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## Germany's capital market and corporate governance

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**Kiel Working Paper No. 1206**

**Germany's Capital Market and Corporate Governance**

by

**Horst Siebert**

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## **Germany's Capital Market and Corporate Governance**

*Abstract:* Germany's capital market relies on bank-intermediated products and not so much on capital market processes. Two of the pillars in Germany's three-pillar banking system, the savings banks and the cooperative banks, have special statutes and are not exposed to the control of the capital market through the usual threat of a change in ownership. Savings banks enjoy public guarantees. In the financing of firms, bank credits are far more important relative to market products - equity and bonds - than in the Anglo-Saxon countries. Moreover, banks so far have had a dominating position in corporate control through their holdings and their votes in the supervisory board in Germany's two-tier system of corporate governance. In this system block holdings are a relevant element. With the banks themselves under the pressure of changed international conditions, the German system of corporate control has yet to prove its viability.

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## **Germany's Capital Market and Corporate Governance**

Germany's bank-based financial system relies on bank-intermediated products and not so much on capital market processes. Moreover, one of the pillars in the three pillar system, the savings banks, is publicly controlled, and the second pillar, the cooperative banks, has a special statute. Both pillars are not exposed to the control of the capital market through the usual threat of a change in ownership. In the financing of firms, bank credits are far more important relative to market products, i.e. equity and bonds, than in the United States and the United Kingdom. Moreover, banks so far have had a dominating position in corporate control through their holdings and their votes in the supervisory board in Germany's two-tier system of corporate governance. This system, also characterized by block holdings, competes with the Anglo-Saxon model of corporate governance. With the banks themselves under the pressure of changed international conditions, the system has yet to prove its viability.<sup>1</sup>

### **The Bank-Intermediated Financial System**

The German financial system is bank-dominated. Banks play a leading role in mobilizing savings, allocating capital, overseeing investment decisions of corporate managers and providing risk management vehicles. They act as intermediaries between households and firms in collecting deposits from households and by extending credits to firms. Households contribute financial assets to the other sectors, which require external funding, i.e. to the non-financial corporations and to government. Banks, also denoted as monetary financial institutions in the official language, are the go-betweens in this net lending and net borrowing process amounting to a volume of roughly 3.5 per cent of GDP annually. Moreover, banks have increasingly financed themselves

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<sup>1</sup> I appreciate critical comments from Martin Albrecht, Claudia Buch, Günter Franke, Christine Hübner, Terhi Jokipii, Christian Pierdzioch, Benedikt Wahler, Ingo Walter and Jens Weidmann.

through the issuance of bonds. The German banks are in close contact with firms and have been called “house banks” (*Hausbanken*). They play an important role in the German approach of corporate governance by controlling the firms through representation on the supervisory boards and through the relationship banking in giving them credits. This intimate approach, relying on personal information and personal contacts, stands in contrast to the market-oriented Anglo-Saxon system where the allocation between savings and investment is predominantly performed by market instruments and a more anonymous market process (European Central Bank 2002a). Whereas part of this difference can be explained by the structure of the enterprise sector – small firms prevailing in Germany rely on credits from banks, whereas the larger firms, for instance in the United States favor market products, the structure does not fully explain the difference in the two approaches.

Evidence of a bank-based intermediation becomes apparent when analyzing the structure of financial assets and of liabilities (Table 1). The resident non-financial sector, i.e. households, non-financial corporations and the government, have provided financial assets in the magnitude of 150 per cent of GDP in the intermediated form of deposits, money market funds and mutual funds shares to the intermediary sector<sup>2</sup>, whereas the market attracted non-intermediated funds of only 110 per cent of GDP (in 2000). A similar picture is painted when one studies the liabilities side. This preference for intermediated products is due to the behavior of households. Non-financial firms prefer non-intermediated products both on their financial investment and on their borrowing side. The dominance of intermediated products in Germany is in contrast to the euro area, where the funds received from the markets were 220 per cent of GDP and 130 per cent from intermediated products (European Central Bank 2002a:68). Non-

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<sup>2</sup> Money market funds and mutual funds take an intermediate position; they are not “intermediated” that they do not run through the balance sheet. They represent “fiduciary” or professionally managed third party assets; the fiduciaries may or may not be banks.

residents of Germany prefer market products. Market products are also more important in the EU with non-intermediated liabilities amounting to 217.7 per cent of GDP (Table 1). The relative importance of intermediation implies that the stock markets as well as shares are relatively less relevant in Germany than in most other countries. Stock market capitalization with 40 per cent of GDP (May 2003) is indeed low compared to other countries.

Table 1: Intermediated and non-intermediated financial assets and liabilities in per cent of GDP <sup>a</sup>

	Financial Assets		Liabilities	
	Intermediated	Non-intermediated	Intermediated	Non-intermediated
Resident non-financial sectors	148.1	110.6	156.6	123.4
Non-residents	48.4	65.0	23.3	71.5
Total	196.5 [162.0]	175.7[169.1]	180.1 [132.4]	194.9 [217.7]

<sup>a</sup> End of 2000 – In brackets, EU values for comparison

Source: European Central Bank (2002a), Table 1

The dominating players among the German intermediaries are the banks, whose assets account for 300 per cent of GDP while the assets of other financial institutions and of insurance companies make up only 41 per cent and 64 per cent respectively (Table 2). Banks in Germany have a virtual monopoly on retail distribution, not in the production of intermediation services. So non-bank intermediaries' market share is trivial compared to the United States. In the European Union, monetary financial institutions play a smaller role, whereas other financial institutions are more important. At the end of 2000, bank loans amounted to 3 trillion euro, and 2.2 trillion euro worth of debt securities were in circulation, meaning that loans by banks accounted for most finance raised by the economy as a whole. Of those debt securities, around 1.4 trillion euro were

issued by banks which used this as a principal instrument to refinance their lending business.

The German financial system differs from the Anglo-Saxon model in that generally banks or credit institutions operate as ‘universal banks’, with the exception of mortgage banks and other banks with special functions (e.g., government-owned banks providing subsidized lending).<sup>3</sup> As a rule, there is no distinction between commercial and investment banks, and hence, the term “banks” in Germany typically refers to financial institutions that are allowed to participate in a broad range of activities, including investment banking, mortgage banking, insurance services (through subsidiaries), security brokering and dealing, payments services (in Germany, that requires a banking licence) and commercial banking activities. The core of the banking business, however, still rests with granting credits to resident non-monetary financial institutions with the main activity being based on the differential in interest rates.

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<sup>3</sup> Part of the difference is related to the dominance of the Mittelstand in the German structure, companies that even in the United States would rely mainly on bank finance.

Table 2: Structure of the German Banking System

<b>Importance of intermediaries, assets in per cent of GDP <sup>a</sup></b>						
Monetary financial institutions		Other financial institutions			Insurance companies	
300.4 [255] <sup>b</sup>		40.1 [50] <sup>b</sup>			64.0 [58] <sup>b</sup>	
<b>Number of monetary financial institutions <sup>a</sup></b>						
Private commercial banks	Cooperative enterprises	Savings banks	Foreign branches and subsidiaries	Other credit institutions	Money market funds	Total
148	1 796	575	146	75	40	2 780
<b>Share of banking groups of the balance sheet total in per cent <sup>c</sup></b>						
Commercial banks	Savings banks and Federal State Banks	Cooperative banks	Mortgage banks	Banks with specific functions	Building societies	
28	36.1	11.5	13.4	8.4	2.6	

<sup>a</sup> At the end of 2000. – <sup>b</sup> In brackets, euro area values for comparison – <sup>c</sup> In July 2003.

Source: European Central Bank (2002a), Tables 3.2, 3.4, 3.5 and 3.6, p. 72-77; for balance sheet total Bundesbank Monthly Report, September 2003, p.24f.

