

Executive Compensation. A Review of the Latest Research

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Abstract

Purpose: The paper presents a review of the latest research on executive compensation and indicates the main problems and weaknesses of the existing solutions as well as trends for the future.

Methodology: In the analysis executive compensation constitutes a crucial element of corporate governance. The analysis is based on a review of the latest studies and research on the effectiveness of executive compensation referring to its size, structure and disclosure.

Findings: The paper presents the latest findings in the practice of executive compensation and it points to the extension of the period of time giving rise to the payment of cash bonuses, the introduction of a range of different indicators, based on which executives are evaluated, simplifying compensation packages, the implementation of deferred payments, the introduction of the “say on pay” rule and clawbacks.

Practical implications: The analysis points out the main weaknesses of executive compensation, which were particularly emphasized in research studies on companies affected by the financial crisis. The paper presents a wide range of suggested solutions that could be implemented in the field of executive compensation in order to provide for a better alignment of the interests of executives with those of shareholders and for the increase in shareholder value.

Originality/value: The paper attempts to identify the most severe corporate governance problems with reference to executive compensation and to confront them with research results as well as the recently proposed and implemented reforms and recommendations.

Keywords: executive compensation, corporate governance

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| Introduction

Executive compensation is one of the fundamental mechanisms of corporate governance, and its main function is to motivate. The main objective of executive compensation in the appropriate size and structure is to motivate executives to take action to increase shareholder value. Executive compensation packages should therefore be designed in such a way to provide for a better alignment of the interests of executives with those of shareholders as well as to encourage them to make bold decisions using market opportunities. The discussion in the literature on the executive remuneration focuses on the effectiveness of the respective compensation packages in relation to the financial results of the company (profit, increase in the stock price, increasing the value of the company). However, in recent years, the size and structure of executive compensation are strongly criticized while studies indicate a low effectiveness of the solutions applied so far. Such a shift in the literature is undoubtedly the aftermath of the financial crisis and the role of executive compensation policy in the context of its outbreak and course. Many studies indicate that there is a correlation between certain executive compensation policies and the dominance of short-term profit orientation in companies and the tendency of executives to take excessive risks. As a result, particularly in Western Europe, analyses on the effectiveness of compensation packages and on the relationship between executive compensation and selected indicators of company profitability have been replaced by the discussion on the direction of changes in the field of executive compensation policy and the search for new solutions that would be free from the identified weaknesses of the pre-crisis period.

This paper presents a review of the latest research on the size and structure of executive compensation and suggests possible changes and recommendations for executive remuneration policy, as the analyzed studies indicate the significance of executive compensation and its contribution to the financial crisis (Europarliament, 2010; Bogle, 2009). The latest researches indicate the most severe weaknesses of the respective executive compensation policies, with reference to their structure, the use of incentive mechanisms or particular elements thereof, and standards of informing investors about the executive compensation policy (Johnson, Ryan and Tian, 2010; Bebchuk and Spamann, 2010). Furthermore, the difficult economic situation and increased control from both the public and shareholders result in fundamental changes in the field of executive compensation (Kirkpatrick, 2009; Kołodkiewicz, 2010).

This paper is organized as follows. The first section presents the main assumptions of executive compensation in relation to its place and role in the system of corporate governance. The second section presents an overview of corporate practice and discusses the key issues and anomalies identified in the practice of executive compensation. The third section analyzes the trends of current changes signaled in recent research studies on the design and effectiveness of executive compensation policies. The final remarks are included in conclusion.

