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Katarzyna KURZEPA-DEDO<sup>1</sup>

## INSTITUTIONAL ANALYSIS OF THE RECOMMENDATION Z FROM THE POLISH FINANCIAL SUPERVISION AUTHORITY ON THE PRINCIPLES OF INTERNAL GOVERNANCE IN BANKS

Corporate governance, which includes, among others, the bank management system, bank organization, and mutual relations of people performing key functions in the bank, after the global financial crisis of 2007, became one of the leading aspects in which banks, as well as national microprudential supervisory authorities, must pay special attention to. This paper aims to present the results of the institutional analysis of the recommendation of the Polish Financial Supervision Authority regarding internal governance in banks, carried out using a normative set method. Thanks to the application of this research method, the sources of the titular recommendation, its administrators, main beneficiaries, and maleficences are determined, and the selected resulting action plan regarding the policy of approving new banking products is reconstructed. The article also contains conclusions resulting from the application of the normative set method to the interpretation of regulations classified as *soft law*.

**Keywords:** Recommendation Z, internal governance in banks, normative set, risk management.

### 1. INTRODUCTION

The global financial crisis of 2007 questioned the rationality of financial institutions and the effectiveness of "private" management of the risks they generated, as well as the then dominant model of micro-prudential supervision exercised by public institutions. This supervision, focusing on the stability of individual entities, did not take due account of their external connections and "failed to notice" the effects of the progressing phenomenon of financialization. It also did not interfere too thoroughly with the internal risk management models of these entities and their corporate governance, which favors the phenomenon of the so-called *moral hazard* (Baker, 1996; Dembinski, 2017; Epstein [ed.], 2006; J. Monkiewicz, M. Monkiewicz, 2019). It was believed that increasing administrative and legal activities on the part of the state would violate the property rights of financial institutions or, more broadly, the freedom to conduct business activity and the bank

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<sup>1</sup> Katarzyna Kurzeпа-Dedo, University of Information Technology and Management in Rzeszow, Poland: e-mail: kkurzeпа@wsiz.edu.pl. ORCID: 0000-0002-4823-1217.

management system. The post-crisis Basel Consensus (Kaszubski, 2006) adopted assumptions different from the above, i.e. that the financial market is generally pro-cyclical and unstable, and that this instability is deepened by the complexity of financial systems and innovative financial services (Baker, 2013). In this context, new anti-crisis strategies and solutions were based, among others, on increasing the role of the state in the security of the financial sector through the implementation of an institutional framework for macroprudential supervision of financial markets, an assessment of corporate governance and internal risk management systems of financial institutions by the competent state authorities. In addition, the creation of multi-level regulatory systems based on a new regulatory and supervisory paradigm has begun. It uses not only the provisions of generally applicable law, but also the so-called soft regulatory instruments (e.g. recommendations, opinions, guidelines classified as *soft law*) (Nieborak, 2016). One of such instruments are recommendations of microprudential supervision authorities addressed to the banking sector.

In the Polish legal system, pursuant to Art. 137 section 1 point 5 of the Banking Act, the competence to issue them rests with the Polish Financial Supervision Authority (PFSA). A list of recommendations addressed to the banking sector, marked with letters of the alphabet, is available on the PFSA website (PFSA, 2024). From the perspective of legal forms of administration activity, the recommendations are perceived as non-normative and non-imperative means of influencing the PFSA on banks. In addition, they are also included in the category of the so-called *soft law* (Czech, 2009, 2013; Ofiarski, 2017; Ofiarski, 2013; Olszak, 2010, 2016) although the legal nature of these regulations is still the subject of analysis in the literature (Czech, 2009; Maśniak, 2016).

Despite the location of Art. 137 section 1 point 5 in Chapter 11 of the Banking Law entitled "Banking supervision" doubts regarding the legal nature of the recommendations themselves have not been resolved. It is currently undisputed that the subjectively and objectively closed catalog of sources of generally applicable law (Article 87 of the Constitution) does not include the regulations in question. The opinion still prevails in the literature that due to the material and structural independence of banks from the Polish Financial Supervision Authority, it is difficult to consider these entities as functionally subordinated to the supervisory authority and, consequently, to accept the thesis that the recommendations applicable to them are acts of internal law.

Prudential standards resulting from the recommendations, due to the lack of the so-called formal sanctions, do not have binding force on their addressees, and, therefore, banks may use practices different from those suggested, provided that they allow them to achieve the same goal, i.e. prudently and stably manage the banking enterprise. Although the Polish Financial Supervision Authority does not use state coercion to enforce the application of the standards of conduct and good practices it recommends, it may be guided by them when making a supervisory assessment of banks in terms of their prudent and stable management (Czech, 2009; Olszak, 2011; Smykła, 2011). Therefore, it seems justified to say that this is a kind of "indirect" way of enforcing recommendations under the so-called follow-up supervision.

Recommendations addressed to banks in terms of the method of their development, form (including division and arrangement of content) and the effects they have are similar to normative acts classified as sources of generally applicable law. In this context, the question arises whether, due to the mentioned similarity, it is possible to apply methods to their interpretation such as in the case of, among others, set, and if so, what will be their results.

The aim of this paper is an institutional analysis of Recommendation Z adopted by the Polish Financial Supervision Authority on October 9, 2020 which defines the principles of internal governance in banks. It was carried out using the normative set method, which allowed determining the sources of this recommendation, its administrators, main beneficiaries and malefices, and to reconstruct the selected scheme of action resulting from it. Moreover, conclusions resulting from the application of the normative set method to the interpretation of regulations classified as *soft law* are presented.

## 2. METHODOLOGY

As a rule, the research method of the normative set is used to interpret legal provisions and takes into account all functional connections of the tested standards and all available sources of information. It is also used to determine the actual or potential socio-economic effects of the tested solutions. The normative set itself is understood as a blueprint for the actions of a manager. This scheme is based on legal standards and involves the participation of various people and entities that differently influence the shape of individual elements of the scheme at subsequent stages of its creation and operation (Chmielnicki, 2015, 2014).

The research method consists of several stages, which, apart from selecting the subject of research (normative act), collecting data regarding it and an institutional analysis of the period before its adoption (stages 1 to 2, respectively), consist in:

- formulating research hypotheses and determining the entities of the action scheme: sources, administrators, beneficiaries and users (including malefices), as well as identifying the benefits and costs related to the implementation of the assumed goal of the action – stage 3,
- reconstruction of connections between formal norms, including the sequence of actions carried out by individual entities established in stage 3, which will lead to the creation of an incomplete action scheme containing only legal solutions – stage 4, and
- reconstruction of connections between formal norms and non-formalized norms, whose results supplement the incomplete action scheme from stage 4 with informal solutions relating to the regulation in question, which will ultimately lead to the creation of a full action scheme (normative set) – stage 5,
- verification of research hypotheses – stage 6,
- an assessment of the nature of the pressure on the formalization of the examined institution and the socio-economic effects of its impact – stage 7,
- forecasting and formulating recommendations – stage 8 (Chmielnicki, 2020).

