, but not only, their metaphoric sense is neglected or misinterpreted.

There are also other kinds of stability applicable in economics. In addition to structural stability, the divide between static and dynamic stability should be mentioned. Static stability indicates whether the economic forces that exert an impact on the system tend to make it move towards the equilibrium point, but does not explain the actual path of the system nor whether the system converges over time to

---

[4] Metaphors are widely discussed in: Ortony [1979]; Tsoukas [1991]; Lakoff and Johnson [1995]; Morgan [1998].

the equilibrium point. The dynamic stability, based on functional analysis is more relevant to economic problems. In economic studies an already mentioned idea of orbitally stable behavior of the systems with periodic motion can be applied. Other types of stability useful in economic studies are distinguished according to the methods of its analysis - local and global stability study as well as “built-in” and “superimposed” dynamic stability analysis [Eatwell et al., 1987, p. 462].

Looking from the point of view systems thinking it may be stated that economic systems (organizations) can also behave in a way which could be captured with already mentioned idea of ultrastability. In such case in modern writings in economics and management an idea of learning organization (system) can be applied.

The cybernetical interpretation of stability has an impact on the new institutionalist economics, where stability is thematized as the stability of institutional arrangements. As D. North puts it: “A basic function of institutions is to provide stability and continuity by dampening the effects of relative price changes” [North, 1997]. Such an approach creates additional challenge since institutions are also changeable so the universal value is undermined. The concept of stability in stability policy opens the possibility for measuring instability as the deviation from goals and targets.

Even this superficial survey shows that stability in economics cannot be interpreted unequivocally. The difficulties are rooted in discrepancies in defining equilibrium in economics, and subsequently, are also resulting from differing interpretations of stability.

Preliminary assertions of stability expose its positive interpretations, similarly as in other areas of systems thinking, including social sciences. Similarly as in general considerations, stability understood as a tendency or at least expression of a tendency to remain in a steady state, cannot be treated in economics as an absolute positive and desirable state of affairs.

2. Origins of the concept of financial stability

Although it is commonly agreed that there is not any more or less specific definition of financial stability, yet many theoreticians and policy makers claim that this concept reflects a desired status of different kinds of financial systems. The search for origins of the term financial stability shows that it was emerging in policy considerations and in academic research as a consequence of disturbances of the financial markets. The results of an „archeological” search for the first applications of the concept of financial stability are of a very preliminary character.

Further inquiry should prove helpful in finding the first ideas of financial stability, the sources of their inspirations and their applications.

It is not simple to identify the author(s) or institution(s), who first made attempts to elaborate a definition of financial stability. Usually this idea is associated with the 19th Century origins of the concept of the Lender of Last Resort (LOLR) put before by H. Thornton [1939] and W. Bagehot [1962]. In several writings on financial stability, a kind of "homely" definition of a financial crisis for the UK by W. Bagehot is quoted. This was that you have a financial crisis "when the Bank of England is the only institution in which people have confidence".

The term "financial stability" was introduced as an opposition to the concept of financial instability proposed by H. Minsky who treated instability as an equivalent of financial crisis [Minsky, 1977].

Results of a not yet too systematic search for the initial applications of the notion "financial stability" show the first use of this term in a paper on bank holding by R. Holland. He uses the terms "stability of financial institutions" and "financial stability" yet without any explanations. He refers to financial stability as a positive aspect of activities of a bank holding company while instability is rather vaguely interpreted as a negative situation [Holland, 1975].

The definitions of financial stability became necessary in the late 1990s when institutional foundations for new regime in the world financial system were established. They were correlated with establishment of such institutions as the Financial Stability Forum and G-20 in 1999 [Porter, 1999].

The Financial Stability Forum was established by the G-7 in April 1999, after the Asian and Russian financial crises, to provide a means for cooperation in the supervision of financial markets among national governments, international financial authorities, regulatory groups, and other experts. The forum's membership includes central bank and treasury representatives and a financial services supervisor from each of the G-7 countries, a single representative of a few more economies, and representatives of several international financial institutions and of global standard setters for banking, securities, and insurance.

Another source of inspiration of the idea of financial stability can be associated with the financial instability hypothesis. It refers to an intrinsic predisposition of the credit-creating institutions, especially commercial banks and related lenders, to undergo periodic waves of crisis and bankruptcy. The hypothesis is most closely associated with the works of H. Minsky although the writings of some other authors, including even J. M. Keynes can also be associated with that concept [Newman et al., 2002, p. 75].

It may be even assumed that it was the financial instability hypothesis which became a source of inspiration for introduction of the term financial instability to other fields of theory and policy of finance and banking. Subsequently, a mirror "positive" idea of financial stability was promulgated and became one of the most important ideas of contemporary finance and banking.

3. A survey of definitions of financial stability

In spite of a large number of works on financial stability, the proposals of definitions are rather scarce and in most cases, rather superficial. They can be divided into the following groups:

- stability as the absence of instability and crisis,
- explicit and descriptive,
- stability of financial system,
- international financial stability,
- financial stability as a global public good.

3.1. Stability as the absence of instability and crisis

The "negative" definitions of financial stability are based on the assumption of the absence of crisis, or in a more scientific form, absence of instability. The "negative" definition has at least three advantages over other approaches.

Firstly, a tendency for simplifications can be found in theoretical considerations. M. Foot, the Honorary President of ACI United Kingdom (Association Cambiste Internationale) – The Financial Markets Association, has observed that the definitions referring to financial crises (the antithesis of financial stability), are not precise because most authors seem to assume that what constitutes a crisis is so obvious that it doesn't need definition [Foot, 2003].

Secondly, in more or less rigorous empirical studies it is also easier to study financial crises as symptoms of acute instability than a vaguely defined financial stability in various stages - from moderate instability to difficult to describe "ideal" state.

Thirdly, for some researchers and practitioners stability is associated with no volatility, while volatility cannot be always treated as a negative feature of financial markets. Crisis sometimes can be a source of opportunity, an inspiration for positive change.

As it was earlier mentioned in, the first "negative" definition of financial stability understood as opposite to instability is being assigned by contemporary writers to an idea by Walter Bagehot describing the critical situation in Britain in the 19th Century. Other definitions began to appear in the 1990s in response to demands of the financial crises and as a foundation for preventive and corrective activities of various financial and non-financial institutions.

Roger W. Ferguson, jr.

It seems useful at the outset to define financial stability and to do so by defining its opposite, financial instability. In my view, the most useful concept of financial instability for central banks and other authorities involves some notion of market failure or externalities that can potentially impinge on real economic activity. Economic research in recent years has identified a variety of market imperfections such as moral hazard and asymmetric information that, if widespread and significant, can result in threats to the functioning of any financial system, such as panics, bank runs, asset price bubbles, excessive leverage, and inadequate risk management.

…..I'll define financial instability as a situation characterized by these three basic criteria: (1) some important set of financial asset prices seem to have diverged sharply from fundamentals; and/or (2) market functioning and credit availability, domestically and perhaps internationally, have been significantly distorted; with the result that (3) aggregate spending deviates (or is likely to deviate) significantly, either above or below, from the economy's ability to produce [Ferguson, 2002].

Andrew Crockett

A.Crockett, General Manager of the BIS and Chairman of the Financial Stability Forum has proposed several interpretations of financial stability. The "negative" definitions goes as follows: "...define financial stability as an absence of instability...a situation in which economic performance is potentially impaired by fluctuations in the price of financial assets or by an inability of financial institutions to meet their contractual obligations. I would like to focus on four aspects of this definition. "Firstly, there should be real economic costs.... Secondly, it is the potential for damage rather than actual damage which matters.... Thirdly, my definition refers...not just to banks but to nonbanks, and to markets as well as to institutions.... Fourth, my definition allows me to address the question of whether banks are special...all institutions that have large exposures - all institutions that are largely interconnected whether or not they are themselves directly involved in the payments system—have the capacity, if they fail, to cause much widespread damage in the system" [Crockett, 1997a].

Another explicit definition of financial stability relating to financial institutions and markets proposed by A. Crockett and used in his subsequent texts [Crockett, 1997b, pp. 8-10]: "A distinction is commonly made between monetary stability and financial stability. …Monetary stability refers to stability of general price level; financial stability, to the stability of the key financial institutions and markets that go up to make up the financial system. While these are conceptually separate objectives of policy, the linkages between the two are now increasingly recognized…..I will take financial stability to apply to both institutions and markets. In other words, stability requires (1) that the key *institutions* in the financial system are stable, in that there is a high degree of confidence that they continue to meet their contractual obligations without interruption or outside assistance; and (2) that the key *markets* are stable, in that participants can confidently transact in them at process that reflect fundamental forces and that do not vary substantially over short periods when there have been no changes in fundamentals.

This does not, however, provide a full definition. Which are the "key institutions" whose stability is important? And what is the degree of price stability in financial markets that is required?

Stability in financial institutions means the absence of stresses that have the potential to cause measurable economic harm beyond a strictly limited group of customers and counterparts….Similarly, stability in financial markets means the absence of price movements that cause economic damage. Prices can and should move to reflect changes in economic fundamentals. It is only when prices in financial markets move by amounts that are much greater than can be accounted for the fundamentals, and do so in a way that damaging economic consequences, that one is justified in talking about "instability" or "crisis" in the financial system.

3.2. Explicit definitions

Age Bakker

In a broad sense, financial stability may be considered as a situation in which the financial sector is able to mobilize savings and allocate funds efficiently and to absorb shocks without major damage to the real economy or other parts of the financial system. Financial stability can be distinguished in the concepts of micro stability, which involves the health of individual financial institutions, and macro stability, which focuses on the health of the financial system as a whole, including the interrelationship between financial institutions, payment and settlement systems and financial markets. The costs of financial instability can be high, especially in emerging markets, where financial buffers to absorb shocks are much smaller [Bakker, 2003].

Wim Duisenberg

"...monetary stability is defined as stability in the general level of prices, or as an absence of inflation or deflation. Financial stability does not have as easy or universally accepted definition. Nevertheless, there seems to be a broad consensus that financial stability refers to the smooth functioning of the key elements that make up the financial system" [Duisenberg, 2001].

Michael Foot

"To progress, we need a definition of financial stability. Let me offer one, which is that we have financial stability where there is: (a) monetary stability defined as *stability of the value of money (of course not identical with a constant value of money) (*b) employment levels close to the economy's natural rate, (c) confidence in the operation of the generality of key financial institutions and markets in the economy, and d) where there are no relative price movements of either real or financial assets within the economy that will undermine (a) or (b).

The first three elements of this definition are, I hope, non-contentious. In respect of (a) and (b), it seems implausible to define financial stability as occurring in a period of rapid inflation, or in a mid-1930s style period of low inflation but high unemployment" [Foot, 2003].

3.3. Descriptive definitions

To this group the definitions not referring directly to the term financial stability can be included. In several writings and speeches the authors either consider financial stability as a commonly well-known idea or try to enumerate risks, threats, determinants, assumptions, and other characteristics of financial stability.

Jean-Claude Trichet

J.-C. Trichet defined three main challenges for maintaining financial stability [Trichet, 2003]. The challenges are stemming from the fact that the „real world" deviates from the „frictionless" ideal world of academic textbooks due to market imperfections.

1. **Imperfect information.** When information is not perfect – or when markets are not fully transparent – investors' decisions may be constantly subject to reassessment, which can lead to inevitable volatility in market prices. This does not necessarily mean that there is an inherent threat to financial stability. On the contrary, the very existence of some level of volatility indicates that

markets are serving the function they are supposed to deliver – that they are an efficient exchange mechanism among economic agents. Nevertheless, some recent episodes of extreme volatility have drawn our attention to more accurately delineating the boundary between „normal" and what could be called „harmful" volatility.

2. **Complete market. N**ew risks are created as more rapidly evolving process of financial innovation, new instruments – and often entirely new markets – are being created, taking us towards more complete markets and providing remedies for the shortcomings of more traditional instruments and markets. While this process clearly increases the efficiency of the financial system, some new risks may also be created along the way. A major recent example is the emergence of instruments to transfer credit risks between banks and other financial institutions. This is changing the activities and risk profiles of financial institutions, as previously credit risks were largely confined to banks
3. **Absence of an international framework for crisis prevention and resolution**. The financial systems inevitably become more integrated, risks stemming from the potential lack of a common framework increase accordingly. Substantial coordination efforts are being made by the international community to overcome this friction.

Financial Stability Forum/Financial Stability Board

Another example of typically enumerative approach to financial stability has been proposed by the Financial Stability Forum. The 12 standard areas have been designated by the FSF as key for sound financial systems and deserving of priority implementation depending on country circumstances. While the key standards vary in terms of their degree of international endorsement, they are broadly accepted as representing minimum requirements for good practice. Some of the key standards are relevant for more than one policy area, e.g. sections of the Code of Good Practices on Transparency in Monetary and Financial Policies have relevance for aspects of payment and settlement as well as financial regulation and supervision [FSB].

3.4.Stability of financial system

Although in some definitions financial stability is treated as an attribute of financial system or monetary system but only in a few definitions the authors make a direct reference to financial system.

Tommaso Padoa-Schioppa

T. Padoa-Schioppa, presented a definition referring to financial system which is accepted by the ECB: …a condition where the financial system is able to withstand shocks without giving way to cumulative processes, which impair the allocation of savings to investment opportunities and the processing of payments in the economy. The definition immediately raises the related question of defining the financial system...which consists of all financial intermediaries, organized and informal markets, payments and settlement circuits, technical infrastructures supporting financial activity, legal and regulatory provisions, and supervisory agencies. This definition permits a complete view of the ways in which savings are channeled towards investment opportunities, information is disseminated and processed, risk is shared among economic agents, and payments are facilitated across the economy. …we do not define financial stability as explicitly referring to banking stability only but it does not contradict the argument that banks play a crucial role in a soundness of the financial sector" [Padoa-Schioppa, 2003].

Nout Wellink

"According to our own definition at the Nederlandsche Bank, a stable financial system is capable of efficiently allocating resources and absorbing shocks, preventing these from having a disruptive effect on the real economy or on other financial systems. Also, the system itself should not be a source of shocks. Our definition thus implies that that money can properly carry out its functions as a means of payment and as a unit of account, while the financial system as a whole can adequately perform its role of mobilizing savings, diversifying risks, and allocating resources. Financial stability is a vital condition for economic growth, as most transactions in the real economy are settled through the financial system. The importance of financial stability is perhaps most visible in situations of financial instability. For example, banks may be reluctant to finance profitable projects, asset prices may deviate excessively from their underlying intrinsic values, or payments may not be settled in time. In extreme cases, financial instability may even lead to bank runs, hyperinflation, or a stock market crash" [Wellink, 2002].

3.5. International financial stability

Most of definitions concern financial stability (stability of financial systems) within a borders of a country. In some instances, the stability extends beyond the borders and becomes and attribute of finance in a region or a facet of the financial system worldwide.

From several examples, the following definitions reflect the directions of studies on international financial stability.

Richard Portes

When considering the role of the EMU in strengthening “international financial stability” the author uses this notion in a very broad sense as absence of a situation when domestic financial crises (instabilities) spread through the world financial system. Occurrence of debt crisis in the 1980s, the Asian crisis in 1990s and then the twin or even triple crises in emerging markets involving exchange-market disturbances, threats to banking systems and sometimes sovereign debt default. According to R. Portes prevention of such crises should be shared both by international financial institutions and by the countries assuring safe flow of capitals worldwide [Portes, 2001].

3.6. Financial stability as a global public good

Together with other factors contributing to undisturbed functioning of financial systems financial stability is regarded as a specific public good. In consequence of spread of financial crises, international financial stability is viewed as a global public good which can be defined as an extension of the concept of public goods to involve more than one nation or country, socio-economic groups, or generations. This idea is promoted by the UNDP (UN).

Since there is no global government that can provide the global public good hence global cooperation becomes essential. Within that approach global financial stability is treated as opposite to crises and instability. Financial crises and the excessive financial volatility they entail constitute a global public bad.

Financial stability is considered as linked with market efficiency. The GPG (global public good) “financial stability and market efficiency” will only emerge, if all building blocks are in place - its national, regional, and global elements as well as required public and private contributions. Achieving the global public good (GPG) “financial stability and market efficiency” requires the following measures [Kaul et al., 2003]:

- to root the design of international cooperation in national policy goals and conditions and to look at GPGs as public goods that now require international cooperation but still ought to have positive utility for all nationally,
- to encourage broader participation in international financial policy-making as a means to reduce collective-action and information as well as burden-sharing problems,

- to engage more actively the epistemic community in exploring possible production paths of the “financial stability and market efficiency”, notably the complementarities between national, regional and international-level measures,
- to finance needed capacity building in developing countries out of the seigniorage earned by the central banks of industrial countries - as an integral part of their efforts to provide sound money.

Activities aiming at strengthening international financial stability are also undertaken by the Financial Stability Forum, G-20, BIS, the G-7 (G-8) and the IMF not always with a direct reference to a public global good [Portes, 2001; Koehler, 2001].

4. Definitions of financial stability by F. Mishkin and G. Schinasi

The above general definitions have predominantly a descriptive and/or enumerative character. Their authors tend to single out the features of financial stability and/or of financial systems without any reference to systemic mechanisms and/or economic theory. Only an introductory reference to mechanisms underneath financial systems stability is provided by T. Padoa-Schioppa [2003]. Other proposals of definitions can be treated as a kind of introductory institutional description.

One of the most influential writers in finance and banking made a link between financial instability and negative increasing consequences of asymmetric information. The assumption of the definition is that the institutional structure of financial markets has evolved to reduce the consequences of asymmetric information ex ante – adverse selection and ex post – moral hazard. According to his definition, financial instability “…occurs when shocks to the financial system interfere with information flow so that the financial system can no longer do its job of channeling funds to those with productive investment opportunities” [Mishkin, 1999].

Four categories of factors lead to increases in asymmetric information problems and financial instability: deterioration of financial sector balance sheets, deterioration of balance sheets due to asset price changes, increases in interest rates and increases in uncertainty.

The main advantage of Mishkin’s “negative definition” is that although it refers to financial instability yet at least some attributes of financial crises are defined. These attributes can be then linked with “sound” economic theory – what the author is perfectly aware of, and they can be also explained with the conceptual apparatus of control theory, or in a broader sense, with systems thinking. The latter is not spelled out openly but the author.

All of the above four groups of factors can be also explained in terms of control, stability, equilibrium and disequilibrium taken from systems thinking, both based upon the first-order cybernetics and based upon the second-order cybernetics. The ideas referring to second order cybernetics, for example the role of observer and the learning process, can be easily associated with asymmetric information. Presence of perfect information allows for applications of external (mechanistic) metaphors. Such an approach is used in mechanistic models of markets.

The most comprehensive attempt to elaborate an explicit and comprehensive definition of financial stability was made by G. Schinasi of the International Monetary Fund [Schinasi, 2004; 2006]. This definition is based upon five principles which, in order to provide material for further discussion, are quoted almost in extenso.

The first principle is that financial stability is a broad concept, encompassing the different aspects of finance (and the financial system)—infrastructure, institutions, and markets. Both private and public persons participate in markets and in vital components of the financial infrastructure (including the legal system and official frameworks for financial regulation, supervision, and surveillance). Accordingly, the term "financial system" can be seen as encompassing both the monetary system with its official understandings, agreements, conventions, and institutions as well as the processes, institutions, and conventions of private financial activities.

Given the close interlinkages between all of these components of the financial system, (expectations of) disturbances in any of the individual components can undermine the overall stability, requiring a systemic perspective. At any given time, stability or instability could be the result of either private institutions and actions, or official institutions and actions, or both simultaneously and/or iteratively.

The second principle is that financial stability not only implies that finance adequately fulfills its role in allocating resources and risks, mobilizing savings, and facilitating wealth accumulation, development, and growth; it should also imply that the systems of payment throughout the economy function smoothly (across official and private, retail and wholesale, and formal and informal payments mechanisms). In other words, financial stability and what is usually regarded as a vital part of monetary stability overlap to a large extent.

The third principle is that the concept of financial stability relates not only to the absence of actual financial crises but also to the ability of the financial system to limit, contain, and deal with the emergence of imbalances before they constitute a threat to itself or economic processes. In a well-functioning and stable financial system, this occurs in part through self-corrective, market-disciplining mechanisms that create resilience and prevent problems from festering and growing into system-wide risks. In this respect, there may be a policy-related trade-off entailing the choice between allowing market mechanisms to work to resolve potential difficulties and intervening quickly and effectively—through liquidity injections via markets, for example—to restore risk-taking and/or to restore stability. Thus, financial stability entails both preventive and remedial dimensions.

The fourth principle is that financial stability be couched in terms of the potential consequences for the real economy. Disturbances in financial markets or at individual financial institutions need not be considered threats to financial stability if they are not expected to damage economic activity at large. In fact, the incidental closing of a financial institution, a rise in asset-price volatility, and sharp and even turbulent corrections in financial markets may be the result of competitive forces, the efficient incorporation of new information, and the economic system's self-correcting and self-disciplining mechanisms. By implication, in the absence of contagion and the high likelihood of systemic effects, such developments may be viewed as welcome—if not healthy—from a financial stability perspective.

The fifth principle is that financial stability be thought of as occurring along a continuum. An example that is more transparent is the health of an organism, which also occurs along a continuum.

A definition consistent with this broad view is as follows [Schinasi, 2004]: "A financial system is in a range of stability whenever it is capable of facilitating (rather than impeding) the performance of an economy, and of dissipating financial imbalances that arise endogenously or as a result of significant adverse and unanticipated events". The Schinasi's definition exposes the following features of financial stability:

- range of stability and continuum occurring across a multitude of observable and measurable variables – an analogy with health,
- multidimensional character,
- a broader approach than, as Schinasi calls that, Newtonian concepts of equilibrium and stability in some disciplines (including economics),
- financial system being in a perpetual state of flux and transformation while its ability to perform its key functions remains well within a set of tolerable boundaries—defined over a set of measurable variables,
- the proposed definition leaves open the possibility that the financial system could become capable of impeding the performance of the economy endogenously, even in the absence of unanticipated events (shocks), for example through the accumulation of imbalances caused by asset mispricing and/or other market "imperfections",

- developments in financial stability cannot be summarized in a single quantitative indicator. In contrast with price stability, for instance, there is as yet no unequivocal unit of measurement for financial stability; this reflects the multifaceted nature of financial stability as it relates to both the stability and resilience of financial institutions, and to the smooth functioning of financial markets and settlement systems developments in financial stability are inherently difficult to forecast,
- developments in financial stability are only partly controllable. The policy instruments that can be used to safeguard financial stability generally have other primary objectives, such as protecting the interests of deposit holders (in the case of prudential instruments), fostering price stability (in the case of monetary policy), or promoting a swift settlement of financial transactions (in the case of policies governing payment and settlement systems).

A more general definition that does not require the specification of what constitutes a "financial system" is: "Financial stability is a condition in which an economy's mechanisms for pricing, allocating, and managing financial risks (credit, liquidity, counterparty, market, etc.) are functioning well enough to contribute to the performance of the economy (as defined above)".

The definition of G. Schinasi provides the most comprehensive picture of all the ideas associated with financial stability. Similarly as in the case of the definition by F. Mishkin, the author tries to associate the "positive" definition of financial stability with at least phenomenology of more rigorous theory of economics and finance.

It may be concluded that the definition by Schinasi, and to a lesser extent, the definition by Mishkin, open the way for the following interpretations:

- possible inclusion into the discourse on financial stability more rigorous theoretical models elaborated in the mainstream theories of economics and finance,
- applications of more advanced models of systems thinking; in the case of the definitions by Mishkin it is the concept of a learning organization (social system), while in the case of the definition by Schinasi the declaration of opposition to mechanistic ideas of stability provides an opportunity to apply models drawn from complex systems theory – non-linearity, complexity, complex adaptive systems and the like; such an approach also gives the way for extending the discussion on financial stability with the ideas relating to complex learning systems.

5. Limitations of the definitions of financial stability

Confrontation of the theoretical considerations drawn from systems thinking and economic theory, which relate to stability of systems with a survey of ideas relating to financial stability (stability of financial systems), allows to draw several conclusions which go deeper than usual enumeration of easily identifiable deficiencies of definitions of that concept.

As a point of departure a typology of functions of financial stability can be distinguished [Oosterloo and Haan, 2003]:

- the objective of maintaining financial stability,
- the assessment of risk to financial stability[5],
- the instruments that can be used in the case of a misalignment between the assessment and the objective,
- the decision-making process,
- the accountability of the institution that is responsible for maintaining financial stability.

The obstacles of accomplishing the above functions resulting from deficiencies in defining financial stability can be divided into three groups:

- epistemological limitations: omission of reference to the metaphorical sense of financial stability
- systemic aspects of stability, associated with theoretical and systemic meaning of the term, especially in relations to systems thinking and/or economic theory,
- limitations associated with definitions and functions of financial systems.

In most cases presented in the survey, the authors of definitions, and eventually their applications, use the term stability without a significant explanatory reference to existing body of knowledge in systems thinking and in economic theory. So far, the only exception are the ideas proposed by Schinasi and Mishkin.

In all proposals of definitions financial stability and/or stability of financial system is treated as a kind of "good thing" or equivalent to health as opposite to a "bad state" – crisis and/or instability. The metaphor of health of an organism is also used by Schinasi [2004, p. 7]. However, health in medicine cannot be precisely defined. It can be treated as a kind of objective described by a set of parameters. Using the same approach it would be then necessary to elaborate a set of characteristics of a stable financial system and relations among them.

---

[5] Here even the use of the term „risk" is narrowing the sense of phenomena threatening (undermining, disturbing, etc.,) financial stability and/or causing crisis/instability.

Additionally, again with an exception of the two aforementioned concepts, there are only a few references to the economic and financial theories of equilibrium and stability. Therefore it can be concluded that the source field of financial stability is not properly defined. It creates significant barriers to any efforts to define characteristics of financial stability. It may also hamper attempts of operationalization of the attributes of that term.

In the definition proposed by G. Schinasi [2004, p. 8] the classical source field of a metaphor of stability is rejected but not any constructive alternative is given: "As a continuum, financial stability can be seen practically as somewhat broader and less precise than the ability to return to a single and sustainable position or time path after a shock or perturbation, as with other (Newtonian) concepts of equilibrium and stability in some disciplines (including economics)".

A question should be then asked: If the source field for the metaphor of stability is so widely extended to almost its denial thus what is the rationale for using such a term? Instead, perhaps it would be more sensible to use the concepts of "health", "robustness", "risks" or the contrary "fragility".

Looking from a systemic point of view and from the point of view of economic theory, the existing definitions of stability, with an exception of the two aforementioned concepts, treat stability as a dormant metaphor. The meaning associated with a steady state is preserved in the term stability (stabilitas), so the metaphor cannot be treated as a dead metaphor. Such a status of the metaphor allows for various interpretations and undermines the communication process.

The systemic deficiencies of the definitions of financial stability are interrelated with the variety of specific definitions. There is nothing as a universal set of characteristics (dimensions) of financial stability (financial systems stability). As an attempt to provide such a universal set the 12 standard areas have been designated by the FSF as key for sound financial systems. They are so universal and incoherent, so they cannot be treated as more specific facets of financial stability (financial systems stability). They are a mixture of regulations, institutional arrangements and supplementary norms, e.g. Codes of Good Practices in Corporate Governance.

These deficiencies reflect only the obstacles in defining financial stability in terms of dimensions (attributes) of financial systems, financial markets and activities of institutions associated with and constituting them. This issue will also require further inquiry.

Multitude of definitions and applications of financial stability undoubtedly undermines it value as a vehicle of communication and policy making. The actors participating in the communication process bear in their mind different meanings and the process of exchange of those meanings is distorted substantially. This situation should be studied with the conceptual apparatus of theory of social communication. It can be only concluded that the rhetoric of financial stability both in theoretical discourse and in policy making is of a very limited efficiency.

Financial stability can be also viewed as a reflexive and at the same time a performative utterance ("act of speech") defined by J. Searle [1979]. As it was emphasized by S. Oosterloo and J. de Haan, the sheer fact of publication of "Reports on Financial Stability" or similar documents by central banks contributes to positive changes of phenomena captured in the meaning of the term financial stability [Oosterloo and Haan, 2003, pp. 18 - 19]. This result has been confirmed in a broad and systematic research done by a group of staff members of the IMF [Čihák, 2006; Čihák et al., 2012]. In other words, it may be stated that publications on financial stability contribute to its improvement.

Obviously one can hardly expect that specialists in finance and banking will begin to study linguistics as to understand better the sense of financial stability. However, since economics and finance can be viewed partly as a rhetoric science, and since a part of the difficulties with defining, studying and implementing measures leading to financial stability are resulting from the fact that many of the proponents of that idea are not aware of the limitations of that term, therefore this kind of reflection is also necessary in the further studies of financial stability [McCloskey, 1998].

Conclusions

The aim of the paper is to provide a preliminary answer to the following questions:

1. What are the theoretical and practical consequences of the absence of universally accepted definitions of financial stability?
2. What could be potential advantages to elaborate, if not a unique, so at least a limited number of widely accepted definitions of "financial stability" allowing to assess multiple aspects of functioning of various kinds of financial systems?
3. What should be the assumptions of such definitions?

The answer to the above question in the paper is positive and we formulate conditions determining the definition of financial stability as a normative concept of theory and policy making.

The main conclusions of the paper can be summarized as follows.

1. Any unique and universal definition of financial stability is obviously unachievable

2. Contemporary economic theory and systems thinking provide a sufficient conceptual apparatus allowing to elaborate “positive” explicit definitions of financial stability understood as an overall property of dynamics (change) of financial institutions and markets (systems) assessed as positive, according to commonly accepted universal criteria, as well as according to the criteria accepted by actors involved in shaping, maintaining and assessing that dynamics. The basic positive attributes of financial systems (institutions and markets) are: an enhanced possibility of prediction of phenomena adversely influencing that dynamics (risks) along with a capability to predict and eventually undertake/stimulate preventive/corrective/pre-emptive measures relating to those phenomena.
3. Due to the relations to dynamics and predictability the definitions can be specified and made relevant to the existing body of knowledge in theory of economics and finance. It especially concerns the ideas of stability and equilibrium used in economics and finance.
4. The definitions can be decomposed into dimensions reflecting characteristics of the markets and criteria of their assessment, characteristics of the institutions and criteria of their assessment and relations between the markets and the institutions – norms and activities.

References

1. Ashby, W. R. 1963. *An introduction to cybernetics*, Wiley, New York.
2. Bagehot, W. 1962. ‘Lombard Street: A Description of the money market’, with a New Introduction by F. C. Genovese, Richard Irwin. Homewood, IL.
3. Bakker, A. 2003. ‘Promoting financial stability: The role of central banks’, in Teunissen, J. J., and Teunissen, M. (eds.), *Financial stability and growth in emerging economies: The role of the financial sector*, FONDAD (Forum on Debt and Development), September, www.fondad.org.
4. Beck, U. 1999. *World risk society*, Polity Press, Cambridge.
5. Bellman, R. 1953. *Stability theory of differential equations*, McGraw Hill, New York.
6. Bertalanffy, L. von 1968. *General Systems Theory*, Braziller, New York.
7. Crockett, A. 1997a. ‘The theory and practice of financial stability’, *GEI Newsletter*, No. 6, (United Kingdom: Gonville and Caius College Cambridge), 11–12 July.
8. 1997b. ‘Why is financial stability a goal of public policy?’, *Economic Review*, FRB of Kansas City, vol. 4.