Besides banks, money market funds, often spin-offs of banks, are another element of monetary financial institutions. Money market funds were introduced in 1994 and by May 2002 had a total market share of around 10 per cent of the monetary financial institutions balance sheet total – a relatively large portion when compared to only around two to three per cent of the euro area balance

sheet total. Such funds invest mainly in high-quality, liquid, short-term government and corporation obligation that can be sold at or close to par value. They stand ready to pay out the deposits immediately; deposits in them are like money and, therefore, included in the money stock M-3. On the liability side of banks' balance sheets, traditional deposits have lost importance relative to money market funds, which provide higher interest.

Other financial intermediaries, essentially made up of investment funds, play a modest role accounting for a share of 11 per cent of households' financial assets (2000, European Central Bank 2002a: 75). Assets of investment funds in the euro area constituted around 40 per cent of total assets in 2000. Special funds making up about two thirds of investment fund assets are issued for institutional investors, for instance insurance companies. Like the investment funds open to the public, accounting for the other third of the assets, they are security-based. The idea of open-ended investment funds is to collect and manage assets on behalf of small investors towards specific objectives regarding the risk, return and maturity of the involved claims. They enable investors from all classes of society to participate in and benefit from profits of productive capital as well as real estate. In open-ended funds, also referred to as mutual funds, the number of certificates is changing constantly. They stand ready to redeem certificates on the investor's demand, as well as to sell new certificates to them without limit; the certificates can be bought and sold at net asset value. The investment fund industry has experienced rapid growth in Germany over the last decade. Since 1995, a key driver of this substantial growth has been the huge increase in special funds.

The German insurance sector includes insurance corporations and pension funds. They play an important part in the financial industry, as the issuance of insurance policies generates substantial investable funds. Like investment funds,

they collect and manage assets, but with the difference that insurance contracts are typically designed with certain guarantees, meaning that the insurance company acts as a risk bearer, while the investment funds usually operate strictly on an individual net asset value basis and do not take on any risk.<sup>4</sup> With respect to gross premium written in 1999, the German insurance industry is the fourth largest insurance market in the world after the United States, Japan and the United Kingdom. Approximately six per cent of the world's premium volume was collected in Germany (Maurer 2003).

Total liabilities of insurance companies and pension funds amount to 64 per cent of GDP. Most of the liabilities are technical insurance reserves for claims held by households; these reserves can be interpreted as precautionary savings for old age. Households can invest in life insurance policies that receive favorable tax treatment. The German Retirement Savings Act of May 2001 created a new system of supplementary pensions in addition to the public pay-as-you-go system. These include pensions agreed upon by the social partners; employees can convert part of their salary into contributions to these pensions, exempting this part of the salary from income taxes and from contributions to the social security system. Households also have claims against pension funds; employers as well as employees have made contributions to these pension funds. Moreover, households have direct claims against firms from company pension commitments amounting to eight per cent of GDP in 2000; these claims are carried on firms' balance sheets as pension provisions.

Most German insurance companies are organized as stock corporations. Only around 15 per cent are listed on the stock exchange, usually the mother company whereas subsidiaries are not listed. This is due to the fact that the current

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<sup>4</sup> If investment companies however, offer their investment products within tax supported individual pension accounts, then they must by law give a so-called 'money back' guarantee due to regulatory solvency requirements.

regulations require obligatory specialization, prohibiting life insurance companies from providing insurance coverage in other lines of business. With more than 850 billion euro of assets under management (in 2000), the German insurance companies can be considered the most important institutional investors within Germany.

### **The Segmented Three Pillars Approach**

A distinct feature of the German banking system is that the private commercial banks have only a very small share of the total market, when measured in terms of the balance sheet total. It may come as a surprise to the international reader and to many Germans as well, that Deutsche Bank, the internationally well-known largest German bank and a major global player, has a market share of only 5.4 per cent in Germany (2003). The top four private banks, Deutsche Bank, Bayerische HypoVereinsbank, Commerzbank and Dresdner Bank, only account for 16 per cent of the market.<sup>5</sup> All the commercial banks together, which do a considerable amount of the more complex type of banking activities such as securities and asset management, make up only 28.0 per cent of the market. Apart from the four big banks this includes the regional commercial banks, statistically among them the Postbank<sup>6</sup>, which account for 3 per cent of the market, and subsidiaries of foreign banks, which have a market share of 1.7 per cent.

The German banking industry is characterized by a large presence of publicly owned or government-influenced institutions. Publicly controlled savings banks

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<sup>5</sup> In terms of pure numbers, commercial banks, among them the five largest commercial banks, account for 5.5 per cent of the total number of 2 780 banks, savings banks for 21 per cent and cooperative banks for 65 per cent (as of 2000, European Central Bank 2002a: 72).

<sup>6</sup> The semi-privatized Postbank with 27 000 employees is used for personal financial transactions such as paying monthly bills in preference to bank accounts. Almost one in three Germans has an account in the Postbank.

including their central institutions, the state banks (*Landesbanken*), make up 36.1 per cent of the market; here important changes in the public guarantees can be expected from 2005 on (see below). Cooperative banks - including their central institution - account for 11.5 per cent. The mortgage banks account for 13.4 per cent, while banks with specific functions, among them government-owned banks for public credits such as the Kreditanstalt für Wiederaufbau, account for 8.4 per cent (Table 2). Savings banks and their central institutions represent a two-tier system where the central institutions, the *Landesbanken*, are true universal banks, performing significant investment banking and wholesale banking functions including liquidity provision and risk transformation. The savings banks and co-operative banks are legally allowed to operate as universal banks. However, the majority clearly focus on retail banking and keeping in touch with their local customers, especially the small and medium-sized firms, due to their local orientation. The same holds for the two-tier system of the cooperatives.

The German banking sector is rather fragmented. The Herfindahl index of market concentration is very low. This could be interpreted to indicate a high intensity of competition between banks in their product markets. If this were the case, Germany could be presumed to have an efficient banking system. This, however, is not a true representation of reality. One aspect is that there is quite a bit of regional segmentation among banks; banks have also tried to establish their own market segments on the product side, where they would be somewhat protected against competition. In this context, banks have used different strategies. The commercial banks shifted resources out of retail banking in the late 1990s, but lately rediscovered it as commission incomes and profits on proprietary trading declined in the wake of the stock market collapse. The savings banks and the cooperatives have stressed their local bias, including the access to liquidity from their local customers. In addition, competition from

foreign banks is low; 214 branches and subsidiaries of foreign banks (131 foreign banks and 83 subsidiaries) were operating in Germany in April 2003.<sup>7</sup> Thus, there is still a great deal of segmentation of the German banking sector.

What is more important: When looking at competition among banks in a wider concept than just counting the numbers of the banks and their market share, when corporate governance of the banking sector and competition in terms of ownership control is taken into account, a very different assessment on the German banking system is obtained. The banking industry is segmented into three pillars: the commercial banks, the savings banks (including the state banks) and the cooperatives. There is even a smaller fourth pillar, albeit a little smaller, the government-owned specialty banks.

With respect to the first pillar, the savings banks were founded in the 19<sup>th</sup> century when the municipalities gave guarantees for the deposits of the customers in order to protect, for instance, workers' savings against loss due to bank failure. The savings banks were also supposed to extend credits to local craftsmen and small businesses that would otherwise have limited or no access to credit. The savings banks, which are in the legal form of public corporations, are obliged to serve the public interest and have other goals in terms of societal, social and cultural responsibilities according to their statutes. They are organized regionally, i.e. as one bank for a region. An explicit profit target is not their first priority. They have accumulated their capital from retained earnings. Profits arise are regularly used to augment reserves or they may partly be distributed to the public owners. Mayors and other local dignitaries are represented on the supervisory boards of these banks, and it is common that savings banks support local initiatives in different walks of life like sports and

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<sup>7</sup> Most keep to a few specialized fields of banking, e.g. trade finance, investment banking or asset management. German banks have 323 branches and 407 subsidiaries abroad, most of them in the European Union (2002).

culture which, of course, is very welcome to the local politicians. In a way, they have a shadow budget at their disposal.