| Executive Compensation As an Element of Corporate Governance

Executive compensation is one of the key elements of corporate governance (Allen and Gale, 2000; Mallin, 2004), which, as opposed to monitoring and control mechanisms, is designed to motivate managers to work for increasing the firm value (Wolf, 1999; Mallin, 2004). The role of executive compensation in the system of corporate governance is emphasized by researchers as well as practitioners, and recommendations pertaining to transparency standards, a proper structure and how this is linked to company results occupy an important place in the documentation of good practices. The main assumptions and design of executive compensation are part of the measures to reduce the classic conflict between the shareholder and the executive, i.e. – using the terminology of the agency theory – between the principal and the agent (Jensen and Meckling, 1976). The principal and the agent differ in such aspects as risk perception, time horizon (time they are likely to spend with the company), level of commitment, and the conflict of interests of both these groups reduces the effectiveness of their cooperation (Jensen and Murphy, 1990; Bruce and Buck, 1997). The relationship between the agent and the principal is also characterized by information asymmetry – the principal does not have full knowledge about the efforts made by the agent and neither about the actual results of his or her work. In addition, the agency theory also raises the problem of incomplete contracts, which means that not all situations can be foreseen in the agreement between the principal and the agent, and therefore the residual control rights are in the hands of the latter (Fama and Jensen, 1983a; Fama and Jensen, 1983b). The solutions and tools based on the achievements in executive compensation studies are thus intended to limit this conflict and the associated costs (Bebchuk and Fried, 2003). In order to achieve these objectives a number of guidelines and recommendations have been formulated for the design of executive compensation, which are presented in Table 1.

As shown in Table 1, executive compensation should include a fixed part and a variable part, which makes the size of total compensation performance-based and increases the alignment of

Table 1 | Practical solutions for executive compensation policies

Main objective	Practical solutions
Alignment of the interests of executives with those of shareholders	Compensation divided into a fixed part and a variable part
Motivation of executives to achieve the objectives set by shareholders	Performance-based bonuses
Making the increase in shareholder value the ultimate goal of executives	Stock options, the return on which is linked to an increase in the stock price of the company
Making the manager feel like a shareholder	Granting restricted stock
Greater transparency of companies, protection of shareholders	Transparency of compensation packages Executive compensation design by a Compensation Committee
No barriers to takeovers and mergers, effective changes at the level of executive directors	High severance payments for dismissed executive directors

Source: own elaboration.

the interests of the executives with the expectations of the shareholders (Jensen and Murphy, 1990). In terms of motivating executives, the size of the compensation is important, but what is even more important is its structure; hence the crucial importance of the correlation between the fixed and the variable component. However, it needs to be remembered that the variable part of the compensation generates a higher risk, which means that the larger its share, the higher the remuneration must be, in order to compensate for the greater risk. Furthermore, the amount of the variable part should be adjusted to the individual preferences of the executive, the development of the industry, the company's investment opportunities and it should take into account many other factors as well (Bebchuk and Fried, 2004). The variable component of the compensation should also make use of the numerous available solutions and include bonuses, stock options, restricted stock, long-term incentive plans, deferred payments (Mallin, 2004). Moreover, in order to increase the motivation of executives and align their interests with the expectations of shareholders, stock options as well as restricted stock are of crucial importance here, which make the executives co-owners of the company and significantly reduce the earlier mentioned agency conflict. The implementation of variable elements of the compensation should depend on clearly defined indicators (financial, market, etc.), based on which the executive will be evaluated (Monks and Minow, 2004; Weresa, 2012). A compensation committee should be actively involved in the design of the executive compensation package, with a majority of independent members (Mallin, 2004). The compensation committee, i.e. a special group set up under the board, deals with designing the executive compensation policy, formulates criteria for the evaluation of the work of executives and conducts this evaluation. Moreover, in the process of structuring executive compensation plans the committee should also take into account the need to reduce the risk of executives blocking takeovers, which is what appropriate severance provisions are for. The last point is to ensure transparency of executive compensation policies in companies and to implement an information policy regarding the size, structure and design of long-term incentive plans.

| Executive Compensation in Practice

The Characteristics of Executive Compensation

Studies on executive compensation mostly focus on two fundamental issues. Firstly, these analyses present corporate practice in terms of the implemented solutions and they enable dynamic tracking of the main trends identified in relation to executive compensation. Secondly, the researchers analyze the effectiveness of these solutions in terms of changes in the company results based on a selection of financial indicators (profit, EBITA, EVA, MVA) as well as the reaction of the capital market (stock price movements). Based on the first group of research studies, some basic characteristics of executive compensation can be formulated (cf. Bebchuk and Grinstein, 2005; Frydman and Jenter, 2010):