So far, the normative set method has been used to interpret the provisions of laws and reconstruct the resulting action patterns (Jankowska-Prochot, 2018; Grotkowska, 2018; Kaczmarek, Kudela, 2018; Iwaniec, 2018; Krzępa-Dedo, Gemzik-Salwach, 2018; Żelasko-Makowska, Sołtysiak, 2016). However, it seems that there are no formal obstacles to use it also for the institutional analysis of regulations classified as *soft law* and created by public administration bodies. For this reason, it was decided to use a set of norms to interpret the provisions of Recommendation Z whose content is consistent with the post-crisis Basel Consensus, as well as the regulatory and supervisory paradigm based on it. It should be noted that the studies devoted to the recommendations of the Polish Financial Supervision Authority, including recommendation entities that may be affected by the recommended prudential standards (Cichy 2020; Fedorowicz, 2021; Nadolska, 2021). Previous studies

on the PFSA's recommendations addressed to the banking sector have not used the normative set method.

The systematics of this paper's content was subordinated to the individual research stages indicated earlier as part of the normative set method.

### **3. THE LEGAL STATUS AND THE STATE OF SOCIO-ECONOMIC RELATIONS BEFORE THE ADOPTION OF RECOMMENDATION Z ON THE PRINCIPLES OF INTERNAL GOVERNANCE IN BANKS**

One of the causes of the *subprime* credit market crisis in the United States in 2007 was, among others, *moral hazard* for members of bank management bodies and the simultaneous lack of effective supervision in this area by public administration bodies. The post-crisis Basel Consensus sees the remedy for limiting the scale of this phenomenon in increasing state interference in the internal order and monitoring of internal risk management procedures of financial institutions (J. Monkiewicz, M. Monkiewicz, 2019).

In response to these expectations, on June 26, 2013, the European Parliament and the Council adopted a directive on the conditions for the admission of credit institutions to the business and the prudential supervision of credit institutions, the so-called CRD IV directive.

In recital 53 of that directive, the attention of Member States was drawn to the fact that, *inter alia*,

[...] Weaknesses in corporate governance in a number of institutions have contributed to excessive risk-taking in the banking sector without due caution, leading to the failure of individual institutions and systemic problems in Member States and globally. The very general provisions on the governance of institutions and the non-binding nature of much of the corporate governance legislation, based essentially on voluntary codes of conduct, did not sufficiently facilitate the effective implementation by institutions of sound corporate governance practices [...].

Recital 54 of the CRD IV Directive states that

In order to eliminate the potentially harmful impact of poorly designed corporate governance mechanisms on sound risk management, Member States should introduce principles and standards to ensure effective supervision by the management body and disseminate an appropriate approach to risk-taking at all levels of credit institutions and investment firms, and enabling competent authorities to monitor the adequacy of internal management arrangements. These principles and standards should apply taking into account the nature, scale and complexity of the institution's activities.

The directive also emphasizes the importance of *suitability* of management bodies members by imposing obligations on national microprudential supervision to verify the primary and secondary assessment of this suitability.

While implementing the provisions of the directive, the Polish legislator, on November 1, 2015, amended the provisions of the Banking Law: Art. 22 section 2, art. 22a section 1 and 2, art. 22aa and art. 22d. One also pays special attention to art. 22aa and 22d of Banking Law regarding requirements for the bodies of members of a bank, a financial holding

company and a mixed financial holding company. Pursuant to art. 22aa section 1 of Banking Law members of the management board and supervisory board of the bank should have knowledge, skills and experience appropriate to the functions they perform and the duties entrusted to them, and provide a guarantee of proper performance of these duties. This warranty in this case refers in particular to the reputation, honesty and reliability of a given person and to his or her ability to run the bank's affairs in a prudent and stable manner. Members of the bank's statutory bodies should meet suitability requirements throughout the entire period of performing their functions, and not only at the time of appointment (Tymczyszyn, Wajda, 2022).

It is worth noting the distinction made by the legislator regarding the individual qualification requirements of a candidate for a management board member and the collective qualification requirements. Efficient functioning of the bank's management board and counteracting the so-called "herd thinking" syndrome is to be fostered by selecting people with diverse competences and knowledge (Wajda, 2018; Stefanicki, 2018).

European Banking Authority (EBA) in order to practically clarify the requirements resulting, among others, from the CRD IV directive, developed, among others, two documents: "Guidelines on internal governance EBA/GL/2017/11 of 21 March 2018" and "Guidelines on the assessment of the liability of members of the management body and key function holders EBA/GL/2017/12 of 21 March 2018" useful for national supervisory authorities. The second document shows that the assessment of the criterion of individual and collective suitability of members of the bank's management body should be assessed on a *on-going basis* by the competent authorities (Article 181 of the EBA/GL/2017/12).

The previously mentioned provisions of the Banking Law and the *soft law* guidelines of the EBA combine the pursuit of professionalization of management and supervisory staff in banks in order to strengthen their corporate governance and, in the macroprudential context, ensuring the security of the state's financial system.

At this point, one more regulation should be noted, namely the "Principles of Corporate Governance for supervised institutions" (PCG), unanimously adopted by the Polish Financial Supervision Authority in a resolution of July 22, 2014. The regulatory body intended the PCG to improve the level of corporate governance in financial institutions and increase transparency of their operations, which is intended to contribute to deepening trust in the financial market. This set defines the internal and external relations of supervised institutions, including relations with shareholders and clients, their organization, the functioning of internal supervision and key internal systems and functions, as well as statutory bodies and the principles of their cooperation. Such a wide scope of interference by the Polish Financial Supervision Authority in internal corporate relations in entities supervised using standards classified as *soft law*, but actually "enforced" as part of the supervisory assessment, was the subject of analyzes by representatives of the literature (Adamska, 2014; Marcinkowska, 2014; Romanowski, Weber-Elżanowska, 2016; Romanowski, Zarzycka, 2020).