9. Čihák, M. 2006. 'How do central banks write on financial stability', *IMF Working Paper*, WP/06/163, IMF, Washington, D.C.
10. Čihák, M., Muñoz, S., Teh Sharifuddin, S., and Tintchev, K. 2012. 'Financial stability reports: What are they good for?', *IMF Working Paper*, WP/12/1, IMF, Washington, D.C.
11. Duisenberg, W. F. 2001. 'The contribution of the euro to financial stability', in *Globalization of financial markets and financial stability - challenges for Europe*, Nomos Verlagsgesellschaft, Baden-Baden.
12. Eatwell, J., Milgate, M., and Newman, P., (eds.) 1987. *The New Palgrave Dictionary of Economics*, vol. 1- 4, Macmillan Press, London.
13. Ferguson, R. W. Jr. 2002. 'Should financial stability be an explicit central bank objective?', Paper presented to an International Monetary Fund conference on Challenges to Central Banking from Globalized Financial Markets, Washington, D.C., September 17.
14. Financial Stability Board, http://www.financialstabilityboard.org/index.htm.
15. Foot, M. 2003. 'What is "Financial Stability" and how do we get it?', Speech by Managing Director, The Financial Services Authority and Honorary President of ACI (UK), The Roy Bridge Memorial Lecture. 3 April.
16. Holland, R. C. 1975. 'Bank holding companies and financial stability', *Journal of Financial and Quantitative Analysis*, vol. 10, no. 4.
17. Kaul, I., Conceiçao, P., Le Goulven, K., and Mendoza, R. U. (eds.) 2003. *Providing global public goods. Managing Globalization*, Oxford University Press, New York.
18. Koehler, H. A. 2001. 'Public-private partnership for financial stability', Address of the Managing Director of the IMF to the Institute for International Finance, Hong Kong SAR, May 31. http://www.imf.org/external/np/speeches/2001/053101.htm.
19. Laidler, D. 2002. 'Two views of the lender of last resort: Thornton and Bagehot', Paper presented at a conference on the "Lender of Last Resort", University of Paris 10 – CNRS, Paris, 23-24 September, http://www.ssc.owo.ca/economics/econref/.
20. Lakoff, G., and Johnson M. 1995. *Metaphors we live by*, University of Chicago Press, Chicago.
21. Luhmann, N. 1991. *Soziologie des Risikos*, Walter de Gruyter, Berlin.
22. McCloskey, D. N. 1998. *The rhetoric of economics*, University of Wisconsin Press, Madison, WI.
23. Mesjasz, C. 1988. 'Applications of Systems Modelling in Peace Research', *Journal of Peace Research*, vol. 25, no. 3.

24. 2010. ‘Complexity of social systems’, *Acta Physica Polonica A*, vol. 117, no. 4, http://przyrbwn.icm.edu.pl/APP/PDF/117/a117z468.pdf.
25. Minsky, H. P. 1977. ‘The theory of systemic fragility’, in Altman, E. I., and Sametz, A. W. (eds.), *Financial crises: Institutions and markets in a fragile environment*, Wiley, New York.
26. Mirowski, P. 1989. *More heat than light: Economics as social physics, physics as nature's economics*, Cambridge University Press, Cambridge.
27. 1994. *Natural images in economic thought: “Markets read in tooth and claw”*, Cambridge University Press, New York/Cambridge.
28. Mishkin, F. 1991. ‘Anatomy of a financial crisis’, *NBER Working Paper*, No. 3934, Cambridge, MA.
29. 1999. ‘Global financial instability: Framework, events, issues’, *Journal of Economic Perspectives*, vol. 13.
30. Morgan, G. 1998. *Images of organization*, Sage Publications, Thousand Oaks, CA.
31. Newman, P., Milgate, M., and Eatwell J. (eds.) 1992. *The New Palgrave Dictionary of Money & Finance*, vol. 1-3, Macmillan Press, London.
32. North, D. C. 1997. ‘The Contribution of the New Institutional Economics to an understanding of the transition problem’, WIDER Annual Lectures 1, UNU World Institute for Development of Economic Research (UNU/WIDER), Helsinki.
33. Oosterloo, S., and de Haan, J. 2003. ‘A survey of institutional frameworks for financial stability’, *Occasional Studies*, vol.1, no.4, De Nederlansche Bank.
34. Ortony, A. (ed.) 1979. *Metaphor and thought,* Cambridge University Press, Cambridge.
35. Padoa-Schioppa, T. 2003. ‘Central banks and financial stability: Exploring the land in between’, in Gaspar, V., Hartmann, P., and Sleijpen, O. (eds.), *The transformation of the European Financial System*, European Central Bank, Frankfurt.
36. Porter, T. 1999. ‘The G-7, the Financial Stability Forum, the G-20, and the Politics of International Financial Regulation’, University of Toronto G8 Information Centre, http://www.g7.utoronto.ca.
37. Portes, R. 2001. ‘The European Contribution to International Financial Stability’, Paper presented at the Colloquy organized by the Banque Centrale de Luxembourg, 18 May, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=289341.
38. Schinasi, G. J. 2004. ‘Defining financial stability’, *IMF Working Paper*, WP 187/04, Washington D.C.

39. 2006, 'Safeguarding financial stability', International Monetary Fund, Washington D.C.
40. Searle, J. R. 1979. *Expression and meaning: Studies in the theory of speech acts*, Cambridge University Press, Cambridge.
41. Thornton, H., 1939. *An enquiry into the nature and effects of the paper credit of Great Britain,* George Allen and Unwin, London.
42. Trichet, J.- C. 2003. 'Financial stability, Speech by President of the European Central Bank', Forum Financier Belge, Brussels, 26 November, http://www.ecb.int/press/key/date/2003/html/sp031126.en.html
43. Tsoukas, H. 1991. 'The missing link: A transformational view of metaphors in organizational science', *Academy of Management Review*, 1991, vol. 16, no. 3.
44. Wellink, N. 2002. 'Current issues in central banking', Central Bank of Aruba, Oranjestad, November 14.

*Emilia Klepczarek**

CHAPTER 2

SOFT LAW AS A FACTOR STABILIZING THE FINANCIAL SYSTEM

Introduction

The increasing globalization and liberalization of the world economy has made the problem of the stability of the financial system one of the main issues at both national and international levels. The rapid spread of financial crises with the so-called contagion effect has triggered lively discussions on methods of counteracting the crisis and has led to attempts to develop effective instruments ensuring financial stability.

The great involvement of supranational institutions, such as the IMF, the BIS (Bank for International Settlements) and the European Commission, should be emphasized. Their efforts to build an international network of financial security, which, in the conceptual dimension, is a set of institutional and regulatory frameworks ensuring the stability of the financial market and, in the institutional dimension, consists of supervision over the financial market, a lender of last resort and a deposit insurance system [Jurkowska-Zeidler, 2008, p.12]. There is also an increasingly strong bottom-up approach emerging directly from various entities in the financial sector. This approach usually takes the form of codes of good practice, which not only enhance the image of the institution, but also improve and make safer the operation of the entire system.[1]

The essence of creating a financial safety net seems to lie in coordinated supervisory activities of national authorities, which in their actions should take into account the global situation and recommendations issued by international decision-making and advisory bodies. The architecture of actions aiming at financial stability should preserve the right sequence of responses to disturbances of that

* University of Lodz

[1] In Poland, internal regulations on good practices have been formulated by: Bank BPH, Bank Gospodarstwa Krajowego (The Body of Ethical Principles of BGK Employees), Bank Pekao S.A. (declares compliance with the so-called Charter of Principles, applicable to all entities of UniCredit Group) and some co-operative banks (such as Bank Spółdzielczy in Gniezno).

stability, in the first place, by taking measures at the national level (taking into account the specificity of the country, e.g., historical conditions, the existing infrastructure, the working of the financial system and the real sphere), followed by supranational actions. This would eliminate possible inconsistencies [Houben et al., 2004, pp. 43-44]. According to this principle, recommendations formulated by the supervising institutions should be flexible enough to be adjusted to country-specific economic and legal conditions, while they should also suggest solutions whose implementation would effectively strengthen the stability of the system and make it possible to avoid risks. Such opportunities are provided by the application of so-called soft law, namely by formulating regulations in the form of recommendations or codes of good practice, which are voluntary and advisory in nature. State authorities and even economic entities are given wide discretion as to the extent of their implementation into business practice.

This paper aims to discuss the use of soft law as one of the factors stabilizing the financial system. The advantages and disadvantages of replacing traditional legal regulations with soft law regulations in certain areas of banking supervision will be presented. An attempt will be made to prove that soft law applied in financial supervision may not only increase the security of particular institutions, but also enhance their effectiveness and public confidence.

1. Soft law – definition, classification and origin of the concept

There is some controversy as to the origin of the term "soft law." While it is attributed to Arnold McNair [Bierzanek, 1987, p. 92], Wellens and Borchardt are of the opinion that the concept of soft law was derived from the work of Dupuy [Borchardt and Wellens, 1989, p. 268]. On the other hand, Van Hoof argues that Dupuy himself admitted to borrowing the term from McNair [Hoof, 1983, s. 187]. Notwithstanding its inventor, the concept in question appeared in legal terminology in the early 1970s, but in practice soft law instruments have been used since the inception of the United Nations [Bothe, 1980, pp. 70-75]. It can therefore be assumed that the establishment of a universal international organization made the sources of international law listed in Article 38 of the Statute of the International Court of Justice no longer sufficient to meet the requirements of the contemporary international community [Pellet, 1985, p. 123]. Attempts to establish supervision laws and methods at the international level led to a search for new instruments which would provide an opportunity to adjust guidelines to particular countries of the Community in a flexible manner. This gave rise to the formulation of declarations, communiqués, memoranda, codes of practice, guidelines, conclusions, standards, charts, reports, gentlemen's agreements, etc. As emphasized by A. Pellet, these agreements have the advantages of treaties without their drawbacks. In his opinion, they are sources of inspiration and support; they determine aspirations and are catalysts for changes in countries which are going to implement them in practice [Pellet, 1985, pp. 126-127].

In considering the issues of soft law in the context of its impact on financial stability one should first take a look at all the recommendations of the BIS and codes of good practice. A summary of the latter shows that the source of the financial turmoil lies not only in the erroneous macroeconomic policy, but also in the misguided, often psychologically conditioned behaviour of managers and other employees of financial institutions. Standards of conduct in the form of codes of conduct formulated at the international level apply to regulations in the area of macroeconomics (Code of Good Practices on Fiscal Transparency, Code of Good Practices in Monetary and Financial Policy, Special Data Dissemination Standard) as well as to particular groups of economic entities, by proposing standards of conduct for employees of institutions operating in the securities, insurance and real estate markets [Jurkowska-Zeidler, 2008, pp.187-188].

The recommendations published by the BIS, and, to be precise, by the Basel Committee on Banking Supervision at the BIS, play an important role in shaping international supervisory regulations. The committee, composed of representatives of central banks and supervisory banking authorities[2] of the G10 countries, has no legislative powers and recommendations issued by the committee are a typical example of soft law instruments without legal force. However, the principles developed by the Basel Committee are so important that shortly after their announcement national banking supervisors introduce regulations based on those recommendations, which are binding for all national financial institutions. Today the implementation of the Committee's recommendations has become a kind of proof of legitimacy of supervisory authorities in relation to international institutions, political partners and investors.

Also at the national level standards for procedures and conduct for individual professional groups are becoming more precise. These standards are in the form of codes of good practice, also known as deontological codes or codes of ethics. Polish economic practice has seen several examples of such "soft rules," of which the most important for creating order and safety of the financial system seems to be the Canon of Good Practice for the Financial Market issued by the Polish Financial Supervision Authority. One should also mention the Best Practice Recommendation on the Polish Bancassurance Market in the field of protective in-

[2] In cases where banking supervision is not the responsibility of the central bank.

surance related to banking products, the Good Practice Principles for Members of the Conference of Financial Companies in Poland, the Code of Good Practice for Institutional Investors and, finally, the Best Practices for WSE Listed Companies.

So many examples of these canons of voluntarily implemented rules and their growing importance in building stable economic sectors which enjoy public trust have encouraged a formal definition of the notion of code of conduct. At the level of European Union legislation, such a definition can be found in Directive 2005/29/EC of the European Parliament and of the Council, where it is given as "an agreement or set of rules not imposed by law, regulation or administrative provision of a member state which defines the behaviour of traders who undertake to be bound by the code in relation to one or more particular commercial practices or business sectors" [European Parliament, 2005]. The International Federation of Accountants has defined a code of good practice as "principles, values, standards, or rules of behaviour that guide the decisions, procedures and systems of an organization in a way that (a) contributes to the welfare of its key stakeholders, and (b) respects the rights of all constituents affected by its operations" [IFAC, 2006, p.9].

These considerations show the dissemination of soft law in today's economic reality. It should be noted that it has both its ardent supporters and strong opponents, who embrace the traditional principles of legislation arguing that every legal norm should consist of a hypothesis, disposition and sanction. Although soft law lacks formally defined sanctions, it should be noted that usually the market sets a price for failing to follow certain principles of soft law. The lack of public confidence or withdrawal of lenders are often much more severe penalties than those set out in the official law. Therefore, the issue of "soft supervision" over the financial market should not be overlooked in the analysis of factors which regulate the principles of its operation and affect the stability of the system.

2. Basel Capital Accords – recommendations stabilizing the global financial system

The Basel Committee on Banking Supervision attempts to respond to the dynamic changes taking place in financial markets by announcing recommendations with the primary goal of strengthening the stability of the international banking system. The Basel Capital Accord (Basel I) was the first such document published in 1988, which established primarily two standards; the minimum capital requirements for banks (so-called capital adequacy), and measurement of credit risk associated with specific categories of balance sheet and off-balance sheet assets

[Żółtowski, 2011, p. 30]. Basel I introduced rigid 8-per cent capital to risk-weighted assets protection. Although the recommendation was not legally binding, shortly after its announcement more than 100 banking supervisors around the world pledged to incorporate it into the existing laws of their countries.

The development of new financial engineering instruments, and, along with it, the identification of new types of banking risk, made it necessary to verify Basel I guidelines. The Basel Committee recognized the need for an individualized approach to risk in particular banks and the need to move away from a rigid indicator designating a minimum level of internal capital. In 2004, considering these issues, the so-called New Capital Accord (Basel II) was developed to meet the new conditions of operation of banking entities. The partial rejection of rigid control of the level of capital and the recognition of new risks, the impact of which was to be taken into account when measuring capital adequacy, were important elements which distinguished this set of recommendations from the previous one.

Regulations contained in the New Basel Capital Accord can be considered a breakthrough in terms of banking supervision. This bold statement is justified by the fact that the risk measurement methodology was almost entirely entrusted to the management of the banks. The banks' boards of directors were required to define and monitor the activities of the entities they managed and to calculate the required internal capital according to their own internal models. Taking into account the fact that the Basel II recommendation were later almost exactly implemented in Community regulations and then in national supervisory rules[3], one should realize that the Basel II recommendations were an enormous challenge for the management and executives of financial institutions. It can be assumed that the regulations formulated pursuant to Basel II were based on the strong conviction that the bank's management would follow the code of ethics, avoid moral hazards and strengthen the long-term stability of individual entities, and consequently of the whole financial system. Only on this condition allowing banks to determine the risk parameters of their own activities would bring the desired results.

Thus, analysis of certain provisions of the New Basel Capital Accord from the point of view of soft law is very useful, and not only because the NBCA itself is an example of a recommendation without legal force. Of far greater importance seems to be the observation that the Basel II rules are a specific expression of confidence in the principles of corporate governance in financial institutions, which, based on good banking practice, should effectively regulate the issues of rational risk management.

[3] The New Capital Accord was introduced into the law of the European Union by adopting the Capital Requirements Directive, CRD.

The assumptions of the New Capital Accord are divided into three pillars. The first pillar, apart from capital requirements associated with risk, focuses also on the issue of operational risk. This kind of risk involves the probability of incurring losses due to erroneous internal processes and due to activities of people and systems, and therefore comprises elements usually not covered by banking law. What previously used to be only a requirement resulting from the use of good practice in the management of operational risk was now strengthened by the necessity to calculate capital requirements linked to this risk [Żółtowski, 2011, pp. 135-136]. The Basel Committee defined 7 types of operational risk which result in losses for banks; these are: internal fraud; external fraud; employment practices and workplace safety; clients, products and business practices; damage to physical assets; business disruption and system failures; execution, delivery and process management. It is easy to see that most of these issues are regulated by principles of corporate governance. It can therefore be concluded that the obligation to manage operational risk, introduced by the Basel II framework, is in fact an obligation to introduce principles of good corporate governance practices and develop methods of forecasting losses resulting from ineffective supervisory regulations.

The second pillar of the Basel II framework is even more focused on supervisory review and on assessment of risk not covered by the first pillar.[4] There is only one condition: banks are expected to create internal regulations for measuring and assessing risk and take measures to reduce it. Banking supervision is defined as a body evaluating the manner and quality of risk management and formulating adequate suggestions. Regulation formed in this way gives plenty of room for using soft law instruments. First, the methodology of calculating the risk covered by the second pillar is entirely entrusted to the management of the banks with full confidence that their actions would be in accordance with good banking practice. Second, banking supervision, clearly accentuated in this part of the Basel II framework, can regulate the market of bank services mainly on the basis of soft law instruments.

This principle is closely reflected in Polish banking supervision, where the Polish Financial Supervision Authority (PFSA) influences the stability of banks by issuing recommendations. As pointed out in the literature, the PFSA creates only a kind of code of ethics for the banking business [Krzyżewski, 2000, pp. 111-121] and provides banks with principles of good banking practice [Tupin, 2000, pp. 19-23]. Although the content of these recommendations would suggest that they are binding for banks, at this point it is necessary to look at the consti-

[4] Pillar 2 concerns the interest rate risk in the banking book, credit concentration risk, liquidity risk, legal risk, strategic risk, and reputation risk, which are not included in Pillar 1.

tutional provisions on the sources of Polish law. The Constitution introduces a limited number of legal act types, dividing them into acts of universally binding law (such as the Constitution, statutes, ratified international agreements and regulations) and internal law acts [The Polish Constitution, 1997]. The internal law comprises of norms applicable only to units subordinate to the authority issuing the said legal acts. The relevant literature indicates that under the current legislation, Polish commercial banks are not subordinate to the Polish Financial Supervision Authority; therefore the PFSA's recommendation cannot be regarded as either generally applicable internal law acts [Pelc, 2010]. Therefore, although in Polish banking practice the PFSA's recommendations are treated as mandatory, it must be stressed that in fact they are soft law instruments and comply with the Basel postulate for the evaluative and advisory role of banking supervision.

The last area of the New Basel Capital Accord, so-called Pillar 3, concerns reporting issues. Similarly to Pillar 1 and Pillar 2, Basel II allows the bank's management full independence in terms of decision-making in the field of reporting documentation. Based on the principle of materiality, the bank's management and supervisory board should develop information and reporting procedures assuming the categorical requirement to include information which, if omitted, could affect the judgment of users making specific economic decisions in relation to the bank.

In concluding the discussion of the content of the New Basel Capital Accord it must be stressed that it offered a ground-breaking approach (in terms of requirements for financial institutions) to the methodology of calculating the risk of individual entities in the banking sector. The Basel II framework, based on the assumption that the bank's management and executives will act in accordance with good banking practice, let the management and executives develop their own strategy for building financial stability.

The events of the 2007–2010 financial crises highlighted the ineffectiveness of the Basel regulations. The question remains open whether the requirements of the NCA were insufficiently restrictive, or were not effectively implemented. It is worth noting that while the European Union directives obliged supervising institutions in all counties to implement the Basel II framework, in the USA, where the crisis began and had the most serious consequences, the New Basel Capital Accord applied only to certain operators in the financial market. That is probably why the political and monetary authorities in Europe point to the need for universal application of the Basel standards. Basel III, developed after the financial crisis, is to be gradually introduced from 2013. New regulations tighten capital requirements and limit the amounts of bonus and dividend payments. The regulations clearly demonstrate that the Committee's confidence in the rational behaviour of management and executives has decreased as through specific provisions it limits the possibility to deleverage banking entities and prevents efforts to maximize short-term profits for managers.

3. The ethics of banking services as a base for the sustainable development of the banking sector

Economic entities in the banking sector are a special type of companies, also because of their low equity to assets ratio. But what especially distinguishes banks from other companies is the special role they play in the economy by accepting depositors' savings and crediting consumption and investment. Therefore, they are often referred to as institutions enjoying public confidence, which is rooted in detailed regulations imposed by external supervision and internal regulations (often created by the banks themselves as a grassroots initiative in order to promote a pro-consumer policy and to improve the image of particular entities or the entire sector). It should be noted that the consequences of the bankruptcy of a bank are borne not so much by the bank's owners (due to the aforementioned low proportion of equity to the bank's liabilities), as by the depositors who keep their money in the bank's accounts. Indirectly, the effects of the collapse of the banking sector are felt throughout the economy and slow down the GDP growth rate. Therefore, the safety of the banking sector lies in the public interest and the operation of the sector is subject to special supervision, which is much more restrictive than in the case of other companies.

Nowadays, the security of banking systems is achieved by providing banks with adequate equity, maintaining high professional and ethical standards of management, ensuring compliance with prudential norms, proper selection of borrowers, requiring collateral for loans, a strict system of banking supervision and a mandatory deposit insurance system [Janiak, 2000, p. 59]. These issues are usually governed by provisions of the law, the very existence of which builds greater confidence in the entities they cover. There is, however, yet another dimension in which the banks are trying to gain a good image – the dimension of non-binding guarantees of fair and sound principles of economic activity in this sector, usually taking the form of codes of good practice.

Codes of ethics became so popular in Polish economic practice that in 2007 the concept was formally defined in the Act on combating unfair commercial practices, where codes of good practice were defined as a "set of principles of conduct and in particular ethical and professional norms for entrepreneurs who have committed to comply with them in relation to one or more market practices." [Journal of Laws, 2007] Article 4 of this Act deems a market practice unfair if it is contrary to codes of good practice and may significantly distort the market behaviour of the average consumer [Journal of Laws, 2007]. Thus, although codes of ethics are voluntarily implemented soft law instruments, the said Act gave them great legal significance on the ground of the Polish legal system.

From the point of view of the debate on the stability of the financial sector, it is worth looking into the content of the Canon of Good Practice for the Financial Market developed in 2007 under the leadership of the Polish Financial Supervision Authority in cooperation with thirty organizations, including providers of financial products and services, organizations and institutions representing the interests of the customers of other market institutions, and academic experts.[5] The Canon was to serve as a proof of ethical conduct of the institutions which implemented it. Interestingly, although some thirty institutions contributed to the work on the Canon, only seventeen declared they would apply it.[6] It should be noted, however, that some of the entities involved in the project had their own codes of ethics, including rules specifically tailored to the nature of their business.

The Canon of Good Practice for the Financial Market assumes that the "financial market is the common good of all its members" [PFSA, 2008], enumerating one by one the core values which should be followed by its participants to ensure sustainable and stable development of the sector: honesty, diligence and competence, dignity and confidence, resources and procedures, internal relations, preventing conflicts of interest, information from customers and for customers, protecting customer information, profiling services, honest advertising, honest competition, settlement of disputes and complaints and market development activities. It can be seen that most of these rules are not quantifiable, difficult to define precisely, and generally it is easier to describe behaviours contradicting them. That is why the ethical dimension of business is so difficult to define in a formal legal system. The critics of such regulations emphasize broad discretion in the interpretation of terms such as "diligence," "competence" and "dignity." Their proponents, however, are of the opinion that the very adoption of such general rules would raise the standards of business practices and build public confidence.

[5] The then President of the PFSA, Stanisław Kluza, said in an interview that "the ethical dimension of the activity of participants of the financial market is one of the pillars of sustainable development, stability, security and reliability of this market", http://www.gazetatrend.pl/artykuly/155-wywiad-z-przewodniczacym-knf-stanislawem-kluza, last accessed 27 March 2012.

[6] According to the PFSA website; http://www.knf.gov.pl/dla_rynku/kanon_praktyk/deklaracje_stosowania_KDPRF, last accessed 27 March 2012.

One might consider the actual consequences of the implementation of codes of professional conduct. Again, it is worth to refer to the 2007–2010 financial crisis, before the outbreak of which the majority of financial institutions applied such general regulations or had developed independently their own codes of business conduct and ethics. Again, it seems that certain standards had not been effectively implemented, while the imperfect quality of the regulations did not matter so much. The American banking sector is a good example of this issue, as both before and during the downturn one could see there multiple examples of unethical behaviour of managers, who promoted short-term profits without diligent attention being paid to careful calculation of risk and disclosure of sensitive information to supervisory authorities as well as to partners and clients of their banks. There is no doubt that moral hazard in the financial sector contributed greatly to the destabilization of the system. It was a sensation when former director of Goldman Sachs, Greg Smith, revealed in the pages of the New York Times some facts about the corporate culture of the bank where he had worked. According to Smith, the banking industry had become toxic and destructive and respect for the client and his dignity had disappeared. The former director frankly admitted that Goldman Sachs's management rewarded those employees who were able to convince customers to buy assets recognized by the market as unprofitable, and the customers themselves were called bad names and their interests were disregarded. Smith wrote, "I truly believe that this decline in the firm's moral fibre represents the single most serious threat to its long-run survival." [Tupolski, 2012] In this way he corroborated the thesis that ethical values are essential for a financial institution to maintain a stable position. On the other hand, the relationship between the introduction of a code of good practice as a regulation binding employees and the actual observance of the code in business practice remains an open question.

4. Soft law and the traditional legislative instruments

The stability of the financial system is the result of many factors. The IMF enumerates the most important of them: macroeconomic stability and a policy framework for maintaining it; an adequate and effective regulatory structure for financial regulation; supervision and surveillance over the financial market; the infrastructure of the financial system; standards and business practices and incentive structures, including a legal system that supports productive private financial contracts [Schinasi, 2004, p. 6]. This set of components stabilizing the sector indicates the essential role of both the traditional legislative instruments and non-regulatory tools. The use of an appropriate combination of these factors leads to a compromise between flexibility and efficiency. There is no doubt that a well-designed and properly enforced law is the most effective instrument in the hands of financial market supervision. However, dynamic changes in the economic environment sometimes force the supervisory authorities to react immediately, which may not be possible due to the complexity of the multistep legislative process. In this situation, the only way to make immediate adjustments and react to unexpected situations in the financial market is to use soft law instruments.

M. Zaleska is of the opinion that the stability of the financial system depends on the institutional environment of the banking system and the economic and financial situation of the banks themselves. She notes, however, that while the institutional factors have a significant effect on the stability of the banking system, by their very nature "legal solutions in the field of external norms influencing banks are extremely unstable." At the same time, Zaleska indicates the importance of the institutions' reaction time to various types of adverse situations and stresses the fact that a longer decision time exacerbates problems in the banking sector [Zaleska, 2001, pp. 203-211].

Also Paul Krugman, a well-known contemporary economist, citing the maxim "go to the church of your choice, but go, goddamn it," advises to always react to issues appearing in the economic environment, especially the negative ones, and suggests that the mere fact of taking a decision by political or supervisory authorities evokes positive psychological reactions in the public, preventing a loss of confidence in the market or a market panic that would otherwise aggravate unfavourable economic trends. Krugman argues that any solution is better than no action and the authorities must not be afraid to make decisions [Krugman, 2001, pp. 180-181]. In this situation, controlling the market with soft law instruments seems to be the optimal solution. Using soft law, it is possible to immediately react to changes in the economy avoiding the long legislative path. Moreover, soft law is so flexible that it can be cancelled immediately after the factors threatening the stability of the system disappear.

But obviously it is not possible to supervise the market only on the basis of "soft rules." The financial system must operate within the rigid framework of the traditional legal system, while soft law instruments can be used only for determining some unquantifiable ethical values or for making immediate adjustments to the principles of operation of banking entities.

There is another important argument for the use of "soft supervision." Stephen Prowse's research proves that strict control of consolidation processes and restrictions imposed on potential owners of banks weaken the impact of market discipline mechanisms [Prowse, 1997, pp. 509-527]. Prowse made this point comparing the incidence of events involving the replacement of executives and other events suggesting a change of policy (such as hostile takeovers, voluntary mergers, actions of the board of directors, etc.) in non-financial entities and in banks. In addition, he made a list of supervisory interventions – actions which in some way discipline the managers but are of non-market nature. He adopted two concepts as to the occurrence of the said supervisory interventions: first, that an intervention takes place when the institution inspected is downgraded in the BOPEC rating[7] to 3 or lower, and second, when a holding gets one of the lowest ratings, that is 4 or 5. Prowse studied a sample of 234 bank holdings and also used the study of Morck et al. [1989] on 454 more entities. Data for the years 1987 to 1992 are given in Table 1.

Table 1. The frequency of events disciplining managers in non-financial entities and bank holdings

Event	Non-financial entities	Bank holdings
Replacement of the management	20.5 %	10.26 %
Hostile takeover	8.8 %	1.71 %
Merger	7.5 %	10.68 %
Total events of market character	36.8 %	22.65 %
Supervisory intervention I (BOEPEC rating of 3, 4 or 5)	-	38.03 %
Supervisory Intervention II (BOEPEC rating of 4 or 5)	-	19.23 %
Total events leading to corporate control changes	36.8%	60.68 % (First case*)
		41.88 % (Second case**)
The number of entities in the sample	454	234

* Event of non-market nature + BOPEC downgrading to a rating of 3, 4 or 5.
** Event of non-market nature + BOPEC downgrading to a rating of 4 or 5.
Source: K. Jackowicz [2004, p. 70].

The data clearly indicate a weakening of market discipline in institutions covered by banking supervision. The banks were affected by disciplinary events only in 23 per cent of the cases, which is over 14 percentage points less than in non-financial entities. It is worth noting that the greatest difference was found for hostile takeovers and the replacement of management by the board of directors, which took place in 1.71% and 10.26% of the examined banks and in as many as 8.8% and 20.5% of the other examined entities, respectively. It is evident that banks are

[7] The BOPEC rating system evaluated five key supervisory factors in American banks: the condition of the bank holding company's bank subsidiaries, non-bank subsidiaries, the parent holding company, profits and capital adequacy. The values range from 1 (best) to 5 (worst).

disciplined by supervision while the other institutions are primarily disciplined by the market.

Conclusions from the above analysis may be twofold. Supervisory interventions may be deemed strong enough as a regulator and sufficiently disciplining the banking sector, so disciplinary events of market nature are no longer necessary in this sector. However, it is also important to note that the cited results provide a strong argument for the opponents of "soft supervision," who claim that the lack of sanctions in soft law instruments means that they are not very effective. Prowse's study shows that when supervisory legal instruments are absent, the role of disciplinary tools is effectively taken over by the market. What is more, hostile takeovers and replacement of poor management (which characteristically occur in banks very rarely) are two of the strongest market mechanisms, which, as shown by the study, not only discipline managers in the entities covered by these mechanisms, but also those of other companies in the business environment [Mikkelson and Partch, 1997, pp. 205-228; Jackowicz, 2004, p. 71]. In addition, increased supervisory regulations weaken the motivation of the private sector to monitor the banks' condition and to influence their managers' decisions.

However, it should be emphasized again that the doctrine according to which bank are a public good absolutely excludes the possibility of disciplining the banking sector only through market tools and soft regulations. The mechanisms of regulatory disciplinary have a positive impact on the scope of negative information about the condition of banks disclosed by managers, providing the lenders with an opportunity to more accurately assess the banks' standing. Furthermore, in their decisions investors take into account supervisory disciplinary actions which facilitate the decision-making processes and build greater confidence in the financial sector, both among shareholders and creditors [Jackowicz, 2004, pp. 57-76]. Thus, seeking the optimum proportions between legal and non-legal regulations in the sphere of finance, soft law should be regarded as a complementary area, not contradicting legal standards. It is a major mistake to violate the optimum proportions, causing either so-called inflation of law or far-reaching deregulation in the banking sector.

A similar position on soft law instruments was expressed by the European Parliament. In the Resolution on institutional and legal implications of the use of 'soft law' instruments adopted on 4 September 2007, members of the Parliament decided that "in the context of the Community, soft law all too often constitutes an ambiguous and ineffective instrument which is liable to have a detrimental effect on Community legislation and institutional balance and should be used with caution, even where it is provided for in the Treaty" [European Parliament, 2007].

However, the entire document refers to laws established at the EU level and expresses some concern about the excessive use of non-legally binding rules for fear of reducing the effectiveness of the European Union in its capacity as a legislator. It also reflects worries about changing the unique model of the Community in the direction of a traditional international organization and about a lack of coherence and coordination in the legal systems of the member states. However, the same resolution contains also provisions revealing benefits of soft law instruments, on condition that they do not become substitutes for legislation. Furthermore, the resolution stresses the important role played by standards and codes of conduct and the need for individual consideration before deciding whether EU institutions should take legislative or non-legislative measures.

The Parliament's position is therefore consistent with the findings presented in this analysis, and the definitely negative overtone of the said resolution results from the specific model of the Community. The EU institutions see harmonization of economic and political structures of their member states as a high priority, and this harmonization may be achieved amongst others through binding Community acts with unambiguous interpretation.