- The conducted analyses indicate a continuous growth of the level of executive compensation; the rate of this growth usually slows down in times of economic downturn or a crash of the

capital market (that is when employee wages fall significantly). Currently, the average CEO salary in the U.S. is estimated approximately for \$12 million (Clementi and Coley, 2009; Forbes, 2009);

- An increase in the level of executive compensation is mainly the result of an increase of the variable component, i.e. mainly the share of stock options, restricted stock, bonuses or other extras in the total package. The share of the variable element is currently estimated at 60–70% of the entire compensation, although there are cases where it constitutes more than 90% (Bogle, 2009; Forbes, 2009);
- The noted increase in the size of executive compensation also results from high severance payments for retiring or dismissed executives to constitute 200–300% of annual earnings (Bebchuk and Fried, 2004);
- Analysts also observe an increasing gap between executive compensation and employee compensation, with average CEO pay being 300 times the average worker pay in the United States (AFL-CIO, 2011).

Although research conducted in the 1990s delivered optimistic conclusions regarding the effectiveness of compensation packages, at the beginning of the 21st century many studies indicated certain limitations of the implemented solutions. Mainly methodological problems were pointed out, which were associated with measuring the actual size of the compensation, particularly stock options, bonus payments for longer periods, the difficulty of calculating non-monetary components. Executive compensation was based on information from the past, making it difficult to analyze the incentive function. It was emphasized that the noted correlation between executive compensation and company results, as indicated by many published research studies, is weak (Conyon, 1997), and the percentage of explained variance of compensation in relation to company results is very low (Griner, 1995/96). What's more, in several cases excluding one large company from the research sample completely altered the obtained results. The second group of arguments criticizing the solutions in the field of executive compensation refers to institutional issues associated with the process of negotiating and structuring remuneration plans. Researchers pointed to excessive bargaining power and knowledge of executives, the low actual effectiveness of the management market, the rigidity of contracts, organizational inertia weakening the position of the compensation committee (Bebchuk and Fried, 2004). As a result, executive compensation was not determined by effective market mechanisms, but under conditions of information asymmetry and the bargaining power of individual players (Bebchuk and Fried, 2003; Hill and Yablon, 2002).

The Main Weaknesses of Executive Compensation

The practice of executive compensation remains one of the most discussed aspects of corporate governance, and at the same time it is the biggest disappointment of the achievements to date in this field. It turned out that executive compensation does not fulfill its role and does not lead to the expected results. Despite the impressive empirical track record, executive compensation practice in

big corporations or banks shows numerous anomalies or even inefficiencies. Many researchers point out that the weaknesses of executive remuneration policies significantly contributed to the current difficult situation in the financial markets (Clarke and Chanlat, 2009; Cheffins, 2009).

The disappointment with the practical effects of executive compensation can be observed in virtually all of the usually analyzed dimensions (Henderson, 2008; Clementi and Coley, 2009; Urbanek, 2010). What's more, according to analysts and researchers it is some of the solutions in the field of executive compensation that have significantly contributed to the outbreak and course of the financial crisis (Isaksson, 2009; Kirkpatrick, 2009). The disappointment of corporate governance practitioners is the greater, as it was the groundbreaking discoveries in the field of motivation and compensation of executives that were supposed to be the remedy for the main problems of corporate governance and constitute a key source for increasing the efficiency of the functioning of companies. The main failure was related to the variable component, the size of which was performance-based and was supposed to align the interests of executives with those of shareholders (Mikołajek-Gocejna, 2010; Kirkpatrick, 2009). While in many cases this method was effective, the side effect entailed increased risks associated with the amount of compensation, which in turn was reflected mainly in an increase in the size of executive packages (Bogle, 2009; House of Commons, 2009). The shocking sizes of executive compensation packages, especially in the United States and Great Britain, did not translate into increased efficiency or an increased value of the company. Moreover, despite declarations that compensation is based on actual results, often different solutions can be observed in practice. For example, an actual lack of dependence between the variable component and company results was observed in the case of investment banks like Bear Stearns, Lehman Brothers or Merrill Lynch, whose executives received bonuses based on rigid contracts, even in times of dramatically deteriorating company results (Farrell, 2010). However, even the recommended solution of paying bonuses for particular results achieved by executives led to many problems – it contributed to an increase in extrinsic motivation at the expense of intrinsic motivation (Rost and Osterloh, 2009). This phenomenon is extremely damaging for the entire incentive system and means that executives do not perceive their work as a comprehensive task of managing a company anymore, but instead focus mainly on those actions that lead directly to increasing their compensation. However, it should be noted that this is not the fault of the executives themselves – a similar reaction to such a design of compensation packages was observed among other professionals, such as doctors and academics (Rost and Osterloh, 2009). An incorrect design of the variable component has also contributed to a greater short-term orientation and an increase in the involvement in riskier projects (Nestor Advisors, 2009). An example of the anomalies in this field are bonuses paid for a period of six months or a year. However, the introduction of the most controversial corporate practice in the form of "guaranteed bonuses", which were paid out regardless of the achieved results, was a complete misunderstanding (Gillespie and Zweig, 2010), and in fact completely contradicted the idea of this financial incentives solution. Furthermore, this practice, and particularly in the financial sector, led to the strongly criticized, so-called "bonus culture", according to which bonuses are a fixed part of company activity. As a result, receiving a bonus (the size of which had to be negotiated with the supervisors until the