Recommendation Z regarding internal governance in banks was adopted unanimously by the Polish Financial Supervision Authority on October 9, 2020<sup>2</sup> and it complements, specifies and develops issues in the field of internal governance in banks, which have already been partially regulated at the national level, among others, in the Banking Law,

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<sup>2</sup> PFSA announcement of October 9, 2020; [https://www.knf.gov.pl/komunikacja/komunikaty?articleId=70994&p\\_id=18](https://www.knf.gov.pl/komunikacja/komunikaty?articleId=70994&p_id=18).

its implementing acts and documents prepared by the Polish Financial Supervision Authority.

The applicable provisions of the Banking Law do not provide any guidelines on how to prepare the provisions of the recommendation, which is why the Polish Financial Supervision Authority used its own legislative practice in its development, which follows the following scheme:

1. developing draft assumptions and internal arrangements,
2. adoption of assumptions by the Polish Financial Supervision Authority,
3. development of a draft recommendation, internal consultations, development of the project after internal consultations at the Office of the Polish Financial Supervision Authority,
4. external consultations and project development after consultations,
5. presentation of the project at a meeting of the Polish Financial Supervision Authority<sup>3</sup>.

There are also no statutory regulations regarding the obligation for the Polish Financial Supervision Authority to justify the socio-economic effects<sup>4</sup> of the recommendations it develops and issues for banks. Nevertheless, in the introductions to these regulations, the Polish Financial Supervision Authority tries to explain the reasons for issuing or amending them, and sometimes also to estimate the impact of the implementation of prudential standards by banks on their business activities<sup>5</sup>.

In the introduction to Recommendation Z, the regulatory authority justified the need to issue it, noting, among other things, that it aims to:

[...] disseminate good practices and counteract the use by banks, within the scope covered by the Recommendation, of incorrect practices that increase the risk of their operations and, consequently, increase the resilience of these institutions to difficult market conditions and thus to increase the stability of the financial sector [...]<sup>6</sup>.

Moreover, it is worth noting that since 2010, the Polish Financial Supervision Authority has been referring in its recommendations to the principle of proportionality – perceived as adapting the adopted solutions to the individual specificity and business profile of the bank – to determine the subjective (universal, cooperative or mortgage banks) and

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<sup>3</sup> Scheme of work on the draft recommendation of the Polish Financial Supervision Authority described by the Director of the Department of Social Communication of the Office of the Polish Financial Supervision Authority in a letter to the author of July 4, 2019, letter reference: DKS.0128.77.2019.JC.

<sup>4</sup> Due to the fact that they do not constitute provisions of generally applicable law, draft recommendations are not subject to the guidelines provided for in Art. art. 66 section 1 point 2 and art. 67 of the Entrepreneurs' Law (consolidated text: Journal of Laws of 2024, item 236, as amended), the Polish Financial Supervision Authority does not have to attach to draft assessments of the expected socio-economic effects of the recommendations, including an assessment of their impact on micro, small and medium-sized entrepreneurs and analysis of compliance of the proposed regulations with the provisions of the Entrepreneurs' Law, as well as to be guided by the principles of proportionality and adequacy when developing them.

<sup>5</sup> See: Introduction to Recommendation S, [nf.gov.pl/knf/pl/komponenty/img/Nowelizacja\\_Rekomendacja\\_S\\_23-07-2020\\_70340.pdf](https://www.knf.gov.pl/knf/pl/komponenty/img/Nowelizacja_Rekomendacja_S_23-07-2020_70340.pdf), s. 2-9.

<sup>6</sup> See: Introduction to Recommendation Z, [https://www.knf.gov.pl/knf/pl/komponenty/img/Rekomendacja\\_Z\\_70998.pdf](https://www.knf.gov.pl/knf/pl/komponenty/img/Rekomendacja_Z_70998.pdf), s.3.

objective scope of their application by banks<sup>7</sup>. Also in the introduction to Recommendation Z there is a reference to the principle of proportionality<sup>8</sup>.

The Polish Financial Supervision Authority has set a deadline for banks to adapt to the recommendations arising from Recommendation Z on January 1, 2022.

#### 4. RESEARCH HYPOTHESES

In the rest of the paper, the following research hypotheses relating to the content of Recommendation Z will be verified using the mentioned method:

1. the main source of the regulation in question were the guidelines developed by foreign institutions and organizations regarding internal management and the suitability of members of the management body, constituting the so-called functional sources of public banking law,
2. the recommendations resulting from it will standardize the internal functioning of banking authorities, making it easier for the Polish Financial Supervision Authority to perform supervisory activities towards these entities,
3. by implementing recommendations in the field of corporate governance banks will increase the transparency of the activities of statutory bodies and the professionalism of people sitting in them, which will better implement the directive of stable and prudent banking activities, which will additionally increase the stability of the financial sector,
4. adapting the banks' internal governance to the requirements arising from Recommendation Z will expand the tasks assigned to their organizational units and increase the number and scope of internal regulations, including: strategies, policies, regulations with new or updated procedures,
5. the implementation of the principles set out in Recommendation Z will increase the responsibilities of bank employees to implement, comply with and monitor new and/or existing procedures, increasing the costs of conducting banking activities, which in turn may result in an increase in the prices of products offered to bank customers,
6. professionalization of management staff in banks will contribute to building a new ethical architecture in these institutions, and thus to limiting the phenomenon of the so-called moral hazard.

#### 5. ENTITIES OF THE ACTION SCHEME<sup>9</sup>

##### 5.1. Sources and their purposes

###### 5.1.1. Constitutive sources – Polish Financial Supervision Authority

The constitutive, i.e. primary, source that gives direction to the legislative initiative under the action plan resulting from Recommendation Z is the Polish Financial Supervision

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<sup>7</sup> See: Introduction to Recommendations B or H, [https://www.knf.gov.pl/knf/pl/komponenty/img/Rekomendacja\\_B\\_26\\_03\\_2019\\_65275.pdf](https://www.knf.gov.pl/knf/pl/komponenty/img/Rekomendacja_B_26_03_2019_65275.pdf), s. 4. [https://www.knf.gov.pl/knf/pl/komponenty/img/knf\\_170534\\_Rekomendacja\\_H\\_2017\\_50303.pdf](https://www.knf.gov.pl/knf/pl/komponenty/img/knf_170534_Rekomendacja_H_2017_50303.pdf), s. 4.

<sup>8</sup> See: Introduction to Recommendation Z, Zob. [https://www.knf.gov.pl/knf/pl/komponenty/img/Rekomendacja\\_Z\\_70998.pdf](https://www.knf.gov.pl/knf/pl/komponenty/img/Rekomendacja_Z_70998.pdf), s. 3-4.