Legally, counties and municipalities are not the owners of the savings banks, although they can demand the distribution of profits. They are merely the guarantors, meaning that the public entity is liable without restriction in the event of a default and hence provides a guarantee for third party lenders. Historically, governmental entities did not put up equity for these banks. Savings banks and their central institutions have received two types of public guarantees. Maintenance obligation (*Anstaltslast*) characterizes the commitment to equip the institution under public law with the necessary means to fulfill its public mission; it is a general concept of German administration that is applied and guaranteed to all public bodies. Guarantee or bail-out obligation (*Gewährsträgerhaftung*) describes the unlimited responsibility of a public corporate body for the liabilities of its public institutions to protect creditors. There are seven private savings banks, for example in Hamburg and Frankfurt, which prove that regional and local savings banks are able to compete in the German market without the two public guarantees.

The central institutions of the savings banks, the Landesbanken, are stock companies and owned by the savings banks and the federal state in which they are located. For instance, the West LB, Germany's fifth largest bank, is owned by the State of North Rhine-Westphalia (42 per cent), by the Rhenish and Westphalian savings banks (17 per cent each group) and by regional authorities. The federal state takes over the maintenance and guarantee obligation in a similar fashion as the municipalities do in the case of the savings banks, even for the business the West LB does in London. This has in recent years become highly controversial – as another state-supported bank, Crédit Lyonnais, did a decade earlier. Public guarantees will change in 2005 (see below).

When a savings bank gets into financial distress, the municipality has to step in and use tax money to consolidate the savings bank. This happened for instance in 1998 when the municipality of Mannheim had to come up with the equivalent of 25.6 million euro to bail out its savings bank; in 2000 it guaranteed another 76.7 million euro. Similarly, when a Federal state bank becomes illiquid, the Land has to bail it out. For instance, in 2002, the Bankgesellschaft Berlin with its subunits of Berliner Sparkasse, Berliner Bank and the Berlin Hypothekenbank, had to be rescued from insolvency, which mainly arose from miscalculation of real estate risks in the mortgage business leading to high losses. The state of Berlin had to inject new capital of 1.7 bill euro and cover potential risks up to 21.6 bill euro in order to attract a private equity holder; Berlin still has 81 per cent of the equity. All this happened in a federal state that is itself in financial distress. The taxpayer has to cover the failure of a bank that is under the strong political influence in its credit policy and in hiring its personnel.

Savings banks are protected against take-over by the legal stipulation of serving the public interest so that they are immune against a take-over bid by commercial banks or cooperatives. They are not for sale and, thus, protected in their ownership structure. Savings banks are so well protected that – while they can merge within a state - it is even not possible for savings banks of neighboring federal states to merge, even if they serve a common economic area. The reason is that the regional principle applies for them, delineating their market area, and that the public interest is defined according the law of the individual Land. For instance, a banking district that cuts across the boundaries of two Länder is made impossible. This is a logical outcome of the definition of the public interest, being usually defined for a state<sup>8</sup>, and of the guarantee

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<sup>8</sup> This does not apply to the states banks.

structure – why would taxpayers of a Land agree to bail out loans to clients in a different Land? In a similar way, savings banks could not take over a cooperative or a commercial bank, because they then would lose the characteristics of the public interest. Similarly, they cannot be taken over by a cooperative or a commercial bank. This may change; some municipalities are now attempting to sell their savings banks, meeting strong opposition from the organization of savings banks and from the states in which they are located and which have some supervisory functions. So far, the first pillar is completely closed off against competition, and a market for corporate control does not exist. Clearly, such a stipulation does not fit into an institutional environment where the EU attempts to reduce institutional barriers between the national regulations.

With respect to the second pillar, the cooperatives that provide mainly retail banking services to their local market are typically owned by their depositors or their borrower clients. Usually a broad ownership is required and ownership shares cannot be sold. Like the savings banks, cooperatives are organized regionally. Again, the cooperatives are not for sale and, thus, not subject to a market of corporate control. Profits are distributed as dividends to the mutual owners. As with the federal state banks, the central institution of the cooperative banking group, the DZ-Bank, provides a wide array of services to their primary institutions. Besides the regionally organized cooperatives there are also a number of nationally active special banks such as banks of the churches, of government officials and of physicians and pharmacists.

The commercial banks, the third pillar, are fully open to competition. Deutsche Bank, Dresdner Bank, a subsidiary of Allianz, HypoVereinsbank and Commerzbank are universal by nature in that their retail and corporate banking businesses are complemented by investment banking activities, however only partly in high-level investment banking relating to mergers and acquisitions.

They form the core of Germany's private commercial banking group. But as noted, the private banks in the third pillar only have a market share of less than one-third. Looking at the banking sector somewhat differently, commercial banks and mortgage banks account only for only 42 per cent of the market volume; the publicly supported banks, the savings banks, the Landesbanken and the government-owned speciality bank make up 44 per cent of the market, not counting the cooperatives with their special status performing specialized services as agricultural, crafts, or mortgage lending. Together with the cooperatives and the building societies, the publicly influenced part of the banking industry is nearly 60 per cent. Surprisingly, this means that Germany, known as a market economy, has a banking system that is strongly influenced by the public sector.

It must be questioned whether this three-pillar banking system is efficient. Benchmarking shows that German banks perform below international standards when profitability is considered. Profitability is defined as the net interest margins, i.e. the banks' revenue from lending minus the remuneration of deposits minus expenses and loan losses, relative to average assets. This figure for Germany, 1.12 per cent in 2001, a record low, is below the EU-11 average; it is about half that of the United States.<sup>9</sup> The return on assets, i.e. the ratio of pre-tax profits to average assets, return on equity and earning power all are much lower than in the United States, and – except for the return on assets – also lower than in the EU-11.<sup>10</sup> In 2002, the banking sector's profitability was down to 0.1 per cent of assets (IMF 2003:31). Low domestic lending margins, high operating costs, significant loan write-offs and the large market share enjoyed by publicly owned and co-operative banks have had the combined effect to keep the profitability of most private German banks among the lowest in Europe. And

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<sup>9</sup> The figures for 1998 were: 1.2 in Germany, 1.5 in the EU-11 and 2.1 in the United States, Belaisch et al. (2001), Table 12.

<sup>10</sup> Ibid

bank profitability has continued to deteriorate drastically, not only since the stock market bubble burst. According to the association of private-sector banks (*Bundesverband deutscher Banken*), German banks' average net profit in per cent of total assets has nearly halved over the past ten years.

Competition in the German banking sector is severely distorted. Savings banks and Landesbanken can compete with the commercial banks under privileged conditions, thus driving down the rates of return. If these semi-public institutions fail, the municipalities and the Länder will pick up the bill. At the same time, they are protected against competition in the market for corporate control since they are not for sale. This means that, in an international comparison, German banks are not efficient. Together with distorted competition, Germany is considered as over-banked in spite of recent consolidation. Thus, the low Herfindahl index mentioned above may be an expression of inefficiency, rather than an indication of competition-induced efficiency through market discipline. All this may be one reason why big German banks, somewhat low in their value in the stock market, have not been taken over by foreigners.

An advantage of the German system seems to be that customers enjoy lower banking fees and lower interest rates for credits than in other countries, possibly also higher rates for deposits. But this comes at a price. The allocation of the factors of production is distorted in that there is a bias in favor of capital relative to labor which is reinforced by wage policy. In addition, lower lending rates are only made possible by an implicit subsidy of the government in the form of guarantees that involve public funds if the risks materialize. Moreover, the system itself is exposed to a systemic risk because the interest rate differential between deposit and lending rates is not sufficient to cover the expected losses emanating from credit risks. The ultimate costs of the system would become

apparent if the government were no longer to finance the subsidies, so that financial institutions would have to ration credits independently of Basel II. It seems that in the years 2001 and 2002 we were not too far from this scenario.

