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Functional Change and Bank Strategy in German Corporate Governance

Dwight B. Crane [a,1], Ulrike Schaede [b,*]

[a] *Harvard Business School, United States*
[b] *University of California, San Diego, Graduate School of International Relations and Pacific Studies, La Jolla, CA 92093-0519, United States*

Abstract

This paper analyses changes in the German corporate governance system in the 1990s, using a functional perspective that separates the functions of governance from the institutions that perform these functions. Financial globalization, harmonized legislation within the European Union, and domestic pressures have triggered a move away from the postwar German system of bank-based governance, and towards more market-oriented processes. The paper shows that these forces have resulted in heightening transparency, more active capital markets, and a greatly reduced role of banks in the governance process. However, Germany's 2002 boycott of EU takeover legislation has created a void in the current governance system: because bank intervention and the market for corporate control are substitutes, a reduced role of a banks and protective takeover legislation mean that one important governance function is currently underserved.

Keywords: Corporate governance reform; Germany, EU takeover code harmonization; Functional perspective

1. Introduction

The corporate governance system of a country determines the set of institutions that are entrusted with the process of monitoring firms, by either inducing or forcing management

* Corresponding author. Tel.: +1 858 534 2357.
E-mail addresses: dcrane@hbs.edu (D.B. Crane), uschaede@ucsd.edu (U. Schaede).
[1] Tel.: +1 617 495 6679.

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to internalize the welfare of the firm's stakeholders.[2] Each country's system is an outgrowth of interrelated factors, including the nation's culture and history, its legal and regulatory framework, and economic structure. Because these vary markedly across countries, a wide variation in systems of corporate governance has emerged over time. However, beginning in the 1990s, globalization of financial and product markets as well as political integration have created pressures for system change, leading some scholars to advocate theories of convergence of governance systems (e.g. Berger & Dore, 1996; Hansmann & Kraakman, 2000).

Yet, when studying single countries in this context, one finds significant resistance to system change and convergence, and a rather complicated reform process (e.g. Ahmadjian, 2003; Charkham, 1994; Gourevitch, 2003; Hopt, Kanda, et al., 1998). An increasing number of scholars, while seeing room for reform and change, now doubt that full convergence will happen. For instance, Bebchuk and Roe (1999) contend that each country's approach to governance is path-dependent, evolving from its history and rules of ownership structure. Because their components are interrelated, systems of corporate governance are highly resistant to change, and to the extent change occurs, it still leads to enduring differences across countries. Gilson (2000) agrees that the formal structure of a governance system is quite resistant to change, but argues that administrative processes can be adapted to some extent; the result of administrative reform he labels "functional convergence".

Adding to the discussion of legal and institutional processes, Milgrom and Roberts (1994) have introduced the notion of system complementarity: system elements are interrelated, so that the effectiveness of one institution or process depends on other parts of the system. Complements are those features whose functionality triggers improved benefits from other system features but that also depend in their performance on other system features to function well. Complements lead to system inertia, since reducing the role of one feature means reducing the effectiveness of other parts of the system.

System complementarity may make change impossible, except through exogenous, traumatic trigger events. Historic examples of such exogenous shocks include WWII and subsequent reorganization in Germany and Japan, or the Asian financial crisis that led to fundamental reforms in Korea. The US, representing one of the world's prominent systems of corporate governance, experienced its own shock in 2001, when the failure of Enron brought to the fore large-scale and systemic regulatory transgressions. Yet, while scandals suggest cracks in a corporate governance system, they speak more to hubris than complete system failure. Regardless, the focus of the corporate governance debate has since shifted, once again, to the possible validity of alternative systems (e.g. Dore, 2000).

This paper sheds additional light on this ongoing debate of system change and convergence by introducing and analyzing the case of Germany. We use a functional perspective of corporate governance and present data that highlight where change has occurred, matched

[2] Tirole (2001) suggests this generic definition. Narrower ones include that of Shleifer and Vishny (1997), who argue that the specific function of corporate governance is to protect providers of capital such that they receive an adequate return on their investment.

with an account of recent legal reforms and institutional changes. We address three questions: (1) Is the German financial system indeed moving away, as some claim, from a bank-dominated system to one in which capital markets play a significant role for large companies? (2) If such a change can be demonstrated, has there been a concurrent reform in the corporate governance system, away from the banks and towards a more market-based system; i.e. is there convergence? And finally, (3) if there is an observable systemic change in German corporate governance but maybe not full convergence, what can be said about the evolving system as a new model?

Germany is an important test case for convergence, because it has long represented a distinct corporate governance system. Between the 1950s and the 1990s, large German banks played a central governance role by combining superior access to information about corporate customers through ownership stakes with their role on supervisory boards and their voting of shareholder proxies. Three major thrusts for change began to challenge this system in the 1990s: (1) the globalization of financial markets, creating an external pull towards markets; (2) the economic and political integration of Europe, resulting in an external push for institutional and legal change; and (3) the results of sustained domestic economic growth, i.e. affluence, creating an internal push towards markets. The confluence of these three forces in the 1990s constituted a serious challenge to the traditional structure of Germany's system of corporate governance.

To address the core questions of this paper, we analyze how these three forces for change have coincided to affect the strategies of large banks, and thus the country's corporate governance system. In particular, we shed light on the important role played by substitutes, a concept that has received insufficient attention in the corporate governance literature. Substitutes are the opposite of complements. Whereas an increase in a complement makes an increase in other governance factors more valuable, an increase in a substitute makes other governance features less important (and a decrease in a substitute simply requires increased performance of other features). Thus, while complements make change difficult by requiring concurrent reforms across the entire system, substitutes can be replaced by strengthening other functions of a governance system, thus simplifying the reform tasks.[3]

Our analysis focuses on the big banks and large firms, because we are interested in the governance implications of the shift away from bank-centered finance, which are most meaningfully studied for large, public corporations. Small- and medium-sized enterprises often have high levels of family ownership, and while they may eventually experience similar changes, they are likely to continue a high dependence on bank loans in the intermediate future.

We begin with a brief description of the functional perspective of corporate governance that frames our analysis. We then provide an overview of the traditional bank-centered German system, and how it structured banks' incentives to assume lead roles in corporate governance. Next we outline the developments that have combined to form the three forces for change, and highlight their most important ramifications. We provide data to show how legal and institutional reforms have caused bank strategies to change. Change is an ongoing process; our analysis extends through early 2003.

[3] For an analysis of complements and substitutes in the Japanese system of corporate governance, see Schaede, Hoshi, and McMillan (1997).

2. System change in corporate governance

We propose that the change process is best analyzed based on a functional perspective, in which the specific functions of corporate governance are separated from the institutions that perform them. The underlying functions of corporate governance, such as protecting the providers of capital, are stable over time and across geographic boundaries, but the institutional arrangements for performing these functions can vary considerably in different environments or over time. Thus, an analysis of change should focus on assessing variations in the processes through which the main functions of corporate governance are delivered. In this section, we introduce this model and operationalize it by determining expected areas of change.