<sup>9</sup> Categories of entities of the action scheme separated in accordance with the recommended research method described in the publication: (Chmielnicki, 2014).

Authority. On March 10, 2015, it adopted the assumptions of the recommendation in question, noting that the purpose of its issuance will be to correct the internal governance practices used by banks, identified as the causes of irregularities or increased risk in their operations<sup>10</sup>. The assumptions also indicate that the provisions of the new recommendation will take into account:

- guidelines of the European Banking Authority of 27 September 2011 on internal management and of 22 November 2012 on the assessment of qualifications of members of the management body of persons performing key functions,
- selected recommendations included, among others: in draft amendments to the guidelines of the Organization for Economic Co-operation and Development (November 2014) and the Basel Committee on Banking Supervision (October 2014).
- the regulatory authority announced that the draft of the new recommendation will be submitted for public consultation in the second half of 2015.
- the final version of Recommendation Z regarding internal governance in banks, adopted by the Polish Financial Supervision Authority on October 9, 2020, includes:
- guidelines on internal governance (EBA/GL/2017/11) of 21 March 2018 and Guidelines on the assessment of the suitability of members of the management body and key function holders (EBA/GL/2017/12) of 21 March 2018. developed by the European Banking Authority,
- selected recommendations included in: the guidelines of the Basel Committee on Banking Supervision "Corporate governance principles for banks" (July 2015), the guidelines of the Organization for Economic Co-operation and Development "G20/OECD Principles of Corporate Governance (September 2015), the document of the European Banking Association Co-operative "Corporate Governance in Co-operative Banks - Key Features" (2016),
- conclusions resulting from observations and experience related to inspections in banks conducted by the Polish Financial Supervision Authority, assessment of statutory solutions of banks and other supervisory activities<sup>11</sup>.

The regulation of internal governance in banks resulting from Recommendation Z covered the following areas of their activities: bank management system, bank organization, principles of operation, powers, duties and responsibilities, as well as mutual relations of the supervisory board, management board and persons performing key functions in the bank. The introduction to the document emphasizes that the above issues are also regulated in the Banking Law and the Regulation of the Minister of Development and Finance of March 6, 2017 on the risk management system and internal control system, remuneration policy and the detailed method of estimating internal capital in banks<sup>12</sup>, and

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<sup>10</sup> See: Announcement of the 251st Meeting of the Polish Financial Supervision Authority of March 10, 2015. Access on the internet: [https://www.knf.gov.pl/knf/pl/komponenty/img/KNF\\_10\\_03\\_2015.pdf](https://www.knf.gov.pl/knf/pl/komponenty/img/KNF_10_03_2015.pdf), s. 2–3.

<sup>11</sup> See: Introduction to Recommendation Z (in:) Resolution No. 289/2020 of the Polish Financial Supervision Authority of October 9, 2020 on the issuance of Recommendation Z regarding internal governance in banks (Journal of Laws of the Polish Financial Supervision Authority of 2020, item 29).

<sup>12</sup> Regulation of the Minister of Development and Finance of March 6, 2017 on the risk management system and internal control system, remuneration policy and the detailed method of estimating internal capital in banks (Journal of Laws of 2017, item 637, as amended). It was amended by the regulation of the Minister of Finance, Funds and Regional Policy of May 27, 2021 amending the



additionally certain detailed issues in the regulations developed by the Polish Financial Supervision Authority: Recommendation H regarding internal control in banks, Recommendation M regarding operational risk management in banks and the "Principles of Corporate Governance for Supervised Institutions"<sup>13</sup>. Recommendation Z is intended by the regulatory body to achieve two goals, which can be considered its ratio legis: first of all, to counteract incorrect practices that would increase the risk of banks' operations, as well as to increase their resistance to difficult market conditions, thereby increasing the stability of the financial sector.

Already at the stage of developing the draft recommendation, the Polish Financial Supervision Authority emphasized the approach based on the principle of proportionality, i.e. that banks should apply the provisions of the recommendation taking into account the scale, complexity and nature of their activities. Cooperative banks and associating banks that are participants in the protection system should provide the Polish Financial Supervision Authority – through the units managing the protection system - with information on how to take into account the principle of proportionality. Additionally, the information should be accompanied by a justification indicating proportionality, rationality and justification in accordance with the "comply or explain" rule. The Polish Financial Supervision Authority stipulated that in the case of the provisions of Recommendation Z, which apply to banks that are parent entities in the group, they should be understood as addressed to entities at the highest national level of consolidation.

Regardless of the solutions proposed in Recommendation Z, the supervisory authority emphasized that banks should also apply the provisions contained in the other recommendations to the extent they relate to the issues covered by the discussed document on the principles set out therein, but also, which is worth emphasizing, other national or international recognized standards or codes on internal governance principles (e.g. "Good Practices of WSE Listed Companies 2016" developed by the Warsaw Stock Exchange). In order to avoid any ambiguity, banks should disclose what documents and to what extent they are guided in their activities.

#### 5.1.2. Resolute sources

The following institutions can be considered as resolving sources, i.e. a kind of "catalyst of the legislative process": the European Banking Authority (EBA), the European Securities and Markets Authority, as well as the Basel Committee on Banking Supervision, the Organization for Economic Co-operation and Development, the European Association of Cooperative Banks and the banks.

The role of foreign supervisory institutions and international organizations was primarily to develop good practices in the field of internal management in banks and guidelines regarding the suitability of members of management bodies in banks and persons performing key functions in them. The Polish Financial Supervision Authority indicated as the basic models for the solutions adopted in Recommendation Z the two previously mentioned documents authored by the European Banking Authority, which can be considered - together with selected guidelines of the Basel Committee on Banking

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regulation on the criteria and method of conducting supervisory examination and assessment in banks (Journal of Laws of 2021, item 987) and from June 1, 2021 . and is valid under the changed name "On the criteria and method of conducting supervisory examination and assessment in banks".

<sup>13</sup> *Ibidem*, p. 2.

Supervision, the Organization for Economic Co-operation and Development, and the European Association of Cooperative Banks – as functional sources prudential standards of Recommendation Z.

In addition, the direction of the solutions adopted in this recommendation was also influenced by the results of supervisory activities undertaken by the Polish Financial Supervision Authority in relation to the banking sector, based on findings from inspections carried out in banks or assessments of banks' statutory solutions. For this reason, banks can also be classified as resolute sources.