### **Recent Financial Market Developments**

During the past decade, significant institutional, political and technological advancements have occurred around the globe, collectively resulting in a breakdown of the traditional way in which banks, and generally financial institutions, do business both in Germany as well as in many other industrialised countries. Structural shifts in the financial system and on financial markets have been caused mainly by the removal or loosening of regulation within the financial sector. While deregulation and globalisation have led to both product as well as geographical expansions within the banking system, the implementation of new technologies has accelerated that process. Banks are facing increased competition, both from within the immediate industry as well as from the non-bank providers of financial institutions. Disintermediation has been occurring as more and more non-banks and on-line banks are now providing the more traditional banking products. These changes have resulted in a fundamental shift in the cost structure of the distribution of financial services. As a result, the way in which banking business is conducted, both on an individual firm level as well as for the industry as a whole, has changed significantly. Moreover, some additional trends of disintermediation have been observed recently. Large-scale public enterprises were privatized, so that the stock market plays a larger role. *Neuer Markt*, a stock-market segment for technology – oriented fastly growing firms, has been established in March 1997; with the end of financial exuberance, it was closed in June 2003. Maybe it was premature and investors were not yet ready to accept major losses - the US NASDAQ bounced back despite similar market pressure.

Until the early 1990s, the German savings and commercial banks could rely on cheap funding through their depositors. That is why Deutsche Bank once was called Germany's biggest savings bank. The customers were mainly interested in the safety of their deposits and did not have too many alternative short-term options. This changed when money market funds and other market instruments became available and when depositors became interested in returns as well. Bank customers have switched to money market funds so that the liability side of the balance sheet structure of banks changed with deposits losing some of their importance relative to market products. The new market products absorbed the commercial banks' cheap funding sources. Further, the enlarged currency area and financial liberalization due to a set of EU directives have created a broad, liquid financial market offering many different types of investments without any exchange rate risk.<sup>11</sup> Thus, the second banking directive of 1989 introduced the principle of mutual recognition. Member states must recognize financial institutions licensed in another country. This created a single "license" or "passport," eliminating the need for EC banks to obtain a local banking charter from the host country for branches and bank products. Banks can offer banking services freely across the EU; according to the principle of home country control the supervisory function is allocated to the home country.<sup>12</sup> Another principle in the second banking directive was the concept of harmonization. It created uniform safety and soundness standards and a comparative competitive environment across the EU. This means that banks operating across countries within the EU faced regulation through a set of harmonised rules rather than a variety of different standards and requirements. Eight more directives were adopted between 1986 and 1992 which required that banks are examined annually at the fully consolidated banking institution level

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<sup>11</sup> The Directives 86/566/EEV and 88/361/EEC were instruments for the full liberalization of the capital markets.

<sup>12</sup> The home country rule replaced the host country rule for which the first banking directive of 1977 had set the criteria of expansion across national boundaries within the European Community.

for risk exposure and risk management. Furthermore, minimum capital and solvency standards were required to be set in order to limit an institution's exposure to large borrowers, along with standards for reporting financial and accounting data. Adoption of all of these directives by each of the member nations was crucial to the long-run integration of the EC banking market. Although segmentation still exists as a result of national regulation - for instance of the insurance industry - borrowers and lenders can take advantage of the broader market. Customers internationalize as well, for instance with a higher mobility of enterprises and an increasing cross-border migration of people, for instance of students and the elderly with respect to their residence.

The larger commercial banks, which have stressed the role of investment banks in their strategy during the years of financial exuberance and now seem to be looking for the right balance between internationalization and home business, need to obtain internationally comparable results in their profits and in their evaluation by the equity market. If they do not succeed in reducing inefficiencies, they run the risk of being taken over. Admittedly, this threat is reduced by the institutional setting under which they operate in Germany, including the low interest rate differential between deposit and lending rates. This threat for a take over may become more real when the remaining institutional segmentations are weakening. The removal of capital gain taxation of divesting cross-holdings is expected to further affect the restructuring of the German industry.

The banks have responded to the changed environment with mergers and acquisitions. The banking sector has consolidated significantly during the last decade, reducing the overall number of banks dramatically from 4 719 in 1990 to 2 592 in 2002. This intense consolidation has been driven by the need to solve cost-related profitability problems due to the combination of its dense network

of branches and high employment costs relative to other European banks. Investment funds and insurance companies have, in addition, started to compete more fiercely for the financial assets of households. Among the banking sector and the insurance sector, Allianz, the insurer, took over Dresdner bank, the third largest German bank, in 2001 to take advantage of expected (so far disappointing) synergy effects in the sale of insurance contracts. This acquisition still lays heavy onto Allianz, which has lost over half its market value and was forced to raise new equity capital. At the same time, the HypoVereinsbank agreed on a strategic partnership with the re-insurer Münchner Rück. The smaller savings and loan and cooperatives are also consolidating within the limits allowed by law. For instance, two central institutions of the co-operative banking group, the DG bank and GZ bank, merged in to the DZ bank in 2001.

Several years of weak growth along with a sharp downturn in the stock market, overambitious expansion strategies and low profitability have put substantial strains on the German banking system. As a result, in 2002 and 2003, speculation increased about a possible banking crisis. Major consolidation measures have brought about a significant improvement; problems still exist however, placing additional pressure on the need for even more consolidation within the sector.

Starting in 2005, the savings banks and the Landesbanken will face a new regulatory regime with respect to their public guarantees. Their cozy position will be dismantled. In the negotiations with the EU Commission, the German authorities have agreed to redraft the legal provisions. The two public guarantees will no longer apply in German law. The maintenance obligation (*Anstaltslast*) will be replaced by a normal ownership structure between the owner and the public sector savings banks. The bail-out obligation (*Gewährsträgerhaftung*) will be completely abolished for all state banks and public sector savings banks.

Losing these state guarantees, which underpin the AAA-ratings and cheap capital-market funding of state wholesale banks, these banks will have to cut costs, refocus operations and become more profit-oriented. The decision by Westdeutsche Landesbank, Germany's largest public-sector bank, to split itself into a public-sector holding company and a private commercial bank, however, does not address the heart of the problem because the private unit will still be hundred per cent publicly owned. Interestingly, an attempt by Standard & Poor's to suggest indicative state bank debt ratings without the guarantees triggered massive political pressure against the firm in 2003. Standard & Poor delayed publication of the ratings, suffering in the process a serious blow to the firm's independence.

Basel II will also have its implications for Germany. The inclusion of the exposure maturity under the preliminary document for the rules to be implemented under Basel II has come as a great surprise to the German banking industry. The consequences entail that a long-term exposure will require up to six times more capital than a one-year exposure. The established corporate structures in Germany mean a significantly higher percentage of long-term involvement of the banking industry than in the US or even the UK. Such capital 'add-ons' will significantly affect the competitiveness of the German banking industry when compared to other structures and increase borrower interest rates to a level that may not be justified by the risk they are taking on.

### **The Stock and the Bond Market**

The stock market is generally less important in Germany than it is in many other countries. The stock market also plays a smaller role than the bond market.

*The stock market.* Measuring the size of the stock market by the relative market capitalisation, i.e. by the ratio of the value of all shares of firms listed on a national exchange and the host country's gross domestic product, Germany's market capitalization of 40 per cent of GDP (in May 2003) is low compared to international standards.<sup>13</sup> It is about the same as in Italy (48), but lower than in France (106), the United Kingdom (128) and the United States (140). Despite the stock market boom, current investment in securities other than shares was higher in the period 1998- 2000 than investment in shares. In contrast to the flow data, holdings of shares are higher. While shareholdings of households have increased from 15 per cent of GDP in the 1990s to 30 per cent in 2000, the ratio remains much lower than that of the euro area at 55 per cent. Shares are more important for firms than for households, accounting for more than 50 per cent of the asset side in the balance sheet of firms (in 2000), again significantly lower than in the euro area (71 per cent).

For households, Germany seems to have developed a somewhat broader culture in equities following the privatization of the telecommunication company Deutsche Telekom in 1996 and following the establishment of the Neuer Markt in 1997. The number of shareholders has risen from 3.2 million at the end of the 1980s to 6.2 million, but has fallen since then due to the slump in the stock market. As other European countries, Germany has witnessed a strong growth in its market capitalisation ratio from 12 per cent to 67 per cent between 1975 and 2000, but other countries such as France having started from about the same ratio have seen a much stronger increase in stock market capitalization. German investors still seem to see equities as "savings" vehicles rather than true risk capital.