2.1. A functional perspective of governance

Effective corporate governance systems perform three key functions.[4] The first is to protect the interests of the providers of financial capital and other resources, and to resolve conflicts among those interests. This protection assures the efficient flow of goods and services to business firms, in particular from creditors. A second function is to provide ways to manage problems stemming from inadequate or incomplete information. Given managers' superior information about the firm's condition and prospects, well-functioning governance systems must ensure information flow and manage problems that result from asymmetric information, such as adverse selection. The third governance function is to monitor and influence the performance of firms and their compliance with rules of behavior. When companies are mismanaged and underperform, mechanisms are needed to recognize the problem and take corrective action.

These basic functions are carried out by various institutions, which can be grouped into four major types: (1) boards of directors, protecting the interests of constituencies and monitoring the performance of managers; (2) banks and other financial institutions, gathering information as part of their credit management process, structuring financial contracts that constrain company behavior, and monitoring performance; (3) information intermediaries, such as accounting firms, securities analysts and rating agencies, improving the flow of information to outside providers of resources; and (4) laws and regulatory bodies (including government agencies, legislators, and self-regulatory organizations), establishing rules and monitoring compliance.

The role of these institutions varies considerably from country to country. Fig. 1 illustrates important differences across the three major corporate governance models. The most common model is the business group-based system of corporate governance. In some countries, business groups are organized around families, while elsewhere they might pivot around a bank or a large industrial enterprise, or a combination thereof (e.g. Granovetter, 2004). While there is tremendous variation among business groups, the focus in their governance is on protecting the interests of stable, inside shareholders. This is often cemented in extensive

[4] This framework has its roots in a functional perspective of the global financial system; see Merton (1995) and Crane, Froot, Mason, et al. (1995). The Global Corporate Governance Project at the Harvard Business School has extended this functional perspective to systems of corporate governance.

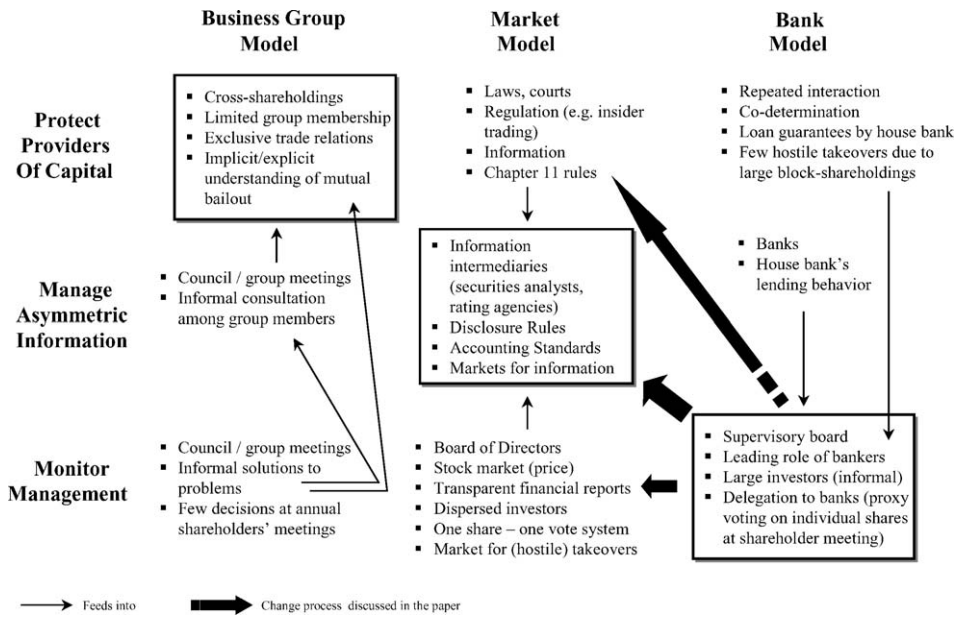

Fig. 1. Structure of corporate governance models.

cross-shareholdings across group members, and supplemented by group council meetings and mutual trade relations.

The second category is the market model, represented primarily by the US and UK. This is based on companies meeting investors and creditors in public financial markets. Because investors and creditors typically have limited information about the company, the focus of governance is on information intermediaries and disclosure rules—i.e. a market for information that underlies the financial markets. The country's legislative and regulatory focus is this market, by improving the flow of information to outside shareholders and protecting their interests. Rules emphasize disclosure, transparency, and standardized accounting practices, and these are implemented and maintained by a large legal profession and a well-established court system.

The third model is that of bank-based governance, where the focus is on supervising management. Banks have superior, in-house information on their loan clients and play a major governance role, and their behavior is interpreted as signals for action by outside investors. A prime example of such a system is Germany, where banks have traditionally played an important role as board member, information provider, owner and lender. In a bank-focused system, the "market for information" is internalized and integrated in a number of financial services offered by the bank. Other information intermediaries remain secondary, and the country's regulatory system focuses on bank supervision while supporting the dominant role of banks.

In transaction cost economics terminology, the bank-focused system creates information within the hierarchy (it is built inside the bank, which considers information to be asset-specific and critical for diverse bank activities), whereas the market-focused system

provides information in the market (it can be bought, because its properties are considered generic). Accordingly, a transition from a bank-focus toward a market-focus requires the development of a market for information, and the appropriate supervisory regulation to monitor this market.

2.2. Analyzing system change in Germany

None of these governance models exists in a pure form, and all systems are constantly under pressure for change at the margins. In the 1990s, however, pressure accumulated to touch the core logic of the bank-based model, through globalization of financial markets and advances in financial technology, regulatory changes, and changes in information tools and the distribution of information.

The basic insight offered by the functional perspective is that a system of corporate governance will work as long as all three functions are adequately provided, regardless of the institutional setup. Institutional differences across countries may translate into different emphasis on one function over another, but not necessarily into "better" or "worse" systems, so long as all three functions of governance are performed. However, in shifting emphasis among the specific institutions of a corporate governance system, it is important to differentiate among complements (mutually enhancing properties) and substitutes (replaceable properties). For example, in a universal banking system, such as Germany's, system change can occur if an evolution in bank strategy leads to a different or reduced role as information intermediaries, so long as the market for information develops, supported by a shift in the regulatory environment.

Beginning in the 1990s, Germany has been subjected to three forces for change: EU rule harmonization, globalization of finance and a subsequent diversification of large firm refinancing options, and changes in investment attitudes by increasingly affluent domestic households. The question of this paper is whether these forces are truly pushing Germany towards a more market-based system. The functional model, as sketched in Fig. 1, suggests three large directions of change, that combine in a shift away from the focus on direct management interference through banks, and towards more emphasis on information and monitoring. The three "change arrows" suggest three areas that can be quantitatively and qualitatively analyzed:

(1) *Disintermediation and growth in the market for corporate control*: As large companies see new options in external financing, they can diversify their sources of funding. Evidence of this can be found in a decline in bank loans in the external financing of large firms, and a growing use of market instruments such as bond and stocks. This in turn should result in a growing number of firms listed on stock exchanges. Concurrent with the shift toward direct financing by firms, we should observe a shift in investment strategies by households, away from savings deposits and life insurance contracts, and towards equity, bonds, and investment funds.