### 5.1.3. Accessory sources

Accessory sources, i.e. those that were involved in the law-making process as part of public consultations – as follows from the PFSA announcement of October 9, 2020 – include: the Polish Bank Association, the National Association of Cooperative Banks, the Ministry of Finance, the National Bank Polish, Bank Guarantee Fund, PwC, EY, Institute of Internal Auditors IIA Poland, POLRISK Risk Management Association<sup>14</sup>.

The consultants for the Recommendation Z project included public authorities (including the Ministry of Finance), the National Bank of Poland, consulting companies (including Ernst and Young) and industry associations (including the Polish Bank Association). The PFSA office did not make public the content of the documents provided as part of these consultations. Likewise the entities participating in them, although there are exceptions<sup>15</sup>. The National Association of Cooperative Banks (NACB) posted on its website short information about sending a letter to the Polish Financial Supervision Authority Office containing comments on the draft Recommendation Z, in which it drew the regulatory body's attention to the very general principle of proportionality indicated in the draft recommendation. The task of NACB is that such a structure generates the risk of a very subjective interpretation of this principle, while imposing on cooperative banks and associating banks the obligation to provide the Polish Financial Supervision Authority with information on how to take it into account<sup>16</sup>.

## 5.2. Authorising bodies and their goals

**5.2.1.** The Polish Financial Supervision Authority was **the constitutive authorising body** of the analyzed recommendation at all stages of legislative work. In addition to the solutions resulting from the previously established guidelines of international institutions and organizations and normative acts, the regulatory body introduced additional solutions in the field of corporate governance into the content of Recommendation Z, enriched with conclusions resulting from inspections carried out in banks, analyzes of the provisions of the statutes and other supervisory activities undertaken. The results of public consultations are also likely to have been taken into account (Cichy, 2020).

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<sup>14</sup> See: Announcement of the Polish Financial Supervision Authority of October 9, 2020. Access on the internet: [https://www.knf.gov.pl/komunikacja/komunikaty?articleId=70994&p\\_id=18](https://www.knf.gov.pl/komunikacja/komunikaty?articleId=70994&p_id=18).

<sup>15</sup> Some of the entities consulting the draft of Recommendation Z refused to share the comments, additions or postulates submitted to the draft of Recommendation Z, arguing that it is standard practice that opinions during public consultations are submitted only to the regulatory body and are not made available externally.

<sup>16</sup> See: „Rekomendacja Z – uwagi KZBS”. Access on the internet: <https://www.kzbs.pl/Rekomendacja-Z--uwagi-KZBS.html>. The full text of the comments is available to members of the National Association of Cooperative Banks after logging in to the website.

It is worth noting that the draft of Recommendation Z was made public by the Polish Financial Supervision Authority in the second half of 2015, and its final version was adopted on October 9, 2020.

**5.2.2.** The European Banking Authority, the European Securities and Markets Authority, the Basel Committee on Banking Supervision, the Organization for Economic Co-operation and Development, and the European Association of Cooperative Banks can be considered as **the administrators of the resolution Z** Recommendation, whose guidelines were, to varying degrees, implemented into the solutions adopted in Recommendation Z. Moreover, additional decision makers were the banks themselves as the practices they used, identified by the Polish Financial Supervision Authority as a source of irregularities or increased risk in their activities, were then taken into account in the work on the recommended solutions.

**5.2.3. Accessory administrative bodies** include state authorities that took part in public consultations and could influence the final shape of Recommendation Z. In the analyzed case, these were: the National Bank of Poland, the Ministry of Finance and the Bank Guarantee Fund. However, due to the practice adopted by the Polish Financial Supervision Authority of not disclosing documentation related to the process of developing recommendations addressed to banks, including those from the stage of public consultations, it is difficult to determine the scope and nature of the participation of the mentioned entities in the process of creating the provisions of Recommendation.

## 6. USERS OF THE ACTION PLAN

Reconstruction of the action plan resulting from Recommendation Z allows one to identify its main users, including:

- **banks**, which by January 1, 2022 should – taking into account the principle of proportionality - adapt their internal order to its recommendations,
- **members of banks' statutory bodies**, primarily the management board and supervisory board, who will have to, among others, meet the suitability criteria and guarantee the proper performance of the duties entrusted to them in the field of bank management,
- **bank employees/organizational units of banks, including those responsible for risk management**, other than members of the bank's statutory bodies/bodies implementing, applying and monitoring procedures and carrying out tasks taking into account the recommendations resulting from Recommendation Z,
- **registry courts** as the introduction by banks of certain solutions resulting from the recommended prudential standards may require new or changes to existing entries in the National Court Register in the scope of, among others: changes in the composition of statutory bodies,
- **the Polish Financial Supervision Authority**, which will be guided by its recommendations in the supervisory process,
- **bank customers** - in terms of efficient and transparent operation of banks and the use of new or changed banking products offered, the contract templates of which should not contain abusive clauses or clauses - despite the different language form - similar to clauses entered in the register of prohibited clauses,
- **the state** as the degree of implementation and subsequent application of prudential standards by banks in the field of internal governance will affect the security of the entire financial sector.

As mentioned earlier, Recommendation Z is an effective tool for preventive supervision for the Polish Financial Supervision Authority, but also a reference point to assess the structure and composition of statutory bodies, and the method of managing banking activities in accordance with the methodology for the examination and supervisory assessment of commercial, associating and cooperative banks (BION) or the methodology for assessing the suitability of members bodies of supervised entities.

The banks themselves may benefit from the implementation of the recommended prudential standards, due to the expected favorable assessment of the Polish Financial Supervision Authority in terms of their internal governance and – as follows from the declared *ratio legis* of the regulation in question - better implementation of the directive on stable and prudent conduct of business, which will allow them to prepare more effectively to future difficult market conditions.

The condition of banks, in particular orderly internal order and transparency of operations, can be considered beneficial for the state itself in terms of financial security, because the banking sector's resistance to possible future financial crises and its flexibility in reacting to them will increase.

Assuming that one of the users of the operational scheme are registration courts, the State Treasury may also be a beneficiary of Recommendation Z, due to the increase in the number of applications and fees charged for entries in the National Court Register.

Organizational and financial costs related to the implementation of new and adaptation of existing ones, among others, regulations, procedures, policies and strategies constituting the internal governance and its management system will be borne by banks, which may result in an increase in the prices of the financial services they offer.

In addition, the beneficiaries of the recommendations of Recommendation Z include the management and supervisory staff of banks, who will be subject to constant control in terms of meeting the criterion of suitability and guarantee of performance of the tasks entrusted to them.

On the part of the registry courts, the cost may be an increase in the number of considered applications for entries in the National Court Register regarding changes, among others, in the composition of statutory bodies.