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<sup>13</sup> Source for data: Capitalization, Statistical Abstract of the United States World Federation of Exchanges (FCSM). The values for 2000 were 67 for Germany, 70 for Italy, 110 for France, 179 for the United Kingdom and 149 for the United States.

On the German stock exchanges, 973 domestic companies and 9 737 foreign companies are listed (January 2004). In addition, shares of 9 677 non-listed public companies are traded. The 42 largest companies (5 per cent largest stocks of all listed stocks) account for 74 per cent of total market capitalization (2000). Electronic trading makes up 44 per cent of the volume traded (2000). In the primary market, the annual issuance of shares (issued by residents) was 11.9 per cent of GDP (in the years 1998-2000). Initial public offerings totalled 25.6 bill euro or 49 per cent of GDP in 2000. The stock segment Neuer Markt was introduced as a special market for growth stock companies which were mostly internationally oriented and committed to high international transparency standards. It was terminated in 2003 because of the bust of the international information and communication technology cycle, along with the correction of the international stock markets, leaving its market capitalisation at around a thirtieth of its peak.

*The bond market.* The German bond market is dominated by banks with a volume of funds allocated from savers to borrowers second behind intermediated credits. Almost two-thirds of the outstanding debts – in total 110 per cent of GDP - were issued by banks. Government bonds account for 40 per cent of GDP. The volume of the German government bonds is only second in Europe to Italian bonds. The ten-year German government bond, known as the Bund, enjoys benchmark status. The Bund future has become the most important hedging instrument for long term interest rate risk in the euro area.

The German bond market is a long-term market where 80 per cent of debt securities are issued with an original maturity of over 4 years. Specialities of the German capital markets are the mortgage-backed bonds and municipal bonds known as ‘Pfandbriefe’. Both are a kind of asset-backed-security, overwhelmingly communal bonds, that provide security independent of the

individual debtor through the existence of a real-estate collateral or a collateral pool of public sector loans.

The European Monetary Union has boosted the trend towards securities by opening up a larger market for bonds in a common currency. In addition, many institutional investors who, until the end of 1998, had spread their portfolio risks among government bonds issued by various EMU member countries began to look for alternatives once the exchange rate risk disappeared. The euro eliminated the currency-matching requirements for certain investors such as insurance companies and pension funds, opening up the whole euro zone to German asset allocation. Bonds issued by German banks have been an attractive alternative for them. As a response, a jumbo issuing of 'Pfandbriefe' with an issue volume of over 500 million euro provided the security independently of the individual debtor by having a public sector body guarantee or through the existence of real estate lien. With the issuance of Jumbo 'Pfandbriefe' came the introduction of book-building as a method of issue and the assignment of an external rating. For the German 'Pfandbriefe' issuers, this rating is commonly AAA. 'Pfandbriefe' have consequently evolved from a German speciality to an international investment vehicle.

### **The Financing of the Enterprise Sector**

In the financing of German enterprises, equity financing has a relatively low importance compared to borrowed funds. For all enterprises in the producing sector, in trade and transportation (but not including communication), equity accounts for 8.1 per cent of the enterprises' balance sheet total in 2001. All own funds, including - besides equity - retained earnings, reserves and capital surplus, make up 17.6 per cent.<sup>14</sup> Provisions represent 19.9 per cent, those for

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<sup>14</sup> Data provided by the Bundesbank.

pensions 8.4 per cent; provisions (excluding those for pensions), which partly may be viewed as equity, make up 11.5 per cent. This means that equity financing in a broad interpretation constitutes only 29.1 per cent of the total liabilities. The overwhelming part of the balance sheet total is financed via borrowed funds (61.9 per cent). Among the credits, 20.4 per cent of all liabilities are from credit institutions, for short-term (9.8) or for long-term credit (10.6). The role of bond financing (*Anleiheverbindlichkeiten*) is very low, making up 0.2 per cent of the liabilities. The data for 2000 are of a similar pattern.

The financing structure varies notably with the legal form of enterprises as the more detailed data for 2000 indicate (Table 3). Corporations have a higher share of equity financing, both from own funds of 23.3 per cent in 2000 and from provisions (excluding those for pensions) of 13.7 per cent. In contrast, partnerships and sole proprietorships have significantly lower internal financing capability. Small and medium sized companies rely heavily on financing via bank loans (Sauve and Scheuer 1999). In the case of sole proprietorships, the internal financing is even negative, which seems to imply that owners on average were not only withdrawing current cash flow but the substance of the firms' assets (although the distinction between firm and personal assets in these cases is often very vague).

Table 3: Financing of German Firms

	All legal forms	Corporations	Partnerships	Sole Proprietorships
Liabilities in per cent of the balance sheet liabilities				
Own Funds <sup>a</sup>	17.21	23.27	11.87	-10.14
Creditors	62.67	51.68	74.74	105.90
Provisions	19.67	24.41	13.20	4.25
- for pensions	8.33	10.77	5.03	0.47
Borrowed Funds in per cent of the sum of borrowed funds <sup>b</sup>				
Short term by credit institutions	11.61	8.19	14.90	20.56
Long term by credit institutions	13.19	8.38	14.69	32.55
Total by credit institutions	24.80	16.57	29.59	53.10
Share of long term borrowing coming from credit institutions	67.39	62.28	58.87	87.86
Short term funds from trade creditors	15.54	13.55	16.52	22.91
Pension Provisions	10.11	14.15	5.72	0.43
Non- Pension Provisions	13.79	17.92	9.29	3.43

<sup>a</sup> Own funds (Eigenmittel): Equity, retained earnings, reserves, capital surplus. – <sup>b</sup> Sum total of liabilities less own funds.

Source: Deutsche Bundesbank, Monthly Report April 2003:60.

Credit institutions are of particular importance in providing long-term financing: 67.4 per cent for the average firm, 62.3 per cent for corporations and an overwhelming 87.9 per cent for sole proprietorships. The lower ratio for partnerships may be due to the role that credits given by one or several of the owner-partners play in those cases. In short-term credit, the non-institutionalized forms such as trade credit by deferred payment decrease the respective percentage of bank loans. Notwithstanding these forms of credit, sole proprietorships depend on banks for more than half of all their borrowed funds. This dependence and their low or inexistent own funds in the firm make them particularly vulnerable to changes in the credit policies of banks.<sup>15</sup>

To put the financing side of German non-financial enterprises into an international perspective, the low market capitalization in Germany is evidence of the small importance of equity finance. While this information does not stem from an internationally consistent data set on the financing structure of the enterprise sector, internationally consistent data show that in Germany bank loans play a much larger role than market instruments of financing. (Table 4). Thus, the ratio of bank loans to the sum of all bank loans plus short- and long-term securities issued by corporations, is about 95.5 per cent in Germany in 2001. This is an unusually high rate even for continental European countries that have traditionally relied more on a bank-based system; the respective shares in France and Italy at 78 per cent and 71 per cent were lower than in Germany. The frontrunners of financial market access of corporations, Japan, the United

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<sup>15</sup> However, there are means of financing such as leasing that (depending on the stipulations of the underlying contract) often do not show up on balance sheets but only in the notes of a company's annual report and as current costs in its profit and loss accounting. Were they fully included with their present value as liabilities on the balance sheet, the above mentioned ratios would then shift even more to external, longer-term financing but somewhat at the cost of the importance of bank loans. Sale-and-lease back arrangements have become increasingly popular in the last years, particularly for firms in financial distress, using the initial cash flow of the sale of assets to pay down some debt. Even major German banks recently undertook such moves, liquidating some of their real estate holdings to counterbalance credit write-offs. Estimates put the share of leasing in financing investments of German firms at around 17 per cent.

Kingdom and the United States, are coming much closer to an equal importance of bank loans and bond issues in corporate finance.