very end) was not considered to be a reward; instead, not receiving a bonus or receiving an insufficient bonus was seen as a punishment and a forecast of an imminent dismissal (McGee, 2012). In American and British companies that are known for their frequent use of incentive instruments, January and February is a period that is referred to as "bonus season", and the high bonuses were considered to be a factor driving property prices upwards and expanding the luxury goods segment (McGee, 2010). Even the introduction of stock options, which was considered to be the flagship achievement of corporate governance, turned out to be a complete failure when it became apparent that their use increases the tendency of managers to manipulate stock price in periods of exercise of stock options (Bebchuk and Fried, 2004; Gillespie and Zweig, 2010). Corporate practice also undermined the fundamental assumption of the incentive function of executive compensation, which granting executives restricted stock was considered to be. This method was supposed to make the executives identify more with shareholders and to take action in their interest more willingly. However, this solution did not work in the case of Lehman Brothers, where the CEO, Richard Fuld, owned large blocks of stock. The collapse of the bank also contributed to a huge financial loss of the CEO (Nestor Advisors, 2009), while shattering the belief that executives owning company stock served as a mechanism that eliminates the agency conflict. Finally, the efforts of shareholders and activists to increase the level of transparency of executive compensation appear to have quite different results than intended. Besides a greater access to data these actions have mainly resulted in an increase in compensation, because the greater transparency made it easier for individual managers to negotiate their compensation packages (Posner, 2010). Table 2 summarizes the main weaknesses of executive compensation, which are often considered to be a significant contribution to the financial crisis.

Table 2 | The main weaknesses of executive compensation policies

Recommendation	Observed side effect
Compensation divided into a fixed part and a variable part	Greater risk, tendency to increase the compensation
Performance-based bonuses	Greater short-term orientation – the inability to maintain an upward trend in the long term, greater involvement in riskier projects Inefficiencies in the form of „guaranteed bonuses“, paid out regardless of the results Decrease in intrinsic motivation, increase in extrinsic motivation
Stock options, the return on which is linked to an increase in the stock price of the company	Manipulation of stock price in periods of exercise of stock options (excessive, artificial increases in stock and subsequent decreases, after their exercise)
Granting restricted stock	No effect or stronger position of managers, e.g. when voting
Transparency of compensation packages	Higher compensation due to increased bargaining power of executives in the process of negotiating their compensation packages
High severance payments for dismissed executive directors	Dramatically high severance payments without the incentive function, a cost to shareholders
Source: own elaboration.	

The last problem that is signaled in Table 2 are the high severance payments for retiring or dismissed executives, which usually amounted to three times the annual earnings. At the same time companies and Compensation Committees agreed to keeping many privileges for their former CEOs (e.g. company cars with driver, golf club memberships, etc.), which definitely did not increase shareholder value.