It seems that the main weakness of soft regulations is not so much their ambiguity but the problem of objective verification of entities in terms of actual observance of soft regulations. Although there exist rules which allow for obtaining specific information on the extent of implemented codes of best practice, such as the "comply or explain" principle adopted by the Warsaw Stock Exchange, however such rules are not applied by other entities which are not members of the WSE. Therefore, it often happens that pledges to use a specific canon of rules are not followed by their actual implementation in business practice.

A partial solution to this problem can be found in Article 7 of the Polish Act on combating unfair commercial practices, under which, if a company informs that it has undertaken to comply with a code of best practice, but it is not the case, it will be deemed an unfair market practice under any circumstances [Journal of Laws, 2007]. Article 3 of the same Act, on the other hand, forbids the use of unfair market practices. However, as mentioned earlier, some aspects of codes of ethics, such as "diligence" or "dignity," are often difficult to define precisely, and it can be very complicated to take action regarding such issues.

The advantages and disadvantages of soft regulations mentioned above make them complementary to the traditional system of law, filling the area not covered by statues, regulations, and other legal acts. At the same time it should be noted that it is important that these two systems of traditional law and soft law do not contain conflicting recommendations. They should, however, be complementary or may reiterate certain rules. Perfect examples of non-legal regulations being incorporated in laws include, in international law, the implementation of the Basel recommendations by banking supervision and, in national law, the evolution of the status of independent members of supervisory boards of public companies (the independence of these members was initially postulated in a code of good practice and was later reflected in an act of law [Journal of Laws, 2009].

Conclusion

Analysis of soft law instruments in the context of their impact on the stability of the financial sector leads to the conclusion that, first, soft law instruments are commonly used in business practice and, second, have a significant impact on the functioning of entities in the financial system. In addition, soft law instruments allow supervisory authorities to react quickly and do not weaken instruments of market discipline so much. However, it is not entirely clear how they impact the stability of the financial system.

The recommendations described in this paper, namely the Basel Committee's recommendations and those of the Polish Financial Supervision Authority, can undoubtedly be seen as factors significantly stabilizing the banking sector. But it is much more difficult to objectively define the significance of codes of professional conduct. It seems that their main drawback is broad discretion in adopting and interpreting them and a lack of effective mechanisms for assessing the degree of their use in business practice.

There is no doubt that the ethical dimension of financial institutions is one of the conditions for security and stability in the sector. Codes of good practice in a way systematize, organize and clarify requirements in terms of ethics, enhancing mutual trust between market participants. The Polish financial market is already defined as a saturated market and entities operating in this market must increasingly compete with added value, and certainly good banking practices are added value. Bank customers are increasingly careful about the transparency and reliability of the information they receive, and about the competence of employees and mutual relations. In this way, they enforce the use of higher standards of services rendered by the banks.

However, the evolution of the banking system towards banking partnership seems to be too slow and ethical principles are violated too often. Numerous examples of abuse show that the adoption of a code is sometimes a purely an image-building move rather than a real attempt to implement pro-consumer attitudes. Therefore, while assessing the impact of canons of good practice on the stabilization of the system, it must be admitted that it is smaller than the impact of other regulations. This does not follow, however, from any imperfection of the recommendations but from the lack of a mechanism enforcing their application.

To summarize the discussion on instruments stabilizing financial sector, it is worth listing five areas of anti-crisis prevention formulated by the IMF advisor, Garry Schinasi. In his opinion, preventive measures must now take place at the level of market discipline, risk management and control systems, stakeholder governance, banking supervision and market surveillance [Schinasi, 2003, pp. 10-11]. This combination of components to ensure stability constitutes therefore a set of areas controlled by legal and non-legal regulations. Thus, one may conclude that both traditional and soft law instruments should be considered important elements contributing to the stabilization of the financial system.

References

1. Bierzanek, R. 1987. '„Miękkie" prawo międzynarodowe', *Sprawy Międzynarodowe*; 1.
2. Borchardt, G. M., and Wellens, K. C. 1989. 'Soft Law in European Community Law', *European Law Review*; 14.
3. Bothe, M. 1980. 'Legal and Non Legal Norms: A Meaningful Distinction in International Relations', *Netherlands Yearbook of International Law*.
4. European Parliament, 2005 - Directive 2005/29/EC of 11 May 2005 concerning unfair business-to-consumer commercial practices in the internal market and amending Directives 84/450/EEC, 97/7/EC, 98/27/EC and 2002/65/EC and Regulation (EC) No 2006/2004 (Unfair Commercial Practices Directive).
5. 2007 - European Parliament resolution of 4 September 2007 on institutional and legal implications of the use of "soft law" instruments (2007/2028(INI)).
6. Hoof, van, G. J. H. 1983. *Rethinking of the Sources of International Law*, Kluvert, Deventer.
7. Houben, A., Kakes, J., and Schinasi, G. 2004. 'Towards a framework for safeguarding financial stability', *IMF Working Paper*, June.
8. IFAC 2006. 'Defining and Developing an Effective Code of Conduct', Exposure Draft, November.
9. Jackowicz, K. 2004. *Dyscyplina rynkowa w bankowości*, Wydawnictwo Wyższej Szkoły Przedsiębiorczości i Zarządzania im. Leona Koźmińskiego, Warsaw.
10. Janiak, A. 2010. 'O przywilejach bankowych, cz. II', *Prawo Bankowe*, No. 10.

11. Journal of Laws 1997. The Polish Constitution of 2 April 1997 (Journal of Laws No. 78, item 483).
12. 2007. The Act of 23 August 2007 on combating unfair commercial practices (Journal of Laws No. 171, item 1206).
13. 2009. The Act of 7 May 2009 on auditors and their self-government, entities authorized to audit financial statements and public supervision (Journal of Laws No. 77, item. 649).
14. Jurkowska-Zeidler, A. 2008. *Bezpieczeństwo rynku finansowego w świetle prawa Unii Europejskiej*, Oficyna a Wolters Kluwe business, Warsaw.
15. Krugman, P. 2001. *Wracają problemy kryzysu gospodarczego*, Wydawnictwo Naukowe PWN, Warsaw.
16. Krzyżewski, J. A. 2000. 'Rekomendacje nadzorcze – charakter prawny i zakres mocy obowiązującej', *Prawo Bankowe*, No. 7-8.
17. Mikkelson, W. H., and Partch, M. M. 1997. 'The Decline of Takeovers and Disciplinary Managerial Turnover', *Financial Economics*, Vol. 44.
18. Morck, R., Schleifer, A., and Vishny, R. 1989. 'Alternative Mechanisms for Corporate Control', *American Economic Review*, Vol. 79.
19. Pelc, P. 2010. 'Rekomendacje Komisji Nadzoru Finansowego w polskim systemie prawnym', http://www.pawelpelc.pl/index.php?display=5&artykul=168, last accessed 24 March 2012.
20. Pellet, A. 1985. 'A new international legal order: What legal tools for what changes?', http://alainpellet.fr/Documents/PELLET%20-%201985%20-%20A%20New%20International%20Legal%20Order.pdf, last accessed 11 March 2012.
21. Polish Financial Supervision Authority (PFSA). 2008. 'The Canon of Good Practice for the Financial Market', http://www.knf.gov.pl/Images/Kanon_DPRF_tcm75-22555.pdf, last accessed 27 March 2012.
22. Prowse, S. 1997. 'Corporate Control in Commercial Banks', *The Journal of Financial Research*, Vol. XX, No. 4, Winter.
23. Schinasi, G. J. 2003. 'Responsibility of central banks for stability in financial markets', *IMF Working Paper*, June, WP/03/121.
24. 2004. 'Defining financial stability', International Monetary Fund, International Capital Markets Department, *IMF Working Paper*, October, WP/04/187.
25. Tupin, R. 2000. 'Odpowiedzialność cywilna Skarbu Państwa za działania lub zaniechania nadzoru bankowego. Część I – Status prawny i kompetencje regulacyjne nadzoru państwowego wobec banków', *Prawo Bankowe*, No. 10.

26. Tupolski, W. 2012. 'Najważniejsze to strzyc klientów, czyli cała prawda o banku Goldman Sachs', *PolskaTimes.pl*, http://m.polskatimes.pl/f/s1o6s/p1ugv/artykul.html?synd=377308, last accessed 27 March 2012.
27. Zaleska, M. 2001. 'Nadzór bankowy i gwarantowanie depozytów', in Jaworski, W. L., and Zawadzka Z. (eds.), *Bankowość. Podręcznik akademicki*, Poltext, Warsaw.
28. Żółtowski, W. 2011. *Zarządzanie ryzykiem bankowym w praktyce*, CeDeWu.pl Wydawnictwa Fachowe, Warsaw.

Monika Marcinkowska[*]

CHAPTER 3

NEW ORDER IN BANKING[1]

Introduction

The smooth functioning of the economy requires a stable and efficient operation of the financial system. Poorly managed financial institutions burden the financial system. First, they adversely affect the rules and institutions of the public sector and, second, they grant loans to the wrong entities (denying loans to stable entities, which hampers the development of the economy) and excessively develop lending activity (which may lead to financial crises) [Kaufmann, 2002].

The financial system is as strong as its governance practices, the financial stability of its institutions and the effectiveness of its market infrastructure. The creation and application of good governance practices is the joint responsibility of market regulators and market participants [Das and Quintyn, 2002, p. 163]. However, there is no single effective remedy for all challenges to corporate governance in the financial sector. Empirical studies and theoretical considerations lead to the conclusion that in order to enhance corporate governance in banking it is necessary to ensure a stronger regulatory supervision, while also strengthening private oversight (market discipline): increasing transparency, the competitiveness of markets and the involvement of the owners [Litan et al., 2002, p. 13].

The recent crisis has exposed many areas of imperfection in the system of corporate governance in banks. This publication identifies the key areas of inefficiency of the system and attempts undertaken to reform it, and presents a discussion of the desired new foundations of the financial order.

1. Identification of the causes of corporate governance ineffectiveness and attempts to reform the system

There are many macro- and microeconomic causes of the 2008 collapse of the financial markets and the global economy. Of great importance was the excessive accumulation of risk in the financial system resulting from weaknesses in

* University of Lodz, Poland.

1 Paper is part of the project financed by the National Science Center.

the corporate governance system in financial institutions, and especially in banks [European Parliament, 2011].

The financial crisis has exposed the weaknesses of corporate governance in banks. Some think that the crisis was brought about by inadequate implementation of corporate governance codes and principles; others argue that at least in part it was caused by a systemic failure of corporate governance (its institutional system is based on popular paradoxical assumptions, such as the primacy of shareholders, profit maximization, effective system of incentives, effective market for corporate control, etc.) [Sun et al., 2011, p. 5].

Moreover, it is pointed out that the fundamental problem of corporate governance in banks results from the lack of a direct relationship between the principles of corporate governance and financial stability. Indeed, the instruments of corporate governance contribute to the achievement of intermediate objectives at the level of individual institutions, but are not directly related to financial stability [Wymeersch, 2008]. There is no obligation imposed on banks, and they are not motivated in any other way, to care for financial stability or reduce systemic risk.

A detailed analysis of the causes of the crisis shows a number of corporate governance issues which require fundamental changes and tighter standards, namely [Kirkpatrick, 2009; Turner, 2009; Walker, 2009; Institute of International Finance, 2008; European Commission, 2010b; OECD, 2009; OECD, 2010; Marcinkowska, 2010]:

- The role, tasks and responsibilities of the board, as well as its size, organization and composition (qualifications of the members) and the functioning of this body and assessment of its work;
- Control of the risk incurred by the bank;
- Assessment of the management and systems of incentive compensation for its members;
- Transparency of the bank that would enable supervisory assessment of its operations (both through institutional supervision and private monitoring);
- The bank's ownership structure and the role of institutional investors.

These issues have been the subject of discussion of many decision-making bodies; some of them have already been taken into account in the new regulations and guidelines, while many more new regulations are still being developed.

As early as February 2009, a group of experts chaired by Jacques de Larosière recommended developing a European system of financial supervisors [The High-level Group of Financial Supervision in the EU, 2009]. In September 2009, a new supervisory structure was introduced (which started operations in January 2011): The European System of Financial Supervisors – ESFS, consisting of bodies supervising banks (the European Banking Authority), insurance companies and pension funds (the European Insurance and Occupational Pensions Authority) and stock exchanges (the European Securities and Markets Authority) operating in the EU. The European Systemic Risk Board is another component of this structure.[2]

Among the new regulations one should first mention an EU initiative: in June 2010 the Green Paper on corporate governance in financial institutions and remuneration policies was published [European Commission, 2010c]. The document summarizes the areas of ineffectiveness and imperfections of corporate governance in banks (they are included in the list given above), points to the already undertaken preliminary legislative initiatives, and then presents, for consultation purposes, possible further solutions. The initiatives mainly concern the question of responsibility, independence and competence of the supervisory board. They strengthen the risk management function, enhance the status of the chief risk officer, introduce a new requirement for external auditors to alert the board of directors and bank supervisory authorities to any substantial risks they discover, enhance bank supervision, promote a greater involvement of the bank's shareholders and encourage them to exercise effective control. These initiatives also concern the issues of remuneration for the management and conflicts of interest. The Green Paper is accompanied by a working paper which shows best practices related to supervisory boards, risk management, owners, supervisors, and external auditors [European Commission, 2010a].

Prior to that, back in 2009, The Commission issued a Recommendation on remuneration policies in the financial sector [European Commission, 2009].[3] The general requirement for banks was to adopt such remuneration policies that would promote correct and effective risk management, would not encourage excessive risk taking, and at the same time would support the implementation of business strategies and reduce conflicts of interest. In particular, the Recommendation defined guidelines on determining the variable component of remuneration.

Furthermore, the European Commission developed new regulations whose primary aim was to ensure more effective risk management in European credit institutions. These should help prevent individual credit institutions from taking

[2] More: http://ec.europa.eu/internal_market/finances/committees/index_en.htm.

[3] In Poland, the recommendations were reflected in the resolution of the Polish Financial Supervision Authority (PFSA) No. 258/2011 dated 04.10.2011 The resolution replaces the PFSA resolution No. 383/2008 on detailed rules for the functioning of the risk management and internal control system and the specifics of estimating internal capital by banks and reviewing the process of assessing and maintaining internal equity, and the principles for determining the policy for variable components of remuneration of banking executives (the PFSA Official Journal, No. 11, pos. 42).

excessive risk, which could otherwise lead to excessive risk accumulation in the financial system. The new legal framework will have three operational objectives [European Parliament, 2011]:

- To increase the effectiveness of the board's control over risk;
- To improve the status of the risk management function;
- To ensure effective monitoring of risk management by supervisory bodies.

Among the global guidelines for banking reform, one should mention further initiatives of the Basel Committee on Banking Supervision (BCBS). First of all, attention should be paid to sectoral "good practices", which take into account the specific nature of banks. General rules aimed at improving corporate governance in banks were updated by the BCBS in October 2010, and the current version of the document sets out 14 principles in 6 areas [BCBS, 2010d]:

- Board practices;
- Senior management;
- Risk management and internal controls;
- Compensation;
- Complex or opaque corporate structures;
- Disclosure and transparency;

This document is further augmented with guidelines for the internal audit function in banks [BCBS, 2011b], which specify 20 principles concerning supervisory expectations in relation to the internal audit function, the relations of internal audit with the supervisory institution, and supervisory assessment of the internal audit function.

The issue of remuneration for members of the top management in banks was also taken into account in the Basel guidelines, as the document formulates compensation principles and standards for assessments methodology [BCBS, 2010c].

Criticism of the regulations on capital adequacy has led to the revision of the previous guidelines (Basel II); the BCBS has strengthened some of the requirements and introduced additional standards in this area (some of them are related to institutional and private supervision exercised over banks) [BCBS, 2010a; BCBS, 2010b].

The Basel guidelines are the basis for the development and revision of regulations in the European Union. In September 2011, the European Banking Authority published guidelines on internal governance[4].

[4] The EBA document repeals the earlier guidelines published by the CEBS (the EBA's predecessor) [CEBS, 2010; CEBS, 2009; CEBS, 2006] .

2. Ethical foundations for a new order of the financial market

Regardless of the identified causes of the global financial crisis, i.e., economic, regulatory, and political factors, it must be stressed that low moral standards and a departure from ethical principles in banking were the crucial causes of the development and spread of the crisis – “financial bankruptcy is accompanied by intellectual and moral bankruptcy” [Flejterski, 2010].

“Greed”, “avarice”, and “lust for profit”, which by the end of the twentieth century became the key business message (wrapped in the philosophy of generating shareholder value), have led to the erosion of moral values in the economy [Visser, 2010, p. 232].[5] The obsession with financial performance and the dogma of higher profits and higher returns on capital corrupt managers, weaken the company, and consequently – the whole social fabric, degrading humanitarian values and leading to immorality and corruption [Dembiński, 2011, p. 147; Minzberg, 2004].[6]

Again, the issue of honesty becomes the key problem in the economy. A system of corporate governance should be founded on honesty, understood not only as legality (referring to a system of law which may demand good behaviours by penalizing bad ones), ethics (referring to agreed standards as to which attitudes are desirable and which are undesirable) and morality (referring to generally accepted social norms of what is desirable or undesirable, good or bad). Honesty must encompass at once legality, ethics and morality. M. Jensen has even added honesty to the set of major factors of production, highlighting its importance for increasing the efficiency of the organization [Cressy et al., 2010, pp. 117-120]. Ethics and morality can support the mechanisms of corporate governance and must become the foundation for systemic changes.

It should be stressed that ethical issues in the world of finance concern four levels [Gasparski et al., 2004, pp. 23-24]:

- Individual behaviour – the responsibility of specialists acting as representatives (agents), such as bankers, managers, etc.;
- Institutional behaviour – rules and standards set by financial organizations, stock exchanges, government regulatory institutions, etc.;

---

[5] “The global financial crisis represents a multi-level failure of responsibility – from the individual and corporate level to the finance sector and entire capitalist system.” [Visser, 2010, p. 232]. The author describes “a culture of greed embedded in the DNA of the company and financial markets”, and proposes as a remedy a revived system of corporate social responsibility.

[6] The authors criticize the current trends in management education and practice and shows the consequences: corruption of the educational process, corruption of managerial practice, corruption of established organizations, and corruption of social institutions.

- Corporate behaviour – people who are responsible for corporations (corporate executives) must act in the interest of the owners, who are not so much responsible for the social damage caused by their corporations (in the broader sense these issues are related to corporate governance);
- Global behaviour – in particular, issues of inequality in the distribution of wealth and poverty, responsibility of the developed countries for assistance to the less-developed ones.

Incentives for ethical behaviour may come from a variety of sources, and may have an impact at different levels: from individual incentives (the ethical and moral values of individuals) and occupational (professional) incentives, to incentives at the level of organization (these are practical measures stimulating and obliging employees to comply with applicable principles, regulations, laws, and ethical standards), to market and regulatory incentives (imposing sanctions and penalties on organizations and individuals who engage in unethical and unacceptable behaviour) [Razaee, 2007, p. 447].

It is crucial for the ethical attitude of organizations to create an adequate ethical climate, that is, stable, psychologically significant, shared perceptions employees hold concerning ethical procedures and policies existing in their company (based on observations rather than feelings or attitudes) [Wimbush and Shepard, 1994, pp. 637-647]. This ethical climate may be different in various organizations, depending on the particular interests of individual employees and teams, friendship between employees and their morality, social responsibility of the organization and its profitability and operational efficiency, as well as on principles, standard procedures, regulations and codes [Sims, 1992, pp. 505-513]. And it is exactly the strong ethical culture of a bank that can complement the formal instruments of corporate governance. It is stressed that this is all the more important in the co-operative sector, where market mechanisms (corporate governance) do not work and do not discipline organizations to behave appropriately [Diacon and Ennew, 1996, pp. 623-634].

Honesty in the world of business means not abusing trust and performing the duties which are assigned to participants of the financial market [Jackson, 1999, p. 13]. Still, the growing gap between financial institutions and their surrounding obscures the sense of responsibility of financial entities [Dembiński, 2004, p. 54].[7]

In the construction of ethical banking rules of key importance are [Dembiński, 2004, p. 58]:

[7] The author points here to the paradox of misconceived responsibility: there is massive responsibility because of the assets involved and a diffused awareness of this responsibility due to the technological and institutional isolation of the financial institution.

- Personal ties between customers and operators;
- Charts and codes of ethics;
- Regulations for financial markets.

It seems, therefore, that the optimal solution would be to merge the corporate governance system with the ethical culture of institutions. Previously, ethics was rarely seen as the foundation of corporate governance [Sullivan, 2009, p. 3]. However, it may be argued that there is an interaction here which promotes building an appropriate framework for the operation of all entities. The adopted principles and codes of ethics support the organization's responsible attitude towards its stakeholders, which is the essence of corporate governance. At the same time, an effective system of corporate governance helps observe the code of ethics implemented by the institution.

A. Bhimani argues that codes of corporate governance promote certain ethical values and principles as well as some moral aspects of the proper conduct of individuals and organizations. These codes, taking into account the concepts of neoclassical economics, by definition introduce the dimension of moral values and ethical ideals in their economically rationalist argument [Bhimani, 2008, pp. 135-147].

Ethical choices within corporate governance are in particular related to how, to what extent, and in relation to whom the basic "virtues" of corporate governance (i.e., the principles concerning duties, responsibility, honesty and transparency) are adhered to. The moral choices (judgments) made in this area are determined by differences in the models of corporate governance. They concern the scope of stakeholders and their expectations to be complied with by the bank and the extent to which these expectations will be incorporated in the bundle of the bank's objectives. Moral judgments are also reflected in the criteria for assessing the success of the organization by attaching importance to the following issues: economic and operational efficiency, involvement of the stakeholders and creating a kind of "corporate citizenship", and, finally, reduction of the imbalance between different groups of stakeholders. [8]

Many argue that corporate codes of ethics can constitute an effective mechanism for governance by providing guidelines for economic attitudes. In particular, such codes are important when other instruments (market mechanisms, state intervention, and social and ethical climate) have not brought about socially optimal effects [Thomson, 2001]. Regulations are not always effective and not always help to enhance enterprise value. Thus, management ethics, ethical education, or social norms will often have better results than strict rules [He and Ho, 2011].

[8] More in West [2009].

However, codes of ethics, despite being meant to control behaviour and attitudes, cannot be a substitute for morality, culture, and character [Razaee, 2007, p. 440].

It is worth noting that research carried out in mature economies has shown that organizations with good corporate governance achieve good results regardless of their regulatory environment [Bruno and Claessens, 2010]. It can therefore be concluded that of greatest importance are internal motivators of good corporate governance. But in a model based on self-regulation it is necessary to ensure internal and external supervision in order to enforce corporate governance requirements [Weismann, 2009].

An interesting example of promoting corporate honesty and social responsibility is the incorporation of this idea into the Dutch corporate governance code. [9] It is worth noting that the core perspective of the code is "that a company is a long-term alliance between the various parties involved in the company." Therefore, this model strongly emphasizes the perspective of stakeholders: the management and supervisory boards are responsible for taking into account the interests of different groups, and corporate social responsibility is seen as a component of the company's primary strategy. It should be noted that in the original draft code the recommendations were even broader and suggested that institutional investors (including mutual funds) should increase their transparency regarding ESG issues (environmental, social and corporate governance). The final version of the Code contains a provision requiring the shareholders to act in accordance with the principles of "reasonableness and fairness."

3. What kind of corporate governance rules should be adopted by banks?

It is essential for the construction of a new financial order to establish a regulatory strategy enhancing the stability of the operations of banks. This requires identifying critical areas of inefficiency in the existing regulations. The four most significant problems include [Acharya and Richardson, 2009, p. 25]:

- Banks are encouraged to undertake excessive risk;
- Regulatory safeguards are poorly designed and inadequately valued, resulting in the problem of institutions too big to fail;
- Growing opacity and the resulting counterparty credit risk externalities
- Existing regulations focus on the risks of individual institutions rather than on systemic risk.

[9] More in Lambooy [2010].

These observations give rise to some overarching principles which should guide the regulations currently being developed [Acharya and Richardson, 2009, p. 30]:

- Strengthening internal management and internal audit within institutions and adjusting remuneration policy so as to reduce excessive risk-taking and diminish the level of financial leverage;
- Fair valuation of government guarantees and their exclusion in certain cases;
- Increasing transparency in order to reduce counterparty credit risk externalities;
- Implementing prudential regulations for large, complex financial institutions, based on their contribution to the risk of the financial system.

The fact that the financial sector is better developed and more stable [Barth et al., 2004] in countries whose governments support the private sector's ability to monitor banks is the starting point for the regulatory and supervisory authorities to determine the strategy for improvement of governance in banks. Thus, the stability of banks is founded not only on support for regulations and institutional supervision, but also for private monitoring (market discipline). Moreover, in order to improve corporate governance in banks, it is necessary to introduce strong and clear incentives for owners, creditors and supervisors so that they would properly carry out their tasks of monitoring and disciplining banks if the banks should take excessive risk [Capiro and Levine, 2002, p. 42].

The risk of over-regulation of the financial sector should be emphasized here. Although at the moment there is a consensus on the need to strengthen legal norms in order to prevent another significant increase in risk, it is also argued that it would be dangerous to create too many regulations or badly designed ones. Such regulations would lead to reduced efficiency and effectiveness of the financial system. And if the new regulations constrain innovation, which would otherwise benefit companies and individual customers, they could have adverse consequences for future economic growth [Mishkin, 2010].

Drafting new regulations for the functioning of the banking sector is nowadays an extremely difficult task – in the face of pressure to tighten regulation, increase supervision or even take "retaliatory" measures against banks, it is difficult to find a happy medium between dangerous under-regulation and dangerous over-regulation. As pointed out by the European Banking Federation, "policy-makers will need to strike a delicate balance between their instinctive reaction in times of stress to regulate and control on the one hand; and on the other, the need to preserve the financial sector's ability to serve the economy and society" [EBF, 2010, p. 2].

The EBF has developed principles that should guide the changes that are being currently introduced and are addressed both to regulators and supervisors, as well as the banking sector. These rules cover nine areas [EBF, 2010, p. 2]:

- Banking in an open market economy – Reforms should respect the values of openness, the freedom of capital movement, the freedom of establishment and a level playing field among financial institutions.
- Properly supervised banking – The model of banking supervision must ensure stability and functionality of the markets, as well as being in step with modern banking.
- Truly commercial banking – Banks must remain commercial in nature; therefore, the crisis-induced public intervention needs to be withdrawn as quickly as possible, in a coordinated and market-sensitive way. Enduring government intervention in the financial system harbours the danger of deactivating market mechanisms and distorting competition.
- Banking without size prescription – To make banking safer, policy-makers should focus on the systemic aspects of financial institutions rather than on their size. (This relates to an institution's activities, the legal underpinning of its component units, its business model and the scale and nature of interconnectedness with others).
- Diverse banking models – The prescription of a specific banking model would limit innovative and successful business. Stable relations are important for banks – and a variety of banking profiles can offer this. Structural principles (legal form, regional principle, mandatory group membership) should not be prescribed.
- Customer-oriented banking – European regulators should continue to focus on banking customers, and in this regard there is a need to increase transparency and build confidence, notably in the field of credit intermediaries and information to consumers. The crisis has highlighted the importance of financial education.
- Robust banking – The banking business is highly sensitive to changes in capital requirements. Over-zealous tightening of the capital regime could have a dramatic impact on banking as well as on the economy (particularly if attention is not paid to the cumulative effect of the changes). Capital requirements must be appropriately calibrated to ensure stability and avoid a reduction in the availability of credit and other financial resources to the wider economy.
- Sustainable banking – Banks and other financial institutions must continue to re-examine the role they play in financing the growth of the real economy and enhancing financial stability. The banking business is crucially dependent

on public trust. Both the public good and the capacity of providers to fulfil their mandates in a competitive, efficient and cost-effective way, can be impaired by deficiencies in professional integrity, transparency and accountability. Banks must further improve risk management, align remuneration and compensation schemes with long-term value creation and gear incentive structures more strongly to customers' wishes and their long-term corporate interest.

- Adaptable banking – Banks must develop robust strategies to be able to adapt to continuously evolving market conditions and changes in the demand for banking services. Adaptability and creativity in such financial areas as change of funding sources, collateral shortages, improved securitization activity, as well as in harnessing technology, will help banks to better assist society in facing its own challenges.

In fact, the principles promoted by the EBF relate to the development of a banking system based on a regulation–self-regulation continuum. As the former head of the Financial Services Authority (FSA), H. Davies, rightly observed, no system of corporate governance will work efficiently without the involvement of shareholders. Regulators cannot be a substitute for interested and responsible owners, but they can to some extent support and complement them [Davies, 2003].

On the other hand, a set of voluntarily accepted recommendations and best practices cannot be an alternative to reliable oversight – both components complement each other and must co-exist together in order to create a stable, strong and dynamic global financial system [Ackermann, 2008]. The same regulations may in fact produce different effects, depending on the existing corporate governance structures in banks [Laeven and Levine, 2009]. In addition, one should bear in mind that incentives for the development of good corporate governance can be distorted in the face of financial threats and crises. Thus, it is all the more important to support regulatory governance with institutional structures of greater independence and transparency, i.e., to ensure best governance practices in supervisory institutions themselves [Das and Quintyn, 2002].

Therefore, one should seek an optimal balance between the regulation of the financial sector and the promotion of self-regulation. Neither regulations alone or corporate governance mechanisms alone can guarantee success. The best results can be achieved by supervisory regulations supporting strong corporate governance based on ethical foundations.

Conclusion

The global financial crisis has demonstrated the need for new paradigms, especially those pertaining to "a balance between economic freedom and discipline, competition and cooperation, self-regulation and intervention, centralization and decentralization, private and public ownership, self-financing and public financing, current and future consumption" [Frąckowiak, 2011, p. 81]. Indeed, it is necessary to redefine the role and organization of the state, society and the economy, and determine points of equilibrium anew.

There is no doubt that ethics and a sense of responsibility supported by a stronger regulatory system and improved supervisory institutions (and macro-prudential supervision) should be the core elements of an improved, stable and responsible financial system [European Commission, 2010d]. Legal standards should only serve as a support for grass-roots initiatives. It is unrealistic to expect that the monitoring and supervision of complex financial markets and institutions may be based solely on regulations, but this does not mean that the state may abandon these processes. An effective regulatory regime must be based on the desire of banks (and other institutions) to maintain high management standards and values as part of their corporate culture [Tomasic, 2011, p. 52].

Corporate governance, especially in the banking sector, should ensure that organizations are concerned with the good of all their stakeholders. However, honesty, transparency and responsibility must be mutual in nature [Marcinkowska, 2010].

References

1. Acharya, V. V., and Richardson, M. 2009. *Restoring Financial Stability. How to Repair a Failed System*, John Wiley & Sons, New York.
2. Ackermann, J. 2008. 'Address to the National Press Club', (http://www.iif.com/regulatory/article+147.php, last accessed 17 July 2008).
3. Barth, J. R., Capiro, G. Jr., and Levine, R. 2004. 'Bank Regulation and Supervision: What Works Best', *Journal of Financial Intermediation*, Vol. 13, Issue 2, April.
4. BCBS 2010a. Basel III: A global regulatory framework for more resilient banks and banking systems, BIS, Basel, December.
5. 2010b. Basel III: International framework for liquidity risk measurement, standards and monitoring, BIS, Basel, December.
6. 2010c. Compensation Principles and Standards Assessment Methodology, BIS, Basel, January.