Table 4: Sources of Corporate Credit – Bank Loans versus Capital Market Financing in an International Comparison <sup>a</sup>

Country	1996	1997	1998	1999	2000	2001	2002
Germany	94.41	95.10	95.59	96.11	96.02	95.54	Na
France	81.93	81.61	80.03	80.45	79.78	77.84	Na
Italy	68.86	68.85	74.84	73.32	71.58	71.35	Na
Euro Area <sup>b</sup>	na	88.73	88.41	88.57	88.72	87.93	87.07
Japan	69.31	68.48	69.62	67.22	67.50	66.29	63.80
United Kingdom <sup>b</sup>	70.42	70.73	67.86	64.40	63.70	62.96	62.59
United States <sup>b,c</sup>	47.37	47.27	46.39	46.11	45.12	44.57	41.65

<sup>a</sup> Bank loans to corporations as a percentage of the sum total of bank loans plus short- and long-term securities issued by corporations, percentage for annual averages. – <sup>b</sup> First quarter averages. – <sup>c</sup> Excluding mortgage credit.

Source: Bank for International Settlements. 73<sup>rd</sup> Annual Report 2003, Graph VII.12, p. 131; <http://www.bis.org/publ/arpdf/ar2003e.pdf>.

The pattern of German corporate financing, in which loans from domestic banks, along with trade credit, traditionally used to dominate, is changing of late. Enterprises today obtain more capital in the marketplace than they used to.

A main reason is that the European Monetary Union has made bond issues more important as a source of corporate financing. The extended market has increased the potential for placing bonds issued by private non-banks. Moreover, there is a growing tendency on the part of German enterprises since the mid-1990's to obtain funds through affiliates abroad. Between the end of 1995 and the end of 2001, domestic enterprises' debt with foreign affiliates increased by around 270 bill euro. During the same period, domestic banks' total lending to domestic enterprises grew by 245 bill euro. The reason for this drift is that financing within groups is handled centrally and that, given the growing number of international mergers, a sharp increase in intra-group flows of funds is the resulting consequence. Financing advantages that an individual group can enjoy within a certain market and tax advantages are exploited. Around 35 per cent of domestic enterprises' total debt with foreign affiliates is accounted for by offshore-affiliates in another European country (The Netherlands Antilles, for example).

There is further fear that the implementation of the Basel II accord as it stands will pose a great threat for the survivability of small and medium-sized enterprises. The proposed internal and external ratings put a greater emphasis on financial ratios rather than on the soft facts which are very decisive factors particularly for small and medium-sized enterprises. Consequences range from worsening ratings to a rise in credit costs. Moreover, the proposal for Basel II is based more on Anglo-American economic and financial structures where credit financing is much less important than in Germany. A rise in costs of financing will therefore have a significant impact on the competitiveness of German small and medium-sized enterprises. This, in turn, would have detrimental effects on many of the banking institutions in Germany.

## **The Approach to Corporate Governance**

Another distinguishing feature of the German banking industry is that commercial banks generally hold equity of firms and thus have capital locked-in in industrial holdings. They play a vital role in corporate governance.

*Bank ownership of firms.* Banks own 13.5 per cent of the shares of the enterprise sector in the late 1990s (Table 5); this share has increased in the 1990s. Moreover, there are cross holdings between the three different groups of intermediaries, banks (monetary financial institutions), other financial institutions and insurance companies. Banks and insurance companies together own 22.5 per cent, nearly a quarter of the shares of the enterprise sector (Table 5). While it is not too surprising that insurance companies hold part of their portfolio in stocks, the case of banks is more unusual. After all, banks should be in the business of debt financial intermediation rather than equity investment. Stock held by banks was and still is used as a lever for banks in their ‘relationship banking’ generating a large amount of loan business to the banks. As predominant providers of capital, it is interesting for the banks to be represented on the boards of firms, giving them permanent contact with their credit customers, enabling them to collect information necessary for extending credits and to actively take part in the corporate governance of firms and thus indirectly controlling their credit risk.

Table 5: Ownership structures of shares in Germany and the United States (1990s)

		Germany		USA	
		Beginning	End	Beginning	End
Non-financial sector:		62.1	47.8	50.8	41.9
	Companies	41.6	29.3	- <sup>a</sup>	- <sup>a</sup>
	Individuals	16.9	17.5	50.8	41.9
	Public authorities	3.6	1.0	0.0	
Financial sector:		25.8	36.1	41.7	49.6
	Banks	10.3	13.5	5.4	3.4
	Insurance companies	11.2	9.0	5.0	6.0
	Pension funds			24.2	24.0
	Investment funds	4.3	13.6	7.1	16.3
Foreign		12.1	18.5	6.9	7.3
Other				0.7	1.1

<sup>a</sup> For the US, share ownership is included under the heading 'other'. Therefore the total of non-financial sector is incomplete. Given the small amount this is probably not an important incorrectness.

Source: Van der Elst (2001)

*The two-tier structure of control and management.* German corporate governance is characterized by a relatively small reliance on capital markets and outside investors, but rather on large inside investors and financial institutions in order to achieve efficiency within the corporate sector. Unlike the Anglo Saxon model of a board of directors who direct the company, manage the business and represent the firm, the German two-tier system of corporate control, which dates

back to the late 1800's, distinguishes between the supervisory board (*Aufsichtsrat*) and the management board (*Vorstand*). The supervisory board is the controlling body of a company. More specifically, it controls the management board, which is the operating arm of a stock company and elects its members. The supervisory board has an insight into all accounts and a veto for businesses where its consent is necessary. Additionally, the management board has to inform the supervisory board of ongoing and planned businesses. Furthermore, the supervisory board has the competence to set the By-Laws unless the statutes are defined by the shareholders' meeting.

The management board is the directing organ of the company. It is to manage the business, especially day-to-day business, in the best interest of the company and represents the company in its business dealings and legal affairs. In a sense, the management board directs the company under its own responsibility.

The shareholders meeting has ultimate rights of control. It can change the charter, decide on dividends and usually has to approve the actions of both boards ex post by a vote of confidence. Additionally, the shareholders meeting elects a part of the supervisory board; in this election, the management's board proposal is usually followed.

This system of corporate governance is an insider control system. The supervisory board members are generally well informed of what is happening within the company and are able to influence the management board, partly by virtue of their membership of the supervisory board, and partly by other means. They must therefore be 'insiders'. In practice, the members of the supervisory board end up with many board mandates and usually a major day-job as well,

often resulting in a lax “Duty of Care” and conflicts of interest in the “Duty of Loyalty”, the essence of board responsibility.

German banks exercise control in the supervisory board of companies where they are represented on the capital side of the supervisory board, whereas labor fills the other side (see another forthcoming working paper). To have a seat in the supervisory board does not necessarily require that banks hold proportional equity of a company. Bankers tend to be elected to the supervisory board due to their comprehensive information on other firms, corporate trends, the political scene and international developments. For example, Deutsche Bank, Dresdner Bank and Commerzbank held around 16 per cent of approximately 231 positions reserved for stockholders on the supervisory boards of the 24 non-financial companies comprising the German stock market index DAX30. Banks therefore have a substantial influence over the exercise of voting rights in publicly held stock corporations. Moreover, they have additional voting power in the shareholders’ meeting via proxy voting by acting in part of the votes of their bank customers in cases when the voting behavior is often not specified by the customer. Banks have conflicts of interests in their role, as equity holders, creditors, advisors, underwriters and fiduciaries, all at the same time. Furthermore, banks have a strong influence on non-incorporated firms if these firms use the bank as their house-bank for credits.

*Cross holdings.* Equity held by banks and insurance companies creates a network of cross holdings between the financial and the non-financial sector. Like spiders, the larger banks and the larger insurance companies are sitting in a delicate and complex cobweb of holdings, so that the firms of the industrial sector and of the service sector are intertwined with the financial sector. These interdependencies are even further intensified if the other financial institutions, e.g. the investment funds, are interrelated with banks or insurance companies as

well, as is the case in Germany (Figure 1). In the 1990s, these cross holdings between the three different groups of intermediaries have increased so that the different groups of financial institutions have become progressively interlinked. This results from mergers and acquisitions as well as the spinning off of subsidiaries to form jointly-owned operations. In the first decade of the 21st century, equity holdings of banks are coming down, with banks actively reducing their holdings in non-financial firms.