In short, the main criticisms with respect to executive compensation practices include (Isaksson, 2009; Kirkpatrick, 2009; Cheffins, 2009):

- The size of executive remuneration– very high salaries, which according to specialists in the field does not only create an incentive for executives anymore, but has a negative impact on the morale in companies and the social perception of companies.
- An inadequate structure of executive compensation, which is manifested in the compensation being excessively based on variable components, associated with e.g. stock price, which may encourage executives to manipulate the results and influence the stock price, for example in periods of exercise of stock options.
- Excessive use of incentive mechanisms in the short term encouraging to take very risky actions, including the excessive use of annual bonuses.
- Poor, insufficient shareholder activism in the process of designing executive compensation, resulting from their passivity or inability to influence this area of corporate governance.
- Poor transparency of compensation packages – many contracts contain complex and complicated provisions, using many different efficiency indicators of managerial activity, which makes it difficult to perform a reliable evaluation and to determine the dependence between the results and the amount of compensation.

The mentioned anomalies of executive compensation policies have become particularly evident in the financial sector, mainly in banks. The dominance of short-term profit orientation, high executive compensation packages, the significant share of the variable component are considered to be major weaknesses and one of the main reasons that led to the financial crisis (Isaksson, 2009; Kirkpatrick, 2009; Cheffins, 2009).

| The Latest Recommendations

The weaknesses and deficiencies that have been identified in the field of executive compensation and their negative impact on companies have become motivators for further analyses and studies (Gillespie and Zweig, 2010; Larcker and Tayan, 2011). An additional impetus for further research are also the reports discussing the implemented solutions in designing executive compensation policies and their impact on the outbreak of the financial crisis (Isaksson, 2009; Kirkpatrick, 2009; Cheffins, 2009). At the same time, the criticism of the solutions that have been used thus far have sparked a public debate on the practice of granting bonuses and

awards. This discussion was particularly turbulent in companies and institutions where the financial situation had deteriorated significantly as a result of the crisis and that were supported by public funds.

The contemporary public criticism of executive compensation policies is particularly evident in Western Europe, especially in Great Britain and in France, as well as in the United States, and mainly applies to members of boards of directors or supervisory boards of the largest listed companies and banks². Even though the previous collapses of the capital market and corporate scandals proved to be opportunities to formulate new policies regarding the size, structure, additional benefits, timing and form of payment of executive compensation, the current financial crisis has led to many changes and often unprecedented actions. The most important ones include renegotiation of signed and legally binding contracts of executives from companies under the Troubled Assets Relief Program (TARP, all of the 250 executives agreed to lower their compensation and signed new agreements) as well as the latest wave of many executives declining to take their bonuses or blocks of stock of the managed companies (Kansas, 2009). A critical analysis of the existing solutions in the field of executive compensation has resulted in specific guidelines and recommendations (Larcker and Tayan, 2011; SEC, 2010; FRC, 2010; European Parliament, 2010). This wave of criticism of the practices in many companies and institutions has led to a renewal of the discussion about executive compensation and its role in the system of corporate governance (Gillespie and Zweig, 2010; Baker and Anderson, 2010). It should also be mentioned that the proposed changes are not perceived as succumbing to social pressure or as a populist move, but as an expression of the increasing power of shareholders who actively participate in the process of structuring executive compensation packages.

The latest studies suggest many solutions and recommendations, which are expected to increase the effectiveness of executive compensation, to ensure a better alignment with the interests of shareholders and to contribute to the long-term value of the company. The most important guidelines and postulates include (Bebchuk and Fred, 2010; Larcker and Tayan, 2011; House of Commons, 2009; European Parliament, 2010):

1. Regarding compensation structure:

- a. The size should depend on the achieved profits as well as other indicators of the effectiveness of the company (e.g. other financial indicators, market indicators, taking into