    Moreover, as large firms diversify their sources of funding, they become subject to the forces of the bond and stock markets. This should lead to an increase in mergers and acquisitions and a decline in stable and block shareholdings, as corporate ownership becomes more disperse.

(2) *The development and growth of a market for information*: For companies to raise funds directly on the market, they need to disclose more information to potential investors in a globally accessible form. A shift towards more market-based transactions requires a shift towards more detailed accounting information, and an increase in the activities of information intermediaries (e.g. banks' research departments, credit rating agencies, etc.). At the same time, the market for information has to be supervised based on new rules and new institutions that are different from the previous system of banking supervision. Thus, change in this area would manifest itself in substantial legal reforms towards a market for information.

(3) *Decline in banks' direct involvement in corporate governance*: The previous two propositions imply a decline in the role of banks in corporate governance; however, it is possible that banks attempt to maintain their roles, either by adapting their own processes and strategies, or by attempting to frustrate new entry into the corporate governance system. Measurable indicators of change in banks' governance strategies are: (a) a decline in the number of bankers among members of the supervisory board; (b) a decline in majority ownership in large companies, as banks diversify risk given their diminished control over their clients; and (c) a decline in large bank activity in the system of proxy voting (as explained in Section 3).

These three broad areas of system change and their expected manifestations lay the ground for our analysis.

3. The German corporate governance system until the 1990s

3.1. The banking system

Between the 1950s and the mid-1990s, the German banking system had three distinctive features that resulted in a special dynamic. First, all banks were universal banks; i.e. by law they could offer the full array of commercial and investment banking services. Thus, the banks' strategic decisions rather than government restrictions determined how corporate finance evolved over time. Second, while consisting of several categories, the financial system was dominated by the "three big banks" (Deutsche Bank, Dresdner Bank, and Commerzbank) (see Table 1). While these three banks played pivotal roles in Germany's political economy, their total share of the domestic deposit market was relatively small. Initially, this was due to a division of labor with cooperative banks (*Volksbanken*) and publicly owned savings banks (*Sparkassen*). These smaller banks focused on household savings and loans to local small-sized companies (*Mittelstand*), which were large in number and of significant economic relevance.[5] Most *Mittelstand* companies were privately held and often family-owned.

[5] The regional central institutions of the *Sparkassen* were the *Landesbanken* ("LB", state banks). *Sparkassen* transferred their surplus funds to the LBs, which were originally in charge of running the finances of the state governments. Over time, the LBs entered all types of banking business, and began to engage in head-on competition with the large commercial banks. See Beckmann (2000).

Table 1
The German banking system (as of June 1999)

Bundesbank
Federal Banking Supervisory Office
(1) Commercial Banks (285)
4 big banks
199 regional and other banks[a]
82 branches of foreign banks
Total balance sheet volume of DM 2755 billion
(2) Public Banks (597)
DGZ—*Deutsche Girozentrale*
12 *Landesbanken* (state banks)
584 *Sparkassen*
Total balance sheet volume of DM 3814 billion
(3) Cooperative Banks (2187)
DG Bank
3 "central" (regional) institutions
2183 cooperatives
Total balance sheet volume of DM 1423 billion
(4) Specialized Banks (74)
Mortgage Banks (32, DM 1548 billion)
Building Societies (*Bausparkassen*, 34, DM 140 billion)
Banks with special functions (8, DM 616 billion)
For example, KfW, *Reconstruction Loan Corporation*

[a] As of 1/1999, this category includes the former "private banks" and the *Postb* and AG. *Source*: Deutsche Bundesbank.

Third, over time fierce competition evolved among the three groups of banks. Although originally markets were rather segmented, banks began to compete head-to-head in the 1960s, when the large banks entered retail banking. At the same time, as some *Mittelstand* companies grew, their banks grew with them and began to offer services similar to those of the big banks. By 1998, the three biggest banks represented only 14.6% of total domestic banking assets (Beckmann, 2000). This small market share, combined with the high fixed costs of an extensive branch network, eventually put pressure on profit margins and began to hamper the big banks' competitiveness in global banking.

Still, the big banks were central to large-scale corporate finance. Here they operated in an environment of limited competition, given the absence of independent investment banks. Through the early 1990s, a comparatively wide spread between corporate loan interest rates and consumer deposit rates made corporate lending the most profitable business, leading the banks to focus on loans rather than underwriting. Throughout the postwar period domestic bank loans typically accounted for over 50% of large firms' external financing (see Table 2).[6] The house bank system flourished while the bond and stock markets remained underdeveloped.

[6] Deutsches Aktieninstitut, *DAI Factbook*, May 2003, Table 03-9.

Table 2
External financing of German corporations, 1950–1990 (amounts in DM billion)

Year	Bank loans	Total external financing	Bank loans as a percent of total
1950	8.5	11.7	72.6
1955	11.3	19.2	58.9
1960	17.6	27.7	63.5
1965	27.3	50.3	54.3
1970	40.7	76.0	53.6
1975	29.1	65.3	44.6
1980	90.2	156.0	57.8
1985	69.7	122.5	56.9
1990	126.7	222.8	56.9

Source: Deutsches Aktieninstitut, *DAI Factbook*, May 2003, Table 03-9.

3.2. Corporate finance

Household savings and investment patterns were consistent with the dominant role of bank lending and small capital markets. The major portion of household savings went into standard savings accounts at banks and similar institutions.[7] This conservative investment philosophy was supported by tax incentives for bank savings plans and life insurance contracts. Accordingly, banks offered specialized savings products, such as insurance and mortgage savings, while alternatives for stock market investments remained limited.

Large corporations were typically organized either as privately held limited liability corporations (*GmbH*), or as public stock corporations (*AG*). Except for more strenuous legal requirements for establishing an *AG* and the possibility of trading *AG* shares on an exchange, there were no significant differences between the two corporate types. Tax rates, disclosure requirements and board representation rules were all based on company size rather than legal form. Traditionally, the vast majority of German firms were *GmbH*: In 1976, there were 2200 *AG* as compared to 60,000 *GmbH*, and in 1996, just 4000 *AG* were dwarfed by more than 500,000 *GmbH*. In other words, just 0.15% of German firms were publicly traded.[8] A big reason for this phenomenon was that most firms were parts of large "*Konzerne*", i.e. they belonged to or were subsidiaries of other companies that were stable owners or dominant partners with little interest in trading the company publicly.

Only the largest *AG* raised funds through active equity issues. Through the 1980s, the stock market remained limited with fewer than 500 listed companies (as compared to the over 5000 in the US). The trading volume of many stocks was very low, because many *AG* were owned by other firms in long-term, stable arrangements. Cross-ownership led to extensive corporate networks. One important example of such a network was that spun by Allianz Holding, which by 1999 held large portions of the two big banks, and was itself owned to a significant degree by these two banks. In addition, these three financial institutions also owned large shares of some of Germany's largest enterprises. Although companies were not obligated to report their cross-holdings until the late 1990s, according

[7] Deutsches Aktieninstitut, *DAI Factbook*, May 2003, Table 07.1-2. For details, see Table 3 below.
[8] Deutsches Aktieninstitut, *DAI Factbook 1999*, Table 01-4.

to one estimate, in the mid-1990s, 97% of all listed companies were part of a *Konzern* (Prigge, 1998).