The PFSA itself is also a party to the regulation in question as to the need to issue or update additional studies specifying or explaining the prudential standards contained in Recommendation Z, e.g. templates for assessing the suitability of a member of the management board, supervisory board or a person performing key functions<sup>17</sup>.

## **7. RECONSTRUCTION OF THE CONNECTIONS BETWEEN INFORMAL AND FORMAL NORMS IN RECOMMENDATION Z**

Recommendation Z is an extensive set of principles and procedures (and guidelines for procedures), which consists of the following elements:

- Introduction,

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<sup>17</sup> See, among others, update of February 1, 2021 in „Metodyka oceny odpowiedniości członków organów podmiotów nadzorowanych przez Komisję Nadzoru Finansowego” by supplementing its point 3.2.1.1.6.2. [https://www.knf.gov.pl/knf/pl/komponenty/img/Metodyka\\_oceny\\_odpowiedniosci\\_czlonkow\\_organow\\_podmiotow\\_nadzorowanych\\_przez\\_KNF\\_1-02-2021.pdf](https://www.knf.gov.pl/knf/pl/komponenty/img/Metodyka_oceny_odpowiedniosci_czlonkow_organow_podmiotow_nadzorowanych_przez_KNF_1-02-2021.pdf) and taking into account changes in the regulatory environment and previous experience related to the application of the Methodology, including feedback from supervised entities (June 2023) [https://www.knf.gov.pl/knf/pl/komponenty/img/Metodyka\\_modul\\_1\\_83353.pdf](https://www.knf.gov.pl/knf/pl/komponenty/img/Metodyka_modul_1_83353.pdf).

- Glossary of terms used,
- (A) General principles of internal governance in the bank – 2 recommendations,
- (B) Principles of operation, powers, duties, responsibilities, mutual relations of the supervisory board and management board and the suitability of members of these bodies and persons performing key functions – 9 recommendations,
- (C) Bank standards of conduct and conflicts of interest at the bank level – 2 recommendations,
- (D) Policy of outsourcing activities, remuneration rules in the bank and dividend policy – 3 recommendations,
- (E) Risk management – 13 recommendations,
- (F) Disclosures – 1 recommendation.

Individual recommendations are extensive and divided into smaller editorial units, for example, recommendation No. 7 regarding the suitability of members of the supervisory board and management board and persons performing key functions in the bank consists of 23 sub-points additionally divided into smaller editorial units – letters.

The action patterns resulting from Recommendation Z create solutions formalized by *soft law* provisions, i.e. legally non-binding standards that supplement and specify:

- standards of generally applicable law: the Banking Law, the Accounting Act, the Commercial Companies Code; implementing acts, among others Regulation of the Minister of Finance of May 7, 2018 on the detailed scope of tasks of the nomination committee in significant banks (Journal of Laws of 2018, item 883), Regulation of the Minister of Finance, Funds and Regional Policy of June 8, 2021 on the risk management system and internal control system and remuneration policy in banks (Journal of Laws, item 1045) of EU regulations, e.g. Commission Delegated Regulation (EU) No. 604/2014 of March 4, 2014 supplementing the Directive of the European Parliament and Council 2013/36/EU with regard to regulatory technical standards with regard to qualitative criteria and appropriate quantitative criteria for determining the categories of employees whose professional activities have a significant impact on the risk profile of the institution (OJ EU L 167, 06/06/2014, p. 30, as amended),
- *soft law* standards previously developed by: the Polish Financial Supervision Authority (in particular: Recommendation H regarding the internal control system in banks and Recommendation M regarding operational risk management in banks and the Principles of Corporate Governance for supervised institutions), the Warsaw Stock Exchange ("Good Practices WSE Listed Companies" 2016, if the bank is a listed company) or by the European Banking Authority in the form of the guidelines mentioned earlier,
- internal standards related to the functioning of banks: statutes, regulations, strategies, policies,
- unformalized rules of operation determining behavior and decisions, including: members of the management board, supervisory board or people responsible for risk management in the bank.

The latter group includes in particular economic rules such as e.g. risk assessment in business activities, risk assessment of introducing new products, but also competence standards that constitute the decision-making process and are important, among others: in the selection procedures for positions in the bank's governing bodies or ethical standards taken into account, among others, conflict management procedures in the bank.

It should be emphasized that not all solutions recommended in Recommendation Z are new. The recommendation in question collects and systematizes good practices eliminating the above-mentioned regulations of generally applicable law and soft law regulations. For this reason it is called the so-called umbrella regulation (Cichy, 2020). Regardless of this, Recommendation Z contains new solutions regarding, among others:

- an assessment of the bank's internal governance and its implementation (recommendation 1.3),
- an assessment of the suitability of a management board member (recommendation 7-8),
- a periodic verification and an assessment of compliance with ethical principles (recommendation 12.4),
- the bank's obligations in terms of managing conflicts of interest, including those arising from kinship or affinity of persons holding specific positions in the management or supervisory board<sup>18</sup>, as well as making public the conflict of interest management policy (including recommendations 13.4., 13.5. and 13.6.),
- director's pay ratio, i.e. a rule meaning specifying in the bank's remuneration rules the maximum ratio of the average total gross remuneration of management board members in an annual period to the average total gross remuneration of other bank employees in an annual period; Moreover, this ratio should be set at a level that enables the bank's employees to effectively perform their tasks, taking into account the need for prudent and stable management of the bank (recommendation 15.3),
- the obligation for the management board member supervising risk management to justify in writing their veto or change their position during management board votes on decisions related to risk management and for the management board to immediately inform the supervisory board about this fact (recommendation 27.3),
- sorting out issues related to the policy of approving new products, as well as introducing a mechanism for refusing to approve a new product or significant changes to existing products by the organizational unit responsible for risk management or the compliance unit (recommendation 29.5).

Regarding the policy of introducing new banking products, Recommendation Z, as mentioned earlier, organizes the existing solutions in this area and adds new recommendations. Reconstruction of activities resulting from recommendation 29 allows the identification of two patterns: the first is the recommended way for the bank to develop a new products approval policy (NPAP), and the second is the procedure for approving new products or significant changes to existing ones based on it. From the point of view of the core of the normative set, the rules resulting from recommendation 29 should be considered crucial rather than optional, because failure to implement them may have

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<sup>18</sup> For example, see § 9 of the "Principles of managing conflicts of interest" applicable at the Cooperative Development Bank. The document also indicates that the management of conflicts of interest in the CDB takes into account provisions resulting from, among others, from Recommendation Z (§ 1 section 3). Access on the internet: [https://www.sbrbank.pl/files/resources/Zasady\\_zarz\\_dzania\\_konfliktami\\_interes\\_w.pdf](https://www.sbrbank.pl/files/resources/Zasady_zarz_dzania_konfliktami_interes_w.pdf).