7. 2010d. Principles for enhancing corporate governance, BIS, Basel, October.
8. 2011a. Basel III: A global regulatory framework for more resilient banks and banking systems - revised version June 2011, BIS, Basel, June.
9. 2011b. The internal audit function in banks. Consultative Document, BIS, Basel, December.
10. Bhimani, A. 2008 'Making corporate governance count: the fusion of ethics and economic rationality', *Journal of Management and Governance*, No. 12.
11. Bruno, V., and Claessens S., 2010. 'Corporate governance and regulation: Can there be too much of a good thing?', *Journal of Financial Intermediation*, Vol. 19.
12. Capiro, G. Jr., and Levine, R. 2002. 'Corporate Governance in Finance: Concepts and International Observations', in Litan, R. E., Pomerleano, M., and Sundararajan, V. (eds.), *Financial sector governance. The roles of the public and private sectors*, Brookings Institution Press, Washington.
13. Cressy, R., Cumming, D., and Mallin, Ch. 2010, 'Entrepreneurship, Governance and Ethics', *Journal of Business Ethics*, Vol. 51.
14. Das, U. S., and Quintyn, M. 2002. 'Financial Crisis Prevention and Management: The Role of Regulatory Governance', in Litan, R. E., Pomerleano, M., and Sundararajan, V. (eds.), *Financial sector governance. The roles of the public and private sectors*, Brookings Institution Press, Washington.
15. Davies, H. 2003. 'Corporate Governance In Financial Institutions', speech at the International Monetary Conference, Berlin, 3.06.2003.
16. Dembiński, P. H. 2004. 'Wyzwania etyczne w działalności finansowej', in Gasparski, W. (ed.), *Uczciwość w świecie finansów*, Wydawnictwo Wyższej Szkoły Przedsiębiorczości i Zarządzania im. Leona Kuźmińskiego, Warsaw.
17. Dembiński, P. H. 2011. *Finanse po zawale. Od euforii finansowej do gospodarczego ładu*, Studio EMKA, Warsaw.
18. Diacon, C. R., and Ennew, C. T. 1996. 'Can Business Ethics Enhance Corporate Governance? Evidence from a Survey of UK Insurance Executives', *Journal of Business Ethics*, Vol. 15.
19. EBA 2011. *Guidelines on Internal Governance*, September.
20. European Banking Federation 2010. *Principles for a successful future of banking in Europe*, Brussels.
21. European Commission 2009. Commission Recommendation of 30 April 2009 on remuneration policies in the financial services sector, 2009/384/EC, OJ L 120/22.
22. 2010a. Commission staff working paper: Corporate Governance in Financial Institutions: Lessons to be drawn from the current financial crisis, best practices. Accompanying document to the Green Paper. Corporate Governance in

financial institutions and remuneration policies, SEC(2010) 669 final, Brussels, 2.06.2010.
23. 2010b. Corporate Governance in Financial Institutions: Lessons to be drawn from the current financial crisis, best practices, Brussels, June.
24. 2010c. Green Paper. Corporate Governance in financial institutions and remuneration policies, COM(2010) 284 final, Brussels, 2.06.2010.
25. 2010d. Towards more responsibility and competitiveness in the European financial sector, EU.
26. European Parliament 2011. Directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate, COM (2011) 453final, Brussels, 20.07.2011.
27. Flejterski, S. 2010. 'W poszukiwaniu nowego paradygmatu zarządzania przedsiębiorstwami bankowymi', in Rogoziński, K., and Panasiuk, A. (eds.), 'Zarządzanie organizacjami usługowymi', *Zeszyty Naukowe*, No. 145, Wydawnictwo Uniwersytetu Ekonomicznego w Poznaniu, Poznań.
28. Frąckowiak, W. 2011. 'Wyzwania dla teorii i praktyki finansów w świetle kryzysu ekonomicznego', in Jajuga, K. (ed.), 'Finanse – nowe wyzwania teorii i praktyki. Problemy wiodące', *Prace Naukowe Uniwersytetu Ekonomicznego we Wrocławiu*, No. 170, Wrocław.
29. Gasparski, W., Lewicka-Strzałecka, A., Rok, B., and Szulczewski, G. 2004. 'Etyka w świecie finansów: pojęcia i zagadnienia', in Gasparski, W. (ed.), *Uczciwość w świecie finansów*, Wydawnictwo Wyższej Szkoły Przedsiębiorczości i Zarządzania im. Leona Kuźmińskiego, Warsaw.
30. He, L., and Ho, S. J. K. 2011. 'Monitoring Costs, Managerial Ethics and Corporate Governance: A Modeling Approach', *Journal of Business Ethics*, Vol. 99, http://ec.europa.eu/internal_market/finances/committees/ index_en.htm.
31. IIF 2008. Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations. Financial Services Industry Response to the Market Turmoil of 2007-2008, July.
32. Jackson, J. 1999. *Biznes i moralność*, Wydawnictwo Naukowe PWN, Warsaw.
33. Kaufmann, D. 2002 'Public and Private Misgovernance in Finance: Perverse Links, Capture, and their Empirics', in Litan, R. E., Pomerleano, M., and Sundararajan, V. (eds.), *Financial sector governance. The roles of the public and private sectors*, Brookings Institution Press, Washington.

34. Kirkpatrick, G. 2009. 'The corporate governance lessons from the financial crisis', *Financial Market Trends*, Vol. 1, No. 96, September.
35. Labooy, T. 2010. 'Institutionalization of corporate social responsibility in the corporate governance code: the New trend of the Dutch model', in Sun, W., Stewart, J., and Pollard, D. (eds.), *Reframing Corporate Social Responsibility: Lessons from the Global Financial Crisis*, Emerald, United Kingdom.
36. Laeven, L., and Levine, R. 2009. 'Bank governance, regulation and risk taking', *Journal of Financial Economics*, Vol. 93.
37. Litan, R. E., Pomerleano, M., and Sundararajan, V. (eds.), 2002, *Financial sector governance. The roles of the public and private sectors*, Brookings Institution Press, Washington.
38. Marcinkowska, M. 2010. 'Jak wzmocnić władztwo korporacyjne w bankach?', in Urbanek, P. (ed.), *Nadzór korporacyjny w warunkach kryzysu gospodarczego*, Wydawnictwo Uniwersytetu Łódzkiego, Łódź.
39. Minzberg, H. 2004. *Managers not MBAs. A hard look at the soft practice of managing and management development*, FT Prentice Hall, London.
40. Mishkin, F. S. 2010. *The Economics of Money, Banking and Financial Markets*, 9th ed., Pearson, Boston.
41. OECD 2009. *Corporate Governance and the Financial Crisis. Key findings and main messages*, June.
42. 2010. *Corporate Governance and the Financial Crisis: Conclusions and emerging good practices to enhance implementation of the Principles*, February.
43. Razaee, Z. 2007. *Corporate Governance Post-Sarbanes-Oxley Act: Regulations, Requirements, and Integrated Processes*, John Wiley and Sons, Hoboken.
44. Sims, R. R. 1992. 'The Challenge of Ethical Behavior in Organizations', *Journal of Business Ethics*, Vol. 11.
45. Sullivan, J. D. 2009. *The Moral Compass of Companies: Business Ethics and Corporate Governance as Anti-Corruption Tools*, International Finance Corporation, Washington.
46. Sun, W., Stewart, J., and Pollard, D. (eds.) 2011. Corporate Governance and the Global Financial Crisis. International Perspectives, Cambridge University Press, Cambridge.
47. The High-level Group of Financial Supervision in the EU (The de Larosière Group) Report. 2009. Brussels.
48. The Polish Financial Supervision Authority, 2011. The resolution of the PFSA No. 258/2011 dated 04.10.2011 The resolution replaces the PFSA resolution No. 383/2008 on detailed rules for the functioning of the risk management

and internal control system and the specifics of estimating internal capital by banks and reviewing the process of assessing and maintaining internal equity, and the principles for determining the policy for variable components of remuneration of banking executives (the PFSA Official Journal, No. 11, pos. 42).
49. Thomson, S. 2001. 'Business Ethics as Corporate Governance', *European Journal of Law and Economics*, 11:2.
50. Tomasic, R. 2011. 'The failure of corporate governance and the limits of law', in Sun, W., Stewart, J., and Pollard, D. (eds.), *Corporate Governance and the Global Financial Crisis. International Perspectives*, Cambridge University Press, Cambridge.
51. Turner, A. 2009. *A regulatory response to the global banking crisis*, FSA, March.
52. Visser, W. 2010. 'CSR 2.0: From the Age of Greed to the Age of Responsibility', in Sun, W., Stewart, J., and Pollard, D. (eds.), *Reframing Corporate Social Responsibility: Lessons from the Global Financial Crisis*, Emerald, United Kingdom.
53. Walker, D. 2009. 'A Review of corporate governance in UK banks and other financial industry entities. Final recommendations', November 26.
54. Weismann, M. F. 2009. 'The Foreign Corrupt Practices Act: The Failure of the Self-regulatory Model of Corporate Governance in the Global Business Environment', *Journal of Business Ethics*, Vol. 88.
55. West, A. 2009. 'Corporate Governance Convergence and Moral Relativism', *Corporate Governance: An International Review*, 17(1).
56. Wimbush, J. C., and Shepard, J. M. 1994. 'Toward an Understanding of Ethical Climate: its relationship to ethical behavior and supervisory influence', *Journal of Business Ethics*, Vol. 13.
57. Wymeersch, E. 2008. 'Corporate Governance and Financial Stability', *Financial Law Institute Working Paper Series*, Working Paper No. WP 2008-11, September.

*Krzysztof Misiołek**

CHAPTER 4

DETERMINANTS OF CORPORATE GOVERNANCE IN BANKS

Introduction

In most cases, banks are large and organizationally complex corporations. Effective corporate governance in banks is the basis for achieving and maintaining public confidence in the banking system and constitutes a critical factor for the proper functioning of individual banks as well as the entire economic system. Corporate governance is an ambiguous concept as there is no single model or theory describing it. Models of corporate governance are divided into financial and social [Wit and Meyer, 1998]. The financial model of corporation focuses on the instrumental representation of the goals of the owners and pays particular attention to economic effectiveness – a company and its components become instruments to achieve it. On the other hand, the social model of corporation accentuates the importance of stakeholders and the necessity to balance their needs in the long term as a condition of survival. The social model of corporation assumes that corporate governance is a concept that refers not only to the owners, but to all stakeholders of the company.

In the case of banks this issue is even more complicated because sometimes they can be both an object and subject of corporate governance. Weak corporate governance may result in a bank's failure and in the loss of confidence in the quality of its management.

1. Definitions of corporate governance

A bank's corporate governance determines its principles of organization and functioning and defines its internal and external relations. It indicates the fundamental relationships between the owners, top management and external supervi-

* Cracow University of Economics

sion bodies as well as the bank's clients and social environment. It presents the essence of using good corporate practices and their critical impact on strategic management, and, what is typical of banks, on the management of banking operations, especially in the area of risk management and compliance with the law.

The mechanisms of corporate governance involve economic and legal institutions which are prone to change as a result of political processes. A. Shleifer and R. Vishny define corporate governance as a set of methods designed to guarantee investors (suppliers, shareholders and creditors) a return on their investment [Shleifer and Vishny, 1996]. Another definition describes this concept as a system by which companies (corporations) are directed and controlled [Cadbury, 1992].[1] Corporate governance involves a set of relationships between a company's executive staff, governing bodies, shareholders, and other stakeholders. Corporate governance [OECD, 2004] should provide proper incentives for the governing bodies and executive staff to pursue objectives that are in the interest of the company and its partners/shareholders; it should also facilitate effective monitoring. An effective corporate governance system – within an individual company and across the economy as a whole – helps provide the degree of confidence that is necessary for the proper functioning of a market economy, thus encouraging companies to use resources more efficiently.

One can quote various classifications of corporate governance systems. M. Jerzemowska [2002], while indicating external and internal systems of ownership and control, defined the Anglo-American model as an external one, and the systems adopted in Continental Europe and Japan as internal. The board of directors (combining the functions of a supervisory board and a management board) found in the Anglo-Saxon system plays a fundamental role in top level decision-making. In principle, representatives of owners generally do not participate in a company's management bodies; they act as observers, and now – in the face of the crisis – monitor the actions of the management bodies. The role of banks is very limited in this respect, and essential for the operation of a corporation are the capital market and the external market for corporate control.

In the German model of corporate governance, the non-executive function of the supervisory board is clearly distinct from the executive function of the management board. German banks, as opposed to American banks, hold an overwhelming part of shares of German companies and play a decisive role in managing the companies (mainly by having seats on supervisory boards and by influencing manage-

[1] B. Wawrzyniak places corporate governance above owner supervision and company management. More models of corporate governance can be found in Lis and Sterniczek [2005]; Dobija and Kołądkiewicz [2011].

ment boards by representatives of banks). It is assumed that managers from the banks have the knowledge, relevant experience and ability to use the influence of the banks they work for. They can also work as consultants for the management board. Management boards try to participate in the work of supervisory bodies and representatives of financial institutions as these institutions can be used as sources of capital and, furthermore as communication channels with other companies through informal networks of members of supervisory boards.

2. Corporate governance in banks

Public confidence is the basis for the functioning of banks [Korenik, 2009].[2] Therefore, banks are subject to statutory regulations to a greater extent than other economic entities and legislation is an essential factor in the development of bank management systems. Other factors resulting from the general strategy and philosophy of the functioning of the banking business seem to be subordinate to legislation [Büschgen, 1997, p. 12]. Generally, banks have complex and often very large groups of stakeholders. They have restrictive regulations and are monitored by banking supervision and rating agencies. Banks are subject to international guidelines and recommendations, and those which are publicly traded companies fall under additional regulations (e.g., concerning information governance). Banking corporate governance has several aspects. On the one hand, corporate governance concentrates on the classical approach to relationships between the owners and management of the bank, including the theory of agency [Ross, 1973, pp. 134–138; Jensen and Meckling, 1976]. This is reflected in analysis of the powers of supervisory and management boards (boards of directors in the one-tier model), compliance with the law and the organization of the management system. On the other hand, corporate governance is a component of a larger system within which banks are subjected to external influences affecting standards related to capital, risk management, and bank security, the latter being reflected in the system of bank management, subjected to external regulations of banking supervision (in Poland, the Polish Financial Supervision Authority).

There is also a third dimension of corporate governance in banking – banks influence their debtors and their actions. It is a very important factor in the corporate governance system, reflected in the theory of agency concerning debt (particularly evident in the German model of corporate governance presented above).

[2] The author indicates internal responsibility (microeconomic, legal, financial, ethical, to the customer, organizational) and public responsibility.

3. The formal structure of corporate governance

From the standpoint of the formal management structure of a commercial bank and the functioning of the corporate governance system, of greatest importance are the rules defining the principles of the development, organization and activities of banks defined in the Banking Act, regulations of the Polish Financial Supervision Authority, the Commercial Companies Code, the cooperative law, and other regulations, also international, etc. Under corporate governance, a bank's statute defines the structure and organization of the bank, the procedure to submit declarations on the rights and obligations, own funds, the principles of creating and using special funds, and the principles of financial management [The Banking Law, 1997]. A bank can be established when own funds are ensured and the entire initial capital is collected. The amount of capital should be adequate to the type of anticipated activity and its scale; the bank must also have an appropriate material base. While analysing corporate governance in a bank, one should pay attention to its founders and candidates for positions on the management board, including its president, who must be a guarantor of safe and stable management.

A special role is played by ownership supervision due to many formal regulations related to the "quality" of the owners and of the capital contributed by them. Article 9 of the Banking Act [Journal of Laws, 1997] states that the management board of a bank shall design, implement and ensure the operation of the management system. The supervisory board of a bank shall supervise the implementation of the management system and assess its adequacy and effectiveness. The proper division of competence and authority between the supervisory board and the management board is an important issue. The lack of such a division leads to many conflicts, which often result from misunderstanding of the function of the supervisory board. It has already been noted that banks must have risk management and internal control systems. Under the risk management system, a bank is obliged to use formalized principles and procedures of risk management; moreover, it sets limits for reducing risk, uses management reporting systems, builds organizational structures adequate to the risk and takes supervisory measures related to risk management in its subsidiaries. Under the internal control system, measures are taken to promote the effectiveness and efficiency of a bank's operations, ensure compliance with the law and other regulations, and guarantee the credibility of financial reports. Considering organizational structures, there is a legal obligation to establish an organizational unit (internal audit) responsible for independent and objective analysis of the adequacy and effectiveness of internal controls as well as for the examination and evaluation of the bank's management system. The information thus produced is addressed to the bank's supervisory board. The supervisory board can additionally strengthen its potential in this respect by appointing an internal audit committee from among its own members to cooperate with and supervise the audit unit functioning under the bank's management system.

The internal dimension of corporate governance concerns the relationship between the owners of the bank and the bank's management. This aspect is also reflected in the theory of agency and the resulting agency costs theory. The agency relationship involves agency costs which are enormous in banks due to their very complicated structures, excessive risk taking, evasion of responsibility resulting from frequent group decision-making (Asset and Liability Management Committees, risk-management committees, loan committees, etc.), and generous remuneration of executives (often unrelated to the actual performance of the bank). This is accompanied by asymmetry of information, which means that people in different places of the organization have different pieces of information and undertake rational decisions according to those pieces and based on their own point of view. Commercial banks are an excellent example of a more complex structure of information asymmetry resulting from the presence of regulations which banks have to respect [Ciancanelli and Gonzales, 2000]. According to D. McNaughton [1995, p. 18], the supervisory boards of commercial banks should normally:

- Approve large loans or those which depart from the accepted rules of the bank's credit policy
- Approve major investments and sale of assets and compensation programs
- Prevent "self-serving" practices (a bank financing transactions of the members of its own board) as well as preferential transactions with persons associated with the bank
- Establish an audit committee to review financial statements and maintain internal controls
- Create an integrated policy in the bank regarding finance, credit, and personnel matters

Of importance is leadership [Davis, 1985, p. 20] as well as a clear vision of the future and a deeply rooted organizational culture, which should be a permanent element of operations executed by the management boards of banks.

4. Corporate governance in the recommendations of the Basel Committee

The principles of good corporate practices [BCBS, 2006, pp. 6 - 19] formulated by the Working Group of the Basel Committee (Basel Committee on Banking Supervision) in 2006 indicate that corporate governance involves the allocation of authority and responsibility and defines the manner of managing the bank, sets the bank's objectives and strategy, sets forth the principles of remunerations in line with long-term objectives, clearly distributes responsibility in the whole organization, determines the bank's risk tolerance/appetite, protects the interests of depositors, meets shareholder obligations and the expectations of other stakeholders, and ensures that the bank will operate in a safe and sound way, honestly and in accordance with applicable laws and regulations. A bank should conduct a risk management function through the actions of specially appointed organizational units, including the Chief Risk Officer (CRO) who has considerable standing and is guaranteed independence, has sufficient authority, resources, and access to the management board. Risks should be identified, assessed, and monitored on an on-going firm-wide and individual basis, and the system should adapt to the environment.

An important priority is to build transparent structures, avoiding excessive complexity which might hinder the effective implementation of corporate governance. The application of principles of corporate governance must be pursued in a manner consistent with the applicable national laws, regulations and codes.

The Committee recognizes that some countries have found it appropriate to adopt a legal framework and standards (e.g. for publicly traded firms), as well as accounting and auditing standards which may be more extensive and prescriptive than the principles set forth in the recommendations.

Due to differences in the models of corporate governance in different countries, the recommendations do not impose a single system of its organization, respecting the existence of one-tier and two-tier board systems.

Staff members should also be encouraged to disclose information they believe evidences illegal or unethical practices, as such practices may adversely affect the reputation of the bank. Whistleblowing procedures should provide protection against reprisal and ensure confidentiality to eliminate threats to employees who inform about substantial dangers the procedures should also build safe ways for direct and indirect communication with the top management.

It is important to maintain a balance between tasks, powers and responsibilities. The organizational structures of a bank should facilitate effective decision-making and an appropriate quality of management in accordance with the long-term goals, strategy and financial standing of the bank and make it possible to regularly monitor the performance of top management, and replace the management if necessary.

The supervisory board as a whole and its individual members should have appropriate experience, competence and personal qualities to fulfil their role effectively. This also applies to the management board; its members should have knowledge of finance, accounting, loan granting, banking operations and payment systems, strategic planning, communication, risk management, internal supervision, regulations concerning supervision and compliance with these regulations. The management board should also understand local, regional and, if necessary, global economic and market forces as well as the legal and regulatory environment.

The bank should have an adequate number and appropriate composition of board members. The bank should identify and nominate candidates and plan their succession. To ensure the independence of candidates the recruitment process should be as extensive as possible and as justified. Independence of the supervisory board can be enhanced by participation of qualified non-executive directors. It is also necessary to pay attention if the candidates are able to commit the necessary time and effort to fulfil their responsibilities, and they must not be engaged in any conflict of interest. In its conduct, the supervisory board should set a good example of appropriate implementation of corporate governance, which should be assisted by the board's proper structure, size, frequency of meetings, and the use of committees. A key role in the functioning of the board is played by its chairman, who should have the required experience, skills, and personal qualities to fulfil these duties, and should encourage critical discussion during the decision-making processes. More and more banks require their chairmen of the supervisory board to be a non-executive member of the board. If the roles of the chairman of the supervisory board and the president of the management board (CEO) are not separated, it becomes particularly important to ensure effective supervisory mechanisms and the possibility to present independent opinions.

The recommendations suggest using supervisory board committees. Each committee should have a charter or other instrument that sets out its mandate, scope and working procedures; furthermore, it may be useful to consider occasional rotation of chairmanship of such committees.

An audit committee is required in every bank. It is responsible for ensuring supervision over the bank through internal and external auditors and for cooperation with auditors, ensuring that the management board shall take the necessary corrective actions in a timely manner to address control weaknesses, non-compliance with policies, laws and regulations and other problems identified by auditors. The audit committee should establish an accounting policy and accounting practices for the bank to pursue. It is necessary to assure the participation of independent directors in the work of the committee.

Every large bank should set up a risk committee responsible for advising the board on the bank's risk tolerance and for overseeing the implementation of strategies in this area, in particular managing the bank's capital, liquidity, credit risk, operational risk, market risk, compliance risk, reputational risk and other risks. The recommendations also suggest appointing other committees, in particular compensation, nominations, and ethics and compliance committees. The recommendations present extensively the issue of conflicts of interest, pointing to risks in this area. They also show situations involving capital groups, where the whole responsibility for the compliance of subsidiaries with corporate governance is borne by the parent company.

The application of principles of corporate governance in the area of management board activities should ensure that the bank's activities are consistent with its strategy and principles of risk management and that the members of the board meet the necessary experience, competence, and credibility requirements in the areas they are responsible for. While designing the bank's structure one should avoid creating excessive and unnecessarily complex structures, and ensure an effective supervisory system for founding subsidiaries and supervising their activities, and ensure the transparency of operational risk management. Ensuring transparency is also necessary in the relationship with shareholders, depositors, and other interested parties and market participants, who are additionally encouraged to actively participate in the system of the bank's corporate governance: shareholders through active and informed exercise of their rights, clients through the use of such banks that guarantee them the expected level of the services and by avoiding banks that are poorly managed, external auditors through effective communication with the supervisory board, management board, and supervision in the bank, and sectoral associations through the promotion of good practices and agreements concluded in this field.

Professional consulting companies can be helpful in the implementation of sound practices of corporate governance; governments can contribute through legislative initiatives in this area; rating agencies through assessment of the way corporate governance affects the characteristics of bank risk; regulators of the stock market, stock exchanges, and other organizations by disseminating information about compliance with principles of governance in banks; and staff members through promoting employee whistleblowing.

5. Corporate governance in the light of the New Capital Accord

On April 1, 2007 the resolutions of the Polish Financial Supervision Authority implementing Directives 2006/48/EC and 2006/49/EC of the European Parliament [2006a, 2006b] and of the Council of June 14, 2006 (15), i.e., the regulations of the New Basel Capital Accord (NCA), entered into force in Poland. The accord consists of a set of rules and recommendations significantly affecting key management processes at banks, in both the strategic and operational spheres. The strategies and policies adopted by banks are updated annually and are subject to approval by the management board and the supervisory board (in Poland, a two-tier corporate governance system is in force, and top management is divided between these two bodies). The resolution of the Polish Financial Supervision Authority KNB No. 4/2007 [PFSA, 2007] states that banks are required to maintain an internal control system covering all bank organizational units. Similarly as in the case of the risk management system, banks are required to develop and implement a policy and procedures of internal control approved by the bank's management and supervisory boards. The NCA applies broadly to banks, subsidiaries and significant minority investments (in banks, various other financial entities), insurance institutions and major capital investments, as well in other non-financial entities.

The New Capital Accord consists of three pillars. The first one defines minimum capital requirements for banking institutions. These requirements are set within the framework of three basic risk types present in the banking business: credit risk, market risk, and operational risk. Emphasis was put on the tasks of corporate governance and supervision in the sphere of functioning of the internal assessment of risk and its application. One should take into consideration the scenarios which assume a negative impact on the bank's economic situation as well as an assessment of the bank management's ability to overcome adverse developments. This applies mainly to economic crises.

The second pillar is based on four fundamental principles. The first one involves supervision performed by the bank's management board and supervisory board, a reliable evaluation of capital, and comprehensive risk assessment, monitoring, reporting, and an internal control system. The second principle involves adequate risk assessment, capital adequacy, evaluation of the sphere of supervision, review of compliance with the minimum requirements and supervisory response. The third principle states that the supervisory institutions should require banks to operate under capital parameters which are higher than the regulatory minimum and the supervisory institutions should have the possibility to enforce it. The fourth principle envisages intervention in the early stages of potential risks – a specific preventive action involving immediate remedial measures if capital is not maintained at the appropriate level.

The second pillar stresses the importance of transparency, responsibility, communication and international cooperation. The second pillar consists of a process of supervisory review involving an assessment by supervisory institutions of internal capital adequacy and the application of the principles and processes of the bank's internal governance in order to verify its approach to determining the value of the capital it is obliged to maintain.

In accordance with the guidelines contained in the third pillar, credit institutions are obliged to disclose information on their risk profile and the capital conservation buffers held to cover the risk inherent in their activities. All important steps in the process of evaluation and risk assessment must be approved by the bank's board of directors (supervisory board); alternatively approval may be granted by the management board in conjunction with a committee appointed by the supervisory board. The management board must present to the supervisory board, or to the appointed committee, information on major changes or exceptions to the established principles of policy which affect the functioning of the bank's rating system. The management board should be familiar with the structures and functioning of the NCA. The management board's tasks include also the approval of major differences between the established procedures and the actual practice. Attention was paid to the importance and significance of reporting, its confidentiality and frequency. It was concluded that reporting should be an instrument ensuring mutual discipline of market participants.

Conclusion

Corporate governance in banks is strictly related to the fact that banks are public institutions which require effective legal, institutional, and customary foundations. One should emphasize the importance of formalized rules and principles of conduct, enforced by both the internal stakeholders of the bank and the increasingly important external stakeholders. In their actions, modern banks also take into account the social and financial models of corporate operations. These models must be followed by proper organizational structures and procedures, supported by adequate corporate culture ensuring appropriate standards and by incentives for professional and responsible conduct, which is essential for good governance. The leading role in this sphere must be played by supervisory and management boards (boards of directors), whose activities should serve as an example of application of corporate governance principles, preventing improper or unlawful actions, excessive risk taking and corruption and making sure that members of those bodies do not take advantage of their privileged position.

References

1. Büschgen, H. E. 1997. *Przedsiębiorstwo bankowe*, Vol. 2, Poltext, Warsaw.
2. Cadbury, A., 1992. 'The Report of the Committee on the Financial Aspects of Corporate Governance', The Committee on the Financial Aspects of Corporate Governance and Gee and Co. Ltd., London, www.ecgi.org/codes/all_codes.php.
3. Ciancanelli, P., and Gonzales, J. A. R. 2000. 'Corporate Governance in Banking: A Conceptual Framework', Social Science Research Network, www.papers.ssrn.com/paper.taf?abstract_id=253714
4. Davis, S. J. 1985. *Excellence in Banking*, MacMillan, New York.
5. Dobija, D., and Koładkiewicz, I. (eds.) 2011. *Ład korporacyjny*, Oficyna, a Wolters Kluwer business, Warsaw.
6. BCBS 2006. *Enhancing Corporate Governance for Banking Organisations*, Working Group on Corporate Governance of the Basel Committee on Banking Supervision, Basel, www.bis.org/publ/bcbs122.pdf?noframes=1.
7. European Parliament 2006a. Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions
8. 2006b. Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions
9. Jensen, M. C., and Meckling, W. H. 1976. 'Theory of the Firm, Managerial Behavior, Agency Costs and Ownership Structure', *Journal of Financial Economics*, October.
10. Jerzemowska, M. 2002. *Nadzór korporacyjny*, Państwowe Wydawnictwo Ekonomiczne, Warsaw .
11. Journal of Laws 1997. The act of 29 August 1997 – The Banking Law (Journal of Laws No. 72, item. 665 amended).

12. Korenik, D. 2009. *Odpowiedzialność banku komercyjnego, próba syntezy*, Difin, Warsaw.
13. Lis, K. A., and Sterniczuk, H. 2005. *Nadzór korporacyjny*, Oficyna Ekonomiczna, Cracow.
14. Mc Naughton, D. 1995. *Zarządzanie nowoczesnym bankiem w okresie zmian, efektywne zarządzanie zmianami*, Fundacja WIB, Warsaw.
15. OECD 2004. *OECD Principles of Corporate Governance*, www.oecd.org.
16. PFSA 2007. *The resolution of the Polish Financial Supervision Authority*, KNB No. 4/2007, www.knf.gov.pl/Images/u4_2007_tcm20-8533.pdf.
17. Ross, S. A. 1973. 'The Economic theory of Agency: the principal's problem', *American Economic Review*, No. 62.
18. Shleifer, A., and Vishny, R. W. 1996. 'A Survey of Corporate Governance', „*NBER Working Paper*", No. 5554, April.
19. Solarz, J. K. 1997. *Zarządzanie strategiczne w bankach*, Poltext, Warsaw.
20. Wawrzyniak, B. 2000. 'Nadzór korporacyjny: perspektywa badań', *Organizacja i Kierowanie*, No. 2, Warsaw.
21. Zalega, K. 2003. 'Nadzór bankowy i corporate governance a konkurencyjność sektora bankowego', *Bank i Kredyt*, No. 7.

*Agnieszka Słomka-Gołębiowska**

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.

* Warsaw School of Economics.

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 industry 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 disclosure 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 supervisory 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.

References

1. Bebchuk, L., Cohen, A., and Spamann H. 2010. 'The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008'. *Yale Journal on Regulation*, 27.
2. Bebchuk, L., and Fried, J. 2010. 'Paying for Long-Term Performance', *University of Pennsylvania Law Review*, 158.
3. Bhagat, S., and Romano, R. 2010. 'Reforming Executive Compensation: Simplicity, Transparency and Committing to the Long-Term', *European Company & Financial Law Review*, 7.
4. Chalmers, K., Koh, P., and Stapledon, G. 2006. 'The determinants of CEO compensation. Rent extraction or labor demand?', *The British Accounting Review*, 38.
5. Core, J., Guay, W., and Larcker, D. 2003. 'Executive Equity Compensation and Incentives: A Survey, *Economic Policy Review*, 9.
6. Core, J., Guay, W., and Thomas, R. 2005. 'Is CEO compensation inefficient pay without performance?' *University of Michigan Law Review*, 103.
7. Core, J., Guay, W., and Verrechia, R. 2003. 'Price versus non-price performance measures in optimal CEO compensation contracts' *The Accounting Review*, 78.
8. Core, J., and Guay, W. 2010. 'Is there a case for regulating executive pay in the financial services industry?, mimeo.
9. Ebert, F., Torres, R., and Papadakis, K. 2008. 'Executive compensation: Trends and policy issues', *International Institute For Labour Studies*, DP/180/2008.
10. European Commission 2009. *Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States*.
11. Fahlenbrach, R., and Stulz, R. 2010. 'CEO Incentives and the Credit Crisis', Dice Center WP 2009-13.

12. Ferrarini, G., and Ungureanu, M. 2011. 'Economics, Politics, and the International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks', *Vanderbilt Law Review*, Vol. 64:2.
13. FSB 2011. *Thematic Review on Compensation Peer Review Report*.
14. Gabaix, X., and Landier, A. 2008. 'Why Has CEO Pay Increased So Much?', *The Quarterly Journal of Economics*, MIT Press, vol. 123(1).
15. Groom, B. 2011. 'Call to end 'corrosive' top pay deals', *Financial Times*, November.
16. Grzybowski, M. 2011. 'Powiązanie wynagrodzenia menedżerów ze wzrostem wartości firmy', *Rzeczpospolita*, 9 listopada.
17. IIF 2011. *Compensation Reform in Wholesale Banking 2011: Assessing Three Years of Progress*, October.
18. Jędrzejewska, D., Mierzejewska, B., and Kaźmierczak, A. 2011. 'Ile zarabia bankowiec', *Gazeta Bankowa*, 1 listopada.
19. Jensen, M., and Murphy K. 1990. 'Performance Pay and Top-Management Incentives', *Journal of Political Economy*, 98(2).
20. OECD 2009. *Corporate Governance and the Financial Crisis: Key Findings and Main Messages*.
21. Prosser, T. 2009. 'Executive compensation and the economic crisis', Turyn, mimeo.
22. PwC 2011. (PricewaterhouseCoopers), 'Wynagrodzenia zarządów największych spółek giełdowych w 2010 roku', Warsaw.
23. Słomka-Gołębiowska, A. 2010. 'Nadzór korporacyjny banków w Polsce w okresie kryzysu finansowego', in Urbanek, P. *Nadzór korporacyjny w warunkach kryzysu gospodarczego*, Wydawnictwo Uniwersytetu Łódzkiego, Łódź.
24. Urbanek, P. 2009. 'CEOs Remuneration in Corporate Governance Codes in EU Member Countries', *Comparative Economic Research. Central and Eastern Europe*", No. 1/2.
25. Urbanek, P. 2010. 'Kryzys finansowy a polityka wynagradzania menedżerów', in Urbanek, P. *Nadzór korporacyjny w warunkach kryzysu gospodarczego*, Wydawnictwo Uniwersytetu Łódzkiego, Łódź.
26. Urbanek, P. 2011. 'Polityka wynagradzania menedżerów w sektorze finansowym a praktyka polskich banków – wnioski z kryzysu finansowego', in Jerzemowska, M. 'Współczesne problemy nadzoru korporacyjnego', *Prace i Materiały Wydziału Zarządzania Uniwersytetu Gdańskiego*, Sopot.