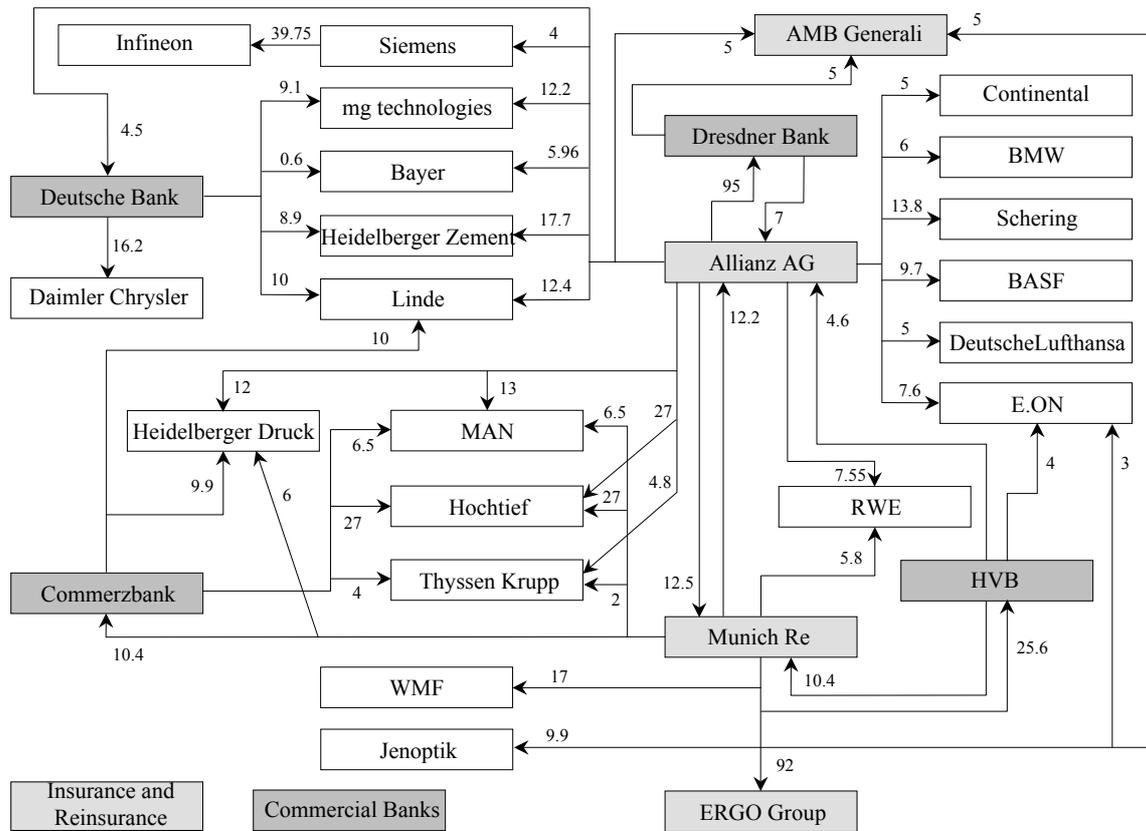
In addition, it has been customary for major German corporations in the past to own large blocks of each others shares. Within the non-financial sector, German corporations held about 30 per cent of the shares of other corporations at the end of the 1990s (Table 5). Many of those cases are either subsidiaries of multinationals separately incorporated in Germany (such as Ford, Alcatel, Nestlé or Pirelli) or other acquisitions in the process of formation of industrial groups that have not led to full mergers (e.g. VW's Audi) or the inverse case of establishing new business lines that are independently incorporated, such as the do-it-yourself chain Praktiker of retail giant Metro or Siemens' Infineon spin-off. Note that most of these holdings do not represent cross holdings in the strict sense, but are hierarchical holdings. Explicit cross holdings can be found on the level of medium-size enterprises where cross ownership refers to ownership titles not listed on the stock exchange. They also refer to joint family ownership. On a more personal level, it is common practise for German industrialists to be in the supervisory board of a number of other non-competing corporations. These cross holdings create the picture of Germany Inc., where important decisions are supposed to be informally coordinated. It must be noted, however, that the ratio of cross holdings without the financial sector has come down considerably during the 1990s from 41.6 per cent to 29.3 per cent. As a result, actual figures of the cross holdings such as Figure 1 differ considerably from

illustrations of the early 1990s.<sup>16</sup> It should also be noted that corporations trade their blocks of shares among themselves; this is a substitute to the market, but again not an open market.

Cross holdings effectively reduce the already low stock-market capitalisation that remains for the market participants other than cross holders even further. When adjusted for the substantial amounts of cross-holdings, the free stock market capitalization in Germany, open to the market participants, is only at 14 per cent of GDP instead of 67, much lower than 48 per cent in the United States and 81 per cent in the United Kingdom (Boehmer 1999).

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<sup>16</sup> Compare for instance for the year 1993 Story and Walter (1997: 184).

Figure 1: Important cross holdings in Germany in per cent of equity, 2002<sup>a</sup>

<sup>a</sup> End of 2002; HBV: HypoVereinsbank.

Source: Germany's Top 500 – Edition 2003. A Handbook of Germany's Largest Corporations, published by F.A.Z.-Institut für Management-, Markt- und Medieninformationen GmbH, November 2002; Bloomberg Information Service, Querries N200 Equity DES and dgp Equity PHDC as of November 8, 2003; and Die Deutschland AG, *Wirtschaftswoche*, 19/2002: 48

*Block holdings.* Cross holdings of banks, other financial institutions, insurance companies and corporations involve a high concentration of the ownership of large firms. Together with a substantial deviation from the 1 share- 1 vote paradigm by way of preferred stock<sup>17</sup>, block holders commanding many votes

<sup>17</sup> Preferred stock allowing multiple votes is a pertinent feature of the legal environment in Germany. The stock corporation law does not permit the issuance of such shares today, but firms that have issued such shares have not been forced to convert them into ordinary shares. Shares of preferred voting stock are not traded at the stock exchange.

tend to dominate or control companies where a block holder appointed board is in control. In the majority of listed companies in Germany, there is a single voting block commanding more than 50 per cent of the votes; in more than 80 per cent there is a single voting block with a blocking majority, i.e. of more than 25 per cent of the votes (Table 6). Large block holders – often heirs to the founding industrialists - and banks control a substantial portion of exchange-listed firms, while the role of smaller shareholders in influencing corporate governance is negligible.

Table 6: Majority control and blocking majority (2000)

	Per cent of listed companies under majority control	Per cent of listed companies with a blocking majority of at least 25 per cent
Austria	68	86
Belgium	65.7	93.6
Germany	64.2	82.5
Italy	56.1	65.8
The Netherlands	39.4	80.4
Spain	32.6	67.1
Sweden	26.3	64.2
UK	2.4	15.9
Nasdaq	2	5.2
NYSE	1.7	7.6

Source: Country chapters in Barca and Becht (2001)

*The issue of control.* The German system gives power to the block-holders and to the managers. Thus, large block-holders have incentives to maximize the value of their shares. Whether this involves maximizing firm value depends on the degree to which they can extract transfers from small shareholders. German law (*Aktiengesetz*) allows sizeable transfers to block-holders once a coalition owns at least 75 per cent of the votes. Another issue and an open question is whether managers are sufficiently controlled; they can form an implicit coalition with large block-holders. Last but not least, cross holdings represent political power. Supervision of the banking sector may be harder, and it may be more difficult for the government to instigate structural adjustment of the economy if cross holdings represent an implicit organization of vested interest. To control the political power of that system by introducing another vested interest - the trade unions - into the supervisory board, leads further away from the market process (see another forthcoming working paper).