Also introduction and letter J in point 5 Fri "Guidelines on counteracting and managing conflicts of interest" included in the "Policy on counteracting conflicts of interest of Santander Bank Polska S.A. Access on the internet: [https://www.santander.pl/regulation\\_file\\_server/time20211221130314/download?id=163825&lang=pl\\_PL](https://www.santander.pl/regulation_file_server/time20211221130314/download?id=163825&lang=pl_PL).

a negative impact on effective risk management in relation to these products, as well as on the periodic supervisory assessment carried out by the Polish Financial Supervision Authority, unless the bank proposes alternative solutions, which are equally effective from the point of view of the stability of banking activities.

The first action plan shows that the bank's management board should develop in writing, and then adopt and implement a new product approval policy (NPAP) approved by the supervisory board. It should include: the definition of a new product/market/activity used within the bank and its organizational units, the development of new products, services and markets, and significant changes to existing products, services and markets. Recommendation 29.2. recommends that the NPAP should also indicate the most important issues taken into account before making a decision to introduce a new product, in particular regarding: compliance with regulatory requirements, valuation models, impact on the size and risk profile, capital adequacy and profitability, as well as the availability of sufficient resources in business units and support units, as well as internal tools and expertise sufficient to understand and monitor the risks associated with change.

It should be emphasized that when making significant changes to the products or services currently offered, the bank should also take into account the provisions of the Regulation of the Minister of Development and Finance of March 6, 2017 on the risk management system and internal control system, remuneration policy and the detailed method of estimating internal capital in banks regarding the introduction of a new product.

The reconstruction of the scheme for preparing the banking policy for approving new products includes not only the norms classified as *soft law*, which include formalized management rules and praxeological rules, but also legal norms resulting from the provisions of generally applicable law.

In the second scheme of operation, the procedure for developing and approving new products or introducing significant changes to existing ones involves several stages. Recommendation 29.2 specifically recommends that a bank should not undertake new business until it has sufficient resources to understand and manage the risks involved. Moreover, the decision to start a new business should indicate the business unit and the persons responsible for it. The organizational unit responsible for risk management and, to the extent appropriate, the compliance unit should also participate in the process of approving new products or significant changes to existing products. The actions taken by these units should, first of all, enable a full and objective assessment of the risk arising from the new activity, taking into account various scenarios, the assessment of any potential weaknesses in the risk management system and the internal control system in the bank, as well as the assessment of the institution's ability to effectively manage the new risk. To make this possible, both bank units indicated in recommendation 29.2 should be provided with: full access to information on new products being prepared (or significant changes to existing products) within individual business lines and portfolios, as well as the authority to request that all changes to existing products be subjected to a formal procedure in within the framework of NPAP.

The new solution provided for in recommendation 29.5 is the so-called small veto of the organizational unit responsible for risk management or compliance. It means that if one of these units expresses a negative opinion as to the appropriateness of approving a new product or significant changes to the existing product, the decision on approval should be made by the bank's management board, and not by a committee appointed by it.

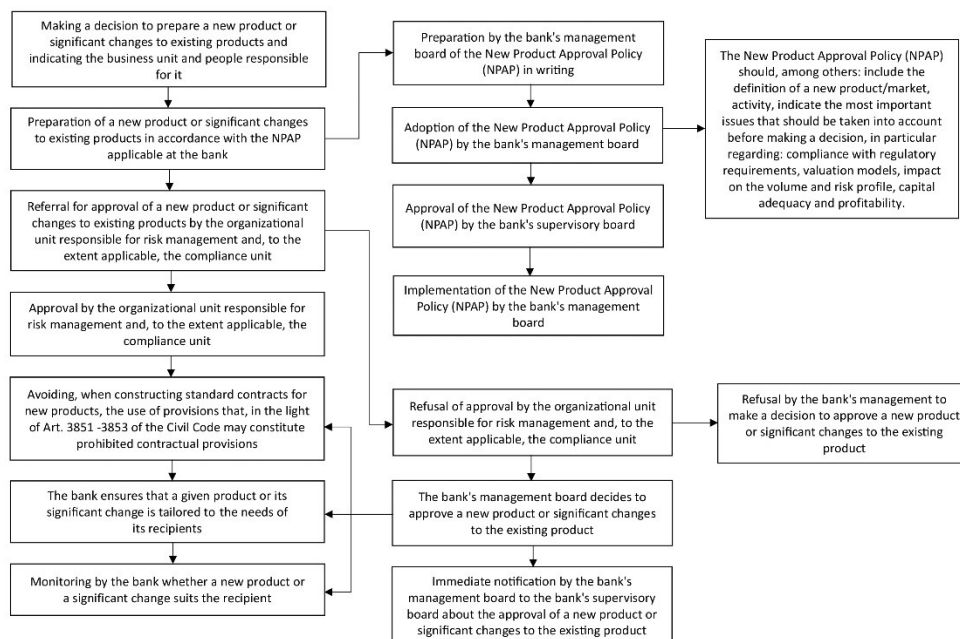


Figure 1. Action diagram regarding the policy of approving new products resulting from Recommendation Z

Source: own study.

Moreover, in such a situation, the bank's management board immediately informs the bank's supervisory board about the approval of the new product or significant changes to the existing product, along with an indication of the reasons why it did not take into account the opinion of the organizational unit responsible for risk management and, to the extent applicable, the compliance unit. Against the background of the wording of recommendation 29.5. it is doubtful whether the competence of the management board presented therein will be applied when both units express negative opinions regarding the approval of a new product or significant changes to the existing product.

In the analyzed action plan, Recommendation Z recommends that, when developing standard contracts for new products, the bank should avoid using provisions that, in the light of Art. 385<sup>1</sup>-385<sup>3</sup> of the Civil Code<sup>19</sup> may constitute prohibited contractual provisions, as well as provisions which, despite their different linguistic form, are similar to those entered in the register of prohibited clauses of the Office of Competition and Consumer Protection (OCCP) (Fedorowicz, 2021). Including provisions in standard contracts that may be considered abusive by courts and the Office of Competition and Consumer Protection may expose the bank to, among others, to the risk of incurring the costs of compensation, costs of court proceedings or the risk of loss of reputation.

Moreover, when introducing a new product or making significant changes to the existing product, the bank should ensure that it is tailored to the needs of its recipients.