*Agata Wieczorek**

CHAPTER 6

INDEPENDENT SUPERVISORY BOARD MEMBERS IN POLISH PUBLIC BANKS

Introduction

One of the factors significantly affecting the effectiveness of a company's operations is the amount of capital. In order to raise capital companies go public and thus provide conditions for accumulating capital for the development and extension of their business activity. However, to attract potential investors, a company must advertise, demonstrating that it has effective supervisory and managing bodies. On the one hand, the management team may increase the value of a company, but, on the other hand, through opportunist actions, it may also lead to numerous undesirable situations which are not in line with the goals of the company and its shareholders. The supervisory board is an institutional solution to prevent such situations.

Major corporate scandals (e.g., the collapse of Enron and WorldCom) triggered numerous debates over the effectiveness of work of supervisory boards. It was noted that they were passive, their members lacked sufficient expertise and demonstrated loyalty to the management teams. One way to prevent such situations is to appoint independent supervisory board members, who are not related to the shareholders or any other entities associated with the company. Independent supervisory board members may also help settle disputes and facilitate the operation of the supervisory body. This idea has been supported by numerous organizations (including the European Commission and the Warsaw Stock Exchange), which recommend the appointment of independent members to company boards.

The objective of this paper is to determine to what extent the banks listed on the Warsaw Stock Exchange (WSE) observe the regulations concerning the appointment of independent supervisory board members as well as whether the members meeting the criteria of independence are appropriately educated and have qualifications to perform their tasks on supervisory boards.

* University of Lodz

1. Independence of supervisory board members in legal and corporate governance regulations

Modern enterprises are characterized by the separation of ownership and control. The management board is in a position to accomplish its own goals which may not always be in line with the interests of the shareholders. Therefore, it is essential that a company has a body supervising its executives. In a joint-stock company, it is the supervisory board which is to watch whether the management board acts in harmony with the corporate goals. Depending on the composition of the supervisory body, the board may perform its tasks more or less effectively. The supervisory board members related to the main shareholder are guided by its interests in taking strategic decisions, while the representatives of employees are guided by employee interests. Board members who are related to the management team tend to accept all the decisions taken by the executives, including those that may diminish the value of the company. Therefore, it is crucial that supervisory board members be independent and have no relationships with the company or its stakeholders. In their decisions they should be primarily guided by the best interests of the company, which will minimize the opportunistic behaviour of the management board.

In the United States, the document which the companies listed on the New York Stock Exchange are obliged to comply with is the Corporate Governance Rule Proposals [NYSE, 2002], which stresses the significance of independent board members. According to these proposals, listed companies must have a majority of independent directors on the board, which will increase the quality of board oversight and lessen the possibility of damaging conflicts of interests. Yet, the exact number of independent board members is not specified there. Section 303A specifies the criteria to be met by independent members of the board of directors. According to the definition [NYSE, 2002]:

a) No director qualifies as "independent" if that director has material relationship with the listed company (directly or as a partner, shareholder or officer of an organization that has a relationship with the company).
b) No director who is, or in the past five years has been, affiliated with or employed by an auditor of the company.
c) No director who is a former employee of the listed company can be "independent" until five years after the employment has ended.
d) No director can be "independent" if he or she is, or in the past five years has been, part of an interlocking directorate in which an executive officer of the listed company serves on the compensation committee of another company that concurrently employs the director.

e) Directors with immediate family members in the foregoing categories are likewise subject to the five-year "cooling-off" provisions for purposes of determining "independence."

The document released a year later also enumerates recommendations concerning independent directors on the company board [Breeden, 2003]. Importantly, all the members of this body, including its chairman, should be absolutely independent of executives, which will allow the board of directors to vote through projects consistent with the goals of shareholders but not necessarily with the managers' needs. Moreover, the document sets forth standards of independence, according to which a director is not independent if:

a) The individual or any close relative by blood or marriage is currently or has been an employee of the company within the past five years with compensation above a level specified by the board;
b) The individual receives (or within the past three years has received) any form of compensation for services as an employee, or as any outside consultant or other professional retained by the Company other than standard fees for board or committee service and is not a partner or employee of any law firm, investment banking firm or other firm providing professional services to the Company;
c) If the individual is an officer, director, partner or employee of any firm that does business with the Company, the director shall not be independent if the volume of cross-business exceeds a level set by the board, with 1% of revenues for either firm or $3 million in any three year period as a recommended starting level; provided that this restriction should not apply to purchase of telecom or other services from the Company by an entity affiliated with the director so long as the director played no role in negotiating any such transaction, and the business took place on arm's length terms;
d) If the individual serves as an officer of any company on whose board an officer of the Company sits, the individual is not independent while any such interlock is in effect;
e) If the individual is an officer, director or employee of a non-profit organization that receives donations from the Company in excess of $100,000 during any year, except for grants to a university, under certain conditions;
f) If the individual is a spouse or relative living in the same household of (i) any elected political official who has received donations from the Company or any senior officer during the current or past five years, (ii) any senior member of any regulatory body with authority over the company, (iii) any person with government contracting responsibility for the company, (iv) a governor

or member of a political executive body, or (v) a legislator who sits on any committee with jurisdiction to enact laws governing the Company or its business operations;

g) If the individual has had any personal commercial transactions with the CEO during the past ten years, or serves as an officer, employee, partner or owner of any organization that has been involved in any commercial transactions with the CEO personally during the past five years, except for routine retail or consumer transactions;
h) The individual has previously served as the Company's CEO.

Given recent corporate scandals, the Organization for Economic Cooperation and Development (OECD) has also emphasized the significance of appointment of independent members to company boards. The document prepared by the OECD [OECD, 2004] recommends the presence of such members on supervisory boards or boards of directors. The appointment of independent members will make it possible for the company board to apply objective criteria of performance evaluation. The OECD stresses that people who meet the criteria of independence are in a position to objectively evaluate the performance of executives. Moreover, they may play a significant role in areas where the interests of the management team, the company, and the partners/shareholders may diverge, such as executive remuneration, succession planning, change of entities auditing the company, take-over defence, and auditing of financial statements [OECD, 2004, s. 70 – 71]. Therefore, each company should declare which members of the board are independent. As regards issues which may result in conflicts of interests, such as financial reporting, nomination of members of the supervisory board or directors on the board of directors, and remuneration of members of corporate bodies, the company's supervisory board may establish special committees. The companies where such committees have been established should guarantee that a specified number of their members meet the criteria of independence. Moreover, supervisory boards should precisely describe in their regulations the mandate, composition and working procedures of such committees.

In view of the importance attached to the role of independent members in the effective operation of the company board, the European Commission issued Recommendation of 15 February 2005 on the role of non-executive directors or members of supervisory boards of listed companies or committees of the (supervisory) board [European Commission, 2005]. The European Commission offered a definition of an independent member, his or her responsibilities, as well as the criteria of independence. The document requires companies to appoint a sufficient number of independent members to ensure that any material conflict of interest involving directors will be properly dealt with. This also guarantees that the company's board will primarily be guided by the company's best interests. Annex II to the Commission Recommendation enumerates the criteria to be met by independent members of company boards. While the European Commission explains that the criteria should be tailored to the national context, it stresses that an independent company board member means a person who [European Commission, 2005]:

a) Is not an executive or managing director of the company or an associated company and has not been in such a position for the previous five years;
b) Has not been an employee of the company or an associated company and has not been in such a position for the previous three years;
c) Has never received significant additional remuneration from the company or an associated company, apart from a fee received as a non-executive or supervisory director;
d) Is not or in any way represents the controlling shareholder;
e) Does not have, or have had within the last year, a significant business relationship with the company or an associated company directly or as a partner, shareholder, director or senior employee of a body having such a relationship. Business relations include the situation of a significant supplier of goods or services (including financial, legal, advisory or consulting services), of a significant customer, and of organisations that receive significant contributions from the company or its group;
f) Is not or has not been within the last three years, partner or employee of the present or former external auditor of the company or an associated company;
g) Is not an executive or managing director in another company in which an executive or managing director is a non-executive or supervisory director and has no other significant links with executive directors or the company through involvement in other companies or bodies;
h) Does not or has not served on the (supervisory) board as a non-executive or supervisory director for more than three terms (or alternatively, more than 12 years where national law provides for normal terms of a very small length);
i) Is not a close family member of an executive or managing director, or of persons specified in the situations referred to in points (a) to (h).

When appointing the company's board, the general meeting of shareholders should be guided by the above criteria. After a decision is taken as to whether a board member can be regarded as independent, the board is obligated to make such information publicly available. Thus, anybody can ascertain whether or not the company follows the regulations concerning the appointment of independent board members. Apart from the criteria of independence, Annex II [European

Commission, 2005] to the European Commission Recommendation enumerates a number of rules which should be followed by a person who meets independence criteria. First of all, when making decisions, independent board members should not be guided by suggestions of other members serving on the board, but only by their own opinion. During the term of office they should not accept or demand any additional remuneration which could undermine the independence of their actions. When taking decisions, they should also be guided by the interests of the company and, if any actions of the board could harm the company, they should clearly express their objections.

Despite the fact that for over ten years independent supervisory board members have played increasingly important roles in the world and in the domestic market, the Polish law does not regulate this area of corporate governance. The Code of Commercial Partnerships and Companies [Commercial Companies Code, 2000] includes provisions concerning the powers, composition, and election of the supervisory board, adoption of resolutions, convocation of meetings, preparation of minutes, and setting the remuneration of board members, but the Code does not cover such issues as independent members on the supervisory board, their characteristics, the criteria they should meet, or the principles they should follow.

As regards corporate governance regulations, the situation looks much better. In 2002, the Warsaw Stock Exchange introduced the Polish version of the Code of Good Practice – "Best Practices in Public Companies in 2002" [WSE, 2002] to be complied with by the companies listed on the WSE. Each public company must submit a statement in which it specifies which rules of the Code it observes and which it does not, along with the reasons for its decision (comply or explain). Moreover, the part dealing with good practices for supervisory bodies includes regulations concerning the independence of supervisory board members. The first part of Best Practices gives a definition of a supervisory board member. Apart from adequate education as well as professional and personal experience, they are expected to dedicate enough time so that they could duly perform their duties. Further regulations concern independent members of the supervisory board. According to rule 20 "(a) At least half of the members of the supervisory board should be independent members. Independent members of the supervisory board should not have relations with the company and its shareholders or employees which could have a significant impact on their ability to make impartial decisions. (b) Detailed criteria of independence should be laid down in the statutes of the company. (c) Without the consent of at least one independent member of the supervisory board, no resolutions should be adopted on the following issues: – all kinds of considerations granted by the company or any entities associated with the company to management board members; – consent to the execution by the company or its subsidiary of a key agreement with an entity associated with the company, member of the supervisory board or the management board, and with their associated entities; and – appointment of an expert auditor to audit the financial statements of the company" [WSE, 2002]. Moreover, it is recommended to publicly state which members of the supervisory board are related to the shareholders and in particular, the strategic investor. However, the document does not include any provisions concerning the establishment of supervisory board committees designed for streamlining the operations of the supervisory body.

Unfortunately, the regulation concerning the number of independent members on the supervisory board has been ignored by the majority of the companies listed on the stock exchange. They explained their decision not to apply this principle by the fact that section 20 of the Code excessively restricts the corporate rights of the dominant shareholders and violates the principle of primacy of the rule of the majority.

Consequently, the Warsaw Stock Exchange introduced amended Best Practices [WSE, 2005] in 2005. Although the regulations concerning the independence of supervisory board members were left mostly unchanged, the Stock Exchange Board did introduce an amendment in view of the arguments given by the listed companies concerning the number of independent members. Rule 20 was extended with subsection (d): "In companies where one shareholder holds a block of shares over 50% of all voting rights, the supervisory board should consist of at least two independent members, including an independent chairman of the audit committee, should such a committee be set up" [WSE, 2005]. The listed companies approved of this change, but still many of them disregarded the rule on independent members. The Stock Exchange Board continued work on improvement of the code. In 2007, the WSE introduced another version of the code [WSE, 2007] with Part III of Best Practices devoted to supervisory boards and including regulations on their independence. Each member on the supervisory board should notify the management board of any economic, financial or family relationship with the holders of 5% or more of voting rights, as such a relationship may affect his or her decisions. The Code recommends that at least two members of the supervisory body should meet the criteria of independence specified in Annex II to the Commission Recommendation of 15 February 2005. However, subsection 6 of Part III of Best Practices stipulates that a person who is an employee of the company or an associated company, as well as persons related to the majority shareholder cannot be deemed to meet independence criteria described in the Annex.

Despite the fact that an increasing number of companies decided to follow all the rules contained in the Code, the Stock Exchange Board issued another set of Best Practices [WSE, 2010]. However, amendments to Best Practices did not concern the part devoted to the independence of supervisory board members. In this respect, Best Practices referred companies to the European Commission Recommendation of 15 February 2005. This may result from the fact that the majority of listed companies had already followed these rules. Many companies realized that success on the stock exchange depends not only on economic performance, but also on adherence to the rules of best practice.

Table 1. Criteria of independence in different legal regulations

Criteria of independence	USA	European Commission	Code of Best Practice*
Is not an executive director or member of the management board	Yes	Yes	Yes
Does not hold more than 5% of voting rights at general meetings	-	Yes	Yes
Is not employed by the company	Yes	Yes	Yes
Has not been a member of management board in another company where the board member is concurrently a chief executive director or a non-executive director on the board of the company	Yes	Yes	Yes
Does not have any business relationship with the company	Yes	Yes	Yes
Has not been employed by a chartered auditor cooperating with the company	Yes	Yes	Yes
Is not paid any extra remuneration by the company	Yes	Yes	Yes
Is not a member of the family of the executive director	Yes	Yes	Yes
Has not been an independent member for longer than 12 years	-	Yes	Yes

* The Code of Best Practice adopted in 2007 and 2010 with regard to independent criteria refers companies to the Recommendation of the European Commission, while Best Practices of 2002 and 2005 require companies to define the criteria on their own in their statutes.
Source: Author's own compilation

When comparing the provisions concerning independence criteria in the legal regulations of the United States, the European Union, and Poland (Table 1) it is worth noting that most of the characteristics of an independent board member are similar in all the above-mentioned documents. Thus, one could argue that the criteria of independence are uniform.

2. Literature review

Taking into account how important the supervisory board is as an internal mechanism of corporate governance, there arises an important question as to whether the composition of the board, and particularly the presence of independent members on the board, enhances its effectiveness of the board.

R.C. Hanson and Moon H. Song examined whether the composition of the board and the ownership structure affect the internal control system in companies [Hanson and Song Moon, 1998], including the monitoring of managers, evaluating management performance, and, when necessary, firing the CEO. They observed that supervision plays a significant role as regards boards with independent members. Moreover, they proved that in companies where most members of the supervisory board met the criteria of independence, executives and the CEO held a small block of shares. According to Hanson and Song, the findings show that two conditions must be met to provide an effective corporate system of internal control: monitoring should be conducted by independent members and the CEO should hold a block of shares. Yet, a number of the companies they studied preferred managers who were owners rather than independent board members.

M.S. Weisbach [1988, s. 431 - 460] tested the hypothesis that outside and inside directors behave differently in their decisions concerning dismissal of top executive officers. Inspired by the work of MacAvoy, he found that inside directors are employed by the company, i.e., apart from sitting on the board they also perform other duties in the company. In turn, those who do not work for the company and are in no way related to it are regarded as outside directors. The remaining directors who are not employed by the company but may have some relationship with it are regarded as "grey directors." To find which board is more effective (outsider-dominated or insider-dominated) in terms of monitoring the management team, Weisbach studied the relationship between CEO dismissals and company performance. A stronger correlation between these factors in companies with boards dominated by outside members would mean that such boards play a more significant role in monitoring the executives. The study involved 367 companies listed on the New York Stock Exchange in 1980. They were divided into 3 groups:

1. Insider-dominated firms with outside directors accounting for less than 40 per cent of the board composition,
2. Mixed firms with outside directors accounting for 40 to 60 per cent of the composition,
3. Outsider-dominated firms with outside directors accounting for at least 60 per cent of the composition.

Analysis revealed that in firms with outsider-dominated boards, the correlation between corporate performance and CEO turnover was stronger than in companies with a different makeup of the board. This means that outsider-dominated boards tend to add to firm value through their CEO changes. This value will be greater if a CEO change was the result the company's poor performance. As regards insider-dominated boards, Weisbach found no such results. These findings do not appear to be influenced by differences in the ownership structure, firm size, or the industry in which the firm operates.

Byrd et al. [2007, s. 1 - 23] analysed the impact of the presence of independent directors on the financial performance of the company and CEO compensation. They introduced a standard two-way director classification scheme. In the first classification, the company board was divided into inside and outside directors. The latter were subdivided into those related to the company and independent ones. The other classification involved a distinction between independent outside "problem" and "non-problem" directors[1]. The underlying hypothesis of the paper was the question whether the presence of truly independent outside directors (so-called non-problem directors) has a significant impact on the effectiveness of corporate governance. To test this hypothesis, 672 publicly-traded firms from the 2004 Russell 1000 index were used. The survey revealed that there is a significant positive correlation between the presence of "non-problem", independent board members and the financial performance of the company, and a negative correlation between the presence of these directors and excessive CEO compensation. Using the standard three-way director categorization (affiliated outside directors, also known as grey directors, independent outside directors and inside directors) did not confirm those findings. Authors concluded that these results may indicate that a truly independent board member may not necessarily be synonymous with a person who is in no way related to the company. Therefore, the definition of an independent director should also include their previous experience in corporate governance.

Studies on the impact of the presence of independent outside directors on the company board have been conducted not only in the United States. C.Y. Wang [2008] analysed the relationship between corporate cash holdings[2] and the presence of independent board members in firms listed on the Taiwan Stock Exchange. Wang proposed two hypotheses. According to the first one, firms with a higher pro-

1 Problem directors are those individuals who have been personally involved, as a director or executive, in one or more corporate bankruptcies, major litigation and other corporate scandals, or have served on remuneration committees that have approved particularly egregious CEO compensation packages.

2 The marginal value of cash holdings shows how much added value is generated for the company by another cash asset.

portion of independent directors on boards are associated with a higher marginal value of cash holdings. According to another hypothesis, firms with independent directors have a higher marginal value of cash holdings than firms without independent directors. The study did not prove conclusively whether there is a positive relationship between the presence of independent directors and the marginal value of cash holdings. The author observed that the presence of independent directors may increase the marginal value of cash holdings only in small firms and those which are unlikely to increase their value. This is possible due to the reduction of agency costs resulting from cash holdings.

Lawrence and Stapledon [1999, s. 1 - 64] focused on two problems: First, is there any relationship between board composition and company performance? Second, does the presence of independent directors on the board positively affect the remuneration of executives? They surveyed corporations listed on the Australian Securities Exchange in late 1995. The survey covered nearly 700 persons who filled almost 900 board positions (some directors were members of more than one board). Non-executive directors accounted for 73 per cent of the sample, out of which 43 per cent were independent non-executive members, and 30 per cent were affiliated non-executive directors. As regards chairpersons, non-executive directors accounted for 83 per cent, of which 45 per cent were independent chairpersons. The first part of the survey was to determine whether the presence of independent board members affects share prices. Analysis did not reveal any substantial evidence supporting this thesis. The second part of the survey was to show whether the remuneration of the CEO is higher when inside directors sit on the remuneration committee. Analysis took into account the classification of companies by size, performance, and ownership structure. The results suggest that Australian companies, regardless of who sits on the remuneration committee, pursue the same policy with regard to CEO remuneration.

In their study, Kiel and Nicholson [2003] also investigated firms in the Australian market. They sought to establish whether there was a correlation between board composition and corporate performance in these firms. They proposed eight hypotheses including one that the number of outside directors on the board did not affect corporate performance. The survey covered 348 companies listed on the Australian Securities Exchange (ASX) in 1996. The results of the analysis only partially supported the hypothesis. As regards market indices, correlation was observed between the number of outside directors sitting on the board and the financial performance of the company. Yet, when accounting measures were used, such results were not valid, which confirmed the hypothesis proposed by the authors that the number of independent board members did not affect the company's financial performance.

Many attempts to establish whether the presence of independent directors on the board has a positive or negative impact on the company's performance have not provided a clear answer. On the one hand, research has shown that the presence of independent members on the board has a positive impact on the effectiveness of the company's system of control. This means that there is a correlation between the company's performance and CEO turnover (in the one-tier model) or the turnover of presidents of the management board (in the two-tier model). In addition, some of the authors dealing with this issue have demonstrated that independent board members have a positive impact on the financial performance of the company. On the other hand, the analysed studies may lead to the conclusion that there is no correlation between the presence of independent members and the profitability indicators of the company or the price of its shares. This means that one cannot draw a definite conclusion that board members meeting the independence criteria have any effect on the performance of the company and the way it is perceived in the market. This does not mean, however, that such board members are not needed on boards since no studies have shown negative effects of employing independent members.

3. Independent supervisory board members in the internal regulations of public banks in Poland

The companies listed on the Warsaw Stock Exchange must comply with the Polish and European Union law, and they also should apply the Best Practices issued by the WSE. Moreover, some sectors of the economy have their own regulations to be observed by companies; e.g., the Banking Act is binding for the banking sector [Journal of Laws, 1997]. Part C of Chapter 2 of the Act is devoted to banks incorporated as joint stock companies. Among other things, it contains recommendations for supervisory boards, which should consist of no fewer than 5 natural persons, with the main competence including the power to appoint and dismiss members of the management board of the bank. The supervisory board must advise the Polish Financial Supervision Authority of any changes in the composition of the management board. Although there are many regulations concerning supervisory boards, the Banking Act includes no recommendations with regard to independent supervisory board members.

This study involved 14 banks listed on the WSE[3] and included data from 2006–2010. Information about supervisory boards was acquired from individual annual reports posted on the banks' websites.

[3] Analysis excluding UniCredito bank, which has adopted the one-tier model of corporate governance.

Apart from observing the hard and soft law, in their operations Polish public banks refer also to their internal regulations such as statutes, supervisory board regulations, and management board regulations. These regulations concern not only the activities of the company but also those of its supervisory and management bodies. Depending on the bank, regulations on the supervisory board composition (the number of independent members), criteria of independence and the definition of an independent member may be included either in the statute or in supervisory board regulations (see Table 2).

Table 2. Regulations on independent members in the documents of Polish public banks

	Definition of an independent member	Number of independent members	Criteria of independence
Bank statutes	4	4	3
Supervisory board regulations	0	1	4
Both documents	1	2	0
Lack of regulations	9	7	7*

* PKO BP does not specify criteria of independence in any document and refers to the Code of Best Practice for WSE Listed Companies.
Source: Author's own compilation

According to the documents given in the table, only five banks decided to include a definition of an independent supervisory board member in their internal regulations. ING Bank put it in its statute as well as in its supervisory board regulations, while such banks as Pekao SA, Millennium, BPH and Fortis gave a definition only in their statutes. Other banks did not develop a definition of an independent member in their documents and or refer to the European Commission Recommendation or to the Code of Best Practice for WSE Listed Companies in this respect.

Appreciating the role of independent members of the supervisory board, some companies in the banking sector decided to put definitions of an independent member in their statutes or supervisory board regulations. Generally speaking, an independent member means an individual who does not have any relationship with the bank or the bank's shareholders or employees, as such a relationship could significantly affect this individual's ability to make impartial decisions. Regulations specify the minimum number of independent members on the supervisory board. Five banks accepted that at least two independent members should sit on the supervisory board. This provision is consistent with the provision on the number of independent members included in the Code of Best Practice adopted by the WSE in 2010. Two banks were more restrictive as regards the number of independent members: BPH had a provision in its statute which required that at least 30 per cent of the members of the supervisory board be independent, while Pekao SA required that at least half of the members of the supervisory board be independent. On the other hand, seven banks did not specify the number of independent members in their supervisory board regulations or statues. Along with the provision in its supervisory board regulations specifying the number of independent board members, ING additionally referred in its statute to the Code of Best Practice for WSE Listed Companies, which also determines the minimum number of persons deemed to be independent on the supervisory board.

Apart from the number of independent supervisory board members, firms in the banking sector often formally define the characteristics of independent members. Seven banks listed on the WSE have included such criteria in their statutes or supervisory board regulations; PKO BP referred to the Code of Best Practice, while six banks did not have such provisions at all. The most frequently applied criteria for an independent member involve, someone who[4]:

- Is not and has not been in the past three years (in three banks) or five years (in four banks) a board member or executive in the bank, its subsidiary companies or its parent company (notwithstanding the form of employment);
- Is not and has not been in the past three years employed in the bank, its subsidiary or associated entity in the understanding of the Polish Accounting Act (in six banks);
- Is not and has not been a shareholder with a block of voting shares of over five per cent (an identical provision in two banks, two per cent in Bank Millennium, while four banks did not set a threshold at all) and is not employed by a shareholder who owns a block of voting shares of over five per cent (provision effective in four banks, no such provision in Bank Millennium, a one per cent limit in Fortis, while BZ WBK uses the phrase: "a controlling shareholder");
- Has not been in the past three years an auditor or an employee of an entity authorized to audit financial statements, which audited the bank's financial statements (all banks);
- Is not paid any extra remuneration (apart from that of a supervisory board member) or any other considerations by the bank, its subsidiary or parent company, except the remuneration paid to the supervisory board member acting as a customer who concluded a standard contract with the firm (all banks);
- Is not a member of the management board in another company where a member of the bank's management board is a supervisory board member (all banks);

[4] Based on statutes and supervisory boards regulations of the banks listed on the WSE.

- Within the last year has not been and is not a substantial customer or counterparty, either directly or as a partner, shareholder, director or senior employee in an entity being in a such relationship with the bank (5 banks apply this rule including two banks not specifying a time limit);
- Has served as an independent supervisory board member for no longer than 12 years (three banks);
- Is not and has not been a spouse, a common-law spouse, or a relative by blood or marriage of a management board member or an employee holding another management position (all banks apply this rule and Bank Handlowy and Pekao SA set a 3-year limit in this respect).

In addition, two banks, Fortis and BZ WBK, included in their supervisory board regulations the basic principles to be followed by the independent members of supervisory bodies. The regulations require the independent members to maintain independence of opinion, to object if a decision may harm the company, and not to demand any additional tangible or intangible benefits.

Table 3. Criteria of independence in internal regulations of Polish public banks

Criteria of independence	Internal bank regulations
Is not a member of the bank's management board	Fortis, BRE, ING, Pekao SA, Millennium, Bank Handlowy, BZ WBK
Is not an employee of the bank	Fortis, BRE, ING, Pekao SA, Bank Handlowy, BZ WBK
Is not a shareholder of the bank	Fortis, BRE, ING, Pekao SA, Millennium, Bank Handlowy, BZ WBK
Is not employed by a certified auditor who has audited the bank	Fortis, BRE, ING, Pekao SA, Millennium, Bank Handlowy, BZ WBK
Is not paid extra remuneration by the bank	Fortis, BRE, ING, Pekao SA, Millennium, Bank Handlowy, BZ WBK
Is not a member of the management board in another company where a member of the bank's management board is also a member of the supervisory board	Fortis, BRE, ING, Pekao SA, Millennium, Bank Handlowy, BZ WBK
Has no business relations with the bank	BRE, ING, Pekao SA, Millennium, BZ WBK
Is not a relative of any member of the bank's management board	Fortis, BRE, ING, Pekao SA, Millennium, Bank Handlowy, BZ WBK
Has not served as an independent member for longer than 12 years	BRE, ING, BZ WBK

Source: Author's own compilation

When one compares the provisions on independence criteria in banks' internal documents (Table 3), it can be seen that they are quite similar. Therefore, it can be said that companies in the banking sector follow the same legal regulations while adopting internal rules for independent supervisory board members.

4. Results of the study

All the listed companies must comply with the Code of Best Practice, but in their compliance statements they may indicate that they do not conform to certain provisions, explaining why. The principle of supervisory board member independence is a provision of the Code which was found unnecessary and was not observed by some companies. Table 4 shows the attitude of banks in this respect.

Table 4. Banks' attitudes towards independent members of the board between 2006 and 2010

Bank	2006	2007	2008	2009	2010
BPH	Yes	Yes	Yes	Yes	Yes
BOŚ	No	No	Yes	Yes	Yes
BRE	Yes	Yes	Yes	Yes	Yes
BZ WBK	Yes	Yes	Yes	Yes	Yes
Fortis	Yes	Yes	Yes	Yes	Yes
Getin Holding	No	No	No	No	No
Noble Bank	No	No	No	No	No
Bank Handlowy	Yes	Yes	Yes	Yes	Yes
ING	Yes	Yes	Yes	Yes	Yes
Kredyt Bank	Yes	Yes	Yes	Yes	Yes
Millennium	Yes	Yes	Yes	Yes	Yes
Nordea	No	No	No	No	No
Pekao SA	Yes	Yes	Yes	Yes	Yes
PKO BP	No	No	Yes	Yes	Yes

Source: Author's own compilation based on annual reports

Table 4 shows that only 3 banks failed to observe the provision on independent board members during the period under study. While PKO BP and BOŚ did not apply this provision in 2006 and 2007, they decided to observe it in 2008 and in subsequent years probably because in July 2007 the Stock Exchange Board lowered the requirement as to the minimum number of independent board members. Previously, independent board members had to account for 50 per cent of supervisory board members, while since July 2007 two independent members on the board have been found to be sufficient. Companies explained that they failed to observe this point of the Code because of the principle of majority rule and protection of minority shareholders. Shareholders who contribute more capital bear a greater economic risk, therefore, it is justified that their interests be considered in proportion to the capital contributed. Accordingly, they should be entitled to appointing candidates to the supervisory board who would ensure the implementation of the strategy adopted by the company. The companies argued that they had strategic investors whose corporate rights would be largely restricted were they to apply this rule.

As it is known which banks declared to observe the rules on independent board members, it is worth reviewing whether they actually applied them. Table 5 presents the number and percentage share of independent members on supervisory boards over the period under study. The banks that declared not to observe the rule were not taken into account, therefore, the data concern only 11 banks.

Table 5. Number and percentage share of independent supervisory board members

	2006		2007		2008		2009		2010	
	No.	%	No.	%	No.	%	No.	%	No.	%
BPH	3	23	3	27	5	42	5	38	6	46
BOŚ	-	-	-	-	5	63	5	63	5	56
BRE	5	56	4	50	5	56	5	50	5	50
BZ WBK	5	71	5	63	5	63	5	71	6	67
Fortis	2	25	2	40	2	33	2	40	3	43
Bank Handlowy	5	56	6	50	6	50	6	50	6	50
ING	4	50	4	50	4	50	4	50	3	38
Kredyt Bank	5	56	5	56	5	56	5	56	4	57
Millennium	7	50	7	50	5	56	6	55	6	55
Pekao SA	5	56	6	67	6	67	6	67	6	67
PKO BP	-	-	-	-	2	29	2	29	2	29

Source: Author's own compilation based on annual reports

Given the original provision of Best Practices in Public Companies in 2002 concerning independent supervisory board members, one can argue that over the entire period under study, three banks (Fortis, BPH, and PKO BP) did not apply it to the full extent, despite their compliance declaration. It can be said that these companies misled the Stock Exchange Board and investors by declaring that they complied with the principles of good practice. However, in 2005 an amendment was introduced to Best Practices in Public Companies allowing fewer independent members on a supervisory board than a half. BPH and Fortis had strategic shareholders owning more than 50 per cent of voting rights. Consequently, to conform to this principle, they had to employ at least two independent supervisory board members, which they actually did. PKO BP observed this regulation since

2008, that is, after successive amendments were introduced to the Code of Best Practice for WSE Listed Companies.