With stock ownership heavily concentrated in large corporate networks, any attempt by a single shareholder to affect change in a company's management was certain to be frustrated. Management was further shielded from the forces of the stock market by the law, which allowed for various types of shares, each associated with special rights. Although by the 1980s the "one share one vote" system had become more common, the 30 largest firms all still had shares with differential voting rights. In particular, there were three ways to inhibit shareholders from exerting control through voting restrictions. First, the company could limit the maximum voting right of one shareholder to 5% or 10%, regardless of ownership. As late as 1995, 20 of the largest German corporations still had voting rights restrictions. Second, companies could issue shares that did not carry votes. For instance, by the early 1990s the Quandt family owned only 3.6% of the BMW AG, but this small portion of shares accounted for 45.6% of all votes. With every capital increase, the company could issue more non-voting shares, thus preserving the majority vote for the family. Finally, shares could be issued with trading limits, so that they could be sold only with the explicit permission of the issuing company. As a result of these limitations, takeovers were rare and hostile takeovers were impossible unless one was able to align several banks and other owners holding tradable shares with voting rights.

3.3. Corporate governance under the bank-led system

Given the limited role of the stock and takeover markets, corporate boards played an important role in corporate governance. Large German companies had two boards.[9] The management board (*Vorstand*) consisted of corporate executives, one of whom was the "speaker of the board", and for all practical intents and purposes the CEO. The management board was in charge of all corporate decisions, so much so that some labeled their situation a "monopoly" (Ulmer, 2001). The supervisory board (*Aufsichtsrat*) consisted of representatives of shareholders and employees. The proportion of labor representation was legally prescribed and differed by industry and company size; firms with more than 2000 employees had to have a 50% labor representation. When voting on issues that needed a simple majority, the chairman had two votes.

Co-determination gave labor a critical voice in board meetings, but over time it also influenced the working dynamics of supervisory board. In the largest firms, labor representatives were not firm employees but mostly union representatives. It was also difficult for shareholder representatives to discuss the pros and cons of management's plans in the presence of labor. Controversial issues were often negotiated informally prior to the board meeting to resolve diversity of opinion within the two groups and represent united fronts at the meeting. Critical issues were rarely discussed at the board meeting, which afforded the board chairman a particularly important role through informal input.[10]

[9] For details on the following summary account, see Hopt et al. (1998) and Schaede (1995).

[10] Ulmer (2001), and interviews with German executives, summer 2001. A famous German legal scholar was cited as complaining: "Nowhere in Germany is there as much lying and as much hush-hush as in the evaluation of the true effects of co-determination over time" (Zoellner, cited in Ulmer (2001, p. 162). An additional problem is

The legally prescribed responsibilities of German supervisory boards were much more limited than normal practices of US boards of directors, as they did not include discussions of management strategy. Instead, the law defined the board's authority narrowly to consist of: (a) approving the company's accounting statements for a specified period; (b) approving major capital expenditures, acquisitions or divestitures; (c) appointing (and dismissing) the management board; and (d) approving dividend payouts. Unlike in the US, German boards had no audit or compensation committees that influenced executive management decisions.

German law also prohibited any crossover in board membership; no corporate executive could be a member of the supervisory board, and vice versa. Combined with strict rules on information privacy, this meant that the board's access to corporate information was much more restricted than in the US. German rules also required less disclosure than international standards, and German companies were allowed to charge various reserves, such as pension reserves, against income, which provided some flexibility in the amount of reported profits. This made financials difficult to follow at times, which opened up a critical role to play for the house bank.

In addition to their superior access to financial information as major lenders, banks gained power in the governance system through three routes: (1) their seats on supervisory boards, often as chairman; (2) direct ownership; and (3) the proxy (depositary) voting system. Board data for the 100 largest firms in 1986 reveal that banks were represented on 75 supervisory boards, and in total held more than 10% of all seats; i.e. on average these largest companies had more than one banker on their supervisory boards. In 1992, of the 30 companies included in the DAX index (i.e. the largest publicly traded firms), 11 supervisory board chairmen and 25% of all supervisory board members were bankers (Prigge, 1998).

Overall, banks owned about 10% of outstanding equity of the major firms (Baums & Fraune, 1995). While this may seem low, most of these shares had unrestricted voting rights. The banks' influence was further enhanced through proxy voting on behalf of corporate and individual shareholders. Most investors held their shares in a custodial account with a big bank. Prior to a company's annual meeting, the bank mailed a proxy (or "depository") form to its clients, with its specified intentions. If an investor disagreed, she could ask the bank to vote differently. Most investors let banks vote as indicated, since it was the easier path and banks had better information. One observer has called proxy voting "the core issue of German corporate governance: unless they have full information, shareholders act rationally if they delegate their vote to the bank" (Wackerbarth, 2001). As a result, the three big banks, controlling the majority of custodial accounts, dominated the shareholder meetings: In 1992, banks represented an average 84% of the votes at the annual shareholder meetings of the 24 largest widely held companies (Baums & Fraune, 1995).

3.4. Bank strategy in a bank-led corporate governance system

Banks were clearly at the center of the German system, performing the three critical functions of corporate governance. As major providers of finance, they structured financial contracts and monitored companies over time. In their role on supervisory boards, bankers

that co-determination was never meant to be about monitoring management; in fact, when the supervisory board discusses issues of the management board, labor is expected to abstain (Ulmer, 2001, p. 163).

protected the interests of providers of resources, including their own, and helped resolve conflicts. Their superior access to information made banks the major information intermediary, obviating the need for independent information providers: a bank's evaluation of a company served as a proxy for a rating or market indicator. Consistent with the central role of banks, the regulatory system focused on banking supervision but remained comparatively underdeveloped on information disclosure and stock market regulation.

It is moot to speculate whether this system was optimal, but recent research suggests that it worked well. Wurgler (2000) demonstrates that the German system was effective in allocating capital resources to industries with high value added.[11] A study by Kaplan (1994) shows evidence of active monitoring, finding that management turnovers were driven by the same measures of weak performance as in the US. Finally, Gorton and Schmid (2000) show empirically that German companies with concentrated bank control have outperformed others over time.

In general, a country's institutional structures reflect its background and needs at a particular stage of history and development. After WWII, German industrial capital and production facilities were largely destroyed and the country faced reconstruction, at a time when households had little money to invest and were wary of anything speculative. In this setting, the German focus on banks provided a happy match for the various interests. Companies needed stable funding that would provide patient capital for highly leveraged plant and equipment investment. Given a general dearth of an educated workforce after 15 years of warfare, many companies also needed financial advice by their house bank. After the experience of the wartime economy, savers appreciated a stable banking system and enjoyed government tax breaks on a variety of bank saving plans.