### **The German versus the Anglo-Saxon System**

Similar two-tier systems of corporate governance as in Germany are in place in Austria and Italy and, for large stock corporations, also in the Netherlands and in France. In contrast, the unitary board system is internationally the most applied structure. Besides in the United States and the United Kingdom, it can be observed in Canada, Belgium, Denmark, Greece, Japan, Sweden, and Spain and, for small stock corporations, also in the Netherlands. In this system, the board of directors directs and represents the company while simultaneously managing the business. It draws up the goals and strategies of the company and elects and controls the officers. It also decides the appropriation of profits and informs the shareholders. Additionally the board of directors has the right to set and change the by-laws. Moreover, it has a trustee-function in the interests of the shareholders. In fact, it has to control itself. To a large extent decisions are made

autonomously by the board of directors. The board of directors consists of inside directors and outside directors. The shareholders meeting elects the members of the board of directors based on nominations from the board, and sets and changes the charter of the company. In extraordinary situations such as a merger or the dissolution of the company, the shareholders meeting is in charge of decisions to be made. As the control of the shareholders meeting is limited, there is a strong focus of power with the board of directors as a whole. Within the board of directors, power is concentrated with the inside directors who can direct the information flow to the outside directors and who have to propose the outside directors for election to the shareholders meeting. Additionally the committees mostly consist only of inside directors.

It is heavily debated in the economics literature whether the Anglo-Saxon system with its strong reliance on the equity market or the German model of corporate control, with banks, block holders and personal contacts, is more efficient. (Holmstrom 1999, Hopt 1999, Mayer 1998)<sup>18</sup>. Leaving aside the question of workers' participation, which will be discussed in another forthcoming working paper, the issues are how strongly management is controlled and how flexible the system responds to changed economic conditions, given that the information provided by the capital market is deliberately distorted.

The Anglo-Saxon system concentrates power in a small group of people and bears a low potential for conflict enabling decisions and their implementation to be made quickly. This ability to adapt quickly to changing conditions supports the competitiveness of a company and the professionalism of the members of the board of directors, unless they are not alert as – to quote Sherlock Holmes - the dog that didn't bark in the night. At the same time, it has a low explicit

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<sup>18</sup> For the view that the relative merit of the two systems is undecided, see Becht, Bolton and Roell (2002:112).

institutional control of the management, relying on the threat potential of the capital market, i.e. the threat from inefficiently managed companies to be taken over, as a decisive mechanism of control.

The German system of control has been called a passive form in the sense that unfavorable developments are prevented. As a form of corporate governance, this may allow a necessary longer-run orientation of firms and may therefore have its advantages. One of the shortcomings of the German system is, however, that it is geared to the incumbent firms and not to the uncertain terrain of the new firms. It is amazing that Germany has managed to solve its structural adjustment mainly in the existing firms, and not by new firms. Indeed, there are only a very few examples that new firms have gained eminence in the German economy. The German approach to corporate governance may be good in marginal improvements, but it is deficient in leapfrogging to new approaches and new products. Incremental technological improvements along established lines, mainly in the export-oriented automobile, machine building, chemical industry, and electro-technical industry are therefore typical for the German industry. In contrast, there was a more remarkable restructuring in the corporate sector of the United States, where the equity markets have forced management to restructure (Holmstrom 1999, Mayer 1998). In Germany, as on the continent, management has greater freedom not to restructure. The block holder model is not good in Schumpeterian innovations, i.e. in major technological breakthroughs. The contention that the Anglo-Saxon system is oriented to the short-term, lacking a long-run orientation, is not backed by the literature.

Another disadvantage of the German approach is that new market solutions such as a functioning venture capital market have more difficulty to develop in an environment that is characterized by intermediated products and by personal

informal relationships.<sup>19</sup> This has negative implications for the financing of new innovative, but risky technologies. Moreover, the commercial banks, savings banks and cooperatives tend to shy away from financing large risks. They are more comfortable with incremental changes. R&D funding of the private sector typically comes from retained earnings, which is a means more plentifully available to established firms with a relatively constant cash flows. In Germany, it has been decried as a destructive short-termism of Anglo-Saxon provenance that firms should be oriented to creating “shareholder value”. What has been given little attention, however, are the severe incentive problems that come with giving creditors an eminent role in corporate governance inviting them to disrespect the interests of the company’s owners and judge investment decisions mainly under the aspect of maintaining the firm’s ability to sustain interest payments. This problem is compounded by German accounting standards that have traditionally espoused a creditor-bias. Accordingly its principles are utmost caution and lowest considerable value rather than the “true and fair view” that Anglo-Saxon accounting standards take as guiding line. It is on these principles that huge asset under-valuations and low market capitalisations flourish. In addition, being in the double role of shareholder and creditor creates a major problem for the German banks themselves. It is likely to expose them to the accumulated risk that make them more prone to adverse economic developments that hit the value of both their credit and stock portfolio. This constellation may actually help to explain the severe baisse of German financial stocks in 2002 and 2003.

An important prerequisite of a governance system for the enterprise sector through the capital market has come to light in the context of the Enron scandal in 2001 and similar cases in the United States in 2001.<sup>20</sup> To use the capital

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<sup>19</sup> <sup>19</sup> The venture capital market has improved.

<sup>20</sup> Compare also the Parmalat case in Italy in 2003.

market as an instrument of control, presupposes that the information processed by the market on the firm's assets and liabilities is reliable. When assets are overvalued and liabilities underreported, i.e. when fraud is possible, the capital market cannot fulfill its controlling function. The supervision of the financial market, guaranteeing transparency and accuracy of financial accounting of publicly traded companies, as intended by the Sarbanes-Oxley Act of 2002 in the United States, is therefore an important prerequisite of the governance of firms.

The German system is changing. The close relations brought about through cross-holdings previously enabled the country to keep foreign competition at bay. As financial markets have grown together, national markets are no longer isolated. A better stock market culture is developing; households have more options for their savings. Quoted companies raise finance internationally, and German stock corporations are in direct competition with demands for capital worldwide. The shareholder structure is becoming more international; several major German companies are now listed at the New York Stock Exchange (e.g. Deutsche Bank, DaimlerChrysler) and have to satisfy the transparency demands that listing entails. A recent law has allowed major listed companies to move to International Accounting Standards for their annual reports, reducing balance sheet reserves creation and creditor bias. The influence of foreign institutional investors and of their expectations is growing. The internationalization of share ownership will eventually change the German block holder model. New regulations of the European Union referring to the take-over of enterprises will also push back preferential arrangements that favor block holders, albeit with quite a few safeguards in the final agreed text of the takeover directive. Moreover, block holding seems to dominate in Germany due to the fact that share owner representatives are more powerful in bargaining with employee representatives on the supervisory board than if they had dispersed votes. Thus,

changes in codetermination may reduce the incentive to have block building. Under conditions of increased globalisation, the large financial concerns increasingly have come to regard the permanence of the German structure as a straightjacket. The tax reform that became effective in 2002 relieves the seller of any capital gains taxes on the sale of these cross-holdings. The reform took away the implicit incentive for banks, insurance companies and corporations to have holdings and to keep their balance sheet reserves under seal. For this reason, larger banks and insurance companies have been selling-off some of their holdings and reinvesting the proceeds in their core businesses. Moreover, the central institutions of the savings banks and the savings banks themselves will lose their public guarantees.<sup>21</sup>

More importantly, the trend is towards international competition.<sup>22</sup> The German model relies on the banks as controlling agents. However, the banks themselves are under international pressure to change and, given their comparatively low market valuation, also face a serious threat of being taken over. How they deal with this challenge, will also play a deciding factor in what the future will hold for the German model. In addition, there is the issue to which extent the German nature of codetermination can survive under global conditions. In the end, only the market process will tell which model is viable.

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<sup>21</sup> Krahen and Schmidt (2004:497) do not find a clear evidence that the German system has changed into a market-based system.

<sup>22</sup> On the issues see European Commission (2002) and Becht, Bolton and Roell (2002). On an interesting taxonomy with respect to the superiority of one of the institutional approaches for the banking industry, albeit without the question of codetermination, see Krahen and Schmidt (2004: 498).

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