² A good example are cases of discussion about the CEOs of banks, some of which remain under post-crisis state control. A lot of controversy was sparked after it was decided that Stephen Hester, the CEO of The Royal Bank of Scotland, which was saved by taxpayers' money, would receive a 900 thousand pound bonus. S. Hester, in the face of public criticism, declined to take his bonus and so he joined the other representatives of the banking sector – RBS chairman Philip Hampton, who declined to take a 1.4 million pound long-term bonus in the form of stock; the Barclays Chairman, who did not receive any bonus for the year 2011 (the year before that he received 750 thousand pounds – for comparison, the Barclays Chairman received 6.75 million pounds in 2010 and 10 million pounds in 2011). The compensation of HSBC CEO Stuart Gulliver was reduced to 4.8 million pounds in 2011 compared to 6.1 million pounds in 2010. Lloyds CEO Antonio Horta-Osorio declined to take his bonus of 2.4 million pounds for the year 2011, while the former Lloyds CEO Eric Daniels had to return part of the received bonus for 2010 of 1.45 million pounds. The cuts or deferral of bonuses also affected many employees at lower organizational levels in UBS, Goldman Sachs and Deutsche Bank.

account effectiveness in areas such as the environment / sustainable development, customer satisfaction, employee satisfaction);

- b. Compensation should take into account the level of risk;
 - c. Compensation should be divided into a fixed part and a variable part;
 - d. The share of the fixed part (salary) should be specified and sufficiently high to ensure adequate standards and cover the liabilities of the executive;
 - e. A significant part of the bonus should be deferred over time and depend on the results achieved over the longer term;
 - f. Executives should spend part of their earnings on purchasing stock of the company, which will lead to a better alignment of the interests of executives with those of shareholders.
2. Regarding bonus calculation:
- a. The size of bonuses should take into account the level of risk and cost of capital;
 - b. The achieved results should be analyzed solely based on the current financial year;
 - c. Bonuses should not be paid in full in cash, but should also include, for example, restricted stock;
 - d. Bonuses should be based on performance over a longer period of time, and their payment should be deferred accordingly.

Particular attention is paid to the possibility of shareholders exerting influence according to the principle of “say on pay” and the exercise of rights of shares (Ferri and Maber, 2013; SEC, 2010). The “say on pay” rule gives shareholders a chance to weigh in on the executive compensation policy of the company by voting to adopt or reject this policy. Even though the vote is not legally binding, it is very important in terms of reforms in the field of executive compensation, because it forces the company to formulate and publish an executive compensation policy, including the indicators that the company takes into account when evaluating the work of executives (Cai and Walking, 2011; UK Treasury, 2009). Furthermore, in case the shareholders reject such a document, although this is not legally binding, this would constitute a very negative signal for the market, being a sign of their disapproval of the executive remuneration policy. The best policies come down to simplifying compensation packages and increasing the transparency of executive compensation, including through the publication of the difference between the highest and lowest salaries within the company and narrowing the difference between the best and worst paid workers of the given company/bank. In addition, it is recommended to introduce “clawback” provisions, requiring the return of part of the compensation if certain targets set out in the agreement relating to the company’s profitability and efficiency have not been met (Larcker and Tayan, 2011; SEC, 2010; FRC, 2010; UK Treasury, 2009).

To conclude, it should be mentioned that the findings of studies and analyses seem to have an impact on the recommendations formulated in the business practice. In the post-crisis reality

many countries and institutions prepared guidelines for the design of executive compensation taking into account the above-mentioned postulates (House of Commons, 2009; SEC, 2010; FRC, 2010; UK Treasury, 2009; European Parliament, 2010).

Conclusion

The financial crisis contributed to a revision of many of the solutions in the field of corporate governance. Executive compensation practices have been criticized for much longer, and many studies have pointed out the low effectiveness of the applied solutions, the lack of relations between compensation and company results and the fact that compensation policies did not create any shareholder value. In recent years, further analyses revealed a number of inefficiencies in the field of executive compensation and after linking these weaknesses to the outbreak of the financial crisis they suggested to revise the applied solutions. A review of the latest studies indicates significant changes in the way executive compensation is perceived and designed from the perspective of corporate governance. The experience of the crisis and recent studies indicate the need to extend the orientation of executives, to implement a wide variety of indicators for evaluating their work and to increase the activity of shareholders. These findings also translate into specific documents formulating recommendations for business practice. At the moment it is difficult to assess the effectiveness of this criticism of executive compensation. However, it is clear that the transparency of executive compensation is increasing, as well as public pressure and awareness regarding the size of these compensation packages.

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