Banks had an interest in keeping this system in place over the years. They had access to low cost household savings deposits and earned stable profits from the net interest spread between savings deposit rates and corporate loan rates, due to government policy that did not press for a more price-competitive environment.[12] This system put banks in a position to play an important role in corporate governance and posed incentives to perform this role effectively, as the banks' own assets were at risk in corporate loans. Because banks also had ownership stakes to protect, their interests were aligned with that of other shareholders. Further increasing the banks' motivation to be diligent in their corporate governance was the network effect: banks often held stakes in companies that were part of cross-shareholding concerns whose other members were also clients of the same house bank.

There were some costs for banks to bear as a result of their heavy involvement in corporate governance. In addition to senior management time and the costs of administering the proxy voting system, banks had to bear responsibility for companies in financial distress. Their lead position often made it impossible to walk away, even when the best action from a

[11] Wurgler (2000) uses as a dependent variable an elasticity measure indicating the extent to which capital investments flow to industries that have growing value-added and are withdrawn from industries with declining value-added, for the time period 1963–1995. He finds that Germany has the highest elasticity of the 65 countries in his sample, i.e. the biggest percentage change in capital investment for a given percentage change in industry value-added (the UK was ranked 10th, and the US 13th).

[12] Germany is not the only country that allowed or encouraged high lending margins. During much of the postwar period, for example, ceilings were imposed in the US on the interest rates that could be paid on household savings and transaction accounts.

pure lender's perspective was liquidation. On balance the benefits of the German system outweighed the costs, and banks sought to maintain their power in corporate governance during the postwar period.

4. Change in the 1990s

In the 1990s Germany's financial system was subjected to three concurrent forces for change which in combination challenged banks to reorient their strategies by initiating a process of legal and institutional change that continues as of 2003.

4.1. Pressures for change

4.1.1. Economic prosperity

In the 1990s, households began to demand more diversified financial options, beyond the traditional bank deposits and insurance contracts. In addition to an affluence effect, this was due to a generation change: in contrast to the prewar generation – who had lost their wealth three times, during WWI, in 1929, and during WWII – Germany's baby-boomers were interested in investment options with varying degrees of risk and return. The expected strains on the country's pension system caused by a rapidly aging population also encouraged some households to increase their own long-term equity investing. The German government encouraged this shift by privatizing several public companies, led by Deutsche Telekom, Deutsche Post and Deutsche Bahn (railroad). The Deutsche Telekom initial public offering generated significant interest and the stock performed well until the temporary halt of the worldwide telecommunication boom in 2000 revealed gross overinvestment in spectrum rights and foreign subsidiaries.

Bankers and other business leaders supported the public's interest in financial markets by backing the formation of The *Deutsche Börse AG* ("German Stock Exchange") as a private stock exchange in 1996, with an initial focus on futures trading and advanced clearing mechanisms. Deutsche Bank, a leading clearing institution in Europe, was a major shareholder and assumed chairmanship of the supervisory board. In 1997, the *Deutsche Börse* opened the *Neuer Markt* (NM), a new market segment for start-up IPOs with more stringent disclosure requirements than the main trading floor. Germany embarked on its own venture capital boom, and within three years of its creation, the NM noted its 300th listing. Although the segment was closed down after the burst of the venture boom in 2002, it has influenced the trading practices at *Deutsche Börse* by way of adoption of some of the NM's more stringent rules.

4.1.2. Globalization

The traditional reliance on bank loans changed with the arrival of international bond markets, new technologies allowing long-distance trading and real-time quotes, and financial instruments such as swaps. As leading German companies listed on the New York and Tokyo Stock Exchanges to attract international capital, they shifted to US GAAP or to International Accounting Standards (IAS) accounting, thus creating competitive pressure within Germany for more disclosure.

This, in turn, affected the profit dynamics of the big German banks in major ways. First, German companies could borrow in the international debt markets at rates lower than the banks could offer on their loans, squeezing the banks' interest margins in the loan business. Big banks had to shift their strategies toward investment banking, as they needed to be able to originate and place debt securities for their major clients. Second, because banks were also major borrowers in the international bond markets, they found themselves competing with their own corporate clients for funds in the same markets. Having to raise funds at low rates created pressure for banks to build strong balance sheets with adequate capital and high profitability.

The importance of adequate capital was heightened by the 1988 international capital adequacy standards, known as the "Basel Accord" or the Bank for International Settlements (BIS) standards. The Accord required banks engaging in international lending to maintain a certain amount of capital relative to the size and risk of loans and other assets. Thus, just when loan margins were falling, German banks had to boost profits in order retain more earnings so as to increase their equity capital base. The combination of low margins on corporate loans and the need to allocate more capital for every loan, made returns on loans unattractive. Banks began to turn to sources of profits other than large corporate loans. In the past, earnings from retail and middle market lending had proved a source of stable profits, but competition with smaller banks had greatly reduced margins there, too.

A further complication was added in 1999 when the Basel Committee released a proposal to replace the 1988 Accord with a more risk-sensitive framework. The strong influence of the US and the UK in the G10 group of governors translated into Anglo-Saxon-style suggestions for assessing capital adequacy: borrowers would be evaluated by credit rating, and the portfolio risk of a bank would be assessed using advanced market risk models. This worried German banks, for there were no domestic credit rating agencies at the time, thus affording US banks an advantage simply by virtue of the fact that more US firms had ratings than foreign ones. Because a borrower without a credit rating was assessed as "full risk" regardless of size or standing, there was a clear need for domestic ratings. Some large banks considered entering this market, and a few independent rating agencies began to spring up after 2000. Regardless of how the new "Basel II" will eventually be shaped, the plans put immediately pressure for reform on banks and companies, as "management behind closed doors" was being replaced by the new formula of "rating equaling transparency equaling access to capital" (Sultze, 2001, pp. 30–31).

4.1.3. The European Union (EU)

During the 1990s, Germany's financial markets underwent significant regulatory change due to pressure towards "harmonizing" domestic laws with a newly emerging EU standard. The Unified European Act of 1987 called for legal harmonization through step-wise revisions of domestic laws based on "EU Directives". Early examples in finance included the 1989 EU Solvency Ratio Law and the Second Banking Coordination Directive. The obligation to "transpose" these EU directives into German law within a period of five years forced the German government to overhaul its banking and finance laws and establish new supervisory agencies.

In 1994, the "Stock Company Law" was revised to make it easier to found an *AG*, eliminating the previous legal bias towards the less open corporate form of the *GmbH*. The

1995 Securities Trading Law introduced insider trading rules. A series of domestically-triggered "Financial Market Promotion Laws" led to reforms of stock market regulation and rules on the issuance of corporate bonds, commercial paper and stocks. In sum, these new laws modernized German capital markets by establishing clearer rules on new financial instruments, appropriate market behavior, and transparency.