<sup>19</sup> Act of April 23, 1964, Civil Code (consolidated text: Journal of Laws of 2023, item 1610, as amended).



The bank also monitors whether a new product or a significant change to an existing product suits the recipient. This is done in particular by controlling the sales process and analyzing complaints and claims submitted by the bank's customers.

In the above scheme of action, reconstructed on the basis of the guidelines resulting from recommendation 29, as in the first scheme, the prevailing norms fall into the category of *soft law*, i.e. formalized management rules and praxeological rules, and they are supplemented by the norms of generally applicable law.

## 8. VERIFICATION OF RESEARCH HYPOTHESES

The normative set method made it possible to formulate the following preliminary conclusions (due to the short period that elapsed after banks implemented the provisions of Recommendation Z) against the background of the previously formulated research hypotheses:

1. the main source of resolution of the discussed regulation were foreign supervisory institutions and international organizations, including primarily the European Banking Authority and the guidelines developed by it (EBA/GL/2017/11 and EBA/GL/2017/12), which can also be considered functional source of public banking law,
2. recommendations resulting from Recommendation Z will contribute to the unification of banks' internal procedures, including: in the scope of organizing internal governance in the bank and its compliance, assessing the suitability of members of the management board, supervisory board and persons performing key functions, assessing the impact of remuneration principles on the way of managing the bank or the policy of approving new products. This will make it easier for the Polish Financial Supervision Authority to perform supervisory activities towards banks in the field of corporate governance,
3. by implementing the discussed recommendations, banks should more efficiently introduce the directive for stable and prudent management of banking activities, and prepare more effectively for future difficult market conditions, due to the growing importance of the quality of corporate governance and the professionalization of staff performing key functions in banks to ensure the security of the banking system and, more broadly, the banking system. financial state,
4. bringing the internal organization of banks into compliance with the requirements arising from Recommendation Z will result in the expansion or reorganization of their internal structure and regulations, e.g. with new units/cells of a controlling or consultative nature, as well as the development of new or modification of existing strategies, policies, regulations in the area of internal governance, e.g. resolving bank conflicts, dividend policy or new product approval policy,
5. the implementation of the prudential standards specified in Recommendation Z involves banks incurring additional organizational costs, including: changes or creation of new procedures, review of existing policies and modification or creation of new units/cells in the bank or new positions, which may affect the prices of products offered to customers,
6. the recommendations resulting from Recommendation Z will lead to the professionalization of management staff in banks and the strengthening of their ethical architecture, contributing to the elimination or at least reduction of the so-called *moral hazard*.

## 9. CONCLUSIONS

The declared *ratio legis* of Recommendation Z is to disseminate good practices in the field of internal governance in banks, which in turn is to minimize the risk of their operations, increase their resistance to difficult market conditions and increase the stability of the financial sector. The essential element of the recommended solutions is the organization of relations between the supervisory board and the management board in the bank, the selection of appropriate people for key positions and the PFSA's monitoring of the suitability of these people during their term of office, as well as risk management procedures in banks.

To put it simply, it can be said that in addition to the need for banks to develop and implement strategies, policies, as well as regulations and plans for the new internal order, the key issue is the selection of such staff who, in the intention of the creators of the Basel Consensus, the EU legislator (CRD IV directive) and national (amendments to the Banking Law in the part regarding bank bodies and their competences, composition and regulations), European (EBA) and national (PFSA) regulatory bodies will be resistant to the phenomenon of moral hazard. This is an ambitious task and a challenge at the same time, because it concerns not only professional suitability (qualifications, professional experience), but also ethical suitability, which is not only difficult to measure, but unfortunately also variable.

In this context, the results of research on the relationship between work in the financial sector and the morality of the people employed there are interesting, although not surprising. According to Marta Rocchi and David Thunder, an ethical financier will perform their work in an ethical manner, even though the financial (banking) environment does not shape such virtues, and what is more, it does not possess them in itself (Rocchi, Thunder, 2019). It seems that only in the longer term will it be possible to assess whether and how good practices implemented by supervised entities in the field of suitability of members of bank bodies and control in this respect by the Polish Financial Supervision Authority will increase the ethical level of bank management staff, while minimizing the phenomenon of moral hazard in their business activities.

The normative set method used for the institutional analysis of Recommendation Z as a *soft law* regulation allowed the determination of its sources, administrators, main beneficiaries and malefices, and the reconstruction of the selected scheme of action, similarly to regulations classified as sources of generally applicable law. Moreover, it also made it possible to formulate the following *de lege ferenda* conclusions regarding the procedure for developing or amending recommendations addressed to banks by the Polish Financial Supervision Authority:

- the strengthening of the transparency of the activities of the PFSA as a public administration body would be facilitated by making public the results of public consultations on draft recommendations for banks, thus making it possible to determine the impact of accessory sources on the final shape of prudential standards, as well as the degree to which the PFSA takes into account the demands made by these sources, and thus the scope optimization of recommended solutions,
- it would also be desirable for the Polish Financial Supervision Authority, as a constitutive source, to assess the socio-economic effects of the draft recommendations addressed to banks.

Moreover, it should be emphasized that equally interesting from the methodological point of view are certain differences noticed during the implementation of individual

research stages within the normative set, resulting from the fact that Recommendation Z is a regulation classified as *soft law*.

Firstly, in the operational schemes reconstructed on the basis of Recommendation Z, the Polish Financial Supervision Authority plays several roles, i.e. as an entity classified as a constitutive source, it is also the legislator/initiator and constitutive administrator of the regulation in question, and in a sense monitors the degree and manner of its implementation. However, the methodological assumptions of the normative set provide that the same entity may assume one or more roles (or even all) within a separate action scheme(s) (Chmielnicki, 2020).

Secondly, the standards resulting from the examined recommendation are formalized standards, although legally non-binding for banks as entities supervised by the Polish Financial Supervision Authority, which is not irrelevant to the findings made in the 4th stage of the research.

Thirdly, the content of Recommendation Z includes an extensive set of good practices and procedures, primarily for the statutory bodies of banks, which provide patterns of numerous separate, but also sometimes overlapping, competences and activities in the field of managing banking activities and risks in these activities. The addressees of these standards implement them based on the principle of proportionality.

Fourthly, something new is the extent to which banks can use alternative solutions when shaping their internal order, including, for example, establishing the so-called the suitability of persons performing key functions in management bodies in relation to the good practices recommended by the Polish Financial Supervision Authority in this respect, if the Polish Financial Supervision Authority may be guided by them in the supervisory assessment of these entities.

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