Importantly, the supervisory board should comprise people with appropriate qualifications, regardless of whether they are related to the strategic investor or not. Therefore, it is necessary to determine whether independent members employed in banks have sufficient expertise to perform their tasks well. Table 6 shows the qualifications of independent supervisory board members in banks.[5]

Table 6. Education of independent supervisory board members in the banking sector between 2006 and 2010

Bank	Number of independent members 2006–2010	Education					
		1	2	3	4	5	6
BPH	9	4	2	2	-	1	-
BOŚ	5	3	1	-	-	1	-
BRE	7	5	1	-	1	-	-
BZ WBK	6	1	2	-	1	2	-
Fortis	5	2	-	-	-	-	1
Bank Handlowy	7	2	2	1	2	-	-
ING	4	2	1	-	-	1	-
Millennium	7	-	2	2	-	-	3
Pekao SA	6	1	-	-	1	-	3
PKO BP	4	3	1	-	-	-	-

1 – Economics, 2 – Law, 3 – Foreign Trade, 4 – Technology, 5 – Finance and Management, 6 – Other.

Source: Author’s own compilation based on annual reports

The data given in Table 6 show that the majority of independent supervisory board members have a degree in economics or law, which reflects professional qualifications of independent members as this knowledge is especially useful in sitting on supervisory boards. The majority of independent supervisory board members with technological education (3 out of 5) attended additional training courses and post-graduate studies aimed to improve their knowledge of organization, management, finance, and marketing. The column “Other” includes persons with artistic education (two masters of art), as well as sociological, biological, or physics graduates. Fortis bank did not provide any information about two board members, while Pekao SA did not show such information about one board member (he is only known to have cooperated with FIAT throughout his career).

[5] As Kredyt Bank does not reveal which supervisory board members are deemed to be independent (their annual reports provide information only about the number of independent members), this bank is not considered. Therefore, table presents 10 companies.

Apart from appropriate education, independent supervisory board members should have professional experience that would help them perform their duties on the supervisory board more effectively. Table 7 presents professional experience of independent members employed in banks. A number of independent members declared professional experience in more than one field and thus the number of individuals in terms of their professional experience differs from the number of independent members.

Table 7. Professional experience of independent supervisory board members in banks between 2006 and 2010

Bank	Number of independent supervisory board members	Professional Experience					
		1	2	3	4	5	6
BPH	9	5	2	1	3	5	3
BOŚ	5	4	1	1	2	4	2
BRE	7	2	1	3	2	6	1
BZ WBK	6	2	1	1	0	6	2
Fortis	5	2	0	2	0	1	1
Bank Handlowy	7	4	2	3	2	5	1
ING	4	3	1	0	1	3	0
Millennium	7	4	2	4	1	4	1
Pekao SA	6	4	0	3	0	4	1
PKO BP	4	4	0	3	0	1	0
Total	60	34	10	21	11	39	12

1 - University teacher, 2 - Legal counsel, 3 - Financial sector, 4 - Business owner/Partner, 5 - Supervisory/ Management board member in another company, 6 - Financial consultant/ adviser.
Source: Author's own compilation based on annual reports

The above table shows that more than half of independent members sitting on supervisory boards in banks were previously or currently scholars or lecturers at universities. Another 35 per cent had gained experience in the financial sector, which gave them an additional advantage as this specific professional background enabled them to help the supervisory body make difficult decisions. Moreover, as many as 39 out of 60 individuals regarded as independent sat on supervisory or management boards of other companies. Thanks to this, they had the opportunity to compare the activities of these bodies in various corporations and, through their experience, add to the value of the supervisory board of the bank in which they worked.

Conclusion

Due to the separation of ownership and control, the owners of capital possess no direct control over the operation of the company. The management board determines through its decisions the company's policy, which is not always in line with the goals of the shareholders. Therefore, one of the bodies operating in the company is the supervisory board whose primary task is to take care of the interests of the company. Through its attitude, the board can reduce opportunistic behaviour of the members of the management board. Therefore, it is important that the supervisory board include people who have no relationship either with the investors or other entities having significant relations with the bank. Thanks to their independence, these persons are able to take impartial decisions focused only on the best interests of the company.

The banks listed on the Warsaw Stock Exchange must comply with the provisions of the Code of Best Practice concerning the independence of board members or explain why they fail to do so. This paper includes an analysis designed to verify whether between 2006 and 2010 all banks listed on the WSE complied with this rule when appointing supervisory board members. It was found that the majority of companies in the financial sector observed this rule. This is good, because this confirms that Polish public companies in the banking sector are aware of the growing importance of complying with the Code of Best Practice with a view of achieving success.

Moreover, the purpose of the study was to determine whether independent members employed on the supervisory boards of banks listed on the Warsaw Stock Exchange had sufficient professional knowledge and expertise to perform their jobs. The results show that the majority of them held a degree in economics or law. This means that they were well prepared professionally to fulfil their duties. Moreover, a considerable number of independent supervisory board members were previous or current members of supervisory or management boards in other companies, academics, or worked in the financial sector. Their professional experience confirms the opinion that independent supervisory board members in banks are well prepared for performing their tasks.

References

1. Breeden, R. C. 2003. *Restoring Trust – The Breeden Report on Corporate Governance for the future of MCI*, Inc., August.
2. Byrd, J., Cooperman, E. S., and Wolfe, G. A. 2007. 'Another look at director independence', FMA Meeting in Orlando, Florida .

3. European Commission 2005. Commission recommendation of 15 February 2005 on the role of non – executive or supervisory directors of listed companies and on the committees of the (supervisory) board (2005/162/EC).
4. NYSE 2002. Corporate Governance Rule Proposals. Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee as Approved by the NYSE Board of Directors, August.
5. Hanson, R. C., and Song Moon, H. 1998. 'Board structure, insider ownership and trading: the case of corporate divestitures', Financial Management Association's Annual Meeting, Chicago.
6. Kiel, G. C., and Nicholson, G. J. 2003. 'Board composition and corporate performance: how the Australian experience in forms constructing theories of corporate governance', 5th International Conference on Corporate Governance and Direction, Henley.
7. Lawrence, J., and Stapledon, G. 1999. 'Do independent directors add value', Centre for Corporate Law and Securities Regulation, Australia.
8. OECD 2004. *OECD Principles of Corporate Governance*, Organization for Economic Co – Operation and Development.
9. The Act of August 29 1997 – the Banking Law (Journal of Laws No. 72, Item 665).
10. Journal of Laws 2000. The Act of 15 September 2000 – the Commercial Companies Code (Journal of Laws No. 94, Item. 1037, amended).
11. Wang, CH. Y. 2008. 'Independent director arrangement and the marginal value of cash holdings: the role of over – investment', Taiwan.
12. Weisbach, M. S. 1998. 'Outside directors and CEO turnover', *Journal of Financial Economics*, No. 20.
13. WSE, 2002. Dobre praktyki w spółkach publicznych w 2002 roku, Komitet Dobrych Praktyk i Instytut Rozwoju Biznesu, Warsaw, July 4, 2002.
14. 2005. Dobre praktyki w spółkach publicznych 2005, Komitet Dobrych Praktyk i Forum Corporate Governance, Warsaw, October 29, 2004.
15. 2007. Best Practice for WSE Listed Companies, the Annex to Resolution No. 12/1170/2007 of the Warsaw Stock Exchange of July 4, 2007.
16. 2010. Best Practice for WSE Listed Companies, the Annex to Resolution No. 17/1249/2010 of the WSE on May 10, 2010.

*Krzysztof Postrach**

CHAPTER 7

SHOULD POLISH BANKS BE DOMESTICATED?

Introduction

For many years now we have seen the process of introducing EU regulations aimed at integrating the banking systems of the Member States. Now, the work which was undertaken because of the recent financial crisis with a view to enhancing the banks' safety is coming to an end. Polish banks are members of international capital groups as subsidiaries and this fact gives rise to problems resulting from the centralization of capital and liquidity management at the level of the group as well as the centralization of supervision in the European Union. The recent financial crisis has highlighted these issues and sparked a debate concerning the fact that most Polish banks are dependent on their foreign headquarters. The question is whether the current ownership structure of banks operating in Poland is beneficial for the Polish economy and whether there is an alternative solution to this situation. The ownership structure of these banks has lately been questioned. There are many arguments in favour of making these banks independent rather than subsidiaries of other banks. This alternative is known as bank domestication. Re-Polonization of banks is also discussed. The domestication of banks is understood as the process by which the share of locally controlled and managed banks in the assets of the banking sector will increase [Kawalec, 2011, pp. 7, 12].

Therefore, domestication does not exclude foreign capital in the ownership structure of banks, but it does exclude the dominant position of foreign capital. Therefore, a dispersed ownership structure is possible (with participation of foreign capital) as well as a concentrated structure, but with a dominant position of domestic capital. Then, re-Polonization is understood as a replacement of a foreign dominant shareholder by a domestic investor, which is associated with a concentrated ownership structure based on domestic capital. The term "domestication of banks" contains more possibilities for shaping the ownership structure of banks, and therefore this concept will be discussed from the point of view of corporate governance. From

* Gdansk University of Technology.

this perspective, possible transformations of the ownership structure of banks operating in Poland as subsidiaries of foreign banks will be assessed.

In order to provide a more complete picture, I deal with the problem of relations between subsidiaries and parent companies in capital groups. I draw attention to the need to define the interests of individual companies and capital groups in view of company law applicable to capital groups and regulations developed at the level of the European Union. The effects of current and future regulations pertaining to the operation of capital groups are also presented. These issues are shown from the point of view of the Polish banking sector.

1. Polish banks as subsidiaries

Banks operating in Poland are subsidiaries within foreign capital groups. Subsidiaries not only benefit from their membership in the capital group, but are also exposed to dangers resulting from the activities of their parent companies – activities dictated by the interests of the group. It is therefore advisable to place the problem of bank subsidiaries operating in Poland but dependent on international banking groups in a broader context.

Corporate governance in capital groups is considered primarily from the point of view of relations between the parent company and its subsidiaries. Subsidiaries are examples of companies with concentrated ownership. The main problem of corporate governance in structures with concentrated ownership is that the dominant shareholders exploit their position at the expense of other shareholders.[1] This problem is referred to as the horizontal agency problem (dispersed ownership structures face the vertical agency problem, involving a conflict of interest between shareholders and managers) [Roe, 2004, pp. 3-4]. This conflict also takes place in capital groups. It occurs with varying intensity depending on the form of the group. This takes place to the greatest extent in capital groups which were established as a result of leveraging votes (through subsidiaries) in relation to the capital involved in the parent company. These are groups of pyramidal structure. This very structure involves the phenomenon of tunnelling (value transfer) from a given company to its controlling shareholder. Such structures are not present in foreign bank holding companies within which the said banks operate in Poland. While there are some cases of the use of dominant position by the owners of banks in Poland which can be described as tunnelling [2], tunnelling as such is not the objec-

[1] A wide description of these practices is presented in Postrach [2006].

[2] A. Stopczyński, director of the banking supervision department of the Polish Financial Supervision Authority said that "when it is necessary to reduce dividends, the owners might try to transfer profits in another way, for example by raising costs of service agreements between the parent company and the subsidiary."

tive of their actions, in contrast to pyramidal structures. Bank holding companies are most closely related to capital operating groups [Trocki, 2004, p. 77]. In these groups, actions are dictated by the interests of the entire group or the parent company. Therefore, those bank subsidiaries operating in Poland which are dependent on international bank holdings are exposed to the adverse effects of such decisions. The risk limits imposed by the foreign parent company on its subsidiaries in a particular country are an example of such decisions. These limits restrict investing surplus liquidity in Treasury securities. In the case of Poland, this means that foreign banks, instead of investing surplus liquidity in Treasury bonds, are forced to invest it in short-term NBP securities with lower interest [Kawalec, 2011 p. 6].

Theoretically, the activity of capital groups should be profitable both for the dominant shareholders and their subsidiaries. They can still implement common market goals, accelerate technological progress, disperse investment risk, and achieve synergy effects. In practice, however, the allocation of these benefits is sometimes uneven; the dominant company often benefits by undermining the subsidiaries, other shareholders, and creditors [Jeżak, 2010, p. 71]. We are faced with dilemmas arising from the autonomy of companies in capital groups. This autonomy is stressed by the doctrine of the law, which orders each company to pursue its own interests, while sometimes these interests do not coincide with the interest of the group of companies. The autonomy of the capital company's interest leads to the "paralysis" of the concept of the capital group as one economic organism [Romanowski, 2010].

It is important to clarify what a company's interest is, which is fairly easy to determine[3]; however, it is harder to determine the interest of the capital group, unless it is assumed that it is the interest of the dominant company (the Code of Commercial Companies defines the interest of a company but does not define the interest of the capital group). Attempts have been made to decide this issue on the basis of the national and EU law applicable to groups of companies.[4] These regulations will decide the permissible range of interference of dominant companies in the activities of their subsidiaries, which, from the formal point of view, are in-

[3] A.S. Nartowski described this interest in a simple way: a company's interest is defined by the resolutions of the general meeting of shareholders [Nartowski, 2010].

[4] For several years, on and off, work has been done to amend the Polish Commercial Companies Code to include the law on groups of companies. At the level of the European Union, the latest document devoted to company law, the report of the reflection group set up by the European Commission in December 2010, considers the issue of groups of companies as one of the most important problems. The main requirement in this regard concerns normative distinction of the interest of a group of companies in order to ensure greater legal security to members of the bodies of the dominant company and its subsidiaries. This will not only let the managers of the dominant company manage the group and companies owned by the group in accordance with the interests of the whole group, but actually this will become their responsibility [European Commission, 2011].

dependent legal entities and should pursue their own interest. These are important decisions because they will affect the way a member of a group of companies is directed and thus, they will affect the operation of subsidiaries.

After all, managers of a subsidiary and members of its supervisory board must take into account civil and criminal liability linked to the obligation to act in the interest of the company. They may be sued by aggrieved parties (minority shareholders, creditors). They may find themselves in a difficult situation if they are forced to pursue the interests of the dominant company which are incompatible with those of the subsidiary.

We are witnessing the development of regulations which should be of interest to management sciences. For the success of the group, it is important to define an appropriate balance between centralization and decentralization of decision-making. The question arises: to what extent and how can the dominant company optimize the performance of the group. As can be seen, the legal aspects of operation of capital groups are linked to issues that should be of interest to management sciences. Unfortunately, these aspects, as noted by J. Jeżak, are underestimated in the Polish literature in the field of management studies [Jeżak, 2010, p.76]. They should also be an important area within corporate governance because they concern the dominance-dependence relationship, and the interests of entities within the capital group – the classic issues of corporate governance.

It should be noted that the issue under consideration is of particular relevance to public companies with minority shareholders. If the adopted solutions do not sufficiently protect the interests of minority shareholders, giving priority to the interests of the group of companies, this will introduce an element of uncertainty and unpredictability in relation to the operation of subsidiaries listed on the stock exchange, resulting in a loss of confidence in these companies. And confidence is crucial for the functioning of the capital market. The level of confidence affects evaluation of companies and their ability to raise capital, and thus determines the development of the stock market and the efficient performance of its essential functions. It is therefore a problem of great practical importance. Only a few companies among those listed on the Warsaw Stock Exchange are without capital ties. The same is true in other EU countries, where public companies are characterized by concentrated ownership structures. This problem concerns banks, which are of interest to us because the vast majority of banks listed on the Warsaw Stock Exchange are subsidiaries of foreign banks.

2. New capital requirements in the banking sector

The banking system in Poland has been dominated by foreign banking groups. Consequently, banks which operate in Poland as subsidiaries within these groups may constrain their lending activity. The financial crisis, ongoing since 2008, has brought about new regulations, agreed by international institutions and governments. This time, these changes mean the greatest transformation in the banking sector in decades. The changes result from the Basel Agreement, a.k.a. Basel III, which postulate to increase the capital of banks [BCBS, 2010a] (requirements concerning the volume of capital which should be at the banks' disposal in case of losses) and to improve the liquidity of banks [BCBS, 2010b] (higher liquidity requirements). EU regulations are designed on the basis of this framework. The consequences of these regulations will also concern banks operating in Poland which are subsidiaries within capital groups of foreign banks. It is therefore appropriate to quote the main provisions of Basel III[5] and drafts of EU regulations.

Of particular note are those provisions of Basel III which are aimed at strengthening the security of banks. These regulations can be divided into two main groups [Morawski, 2011, p. 2]:

- Regulations on the amount and "quality" of banks' core equity capital. The Tier 1 Ratio (the ratio of a bank's core equity capital to its total risk weighted assets (RWA) is to be higher.[6] These changes will be introduced gradually from 2013 to 2019. In 2018, the principle will be introduced which will limit the leverage level on basic capital to a factor of 33.
- Regulations regarding the liquidity of banks. They ensure appropriate funds in the event clients withdraw their money. If clients do so, the bank must sell its assets. Then, if the assets are not sufficiently liquid (few transactions in the market), the bank sells its assets at ever-lower prices. At some point the value of the bank's assets may be lower than that of its liabilities, which would automatically make the bank bankrupt. Therefore, banks must maintain

[5] The Basel Committee on Banking Supervision was established in 1974 and has been engaged in the development of rules which are to ensure stable functioning of the banking system. New regulations were introduced as a response to subsequent crises in the banking sector. In 1988 an agreement was reached which was called Basel I. However, Basel I did not prevent the financial crises of the late 1990s. In 2004, the New Capital Accord (Basel II) was concluded. The provisions of Basel II were implemented in the coming years, but proved to be inadequate, which was demonstrated by the collapse of Lehman Brothers Bank, which had met all the requirements of those provisions. The recent crisis has forced the Committee to develop subsequent regulations, which are referred to as Basel III.

[6] The minimum level of this ratio is 4.5 per cent (previously it was 2 per cent.) In addition, banks will have to maintain a capital safety buffer of 2.5 per cent and a counter-cyclical buffer ranging from 0 to 2.5 per cent of their assets.

a sufficient amount of liquid assets to ensure financing for a period of 30 days of a potential liquidity crisis. Long-term assets, such as mortgages, will be adequately financed by liabilities with maturities greater than one year. The number of assets classified as the most liquid has been reduced.

The Basel III provisions will be implemented in the European Union although not in their entirety, based on the CRD (Capital Requirements Directive), the European Commission package IV. The package will consist of a directive (CRD IV) and a regulation (CRR IV). The task of the CRD IV is to introduce uniform regulations for credit institutions which are meant to prevent problems with the quality of the portfolio and with liquidity. The directive will require the national supervisors, as part of monitoring of the banking market, to impose immediate sanctions on those entities which do not observe the provisions of the CRD IV. In the aftermath of the public finance crisis in several countries of the Euro zone, the European Banking Authority (EBA) acted on the proposal for a CRD IV Directive and subjected 71 large European banks to a so-called stress-tests in order to determine whether they need to increase their equity (based on data as of 30 September 2011). Among them, 31 banks were required to strengthen their capital position. Total recapitalization amounted to Euro 114 billion and banks were required to remedy this capital shortfall by the end of June 2012 (the national supervisory authorities may, following consultation with the EBA, allow the banks to reach the required Core Tier 1 ratio of 9% gradually.)

3. Centralization of supervision and management of capital

The above-mentioned increased requirements for capital and liquidity will be a problem not only for the banks that do not meet these requirements, but will also have an impact on those banks that do. Prudential requirements apply to capital groups and, consequently, subsidiary banks can be used to improve the indicators calculated at a consolidated level. This is a problem which should be considered not only in relation to the period of banks' adjustment to higher standards. As it was shown earlier, the mere fact of being in a capital group as a subsidiary may pose a risk to those companies, their minority shareholders and creditors. In the case of banks, it is a much larger problem because it affects the financial system and the economy. The problem is aggravated by the EU regulations on financial supervision. From the point of view of the concept of banks' independence, regulations concerning supervision over banking groups are essential. Evaluation of these regulations will be conducted from the perspective of the host countries, which include Poland.

In 2007, a significant change took place with regard to supervision of international groups. This was because the CRD Directive, implementing the provisions of Basel III, came into force. Previously, a single bank was an entity subjected to regulation and supervision. National supervision authorities could take binding decisions with regard to a bank member of a group, even if such decisions were contrary to the expectations of the parent bank [Reich, 2011, p. 2]. The said Directive introduced consolidated supervision standards and supervision on a consolidated basis. In this way, the supervisors started to deal with banking groups. This means that a consolidated supervisor may make decisions concerning members of a banking group without taking responsibility for the safety of banks situated in other countries.

Supervision at the European Union level was implemented by the college of supervisors consisting of supervisors from the home country and local supervisors from the countries hosting the banks belonging to the group. In 2011, the European System of Financial Supervisors was established, with sectoral supervisory agencies working under it. They (councils of supervisors, represented by supervisors from all member countries) can make binding decisions, which were previously reserved for national supervisors [Reich, 2011, p. 3]. The transfer of the powers of group supervisors to these bodies was dictated by the need to create strong European supervision. They are a more representative body than the former colleges of supervisors, where final decisions were made by the group supervisor. Supervisors from host countries are concerned that these bodies shall be dominated by supervisors from the countries where the parent companies of banking groups reside (the so-called old EU countries) and that the decisions taken will favour the parent companies [Kluza, 2010, p. 12].

Supervising capital groups on the basis of consolidated supervisory standards along with the unification of prudential regulations of the European Union (Single Rule Book) will make it difficult for local supervision to influence the banking system. This presents a special difficulty for financial supervision in Poland due to the fact that it would have to consult its decisions with supervision in the country where the parent company has its seat. For such supervisors, consolidated supervising standards are the basis for making decisions in relation to the level and quality of capital. Within such centralized supervision, there is no room for taking into account the specifics of the local market, e.g., differences in the course of the business cycle and in the fact that the host countries may take anti-cyclical measures at different moments than the home markets [Kluza, 2010].

Supervision of a banking group with uniform standards for the whole area of the group's operation in the European Union must have implications for the operations of the parent banks. Of special note is, in its present form, the provision specified in the draft CRD IV on the management of liquidity and capital at a capital group level. One of the most disadvantageous provisions, from the point of view of the host countries, is the proposal authorizing the subsidiary bank to refuse to comply with a higher capital buffer set by a country in which the subsidiary resides. When this provision is adopted, it will have far-reaching consequences for the safe functioning of the banking sector in Poland.

The impact of parent companies on their subsidiaries in Poland in terms of improvement of the situation in the group regarding capital and liquidity requirements will have an adverse effect on banks operating in Poland and, most of all, on the national economy. Centralized management of liquidity and capital will allow for transferring funds within the banking group. In this situation, subsidiaries will resemble branches of foreign banks. This will seriously reduce the powers of local supervision.

It appears that the threat to banks subsidiaries involves not only the possibility of transferring funds from one bank to another. Improvement of capital ratios at the level of the group does not necessarily involve transfer of funds (collecting dividend, cash transfers).[7] The parent company may reduce or inhibit the growth of assets in subsidiaries by reducing their lending activity. The surplus left with subsidiaries will improve capital adequacy in the group.

As can be seen, the draft regulations for banking groups are consistent with the above demands of the new laws on groups of companies. Regardless of such threats, resulting from the development of new regulations forced by the financial crisis, it is necessary to take into account other consequences of the position of Polish banks as subsidiaries of foreign capital groups. This concerns the previously mentioned problem characteristic of capital groups, that is, parent companies affecting subsidiaries while implementing the interest of the capital group.

4. Threats to lending activity

It is a widely shared opinion that when the CRD IV Directive comes into force it will limit the subsidiaries' lending activity. Given that the vast majority of large banks operating in Poland are owned by foreign investors, this is a threat not only to the Polish banking sector, but also to Poland's economy.

[7] Balancing within a group is beneficial for home countries, and that is why politicians from the countries that have the largest European banks opt for this.

Before the crisis, many foreign entities present in the Central and Eastern Europe financed their subsidiaries so that the subsidiaries could extend their local lending activity with these funds. This was also partially the case in Poland. [8] The foreign liabilities of Polish banks (mainly what the subsidiaries owe to the parent banks, but not only) amount to approximately PLN 240 billion. This figure represents 18 per cent of the assets of the banking sector. In the face of the new capital requirements imposed on the largest European banks, the banks were obliged to reach best quality capital at the level of 9 per cent of risk weighted assets by mid-2012. Since under the present circumstances it is extremely difficult to raise additional capital, many banks are going to achieve this objective by reducing their total balance sheet. In this situation, the number of banks interested in acquiring new assets has plummeted. The buyers require the sellers to participate further in financing the existing credit portfolio (especially in foreign currency) of local subsidiaries, but the present owners are not interested. For the sellers, a sale makes sense, from the point of view of deleveraging the group, if it releases the funds lent to the bank. It should be assumed that if such sales do not take place, the bank owners will change their market strategies for their subsidiaries in Poland. The main objective of subsidiaries would be to repay the lines of credit that had been granted to them. In the case of these banks, their market activity would be concentrated on acquiring new deposits, but these deposits would be used to replace the lines of credit repaid, rather than grant new loans. This would adversely affect the dynamics of the whole sector [Kornasewicz and Halesiak, 2011, pp. 11-12]. This action can be defined, as it was earlier mentioned, as optimizing the results of the whole group. Of similar nature are activities aimed at reducing lending activity in subsidiaries and using the released capital in other markets, where the group is short of capital.

Considering the ownership structure of banks in Poland, we have to adopt a longer perspective and take into account not only the risks described above, associated with the transition period during which the banks will adapt to the new prudential requirements, but also some major threats resulting from the transfer of risk from external markets to local markets. This opinion seems to be confirmed by the declining importance of parent banks in internal financing of the lending activity of their foreign subsidiaries over the last four years. On the other hand, the share of funds acquired by bank subsidiaries in their own markets is growing. It turns out, however, that they are not able to adequately replace the loss of internal

[8] Not all banks can expect such financing under normal conditions. For example, BZ WBK, owned by Santander, or Bank Śląski of ING Group do not receive funds to increase their lending activity from their owners.

financing. The study on the lending activity and deposits of bank subsidiaries (foreign banks, dependent on large international banking groups) and domestic banks, conducted between 1992 and 2009, has shown that during the financial crisis the lending activity of foreign banks in relation to domestic banks in host markets was significantly lower (it grew slightly in the years 1992–1997 and in 1999) [Haas and Lelyveld, 2011, p. 6].

This is mainly explained by the much lower funds received from the parent banks. Since late 2008, the phenomenon of reverse flow inside banking groups has been observed, i.e., capital has flowed from foreign bank subsidiaries to the parent banks [Zarazik, 2011, p. 5]. In Poland, foreign banking groups have limited lending to Polish companies while at the same time PKO BP has increased the loan portfolio for enterprises by 23 per cent in real terms (Table 1). In 2009, out of 10 major banks, PKO BP was the only bank that was willing to lend to new corporate customers [Kawalec, 2011, p. 3].

Table 1. Growth of loans in Poland in the years 2009–2010

Total real growth in 2009–2010, in per cent.	
Poland's GDP	5.6
Growth of loans to businesses across the banking sector	-6.3
Growth of loans to businesses granted by PKO BP	22.7
Growth of loans to businesses granted by co-operative banks	36.5
Growth of loans to businesses granted by other commercial banks (i.e., without PKO BP)	-11.0

Source: Kawalec [2011, p. 3].

5. Rationale for domestication of banks

Nearly 70% of the assets of the Polish banking sector is owned by entities that are subsidiaries of foreign entities [Kluza, 2010, p. 12]. Having this in mind, and given the course of the global financial crisis, the growing government debt crisis in the EU, as well as the expected effects of the implementation of Basel III, S. Kawalec proposed to take a new perspective on the structure of the Polish banking sector and to make Polish banks independent [Kawalec, 2011].[9] The concept of this transformation is termed, as mentioned in the introduction, as domestication of banks. It can be described as follows [Kawalec, 2011]:

[9] This paper started a lively discussion on ownership transformations in the Polish banking sector.

- The conditions for the operation of the Polish banking sector, dominated by the foreign-controlled banks, are not conducive to a stable and efficient performance of the financial intermediation function by this sector and do not reduce the country's macroeconomic risk.
- Almost all banking systems in the largest EU economies, with the exception of Poland, are dominated by banks with decision-making centres in particular countries.
- In the early period of transformation in Poland there was a shortage of bank management competencies in a market economy and a deficiency of Polish investors with adequate capital who could become competent and reliable shareholders controlling banks.
- In the process of privatization, reliable foreign strategic investors were sought to support banks with capital, appropriate management, and transfer of know-how.
- Currently, the Polish financial market is well developed and there is no need for it to be based on management exercised by foreign institutions because:
- There are a large number of Polish managers who are capable of managing banks and have gained practical experience.
- There is a wide group of professional institutional investors, primarily OFE and TFI, with large sums of money and management teams capable of professional judgment, which are ready to participate in a professional system of corporate governance.
- Furthermore, there exists a strong and relatively competent supervisory infrastructure.
- A bank which is part of an international banking group is guided in its activities in the Polish market not only by assessing the situation and prospects of Poland's economy as well as its own financial situation, but also by the situation of the whole banking group. As a result, the problems in the economy of the group's home country or the financial problems of the group can significantly affect the financial intermediation function performed by banks in Poland.
- In order to effectively stop booms in particular segments of the market it may be necessary to adapt the parameters of banks' operation to the situation on the local domestic market. These parameters involve: capital requirements, maximum ratio of credit to the value of real estate or income, etc., but it will be difficult if the so-called "maximum harmonization" of supervisory rules proposed by the European Commission is introduced. The only body with authority to influence a bank's policy through prudential parameters will be

supervision at the level of the banking group, and the parameters will be uniform for the entire area of the banking group's operations in the EU.

- The expected centralization of management of capital and liquidity in large international banking groups will mean in practice the abolition of requirements ensuring liquidity and a stable capital base in particular bank subsidiaries operating in other countries than the parent bank.

Guided by these premises, S. Kawalec proposes that the share of banks controlled and managed locally in the assets of the banking sector in Poland should be increased. However, the objective of the regulators' policy should not be to eliminate banks dependent on foreign banking groups, but to reduce, to a reasonable size, the share of their assets in the assets of the banking sector. It would be reasonable to reverse the present structure, in which banks dependent on foreign financial institutions hold two-thirds of the sector's assets, while locally controlled banks account for only about one-third.

In order to get a full picture one should also discuss the opinions of the opponents and sceptics of the concept of domestication of banks, who point out that:

- Such a model precludes the possibility of obtaining support from the owner in difficult situations.
- OFE investment funds will prefer a short-term approach.
- Polish banks still have little capital, which should not be used to pay off foreign capital.

With regard to the first objection, it should be noted that all the world's largest banks have an ownership structure as the one proposed. The Hungarian OTP bank is similar to foreign bank subsidiaries in Poland in terms of size and after privatization it has been working without strategic investor. In Canada, there is a rule that the bank which collects domestic deposits must not have a shareholder holding more than 20 per cent of its shares (previously the threshold was 10 per cent).

In the last two years, four European banking groups have decided to sell their banks in Poland. In the light of the arguments quoted above it would be advisable to take advantage of this situation and change the structure of the Polish banking system.

Conclusion

At the time when Polish banks were privatized, EU regulations did not provide any special treatment for EU banking groups, the relationships between parent and subsidiary banks, or between home and host supervision. The course of the global financial crisis, the increasing crisis of government indebtedness in EU countries, as well as the expected effects of the implementation of Basel III and the proposed CRD IV regulations incline one to make proposals for changes in the ownership structure of the Polish banking sector. Banks operate as subsidiaries within international banking groups. The resulting problem is not so much the risk of tunnelling as the fact that bank subsidiaries are subjected to the process of optimizing the results of the capital group. In the case of banks, this process is not only important for minority shareholders, but, most of all, for the economy. Its negative consequences for the economy (in the form of reduced lending activity of subsidiary banks) will be followed by the centralization of capital and liquidity management processes at the level of banking groups. Therefore the problem concerns not only the transitional period when banking groups will be adapting to new capital requirements. Importantly, Polish banking supervision will be subject to restrictions in setting prudential parameters in relation to banks which are members of banking groups with head offices in other EU countries. As can be seen, it is an unfavourable situation from the point of view of the national economy to have banks which are not managed or controlled locally. Therefore, it would be advisable to request relevant institutions (the Polish Financial Supervision Authority, the National Bank of Poland, and the government) to increase the share of locally controlled banks in the assets of the Polish banking sector, which can be described as domestication of banks.