To be sure, none of this came without resistance and debate. Whereas in the early stages of EU harmonization, Germany had earned the image of an eager reformer, when the core financial structure of the country was touched in the mid-1990s, it became one of the "EU laggards." Smaller banks objected to the shift away from bank lending; most companies opposed the introduction of stricter accounting rules; some supervisory board members were apparently displeased by insider trading regulation; and unions objected to the increasing role of shareholder value maximization as a management goal. Yet, in the end EU pressure prevailed, and the locomotive of legal reform was clearly in motion.

4.2. Institutional and legal changes in the domestic financial market

The changes necessary to comply with EU harmonization galvanized the German law-making process by requiring numerous changes in a large number of domestic laws as well as new laws.[13] The four main legal changes for the purpose of corporate governance through 2002 were the tax law, two transparency-related laws, the Corporate Governance Code of 2002, and the 2002 Takeover Law.

4.2.1. Tax changes

During the stock market boom of the late 1990s, the German government initiated a capital gain tax reform, pushed by large financial institutions eager to dissolve their large holdings and restructure business groups. Before January 2002, all stock sales by a company were subject to a 40% capital gains tax. The abolition of this tax caused optimists to predict an immediate breakup of the "Deutschland AG", by tempting large corporate shareholders to unlock some of their cross-ownership positions, thereby inviting new investors to a more liquid market. Although the 2002 stock market slump has made it difficult for large shareholders to take immediate action, the change means that the tax no longer interferes with the unraveling of cross-shareholdings.

4.2.2. The "KONTRAG" and the "TRAPUG"

In 1998, EU pressure for more transparency in share ownership, accounting, and corporate governance led to the introduction of the "Law on Control and Transparency in Companies" (in German abbreviated into the *KonTraG*, for "*con*trol and *tra*nsparency law"). While many had high hopes for the *KonTraG* as a milestone in reform, it lacked sanctions. In the end, its most important contribution may have been a first reorientation of the entire system towards shareholder value (Seibert, 2002a, 2002b).

[13] Because the German rules on public companies and stock exchanges extend over a large number of different individual statutes, each introduction of a new law or change of an existing law according the EU requirements caused an avalanche of larger and smaller changes in a variety of related legislation. See Nowak (2001) for an overview article.

The *KonTraG* strengthened disclosure rules and transparency in cross-shareholdings, by way of a new requirement to report certain thresholds in ownership of a firm.[14] To limit the double influence of banks at annual meetings, if a bank owns more than 5% of a firm, it has to choose whether to vote either on its own shares or on its proxy holdings; no longer can it vote on both. To constrict cross-governance among the largest firms, especially by a few leading bank executives, one individual was limited to no more than ten board memberships (chairman positions counting double). The *KonTraG* also abolished voting right limits and stipulated that, by 2003, all listed companies had to adopt a "one share one vote" system. Finally, the law allowed companies to buy back their own shares, making possible stock options as a form of executive pay (even though tax rules remained uncertain).

Cross-shareholdings thresholds now have to be reported to, and are made public by, the new Supervisory Office for Securities Trading, established in 1995 through a new Securities Trading Act (and merged in 2001 with the Banking Supervisory Agency into the Federal Supervisory Office for Financial Services). In charge of collecting data on cross-shareholdings, ownership thresholds, insider trading and other securities markets oversight, this new agency was an official sign that Germany aimed to create and maintain bona fide bond and stock markets.

In July 2002, the new "Transparency and Disclosure Law" (*TraPuG*, from "*tra*nsparency and *pu*blication" law), further strengthened the role of the supervisory board through new reporting obligations by management to the board, both in terms of completeness and immediacy, as well as new rules on board involvement in actual management decisions (approximating its rights more to those of US boards). The board is now specifically required to produce a list of management items it demands to vote on; the law envisions this list to include all decisions that fundamentally affect the profitability or risk exposure of the company.[15] The standing of the supervisory board chairman is curtailed in that every board member can request information or even call a meeting. The law prescribes that, in principle, all firms have to hold at least two board meetings per year.

4.2.3. The corporate governance code

Perhaps the most critical aspect of the *TraPuG* was its legal anchoring of the 2002 Corporate Governance Code (an ethical code rather than a law). Aimed at international investors, this Code offers clear explanations of German corporate governance rules, plus advice on new, best practices. The Code was crafted by a committee representing major private actors in the German economy, and its stipulations are not binding. While this type of self-regulation is common in Anglo-Saxon legal systems, it is rare in Civil Code countries. Next to global marketing, one objective with the Code may have been to turn into quasi-law improvements that were widely considered reasonable but politically and institutionally

[14] Companies had to notify the Supervisory Office whenever their ownership in a traded firm exceeded or fell below the thresholds of 5%, 10%, 25%, and 50%. Although this rule still allowed companies to avoid reporting by holding, e.g. 24.9%, it was a major improvement over the existing system. In terms of accounting, annual report disclosure rules remained lenient compared with US GAAP rules or IAS rules; yet, companies listed at the *Neuer Markt* had to use either the IAS or the GAAP to ensure international compatibility. Many companies in the DAX 30 likewise opted to use international accounting standards.

[15] Smaller items include new rules on audit reports; rules on capital increases; allowing dividend payments in kind; and requesting electronic postings on the federal register board.

difficult to spell out in a statute.[16] The voluntary character of the Code was compensated by a constraint introduced through the *TraPuG*: every year, companies are obligated to report to the federal registry whether and to what extent they have complied and will comply in the future with the Code (the so-called "comply-or-explain" rule).[17]

The Code contains about 50 strong recommendations (expressed as "will/shall") and 15 suggestions ("should/can"). Important new reforms introduced by the commendations include:

- annual reports will be posted on the internet;
- annual reports will contain specific information on stock options;
- management will be liable to owners if it violates fiduciary responsibilities or the law;
- minority shareholders will have the right to sue;
- the supervisory board will determine management's information- and disclosure obligations;
- the board will not include more than two former managers;
- the supervisory board will have an age limit for members and will form committees;
- board member attendance will be noticed and reported;
- shareholders and employees will meet separately before the supervisory board meeting (while contradicting the Co-Determination Law, de facto this reflects catching up with reality, see Section 3);
- analysts and shareholders will receive the same information on the company.

Overall, this Code brought German practices closer to those common in the US and the UK, and clearly indicated a transition – at least in rules – to a more market- and information-based approach to corporate governance. Because the Code was crafted by industry and most of its recommendations reflected sound management, it was expected that most listed companies, as well as unlisted firms interested in a Basel II rating, would voluntarily comply with the Code.

4.2.4. The Takeover Law

One of the earliest EU initiatives was takeover regulation. Yet, the "13th EU Directive" on takeovers records one of the most convoluted histories of all EU efforts and was still being rewritten as of 2003. After Spain and the UK had haggled for years on an issue that seemed secondary to most observers, they finally agreed based on German mediation in 2000, only for Germany itself to vote against the Directive in 2001. Germany's concern was the so-called "obligation of neutrality" by management when faced with a hostile takeover bid, which would disadvantage countries that allow only management reaction as a defense

[16] To invite foreign institutional investors to Germany, the code was immediately translated into English; see www.corgov.de. For details on the contents and legal issues of the Code and the *TraPuG*, see, e.g. Seibert (2002a), Berg and Stöcker (2002), Knigge (2002); for a discussion of recent changes in equity-related legislation in Germany, see Seibert (2002b), Ulmer (2001).

[17] This followed the UK model, where private suggestions have been brought together in a "Combined Code" (consisting of "Principles of Good Governance" and a "Code of Best Practice"); while this Code is appended to official stock listing rules, the supervisory authority cannot use the annual compliance statement regulatory action such as delisting.

mechanism.[18] Having voted down the EU Directive, in 2002 Germany passed its own "Takeover Law" (*WpÜG*, lit.: Securities Purchase and Takeover Law) which allowed management to adopt defensive measures with the simple approval of the supervisory board.[19] For some observers, this provision was "hostile to takeovers" and turned this law into an "Anti-Takeover Law".[20]

The 2002 Takeover Law is rather complicated and bureaucratic. Stock purchases of firms headquartered in Germany are grouped in three categories. For "simple offers" of less than 30% of a firm, a few restrictions on disclosure apply (similar to the US). Second, if an investor inadvertently ends up holding more than 30% of a firm, he faces comprehensive rules on "passively crossing of the line". Third, very strict rules apply for purchases of more than 30% (i.e. a controlling share) of a firm. The stated goal was to protect small shareholders in the conflict of interest between the target firm's management (that wants to defend) and its shareholders (that want to benefit from rising firm value). In reality, a legal and procedural headache was created. In contrast to London, where takeover offers are mostly governed by the City Code in an informal, case-by-case manner, thus allowing for such rules (Charkham, 1994), the new German law put all majority control purchases under the immediate purview of the regulators and the courts.

The EU Takeover Directive draft foresaw that after the announcement of a public offer, target management had to remain neutral. The German law allows for four exemptions to this basic rule: (1) management may design new corporate strategies; (2) management may invite competing bids; (3) management may ask owners for an ex ante authorization of defense measures in case of a hostile bid (valid for 18 months); and (4) management may adopt defensive measures with approval of the supervisory board. This last addition of simple board approval caused great concerns within the EU, as it enables German firms to defend hostile bids in ways not allowed elsewhere in the Union. Thus, while EU pressure has clearly pushed Germany's corporate governance system towards the market, German lawmakers resisted this pressure in the area of corporate control.

5. Data analysis

In Section 2 we identified three major areas where change is quantifiable and would indicate a system shift from a bank-based to a more market-based model: disintermediation and the growth of capital markets; the development of a market for information; and a decline in the governance role of banks. One challenge with measuring ongoing change is that a true shift in governance processes may not yet be reflected in reported data. In addition, exogenous shocks unrelated to governance, such as an economic downturn, cannot easily

[18] The argument, typically couched in "level playing field" terminology, was caused by the existence in a few EU countries of "golden shares", i.e. shares that grant the government majority voting rights in national firms. Some felt that the issue was exaggerated, given that fewer than ten companies within the EU had even issued such shares (Wackerbarth, 2001).

[19] For overview articles on this law, see Hopt (2002a, 2002b), Gordon (2002), Thoma (2002), Wackerbarth (2001).

[20] Conversation with Harald Baum (2002); Gordon (2002).

Table 3
External financing of German corporations, 1950–2001 (1950–1990 in DM billion; 1991–2001 in Euro billion)[a]

Year	Bank loans	Total external financing	Bank loans as a percent of total
1950	8.5	11.7	72.6
1955	11.3	19.2	58.9
1960	17.6	27.7	63.5
1965	27.3	50.3	54.3
1970	40.7	76.0	53.6
1975	29.1	65.3	44.6
1980	90.2	156.0	57.8
1985	69.7	122.5	56.9
1990	126.7	222.8	56.9
1991	90.1	129.1	69.8
1992	n.a.	n.a.	n.a.
1993	37.0	115.0	32.2
1994	17.2	105.3	16.3
1995	57.9	81.5	71.0
1996	51.0	88.6	57.6
1997	44.0	79.1	55.6
1998	68.9	165.6	41.6
1999	71.1	198.1	35.9
2000	43.3	349.2	12.4
2001	40.3	169.4	23.8

Source: Deutsches Aktieninstitut, *DAI Factbook*, May 2003; Table 03-9 for 1950–1990 and Table 04-6 for 1991–2001.

[a] The basis of reporting changed in more recent years so that data for 1991–2001 are not completely consistent with earlier years.

be filtered out. But even with these caveats, the data bespeak some important changes in the German system.

5.1. Capital markets

The traditional strong reliance of large German firms on lending has clearly lessened since the 1990s. Table 3 shows that while the share of bank loans in external financing tends to fluctuate from year to year depending on the level of interest rates and economic activity, there is a distinct downward trend in loan dependency throughout the 1990s, with bank loans falling below 25% of external funding in 2000 and 2001.

During this same time period, international bond issues by German companies rose dramatically. For tax purposes, a major share of German bonds are issued through subsidiaries or shell corporations in neighboring European countries. As Fig. 2 shows, total annual bond issues by German companies (including those by European subsidiaries), which historically had been less than $2 billion, exceeded $4 billion in 1997 and 1998, then jumped to about $19 billion in 1999, and increased sharply again to exceed $30 billion in 2000–2002. Contributing to this jump was the introduction of the Euro in 1999, which merged the various European bond markets into one very large, liquid and attractive single-currency market.[21]

[21] Thomson Financial, *SDC Platinum*. The slowdown in growth in 2002 was due to low interest rates at that time, which invited companies to issue long-term debt and pay off other debt and loans.

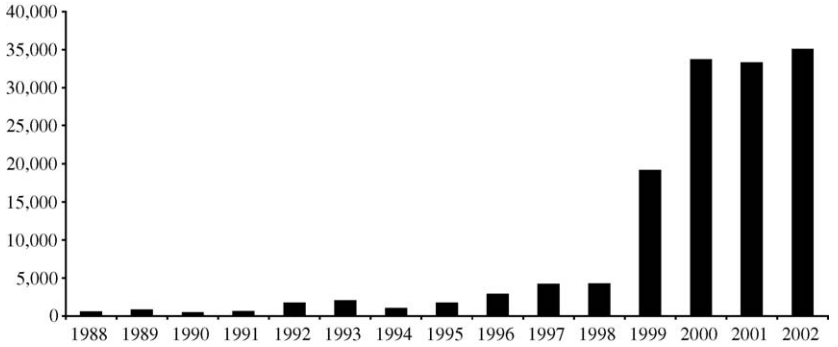

Fig. 2. Volume of bonds issued by German companies (millions of US$).