References

1. BCBS, 2010a. *Basel III: A global regulatory framework for more resilient banks and banking systems*, Basel Committee on Banking Supervision, December.
2. 2010b. *Basel III: International for liquidity risk measurement, standards and monitoring*, Basel Committee on Banking Supervision, December.
3. European Commission, 2011. *Report of the Reflection Group on the Future of EU Company Law*, European Commission Internal Market and Services, Brussels, April, http://ec.europa.eu/internal_market/company/docs/modern/reflectiongroup_report_en.pdf.
4. Haas, R. de, and van Lelyveld, I. 2011. 'Multinational banks and the global financial crisis: weathering the perfect storm?', European Bank for Reconstruction and Development, *Working Paper* No. 135, December.
5. Jeżak, J. 2010. *Ład korporacyjny. Doświadczenia światowe oraz kierunki rozwoju*, Wydawnictwo C.H. Beck, Warsaw.

6. Kawalec, S. 2011. ‘Banki powinny być pod krajową kontrolą’, Obserwatorfinansowy.pl, http://www.obserwatorfinansowy.pl/2011/11/02/banki-w-polsce-trzeba-spolonizowac-ale-nie-upanstwowic/.
7. Kluza, S. 2010. ‘Europejski system nadzoru finansowego po kryzysie’, *Zeszyty BRE Bank - CASE*, No. 109.
8. Kornasiewicz, A., and Halesiak, A. 2011. ‘Konsekwencje kryzysu w strefie euro dla polskiego i europejskiego sektora bankowego. Głos w e-debacie zorganizowanej przez Instytut Badań nad Gospodarką Rynkową’, Instytut Badań nad Gospodarką Rynkową, November, http://www.rf.edu.pl/uploads/tx_mmforum/c3dbcd6879c460a5025d07358552da15A_Kornasiewicz_i_A_Halesiak.pdf.
9. Morawski, I. 2011. ‘Bazylea III: bezpieczniejsze banki, ale większe koszty’, Obserwatorfinansowy.pl, http://www.obserwatorfinansowy.pl/2011/06/10/bazylea-iii-banki-regulacje-strefa-euro-trichet/.
10. Nartowski, A.S. 2010. ‘Prawo o grupach spółek musi nadążać za praktyką’, *Przegląd Corporate Governance,* nr 2.
11. Postrach, K. 2006. ‘Cele nadzoru korporacyjnego w polskich spółkach giełdowych’, in Rudolf, S. (ed.), *Tendencje zmian w nadzorze korporacyjnym*, Wydawnictwo Uniwersytetu Łódzkiego, Łódź.
12. Reich, A. 2011. ‘Centralizacja nadzoru i regulacji w Unii Europejskiej. Udomowienie banków. Głos w e-debacie zorganizowanej przez Instytut Badań nad Gospodarką Rynkową’, Instytut Badań nad Gospodarką Rynkową listopad, http://www.rf.edu.pl/uploads/tx_mmforum/f98fb20e00187dfe14c8686ec870af5fA_Reich.pdf.
13. Roe, M. J. 2004. ‘The Institutions of Corporate Governance’, *Discussion Paper* No. 488, Cambridge, MA.
14. Romanowski, M. 2010. ‘Prawo holdingów finansowych a hazard moralny, XVII Seminarium Gdańskiej Akademii Bankowej, Moral hazard w biznesie i polityce gospodarczej, prezentacja’, Instytut Badań nad Gospodarką Rynkową, Gdańska Akademia Bankowa, June, http://www.gab.com.pl/strony/rn2010/?v=prezentacje.
15. Trocki, M. 2004. *Grupy kapitałowe. Tworzenie i funkcjonowanie*, Wydawnictwo Naukowe PWN, Warsaw.
16. Wilkowicz, Ł. 2010. ‘Koniec z dokładaniem kapitału szufelką’, *Parkiet*, September 20.
17. Zarazik, Z., 2011. ‘Grupy bankowe odwracają sie od spółek na lokalnych rynkach’, http://www.obserwatorfinansowy.pl/2011/12/23/grupy-bankowe-odwracaja-sie-od-spolek-na-lokalnych-rynkach.

*Piotr Masiukiewicz**

CHAPTER 8

RECEIVERSHIP IN BANKING: THEORY AND PRACTICE

Introduction

Studies on bankruptcies show that one of the major causes of this phenomenon is dysfunction of ownership supervision including insufficient use of an early warning system. Business practice provides a lot of evidence, and the latest international financial crisis is a real laboratory full of examples for the lack of this supervision [Mączyńska, 2010, p. 301].

One of the most important barriers to changes aimed at preventing corporate disturbances and irregularities, which in extreme cases can lead to bankruptcies, is the underdevelopment of the broadly understood institutional and regulatory infrastructure and its maladjustment to the requirements of the contemporary market [Mączyńska, 2010, p. 302]. Part of this infrastructure is the support infrastructure of repair and bankruptcy processes; forecast and early warning support infrastructure; juridical, supervisory, and audit infrastructure; as well as research and scientific infrastructure. Receivership management (administration order in the UK) is an important instrument for effective rehabilitation of banks and prevention of an accelerating financial crisis.

If a bank finds itself in crisis, the institution of receivership management is indispensable:

- This is an important instrument of intervention of financial supervision when there is a risk of bankruptcy;
- Its use is justified by the responsibility of the State for financial stability and involves regulations introduced in the banking sector, licensing, state supervision, and the established system of deposit guarantees;
- The risk related to the reorganization process in a bank often lies in inefficient management and an incompetent board; hence it is important that financial supervision may enter into a bank with authority.

* Warsaw School of Economics.

Justification for the use of this management instrument can be found in the theory of intervention, crisis theories, and the doctrine of public good and other doctrines.

The thesis of the paper is as follows: receivership management is an effective legal and managerial instrument for rehabilitation of banks, but regulations in this field are insufficient in Poland.

Regulatory changes that would increase the effectiveness of this institution in the event of a crisis are needed since a banking crisis cannot be ruled out.

1. Theoretical aspects of intervention during crisis

The growing social significance of banking, state regulation and supervision over the banking industry, as well as attempts to calculate the social costs of bankruptcies have led to the dissemination of two doctrines justifying state intervention (Too Big To Fail, TBTF, and Too Important To Fail, TITF). E. Gardener and P. Molyneux [1998] have devoted many works to these doctrines arguing that because of the importance of systemic risk, some banks (so-called strategic banks) deserve to be rescued by the state (also by nationalization) and the TBTF and TITF doctrines have become a recognized practice in many countries [Gardener and Molyneux, 1998]. C. James's research has shown that closures of insolvent banks are more expensive than their rehabilitation, acquisition by a healthy bank, or even nationalization [James, 1991]. Other theorists think, however, that trust in state help for banks leads to intensified moral hazard practiced by bank CEOs.

In their financial contagion model, F. Allen and D. Gale take into account the role of regulation and state intervention in banking. In their view, a crisis becomes contagious through inter-bank deposit markets. These markets do not generate liquidity, but allocate it. If the demand for liquidity is greater than the short-term asset reserves, there will be shortages of liquidity in some regions, followed by bank runs and bankruptcies. In addition, it is necessary to take into account the potential loss of public trust and the contagion effect in banks. In such cases, state intervention is required, also in the form of the lender of last resort [Allen, and Gale, 2000].

The new thesis offered by G. Corrigan, according to which banks are perceived not only as institutions of public trust, but even more broadly as a public good, and therefore the whole society should bear the costs associated with them (systemic risk is risk for the general public), has generated a lot of discussion and criticism [Corrigan, 1992, p. 3]. However, A. Greenspan also saw stability as a public good. He said that the function of the lender of last resort was, and is, indispensable because "markets generally work, but from time to time they collapse. When this happens, government intervention is required to ensure stability, which is a public good" [Greenspan, 1988]. The doctrine of public good justified state help during the last crisis. It should be noted that the New Capital Accord, which defines the principles of risk management (called the CRD directive in the EU), includes the assumption that financial supervision will take corrective action towards banks in a situation of crisis [Masiukiewicz, 2011b, p. 35].

The security of the financial system and the protection of the clients' funds are public goods and justify the use of rehabilitation instruments (direct intervention) in banks by financial supervision [Journal of Laws, 2006]. The subprime financial crisis is an example of state intervention in financial institutions on an unprecedented scale; intervention measures are estimated at about 3.5 billion euros.

In the light of the theory of financial supervision receivership (administration order) is an instrument of direct intervention of state supervision. It is used when other supervisory instruments are no longer effective [Stocka and Kołacz, 2009; Davies and Green, 2008]. Such a decision is always risky for the government agency which assumes responsibility for the situation, and the clients' response can be unexpected (e.g., a run on banks) [Masiukiewicz, 2011b].

The institution of receivership management (administration order, compulsory administration) should also be considered in the context of its role in maintaining financial stability, as this type of management may fulfil the following tasks:

- Rehabilitation of systemically important financial institutions (SIFIs);
- Under conditions of a systemic crisis the introduction of such management to a large number of banks should inactivate panic and calm down the financial markets;
- Finding new strategic investors and quick sale or takeover of bankrupt banks.

Receivership can be defined as a managerial body in a financial entity appointed by the state financial supervisory authority. This management has the task of effectively rehabilitating the entity and to this end it has been equipped by law with powers of ordinary management, supervisory board, and the general meeting of shareholders.

2. Corporate governance and receivership management

Financial market regulations are based on sound corporate governance both in the context of risk management and reliability of financial statements [Davies and Green, 2008, p. 134]. At the same time, regulators of the financial sector are generally not responsible for corporate governance, which covers a broader spectrum of issues [Davies and Green, 2008]. The OECD principles of corporate governance adopted in 1999 provide guidance for legislative and regulatory initiatives [OECD, 2004]. The Financial Stability Forum found these principles to be some of the key standards for a robust financial system. However, consistent standards of corporate governance have not been agreed upon at the international level yet due to significant differences in legal options as well as in terms of their substantive content [Davies and Green, 2008, p. 135].

The regulations in force in Poland allow the Polish Financial Supervision Authority to affect the shape of the statute, the composition of the first supervisory board and of the management board and ownership structure (the licensing process) and then in every case the Authority approves the appointment of the President and the Vice-President of the bank, and also gives its consent to holding blocks of shares in excess of statutory limits.

A study conducted by McKinsey found that over 78 per cent of the surveyed investors in Western Europe were willing to pay a higher premium for companies with good corporate governance, enabling the growth of shareholder value over the long term [Jerzemowska and Campbell, 2008, p. 193].

In the light of the recommendations of the Working Group of the Basel Committee, the functions of banking supervision in the system of corporate governance are as follows [BCBS, 2006]:

- Supervision should provide banks with guidelines on good corporate practices;
- Corporate governance should be considered part of depositor protection
- Supervision should lead to the adoption and implementation of corporate governance rules in banks;
- Supervision should assess the quality of bank audits and internal control functions;
- Supervision should evaluate the results of bank groups;
- Financial supervision should inform the supervisory and management boards about the problems disclosed by its inspections.

These international documents do not refer to the institution of receivership management, but such reference to rehabilitation programmes and indirectly to receivership management can be found in the recommendations of the World Bank on the development of effective national systems addressing insolvency and creditor rights [World Bank, 2001]. The World Bank recommends including in legal regulations the possibility to quickly and effectively implement rehabilitation, ensuring legal supervision of such a rehabilitation process, and administration that enables stabilization and maintaining the company in business. The supervisory bodies responsible for supervising the activities of administrators should perform their functions independently and in a transparent manner.

In recent years, the issue of rehabilitation of companies and banks has become of particular interest in the European Union. The EU initiative "A second chance to entrepreneurs" promotes in the broad sense both re-starting a business after bankruptcy and rehabilitation or restructuring in the face of bankruptcy – within a rehabilitation process. The new EU regulations on state support for the rehabilitation processes in companies and banks include:

a) Community guidelines on state aid for rescuing and restructuring firms in difficulty, Brussels, 2004 [European Communities, 2004];

b) Directive of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions [European Parliament, 2001];

c) EU Commission Communication "Bank Resolution Funds" [European Commission, 2010].

The issue of funding the rehabilitation processes in banks is currently the subject of extensive consultations and a banking tax is to serve this purpose [Masiukiewicz and Dec, 2011]. Both at the EU level (the Committee of European Banking Supervisors, CEBS) and at the international level work and tests are underway on rehabilitation and recovery plans which will be a key element of a future EU framework for crisis prevention. The new EU regulations are not sufficiently popularized or implemented in Poland.

The availability of financial leverage within a repair process is usually a key factor of success. According to M. Iwanicz-Drozdowska, "in most countries, there are no clear rules of responsibility and competence in the field of crisis management. In this respect, of key importance is the public authority, which is responsible for financing of rehabilitation actions" [Iwanicz-Drozdowska, 2008, p. 95].

In the light of the above analysis, it should be noted that many experts and a number of institutions appreciate the necessity of state intervention in a banking crisis, but there are also opposing positions both in science and business practice.

The use of receivership by Polish supervision was significant, as shown in Table 1.

Table 1. Receiverships in banks established by banking supervision in Poland

Number of receiverships established in Poland	1991–1997	1998–2010	Total
1. Commercial banks	13	10	23
2. Cooperative banks	13	6	19
Total	26	14	42

Source: National Polish Bank and the Polish Financial Supervision Authority data.

Not all receiverships have been successful as several banks under receivership have failed, including BSRz Poznań, Bank Posnania, and Bank Staropolski.

The institution of receivership is regulated by the Polish law not only for banks but also for other financial institutions, such as insurance companies [Journal of Laws, 2003].

3. Criteria for establishing receivership management

The rationale for introducing receivership management may vary:

- Loss of trust in a bank's governing bodies and auditors;
- Legal conditions (e.g., wrongful trading by the management board);
- Economic conditions, restoration of effective management (including financial liquidity);
- Risk reduction (also through recapitalization of the bank);
- Identification of criminal activity (including creative accounting);
- Protection of depositors' interests and preventing a panic of the clients;
- Restoring the trust of depositors and stakeholders.

Table 2. Entities reporting the need to initiate rehabilitation proceedings

No.	Types of banks	On-site supervision, Polish National Bank	Supervision analyst (so-called behind the desk control, Polish National Bank)	Bank management	Independent auditor	Total
1	Commercial banks					
1.1	Banks operating independently	17	10	12	4	43
	Merged or acquired banks					
1.2	TOTAL	15	5	6	3	29
	Structure in %					
x		32	15	18	7	72
x		44.5	20.8	25.0	9.7	100.0
2	Co-operative banks					
2.1	Banks operating independently	186	156	177	1	520
	Merged or acquired banks					
2.2	TOTAL	290	210	254	5	759
x	Structure in %	476	366	431	6	1279
x		37.2	28.6	33.7	0.5	100.0

Source: National Polish Bank data.

The unique analysis of entities reporting the need to initiate rehabilitation programmes conducted by the General Inspectorate of Banking Supervision of the Polish National Bank revealed that in most cases crises in banks were disclosed by bank supervision and not by the management following an internal audit. The results of this study are shown in Table 2. The question arises whether these issues were ignored by the management boards or perhaps the banks' internal audit departments (control departments, controlling posts in cooperative banks) did not have adequate skills. This is also a measure of the effectiveness of financial supervision.

The work of external auditors revealing the need to initiate rehabilitation programmes (Table 2) was almost negligible. This is a dangerous situation, both for financial supervision and in view of possible consequences for the entire national financial system. Thus, the supervisory authorities lost trust in banks' statutory governing bodies and auditors, which hastened the introduction of receivership.

The Polish Financial Supervision Authority is not entirely free to introduce receivership into banks; conditions justifying such decisions have been set out in the banking law. Such decisions are of special nature (no administrative appeal can be made) and the PFSA takes responsibility for the receivership introduced into a bank.

The banking law strictly regulates the tasks and powers of receiverships. The tasks are specified in detail by the PFSA for each receivership management in individual resolutions establishing receivership.

In the light of Art. 145 of the Banking Act [Journal of Laws, 1997], if a bank's management fails to submit for approval the reorganization programme consistent with the requirements and in due time, or if the performance of that programme proves ineffective, the PFSA may decide to establish receivership management for the duration of the reorganization programme. The establishing of receivership shall not affect the organization and operation of the bank as a legal person, with the exception of the changes provided for under the Banking Act.

The receivership team shall assume the power to pass resolutions and take decisions in all matters reserved for the bank's governing bodies under the Banking Act and the bank's articles of association. On the day of establishing receivership, members of the its management board shall be dismissed *ex lege* and proxies and powers of attorney granted prior to that day shall expire. The competence of other bank authorities (the supervisory board and general meeting of shareholders) shall be suspended.

The supervisory board may appeal the decision to establish receivership (despite being suspended) to a commercial court, but this does not delay the execution of the decision.[1] The establishment of receivership must be recorded with a court register under which the bank falls.

The receivership draws up a reorganisation programme and obtains approval for the programme from the PFSA, manages the programme and reports the results achieved under the programme to the PFSA and the supervisory board at least every three months.

Based on Art. 146 of the Banking Act, if necessary, members of the receivership team shall be granted unpaid leaves from their places of employment for the duration of their duties, and their remunerations shall be set by the PFSA. Art. 169 of the Act states that the institution of receivership shall render void any rights held by members of the bank's management bodies concerning severance pay and remuneration for the period following the termination of their contract of employment. [2] The expenses of receivership administration will be borne by the bank.

In accordance with Art. 148, as of the day specified in the decision of the PFSA for a bank to be taken over by another bank or to be liquidated, the management board and the receivership of the bank being acquired shall be dissolved and the decision-making powers of its management bodies shall be suspended, the supervisory board of the acquired bank as well, the proxies and powers of attorney issued by the acquired bank shall expire, and the acquiring bank shall assume administration of the assets of the acquired bank.

The acquired bank's own funds shall be assigned to cover balance sheet losses. If a bank's assets are not sufficient to cover its liabilities, the bank's administrators shall immediately notify the PFSA, which shall take a decision to suspend the bank's operations and thereupon a decision for the bank to be taken over by another bank or to file for bankruptcy with the competent court. The decision to suspend a bank's operations, or for it to be taken over or file for bankruptcy may also be taken by the PFSA on its own initiative. If a bank has ordinary management, then along with the decision on suspension, takeover or filing for bankruptcy, the bank may be placed into receivership.[3]

[1] Articles 127 & 3 of the Code of Administrative Procedure shall not apply.

[2] Undue severance payments made by ordinary management took place in practice, for example in Bank Częstochowa S.A.

[3] Such a decision was made in relation to Bank Staropolski SA [Masiukiewicz and Mackiewicz, 2009] .

The consequences of placing a bank into receivership are as follows:

- Specific restriction of the rights of shareholders and statutory bodies (the management board shall be dissolved and the supervisory board and general meeting of shareholders suspended);
- The receivership holds the full authority in the company (the powers of all its governing bodies);
- The aims and main tasks of the new body are determined by the financial supervision authority;
- The supervisory board may file an appeal against the decision of the financial supervision authority with an administrative court, which shall not, however, suspend the activities of the new body;
- The possibility to significantly reduce procedures resulting from the Commercial Companies Code (e.g., convening a general meeting of shareholders);
- Statutory obligation to cover the operating costs of receivership by the bank.

4. The risk of placing a bank in receivership

There are a number of risks linked to the management board (and the supervisory board); the literature usually indicates wrongful trading, recklessness, dishonesty, and lack of qualifications. In some EU countries such as Belgium, France, and Great Britain, CEOs may suffer severe consequences, set out in the law, for such conduct [Jerzemowska and Campbell, 2008, p. 202].

The introduction of a new ordinary management or of receivership team to a bank in order to rehabilitate it involves various risks. Such risks have been revealed over the last 20 years in banks undergoing rehabilitation. These risks include:

- The risk that the new management which undertakes rehabilitation will not know the specificity of a particular company and may not have sufficient experience in managing a crisis situation;
- The possibility of hostile behaviour of the owners, supervisory board and former management board (e.g., Posnania Bank, Bank Wschodni);
- The possibility of triggering bank runs by the very fact of placing banks in receivership and inaccurate media coverage (e.g., BSRz in Poznań, Bank Wschodni and Bank Częstochowa);
- A possible failure of the mission – inability to obtain financial leverage or a new investor or acquiring bank, resulting in the bank's failure;
- Inability to identify creative accounting and, in the long term, after learning the real losses, inability to pursue effective rehabilitation, or bankruptcy (moral responsibility of banking supervision – e.g., Bank Staropolski);

- Dishonesty of employees and former executives acting to the detriment of the bank, and thus also to the detriment of the receivership team (e.g., Bank Staropolski and other banks).

The presence of these risks to a large extent hampers the management of rehabilitation.

A full and fast verification of personnel is a prerequisite for a successful rehabilitation of a bank. In many cases, senior management is co-responsible for the crisis and is associated with the ousted management board (e.g., Animex Bank SA and Bank Wschodni SA, whose board members were convicted in criminal cases and sentenced to long terms) or with members of the supervisory board or shareholders.[4] In order to maintain the continuity of the institution and ensure sources of information, and also because of costs, it is important to restructure personnel in stages.

In the 1990s, a lot of executives in the rehabilitated banks were dismissed or replaced by professionals from other banks and other cities. Flexibility in this respect is by the nature of things limited because high-class professionals are reluctant to come to bankrupt banks. For example ING, which took over the bankrupt Barrings Bank, had to pay a bonus of about $100 million to keep the staff from leaving the bank [Heffernan, 2007, p. 484]. E. Altman also shows the importance of this barrier.[5]

The percentage of senior management turnover in the banks surveyed by the author ranged from 40 to 85 per cent (see Table 3).[6]

Table 3. The scale of senior management turnover in banks under rehabilitation (under receivership)

No.	Bank	Senior management turnover rate (%)*	Remarks
1	Bank Posnania SA	60.0	* Applies to directors and deputy directors of branches and branch offices (departments).
2	Bank Staropolski SA	75.0	
3	BPE Animex Bank SA	40.0	
4	Bank Wschodni SA	70.0	
5	Bank Przemysłowy SA	85.0	

Source: Masiukiewicz [2011b, p. 154].

Personnel selection methods are important both in terms of staff honesty, loyalty, and competence. Complex social engineering techniques are used here and receivership works under time pressure and in conditions of incomplete information.

[4] This was the case in Bank Społem SA and Bank Wschodni SA. Bank Społem hired former employees and members of consumer cooperatives without experience and formal qualifications.

[5] More in Altman and Hotchkiss [2007].

[6] More in Masiukiewicz [2011].

Another problem that may arise in the future is the recruitment of staff experienced in bank crisis management by the PFSA. Thus, the PFSA should develop a "human resource bank" and train personnel.

Analysis of litigation documents related to the establishment of receivership shows that this legal instrument has stirred a lot of controversy. Court records expose poor economic situation in banks and low professionalism of their management [Frysztak, 2009, p. 86]. The following issues have been found in cases heard by courts:

- Legitimacy of introducing receivership in objecting banks;
- Composition of the receivership team;
- Right of a bank's body to represent the bank before the commercial court in proceedings resulting from objection;
- Admissibility of court proceedings before the commercial court and admissibility of the subject of objection;
- Protection of objection.

The cases were eventually dismissed. However, the main reason for dismissals was the fact that the receivership was already over (so a court ruling was no longer necessary) or the bank had already been liquidated (so a court ruling was no longer possible). In this situation, there is no practice of judicature which could be drawn upon in the future [Frysztak, 2009, p. 86].

5. The first organizational decisions

The process of bank rehabilitation by receivership, especially in its initial phase, requires many tactical and operational decisions to be taken under conditions of uncertainty and high risk [Masiukiewicz, 2006]. At the beginning of receivership, which usually takes place in an unknown environment, it is usually necessary to take organizational decisions concerning:

- The choice of method of operational crisis management – whether this management be performed by the receivership or crisis team or by some other body;
- The choice of strategy for a rehabilitation programme and the selection of a team to prepare it;
- The manner of development of an austerity plan and its scope;
- Review and verification of bank instructions and rules;
- Adjustment of the management information system (MIS) for emergency purposes, and determination of the scope of daily operational managerial information to be introduced in the bank;

- Assessment of the organizational structure and, if necessary, the development of a concept of changes;
- Determination of the extent of trust in the personnel and verification of powers of attorney and user access rights to IT systems;
- Construction of a public relations system for the needs of the rehabilitation process;
- Development of a system of deposit withdrawals in case of a panic;
- Establishing the form and frequency of cooperation with the shareholders and the present (suspended) supervisory board;
- Determining the form of cooperation with the trade unions.

Time is of the essence for the effectiveness of these decisions; they should be made within the first few days. Hence, it is important for the receivership team to study the basic internal regulations of the bank under rehabilitation in advance. Such opportunity was provided to receiverships by the General Inspectorate of Banking Supervision (GIBS) of the National Bank of Poland (NBP). Many managerial issues related to rehabilitation are determined by the specific characteristics of a particular bank. Receivership management (or ordinary management conducting rehabilitation) should take flexible organizational decisions depending on the available information and assessments; the fundamental thing is to rely on previous supervisory inspections and the results of internal controls and audits [Masiukiewicz, 2008].

It should be noted that, especially in the first period of receivership, decisions must be made under conditions of high risk, incomplete and sometimes erroneous information, without confidence that the current financial statement is accurate and true. [7] Hence, when appointing receivership, the NBP has always employed independent, reputable auditors to perform audit. In such extreme conditions the receivership teams were not insured (by the banking supervision or by the bank under rehabilitation) against third party liability claims. In Poland, directors and officers (D&O) insurance was launched already in 1992 by AIG Poland, and later also by other insurance companies. D&O insurance is designed for people serving on the management and supervisory boards, as well as for holders of commercial powers of attorney. Such insurance gives protection from the effects of improper action, but not from criminal liability [Pauch, 2009].

In a 2007–2009 survey banks were asked what the most important measures concerning organizational changes were that should be implemented in a time of crisis (Table 4).

---

[7] More in Masiukiewicz [2006].

Table 4. The most important measures involving organizational changes that should be implemented in a time of crisis in a bank

Specification	Responses of the surveyed banks 2009 N = 37	Responses of the surveyed banks 2007 N = 36
1. Perform reorganization of the bank	54.1%	63.9%
2. Implement an austerity programme	89.2%	77.8%
3. Sell property unnecessary for operational activities	54.1%	50.0%
4. Outsource the sales of the bank's core products (reduce the bank's own network)	5.4%	2.8%
5. Centralize decisions, i.e., withdraw some powers of attorney	40.5%	38.9%
6. Increase the powers of the management board	5.4%	16.7%
7. Other measures	0.0%	5.4%

Note: Percentages do not add up to 100% as the respondents could indicate up to 3 answers. Previously published in Masiukiewicz [2011, p. 134].

Most indications concerned the implementation of an austerity programme – 78% in 2007 and 89% in 2009. This was followed by bank reorganization and selling assets not critical to operational activities, centralization of decision-making (i.e., withdraw some powers of attorney), and outsourcing the sales of basic banking products. The banks themselves suggested soliciting advice from the associating bank. Preference was given to the traditional austerity regime and sale of assets; surprisingly, outsourcing of distribution was not appreciated. The surveyed banks did not produce any other original ideas about reorganization during crisis.

6. Decision-making determinants of receivership management and the efficiency of the process

Decisions in banks under rehabilitation are often unconventional in nature and give rise to ethical dilemmas. Legal regulations do not always create favourable conditions for solving such dilemmas.

According to the McKinsey report, the methods of rescuing troubled banks are similar all over the world. Rather than looking for a magic formula for bank problems, one should focus on three key issues decisive for the future, i.e., ensuring liquidity, reduction of credit risk, and provision of new capital [Barton et al., 2004].

However, in the process of bank rehabilitation many qualitative, non-programmable decisions are made that are absent in normal business activities [Masiukiewicz, 2011a].

Limitations of decision-making in a bank under rehabilitation occur in areas such as:

- Statutory limitations;
- Recommendations of financial supervision;
- Changes in customer behaviour (e.g., closing of bank accounts, deposit withdrawals, loss of public trust, risk of panic);
- Time pressure (resulting in the need for rapid, sometimes intuitive, decisions);
- False information and creative financial reporting in the bank;
- Conditions of considerable uncertainty and high risk during the functioning of receivership.

This is a traumatic situation for receivership teams. The estimation of the likelihood of the present (and anticipated) conditions for making a decision is highly difficult. Thus, decision-making, which becomes to some extent intuitive, increases the role of ethics in the process. It should also be noted that the sense of legalism is deeply ingrained in the minds of bankers. Under the circumstances, ethical decisions in the management of rehabilitation should be based on some basic criteria such as compliance with the objectives of the action undertaken, the lesser evil, greater moral value, and compliance with legal norms.

The receivership team is forced to make a number of unusual decisions in the bank under rehabilitation. Some of them affect the professional and financial interests of its employees and clients and may result in acts of discontent, violence and other unethical behaviour of the bank's stakeholders. Decision-making dilemmas are also produced by imprecise legal standards or inadequate knowledge of the law on the part of stakeholders. At the same time, some of the bank's stakeholders (including banks competing in a given region) try to advance their interests at the expense of the bank under rehabilitation.

In the practice of rehabilitation there are many decision-making dilemmas, such as: [8]

- The dilemma between honesty of information and the imperative of rehabilitation;
- The dilemma between social responsibility and additional profits;
- The dilemma between just remuneration and the priority of the austerity programme;
- The dilemma between corporate social responsibility and efficiency of activities.

These are typical dilemmas of managers; they must continuously choose between effective business without ethics or ethics without business.

---

[8] More in Masiukiewicz [2006].

It is an urgent and necessary task to clarify legal provisions, define procedures for the operation of receivership teams in the first and most difficult phase of placing a bank under rehabilitation, and determine the objectives of state aid for receivership. Perhaps receivership teams should be provided with legal protection similar to that granted to civil servants. The decision to appoint a receivership team should define priorities, strategy of rehabilitation, competence framework (scope of duties) as well as remuneration and compulsory civil liability insurance for managers at the expense of the bank under rehabilitation.

It would be helpful for receivership teams to develop decision-making standards at the stage of their assuming control over banks (including replacement of powers of attorneys for employees, range of debt collection, turnover of staff in the bank, the scope and timing of inventory-taking, relationships with customers, including payments of clients' deposits in the case of fortuitous events at the moment of suspending the bank's operation, relations with the media, and others).

Rehabilitation requires financial leverage. Two types of leverage should be considered in the situation of a liquidity crisis, i.e., short-term and long-term leverage. Quick access to funds in the event of trouble would be possible at the Polish National Bank in the form of lombard credit, which is expensive and requires first-class collateral, and thus does not appear to be a good instrument for rescuing liquidity during a crisis at a bank. Expensive loans do not solve problems; for example, during the recent subprime crisis, the FED and ECB offered loans at a discount and with lower collateral requirements, perhaps recognizing that there was a need to help, and not to "finish the banks off" [Masiukiewicz, 2009]. S. Hefernan believes that "if the LoLR considers that the root of the problem lies in a bank run or bank panic, and not in the bank's financial situation, it can reduce the necessary collateral requirements and reduce the punitive rate of interest" [Heffernan, 2007, p. 574].

It should be noted that during a bank panic banks may additionally be affected by adverse conditions resulting from a national or international systemic crisis (e.g., the domino effect that occurred in the subprime crisis in the U.S.).

The history of bank failures in Poland shows that some of them could have been saved if financial leverage had been used early enough. The late use of financial leverage for some banks under rehabilitation resulted in a prolonged process of rehabilitation. At the same time, an exceptional example of Bank Wschodni indicates that thanks to the intervention of the General Inspectorate of Banking Supervision of the Polish National Bank and early use of financial leverage (the deposit of the future investor, the deposit of Bank Społem as a future acquiring bank), the bank managed to avoid bankruptcy, even though it had met all criteria for bankruptcy [Masiukiewicz, 2011b, p. 296].

The role of the Bank Guarantee Fund (BGF) in the process of bank rehabilitation needs to be redefined. The BGF, which has significant financial resources, should actively participate in the management of rehabilitation already at the stage of commencing receivership proceedings. The BGF could temporarily own newly issued shares of a bank under rehabilitation, being guaranteed some seats on the ordinary management board, receivership team or supervisory board, as well as having a guaranteed exit from the investment. Loss and profit sharing under purchase and assumption (P&A) transactions could be a good instrument supporting acquisitions. If the institution acquiring the endangered bank is concerned that it may suffer losses as a result of acquiring a portfolio of assets, it can sign a contract on partial compensation of losses with a guarantee institution. However, if the acquiring institution achieved an unexpected profit from this transaction, it would have to share it with the guarantee institution.

Another issue to be considered is the abolishment of certain instruments used by financial supervision during rehabilitation, such as the ban on advertising and the introduction of maximum interest rate ceilings on deposits and loans. These instruments raise doubts and significantly hamper the management of the rehabilitation process.

The recommendation to cover losses with equity during rehabilitation and the introduction of maximum interest rates for deposits and loans prevents the receivership team from conducting further lending process due to the lack of capital adequacy and due to competitive barriers. So how can one carry out rehabilitation facing such barriers without breaking the law?

The rules for selecting managers for the receivership team should be legally defined. The requirement of at least ten years of practice in banking does not seem to be excessive. It is necessary to organize a system of training for future receivers (including curators, liquidators and others) under the auspices of the Polish Financial Supervision Authority.

Conclusion

Poland has a unique experience in rehabilitation of banks by receivership teams. A period of financial stability is a good time to work on improving the model of receivership.

There are a number of barriers present during the operation of receivership in banks that need further analysis and legislative changes; these include the interest rate ceiling and a ban on advertising introduced by the financial supervision authority for the period of bank rehabilitation, and other problems. An essential barrier is difficult access to financial leverage during rehabilitation, while the function of the lender of last resort has not been regulated by the Polish law.

Because of the great responsibility and powers of receivership, the eligibility requirements for members of receivership teams must be clarified and receivers should be better protected (e.g., with statutory liability insurance).

Recommendations in the field of business practice are as follows:

- The institution of receivership has turned out to be an efficient and effective tool of rehabilitation (proven in the Polish banking sector) and should be maintained;
- The legal framework for the functioning of receivership and the reduced decision-making competence of receivership do not fit into the current changes in the market and require legal corrections;
- Legal uncertainty concerning appealing decisions to establish receivership are groundless;
- The supervision authority should have at its disposal a supply of staff and ensure training for future receivers;
- The possibility of establishing such bodies in certain non-banking institutions should be considered.

References

1. Allen, F., and Gale, D. 2000. 'Financial Contagion', *Journal of Political Economy*, Vol. 108, No. 1.
2. Altman, E. I., and Hotchkiss, E. 2007. *Trudności finansowe a upadłość firm*, Wydawnictwa Fachowe CeDeWu, Warsaw.
3. Barton, D., Newell, R., and Wilson G. 2004. 'Pursuing Best Practice in Bank Turnarounds', *The Mc Kinsey Quarterly*, July.
4. BCBS 2006. *Enhancing Corporate Governance for Banking Organizations*, Working Group on Corporate Governance of the Basel Committee on Banking Supervision, Basel, www.bis.org/publ/bcbs122.pdf?noframes=1.
5. Corrigan, G. 1992. 'Challenges Facing the International Community of Bank Supervisors', *Quarterly Review*, Federal Reserve Bank of New York, Autumn.
6. Davies, H., and Green, D. 2008. *Global Financial Regulation*, Polity Press Ltd. Cambridge.
7. European Commission 2004. *Community guidelines on State aid for rescuing and restructuring firms in difficulty*, Communication from the Commission, Brussels.

8. European Commission 2010. *Bank Resolution Funds*, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the European Central Bank, COM 254, Brussels.
9. European Parliament 2001. Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganization and winding up of credit institutions, (OJ L 125, 5.5.2001).
10. Frysztak, M. 2009. *Nadzór bankowy w praktyce*, Wydawnictwo CH Beck, Warsaw.
11. Gardener, E. P. M., and Molyneux, P. 1998. 'Powrót do doktryny TBTF: postępowanie wobec banków strategicznych zagrożonych upadłością', *Bezpieczny Bank*, No. 1.
12. Greenspan, A. 1988. 'A Testimony by Alan Greenspan Before the Committee on Banking', Housing and Urban Affairs of United States Senate.
13. Heffernan, S. 2007. *Nowoczesna bankowość*, Wydawnictwo Naukowe PWN, Warsaw.
14. Iwanicz – Drozdowska, M. 2008. *Bezpieczeństwo rynku usług finansowych. Perspektywa Unii Europejskiej*, Oficyna Wydawnicza SGH, Warsaw.
15. James, C. 1991. 'The Losses Realized in Bank Failures', *Journal of Finance*, No. 9.
16. Jerzemowska, M., and Campbell, K. 2008. 'Nadzór korporacyjny a zagrożenie przedsiębiorstwa bankructwem', in Mączyńska, E. (ed.), *Bankructwa przedsiębiorstw. Wybrane aspekty instytucjonalne*, Oficyna Wydawnicza SGH, Warsaw.
17. Journal of Laws 1997. The act of 29 August 1997 – The Banking Law (Journal of Laws No. 72, item. 665 amended).
18. 2003. The Act of 22 May 2003 on Insurance Activity (Journal of Laws No. 134/2003, pos. 1151, amended).
19. 2006. The Act of 21 June 2006 on the Supervision of Financial Markets, (Journal of Laws No. 157/2006, pos. 1119, amended).
20. Mączyńska, E. 2010. 'Bankructwa przedsiębiorstw a nadzór właścicielski', in Mączyńska, E. (ed.), *Cykle życie i bankructwa przedsiębiorstw*, Oficyna Wydawnicza SGH, Warsaw.
21. Masiukiewicz, P. 2006. 'Dylematy podejmowania decyzji w sanowanym banku', *Prakseologia*, PAN, No. 146.
22. 2008. 'Przygotowanie do kryzysu w bankach', *Kwartalnik Nauk o Przedsiębiorstwie SGH*, No. 3.

23. 2009. 'Kryzys banku a interwencje państwa', in Lichniak, I. (ed.), *Wyzwania ekonomiczne w warunkach kryzysu*, Oficyna Wydawnicza SGH, Warsaw.
24. 2011a. 'Strategic Decision – Bank Rehabilitation or Bankruptcy', in Domańska-Szaruga, B. (ed.), *Management Under Conditions of Risk and Uncertainty*, W. Wereda, Wydawnictwo Studio Emka, Warsaw.
25. 2011b. *Zarządzanie sanacją banku*, Oficyna Wydawnicza SGH, Warsaw.
26. Masiukiewicz, P., and Dec, P. 2011. 'Banking Tax in European Union', *Annals of Dunarea de Jos University of Galati*, Fascicle I. Economics and Applied Informatics, No. 2.
27. Masiukiewicz, P., and Mackiewicz, S. 2009. 'Bank Staropolski – specyfika zarządzania lokatami i ich eksport', in Mączyńska, E. (ed.), *Meandry upadłości przedsiębiorstw. Klęska czy druga szansa?*, Oficyna Wydawnicza SGH, Warsaw.
28. OECD 2004. *Principles of Corporate Governance*, OECD, www.oecd.org.
29. Pauch, D. 2009. 'Ubezpieczenie D&O i POSI jako instrumenty ochrony kadry menedżerskiej', in Pawłowicz, L., and Czerwiński, M. (eds.), 'Społeczno-ekonomiczne wymiary globalnego kryzysu finansowego', *Prace i Materiały Wydziału Zarządzania Uniwersytetu Gdańskiego*, No. 3/1/2009, Fundacja Rozwoju Uniwersytetu Gdańskiego, Sopot.
30. Stocka, A., and Kołacz, J. 2009. *Zintegrowany nadzór nad rynkiem finansowym w Polsce*, Wydawnictwo PTM, Warsaw.
31. World Bank 2001. *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems*, April, www.worldbank.org/ifa/Insolvency%20Principles%20and%20Guidelines%20April.pdf , access 10.10.2011.

*Magdalena Jerzemowska**

CHAPTER 9

THE MAIN BANK SYSTEM AS PART OF JAPANESE CORPORATE GOVERNANCE

One of the differentiating features of classical models of corporate governance is the role of banks in financing enterprises [Milhaupt, 2001]. Banks play an important part in corporate governance in countries embracing the continental-Japanese model, and especially in Japan[1], and are less important in countries with the Anglo-American model.

Several key features may be distinguished in the Japanese system of corporate governance, namely the main bank system in which banks supervise their customers–companies, the lack of an external control market, company boards dominated by employees focusing mainly on operational management, and the system of lifetime employment [Milhaupt, 2001]. Japanese banks play a major role in gathering savings, allocating capital, monitoring investment decisions taken by the management of companies functioning within the main bank system, and managing risk. The assessment of these relationships and their impact on the growth of business and economy is not clear, both in theory and practice.

Japan did not join countries developing capitalist economies until the mid-nineteenth century (after a period of two hundred and fifty years of isolation), and therefore began industrialization much later than such countries as the United Kingdom, the United States, or Germany. However, within half a century (during the Meiji era[2]), the Land of Cherry Blossoms managed to bridge the gap and become one of the most economically developed countries, which it has remained to this day. A number of factors have contributed to this success: the consistent policy of the government, the activity of entrepreneurs, tradition, and also banks. The

* University of Gdańsk.

[1] The key features of the Japanese system of corporate governance include: the main bank system, company boards dominated by employees and focused on operational management and the system of lifetime employment.

[2] The following periods (eras) may be distinguished in the development of Japanese economy: Meiji (1868–1912), Taisho (1912–1926), Showa (1926 – 1989), and Haisai (since 1989).

key factors of success include the ability to learn from the best models, namely from the achievements and knowledge of the leading countries. The Tokyo Stock Exchange was based on solutions derived from Brussels, the banks were established and developed according to patterns derived from Germany and railway investments were developed based on the knowledge and experience of Scottish engineers.

The Meiji period was characterized by dynamic industrialization, free competition, the desire to maximize profits, and yet a relatively weak position of the government [Teranishi, 2000, p. 43]. The lack of a strong middle class meant that the country's industrialization and development initiatives were undertaken by the state.

During this period the capital market began to play an important role in the economy. Medium and large enterprises – zaibatsu – specific forms of monopoly, sought funds on this market. The market fulfilled its functions, namely generated capital and enabled valuation of assets. Companies routinely issued shares and trade in shares was very active. Cross-ownership of shares was extremely rare [Hoshi and Kashyap, 2001, p. 3].

Bonds were a more important source of financing than bank loans. More than half of household savings were invested in securities, which were also used as collateral for loans since 1915.

The number of banks was rapidly increasing; in 1881 there were 90 banks, in 1889 – 210, and in 1900 as many as 2060 banks. They were important, but not dominant.

The former system of corporate governance was very similar to the current U.S. system, the capital market was very important, a policy of maximizing dividends and remuneration for managers was pursued, external directors were engaged, and industry trade unions were in existence [Dore, 2000, pp. 32–33]. In order to reduce (agency) conflicts, companies used to regularly pay high dividends and the remuneration of the managers was linked to the performance of the company. Sanctions were introduced against managers as they could lose their reputation in the manager market (managerial capital losses); managerial freedom of decision making was restricted (law and statutes) and prominent businessmen were appointed to boards [Miwa and Ramseyer, 1999].

At the beginning of the 20th century (the Taisho period, 1912–1926) Japan was already a strong capitalist state ruled by political parties, bureaucracy, high financial circles (zaibatsu) and a military clique, planning to expand its territory and political influence. The Japanese military plans had a very strong influence on the country's economy. To a large extent this policy was inspired by zaibatsu conglomerates (financial cliques) or konzerns (named after German Konzern) which could be defined as a kind of consortium or syndicate. They were usually organized as holding companies (mochikobukaisha), but comprised also other forms of organization. The equity of the main company (honsha) was usually owned by a family. [3]

The honsha held the shares of production, financial, and trade companies (branches) owned by the organization and exercised full control over their operational activities. Initially, the constituent entities forming holdings were partner companies since it was not until the 1930s that they began to sell their shares.

Zaibatsu employees were very strongly associated with the family owners and with other employees of the holding. Employees participated in the distribution of zaibatsu income; the managers received very high remuneration and other bonuses. In this way the specificity of Japanese companies was created and has continued to fascinate Western countries ever since.[4]

Zaibatsu pursued specific military goals by carrying out government contracts. Companies manufacturing for war needs acquired the necessary funds primarily from banks, so the government had to ensure that the banks had sufficient resources and made them available on favorable terms. Moreover, some banks were entrusted with financing specific companies important from the military point of view. This contributed to the formation of a strong relationship between banks and companies and a new relationship between the lender and the borrower was established – bank-centered financing. This policy led to a gradual reduction of the function of the capital market because of the implementation of strictly defined objectives of zaibatsu and thus of the government. The securities market was dominated by government bonds and began to decline. Between 1930 and 1945 (the Showa era), the Japanese financial system evolved from a system based on a capital market into a system dominated by banks. The existing legal regulations made it possible to build mighty banks, especially zaibatsu banks. This also resulted in a change of the corporate governance system as managers became increasingly important, particularly those in the banks [Jerzemowska, 2002, p. 80].

[3] The roots of some zaibatsu reach back to ancient times, e.g., the 16th century (Sumitomo), 17th century (Mitsui), or 19th century (Mitsubishi, 1871). These three zaibatsu conglomerates strived to reach an oligopoly position in various fields of economy. Another large group was the Yasuda financial group, while smaller groups included Okura, Furukawa, Asano, Fujita, and Kawasaki, established in the 1870s. After World War II, Americans reported that there were 31 such families.

[4] It is difficult to determine the power and strength of zaibatsu because they did not prepare consolidated accounts. It is known that the largest zaibatsu, Mitsui, covered one-tenth of the economic activity of the country, Mitsubishi was one-third the size of Mitsui and Sumitomo one-ninth. During this period, the zaibatsu were too big to fail.

The defeat of Japanese militarism meant that the country came under U.S. occupation (1945–1951) [Nowa Encyklopedia Powszechna PWN, 1996, pp. 141–142], and the main goal of the U.S. policy was to destroy the military power of Japan. To achieve this it was necessary to break the power of zaibatsu which were the basis of Japanese nationalism and the expansionism of the Showa era. In 1948, the use of prewar zaibatsu names, trademarks and logos was banned.[5] These measures had serious implications since they affected one-third of the capital invested by all Japanese corporations in 1945.

The Japanese economy emerged from the turmoil of the war badly damaged and weakened, national funds were insufficient in relation to the investment needs, companies had huge debts to banks and each other, and there was a general lack of liquidity.

In addition, the Japanese government made a decision to control foreign investments and ration capital, but, more importantly made sure that people's savings were deposited at those banks which suffered the least damage in the course of the war. Regular inflows of capital increased the importance and power of those entities and soon the banks became the center of the system financing the reconstruction and development of Japan. Performing such an important role in the financial reform of companies and the country also strengthened their position as the dominant financial institutions. One of the features of the post-war Japanese financial system was a clear separation of banking and securities trading, as the Securities and Exchange Act of 1948 (Section 65) forbade banks to trade in securities [Hamao and Hoshi, 2000, p. 105].

In 1949, the ban on cross-ownership of shares was lifted and companies began to mutually acquire their securities (cross-ownership) as part of recapitalization. It was a way to avoid, especially in the 1960s, hostile takeovers (form U.S. investors), resulting in an increase in shareholder equity [Dore, 2000, p. 34]. In a situation where issues of bonds and shares were controlled and constrained by formal and informal rules, many companies found it impossible to raise capital from those sources. Thus banks became the only source of capital for companies, because funding with foreign equity was forbidden [Hoshi and Kashyap, 2001, p. 6]. Banks were also the only possibility for household saving and offered their customers a low interest rate, determined by the Minister of Finance. The role of banks, because of the existing regulations, consisted in receiving deposits from the public and in granting credits to companies. This resulted in a very strong relationship between banks and companies in the field of acquiring and granting

[5] This ban was lifted in 1952 and companies began to adopt the names of their former zaibatsu, or new companies adopted those names.

loans, cross-shareholding, personal and supervisory relations. The obligatory social theme was "united in development." The Minister of Finance (enjoying very broad powers) presided over the financial system and "convoyed" banks in the sense that he protected them from falling into bankruptcy and therefore the system was called "the convoyed system." The minister also oversaw the finances of the country.

By 1955, as a consequence of voluntary or forced implementation of multi-directional changes, the financial system in Japan had evolved into one that was entirely different from its predecessor. The new system, called the main bank system, or keiretsu (enterprise group), was created after the war by the companies of four major zaibatsu. By the end of the 1960s, there were established six interrelated groups of manufacturing companies and financial institutions forming "enterprise groups" (Kigyo shudan or keiretsu), in which banks became market leaders.[6] Already in the 1950s, the dependence of manufacturing companies on the banks which financed them became clear. The system of keiretsu financing matured by the end of the 1970s.

It should be noted that there are significant differences between the zaibatsu group and the keiretsu group. Companies forming a keiretsu group are much more independent than Honsha companies. This is due to the nature of ownership and control. Such companies are not controlled by one family and there is no company that would have the right to manage the other ones because each company within the group is separately listed on the stock exchange.

Relations within the main bank system meant the establishment of long-term relations between a company and its bank, as the bank supported the activity of the company and assumed the risks of its activity [Koyama, 2003]. The benefits of such a system were much higher than the costs.

However, it is not possible to clearly define keiretsu. The main bank system is not a legal institution. Its functions are not specified in any regulations or statutes, and its responsibilities are not defined with respect to group companies. In this form of business organization, the bank becomes the main organizer of capital for the company, holds its shares, and provides it with all other financial services. The bank helps the company to enter the capital market by providing it with financial guarantees or floating its shares. The bank monitors company managers and is obliged to rescue the company in the event of financial difficulties. The

[6] The three largest were developed from pre-war zaibatsu. In the other three a particularly important role (the core) was played by banks. The largest was created around the Fuji Bank, a successor to Yasuda zaibatsu. The two remaining groups were developed already after the war around pre-war banks.

main bank has a decisive influence on the appointment of members of the board of directors (who usually cannot be external directors) and also, if need be, on the replacement of the managing staff. The bank also provides information and advice to the managing staff on matters of company management. In the event of financial difficulties, the bank develops or participates in the development of recovery plans for companies in trouble, provides financial help and also acts a coordinator of its borrowers.

The term keiretsu is used in relation to two different groups: vertical groups (supply chains with one parent company) and horizontal groups (groups of equal companies). More precisely, horizontal groups are called "Kigyo shudan" (enterprise groups), but this term is little known outside Japan. However, the distinction is important and this name should be used.

The term "enterprise alignments – Kigyo keiretsu" began to be used during the Second World War and is difficult to translate into other languages. It includes not only branches (50% of equity), affiliated companies (20% of equity), but also a large number of subcontractors who are divided into first, second and third-ranking. Similarly, affiliated companies differ in terms of the power of their status in respect of the parent company [Okumura, 1984]. The main characteristics of the group are: cross-holding of shares in the group and regular meetings between the presidents of corporations (Sacho-kai) within the group. In fact, these are meetings of shareholders controlling a given corporation. Another feature is the creation of joint ventures by members of the group. The main bank, supported by other financial institutions of the group, grants preferential loans to members of the group. These loans used to be called "keiretsu yushi – alignment loans". The fifth feature of enterprise alignments involves the presence of a "sogo shosha" in the group, i.e., a large commercial corporation which forms the core unifying the companies of the group. The corporation conducts transactions within the group, increases the number of these transactions and coordinates projects for international expansion. The benefits resulting from the synergy of the group are yet another feature, and especially the direct use of wage disparities that are present in the economy (wages in small and large companies); reduction of the risk faced by major corporations through the use of related companies; and protection against the trophic expansion of large corporations [Hoshi and Kashyap, 2001; Yamada, 2000; Dore, 2000, pp. 32 – 33; Nowa Encyklopedia Powszechna PWN, 1996, pp. 191 and 197].[7]

---

[7] It is worth mentioning that the Japanese post office to this day remains the largest financial institution engaged in individual deposits and loans, life insurance, and postal services.

Despite the fact that banks were the largest shareholders (in the mid-1970s they owned one-sixth of the companies listed on the Tokyo Stock Market), they did not exert a direct impact on the operational activity of companies. However, their role in the corporate governance of those companies became very important.

Many large Japanese companies belong to financial keiretsu, which are characterized by a complex network of internal relationships centered around the bank. Other large companies have created similar groups called industrial keiretsu (manufacturing keiretsu), which are centered around large industrial organizations. Companies in industrial keiretsu also have their own main bank, related to them through share ownership. Banks, as well as other companies of the equity-linked group, are so-called stable shareholders, whose holdings do not change over time [Morck et al., 2000].

Until the 1970s, the Japanese central bank system consisted of several complementary components [Aoki and Saxonhouse, 2000, p. 19]: contractual relationships of a specific type between banks and companies; specific inter-bank relationships (delegation of monitoring), a definite set of measures regulating bank deposits and their guarantees, financing constraints, and obtaining loans.

In 1973, the oil crisis led to a significant budget deficit in Japan, which was financed with government bonds. It also started a new period of development of the Japanese financial system. It was necessary to create a secondary market for trading securities, which in turn implied the gradual deregulation and modification of the existing financial system.

Since the end of the war, the Japanese government pursued a policy of avoiding a deficit, and therefore had no experience of eliminating it. The lack of a developed bond market became a problem at that moment. It was necessary to open the government bond market, thus starting the process of deregulation and transformation of the financial system. The restrictions on the issuance of bonds and foreign exchange were lifted. The 1980 "Foreign Exchange Act" reform allowed the inflow of foreign capital to Japan and its generation abroad. Deregulation of the stock market, however, took place at a slower pace.

Summing up, it can be said that during this period the capital market and objective valuation did not grow in importance, while certain weaknesses and disturbances resulting from the limited significance and function of the capital market slowly began to appear.

Since the 1970s, the Japanese financial system has been undergoing changes facilitating the issuance of bonds for companies. In 1977, a regulation was adopted according to which banks were allowed to hold no more than 5 per cent of companies' shares and were given ten years to make appropriate adjustments.

Despite that, between 1976 and 1982 banks remained strong and continued to exert a significant influence on companies as they were the only source of external capital for companies since the capital market made it difficult to issue bonds and companies were not allowed to issue bonds abroad. On the other hand, the years 1989–1995 were a period of a serious weakening of the banks. They lost their monopoly in terms of providing capital for companies because companies were now allowed to raise capital from foreign markets and the banks began to feel increasing stress resulting from bad debts. The late 1980s and the early 1990s are called the "bubble economy" in Japan. This was the result of the government's macroeconomic policy, to a large extent imposed by the U.S. government (Plaza Accord, 1985), as well as the consequence of the progressive liberalization of the financial system.

The period of the Japanese crisis can be divided into three stages. The first one covers the years 1990 to 1993, a period of collapsing asset prices and declining economic growth Between 1990 and 1993, companies listed on the TSM lost on average 57 per cent of their market value and the banks suffered because of the crisis [Koo-Kang and Stulz, 1997]. Companies which were more indebted to the banks performed worse and also invested less, which indicates the negative consequences of dependence on banks for financing.. The government made the first intervention in the financial market to form the basis for future reforms. The 1993 reform (introduced on 1 April 1993) allowed banks to broaden their activity and the range of services they could offer. The banks were permitted to establish subsidiaries specializing in securities and trusts and could diversify their core business [Hamao and Hoshi, 2000, p. 105].

However, because of the delay in reform actions, Japanese difficulties turned into a major crisis[8] in 1997 (the second crisis concerns the 1997–1999 period). The following symptoms of the crisis can be specified in banking activity [Corbett, 2000]:

- A decrease in the value of collateral in relation to the value of loans meant increased risk for the banks;
- A decline in asset prices entailed changes in the banks' balance sheets;
- The value of overdue loans in relation to total loans increased;
- Reserves for loans and write-offs resulted in reduced bank profits;
- Bankruptcies of companies and bank write-offs on overdue loans reached such proportions that the banks became insolvent.

[8] According to the interpretation of the IMF, a crisis (recession) occurs when the value of nonperforming loans divided by the total value of the loan portfolio is higher than 2 per cent, the cost of corrective measures accounts for at least 2% GDP.

During the second crisis, it was very difficult to obtain bank loans due to very strict restrictions. However, the measures taken during this period led to a recovery in the credit market and in the economy between 1999 and 2003 [Hoshi and Kashyap, 2008].

Changes in political and economic factors initiated further transformation of the financial system (deregulation), and especially of bank-centered financing. Large companies with international operations gradually reduced their dependence on banks, which in turn began to provide loans to small and medium-sized companies which did not have stable relations with large banks. In this way, the main bank system, a system based on direct long-term market relationships between banks and companies, began to fall apart, or at least to loosen. Companies not only began to reduce their dependence on bank loans, but also decreased the number of directors appointed to their boards by banks. These changes diminished the ability of banks to monitor their clients and many interventions aimed at getting companies out of difficult financial situations were very turbulent. Banks also significantly decreased their commitment to reducing the risks of the companies in the system. Japan did not have a corporate governance system that could predict and minimize the impact of the situation. Because of cross-shareholding, general meetings of shareholders became ceremonies. The distinguishing feature of the Japanese system is the board of auditors. The auditors have a lower position, resulting from tradition, than CEOs and often must respect the CEOs' decisions, especially that usually they are former employees of the company [Yamada, 2000, p. 105].

Evaluation of the effectiveness of long-term bank interventions is difficult and ambiguous [Aoki et al., 1994], and largely depends on the period to which it relates.

Some authors believe that it is not reasonable to claim that main banks play a special role in relation to companies [Hall and Weinstein, 2000, pp. 64 - 65]. There is no evidence that keiretsu make more effective investments and develop faster than other companies. The main bank system helps companies raise capital, but does not increase their profitability. Studies show that when facing financial difficulties Japanese companies reduce research and development costs as fast as Anglo-American companies. A major drawback of the main bank system is the fact that well-informed banks can use their position to achieve their own benefits and companies may become hostages to their banks. Furthermore, restricting the sources of raising capital to bank loans only may be a problem for companies, especially in a situation where the bank itself faces a difficult financial situation. Many companies could not raise capital from the capital market since they did not meet the requirements. In such a situation companies were forced to abandon even very profitable investments.

Until the beginning of the 1990s, companies, as a rule, did not change their main banks. At that time, there were no problems with the financing of companies by banks, but in the last decade of the 20th century the situation changed in this respect considerably.

Other authors are of the opinion that the key advantage of the main bank system is the concentration of companies' debts in specific banks. This was particularly important at a time of financial difficulties within companies. The banks had adequate information and helped implement appropriate corrective actions. The banks were therefore a constant source of capital for companies – dedicated entities which the companies could always count on, contributing to increased efficiency of companies [Schaede et al., 1998]. Some authors argue that such actions usually resulted in serious losses for the banks while the companies' performance improved only slightly. There were no individual programs adapted to the specific situation of particular companies and routine operations turned out to be less effective [Schaede et al., 1998, p. 179]. Some authors think that the principal task of the main bank system is to overcome the weakness of the capital market or to gain tax advantages, or possibly to combine these objectives [Hayashi, 2000, p. 60]. Some authors believe that the advantages include the fact that Japanese companies with strong ties to banks make more profitable acquisitions and also investment decisions of companies with strong relations with banks are less dependent on their state of liquidity. A main bank usually intervenes very quickly, even before a crisis strikes, making the corrective action more effective, which confirms the advantage of the main bank system over the Anglo-Saxon system. The main difference between the two systems lies in the communication between the company and the external entities supervising it. The main bank constantly gathers information about the company, and also can obtain confidential information from its management. The main bank can therefore intervene quickly, and with a good knowledge of the activities and financial position of the company these interventions can be effective. Investment decisions in the capital market are taken by investors with high asymmetry of information. The American system is the opposite of those in Germany and Japan. The latter countries have established a system minimizing the impact of impatient shareholders, while the Anglo-American system is oriented at maximizing the impact of impatient shareholders [Thurow, 1993, p. 136].

Only after thorough research and profound analysis is it possible to decide which approach to embrace. The implications of the reforms and opening up of the Japanese economy to foreign capital have resulted in significant changes to the main bank system and have serious repercussions for Japanese corporate governance. However, it should be noted that despite the gradually decreasing importance of the main bank system it continues to be a significant feature differentiating the Japanese corporate governance model from the Anglo-Saxon one [Koo-Kang and Stulz, 1997].

References

1. Aoki, M., Patrick, H., and Sheard, P. 1994. 'The Japanese main bank system: An introductory overview', in Aoki, M. and Patrick, H. (eds.), *The Japanese main bank system: Its relevancy for developing and transforming socialist economies*, Oxford University Press.
2. Corbett, J. 2000. 'Japan's Banking Crisis in International Perspective', in Aoki, M., and Saxonhouse, G., (eds.), *Finance, Governance and Competitiveness in Japan*, Oxford University Press.
3. Dore, R. 2000. *Stock Market capitalism Welfare capitalism: Japan and Germany versus Anglo-Saxon*, Oxford University Press, Oxford.
4. Hall, B. J., and Weinstein, D. E. 2000. 'Main Banks, Creditor Concentration, and the Resolution of Financial Distress in Japan', in Aoki, M., and Saxonhouse, G., (eds.), *Finance, Governance and Competitiveness in Japan*, Oxford University Press.
5. Hamao, Y., and Hoshi, T. 2000. 'Bank-owned Security Subsidiaries in Japan: Evidence after 1993 Financial System Reforms', in Aoki, M., and Saxonhouse, G., (eds.), *Finance, Governance and Competitiveness in Japan*, Oxford University Press.
6. Hayashi, F. 2000. 'The Main Bank System and Corporate Investment: An Empirical Reassessment', in Aoki, M., and Saxonhouse, G., (eds.), *Finance, Governance and Competitiveness in Japan*, Oxford University Press.
7. Hoshi, T., and Kashyap, A. K. 2001. *Corporate Financing and Governance in Japan*, The MIT Press.
8. 2008. 'Will the U.S. Bank Recapitalization Succeed? Eight Lessons from Japan', *NBER Working Paper*, October, no. 14401.
9. Jerzemowska, M. 2002. *Nadzór korporacyjny*, PWE, Warsaw.
10. Koo-Kang, J., and Stulz, R. M. 1997. 'Is bank-centered corporate governance worth it? A cross sectional analysis of the performance of Japanese firms during the asset price deflation', *NBER Working Paper*, No. 6238, October.
11. Koyama, Y. 2003. 'Bad Loans Problem and Banking System Crisis in Japan', paper presented at conference *European and Asian Experiences and Public Policy Consideration*, University of Greenwich Business School, London, July.

12. Milhaupt, C. J. 2001. ‘Creative Norm Destruction: The Evolution of Nonlegal Rules in Japanese Corporate Governance’, *Columbia University School of Law Working Paper*, No. 190.
13. Miwa, Y., and Ramseyer, M. 1999. ‘The value of prominent directors: Lessons in corporate governance from Transitional Japan’, *Harvard Law and Economics Discussion Paper*, November 12, No. 267.
14. Morck, R., Nakamura, M., and Shivdasani, A. 2000. ‘Banks, ownership structure, and firm value in Japan’, *The Journal of Business,* October; 73, 4.
15. *Nowa Encyklopedia Powszechna PWN*. 1996. Wydawnictwo Naukowe PWN, Warsaw.
16. Okumura, H. 1984. ‘Enterprise Groups in Japan’, *The Journal of Commercial Papers*, No. 147.
17. Schaede, U., Hoshi, T., and McMillan, J. 1998. ‘Deregulation and Japanese Corporate Governance’, *Graduate School of International Relations and Pacific Studies*, University of California, San Diego, www.nmjc.org/jiap/dereg/papers/deregcon/schaede.html.
18. Teranishi, J. 2000. ‘The Fall of the Taisho Economic System’, in Aoki, M., and Saxonhouse, G.R. (eds.), *Finance, Governance and Competitiveness in Japa*n, Oxford University Press, Oxford.
19. Thurow, L. 1993. *Head-to-Head: The coming economic battle among Japan, Europe and America*, Warner Books.
20. Yamada, T. 2000. ‘Japanese Corporate System, Financial Institutions and International Finance from Legal Point of View’, *Hosei Riron*, Vol. 33, No. 1.