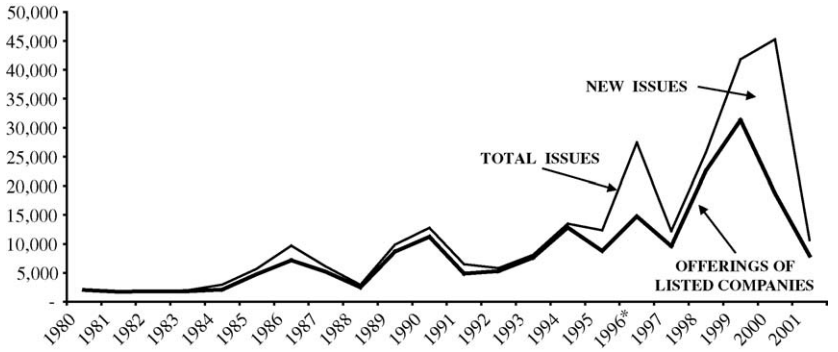

Fig. 3. Share offerings of German enterprises, 1980–2001 (Euro millions).

The stock market has also become a more important source of funds for German companies. Throughout the 1980s, total share offerings per year, including initial public offerings (IPO) and secondary issues by listed companies, had remained below €10 billion. Fig. 3 shows that offerings increased substantially in the 1990s (the 1996 spike is attributable to the Deutsche Telekom IPO of €27.4 billion). This was not just an IPO phenomenon, as already listed companies also increased their equity base. Further reflecting the growth of the equity market, the number of companies traded on domestic stock exchanges rose from 679 in 1987 to 931 in 1999. The booming stock market in the late 1990s and the opening of the *Neuer Markt* attracted new IPOs before the market crashed in 2002. As of 2002, there were 867 listed German companies.[22]

Yet, compared with the United States, an economy about four times as large, the role of equity remains limited in Germany. In spite of the impressive fact that in 2000, German total issues exceeded €45 billion, this was equivalent to less than 10% of total issues at NASDAQ and the NYSE in the same year.[23] While German firms are partially replacing

[22] Deutsches Aktieninstitut, *DAI Factbook*, May 2003, Table 02-1.
[23] Deutsches Aktieninstitut, *DAI Factbook*, May 2003, Table 03-2.

bank loans with public securities, the stock market is still not the primary arena of financing. This means that while shareholder interests are becoming more important, they still lack the prominence they have in the United States.

The shift away from corporate lending corresponded with a partial shift in household financial assets from savings to investments in bonds, stocks and investment funds. The share of the population older than 14 years owning stocks rose from less than 7% in the 1980s to almost 10% in 2000, and then fell off again to about 8%; those holding investment funds doubled from 9% in 1997 to 18.0% in 2002.[24] Table 4 shows the composition of household assets. Investment assets accounted for only 24.3% of household financial wealth in 1991, but grew to 38.4% of total wealth in 1999. The share of investments declined somewhat in 2000 and 2001, but still accounted for over 30%. In nominal terms, total holdings of these investment vehicles grew from €490.5 billion to €1152.4 billion, which is an annual growth rate of 14.7% from 1991 to 1999. This compared to an annual growth rate of 5.7% for traditional savings instruments over the same time period.

One might argue that this growth in investments is simply due to an increase in market valuation, rather than to a shift of funds from savings to investments. The strong bond and stock markets in the 1900s clearly contributed to the growth in value of financial assets held, but given the tendency of German households to weight their portfolios towards bonds, returns alone cannot explain the growth in investments. The average annual return from 1991 to 1999 on German government bonds was 8.6%, and growth in the DAX index averaged 20.4%.[25] Assuming that the average household held 30% of investments in stocks and 70% in bonds – according to the old German "rule of thumb" – then returns in the 1990s would have been 12.1%. Therefore, there was a positive inflow of funds into investment vehicles, which heightened household exposure to the capital markets and their interest in corporate governance questions.

The increase in external financing also exposed large companies to the discipline of capital markets, as exemplified by the 1999 acquisition of Mannsemann AG by the UK firm Vodafone. While this deal was just one of a fast growing number of M&A deals since the 1990s, its size and the publicity around the fight for control were unprecedented. Table 5 shows that in 1988, there were only 113 deals with a total value of $4.2 billion. The number of deals rose to over 1500 in both 1999 and 2000, with total values exceeding $100 billion each year (not including the Vodafone-Mannesmann acquisition). The 2002 German Takeover Law can be interpreted, at least in part, as a political reaction to this development, as the Mannesmann case triggered concerns about traditional, major German corporations being taking over by foreign interests, thus possibly affecting employment and tax revenues. It will be interesting to see how the Takeover Law affects Germany's M&A statistics in the future.

Finally, it is still too early to comment on the combined effects of these ongoing changes on cross-shareholdings, though first indicators point towards change. In 1991, only about 10% of German publicly traded firms were widely held or had no shareholder with a

[24] Deutsches Aktieninstitut, *DAI Factbook*, May 2003, Table 08.3-Zahl-D. This occurred in spite of a very rocky start of the German version of a private 401(k) pension investment scheme; once this develops, further increases can be expected.

[25] Deutsches Aktieninstitut, *DAI Factbook*, May 2003.

Table 4
Household financial assets in Germany, 1950–2001 (assets at year-end; 1950–1990 in DM billion; 1991–2001 in Euro billion)[a]

Year	Savings instruments				Investment Instruments						
	Deposits at banks and S&Ls	Claims on insurance companies	Total savings	Savings percent of total assets	Money market paper	Bonds	Stocks	Investment funds	Total investments	Investments percent of total assets	Total financial assets[b]
1950	12.4	3.8	16.2	63.6	n.a.	0.3	6.8		7.1	27.8	25.5
1955	37.8	10.9	48.7	67.7	n.a.	1.9	14.1	n.a.	16.0	22.2	72.0
1960	87.1	22.8	109.9	64.5	n.a.	5.7	41.4	n.a.	47.1	27.6	170.4
1965	169.9	43.8	213.7	72.2	n.a.	19.8	40.5	n.a.	60.3	20.4	295.9
1970	319.1	77.8	396.9	75.0	n.a.	40.2	59.3	n.a.	99.5	18.8	529.1
1975	614.8	142.1	756.9	78.0	n.a.	85.6	68.8	n.a.	154.4	15.9	970.0
1980	971.3	246.2	1217.5	77.7	n.a.	170.4	70.8	n.a.	241.2	15.4	1566.5
1985	1285.7	412.3	1698.0	72.1	n.a.	332.6	155.8	n.a.	488.4	20.7	2354.9
1990	1725.3	644.3	2369.6	73.5	n.a.	439.9	174.9	n.a.	614.8	19.1	3223.9
1991	925.7	380.4	1306.1	64.7	5.8	270.4	130.6	83.6	490.5	24.3	2020.1
1992	993.5	413.9	1407.4	64.5	7.4	291.7	124.2	108.8	532.1	24.4	2181.2
1993	1089.0	543.5	1543.5	63.8	6.9	300.0	172.2	135.9	615.0	25.4	2419.9
1994	1093.3	496.6	1589.9	63.2	4.4	300.6	170.6	173.9	649.5	25.8	2516.5
1995	1127.3	544.1	1671.4	61.9	2.5	363.0	187.2	190.1	742.8	27.5	2701.2
1996	1179.6	595.7	1775.3	61.6	2.4	366.3	221.4	209.5	799.6	27.8	2879.7
1997	1210.1	649.2	1859.3	60.3	1.8	358.9	293.7	243.7	898.2	29.1	3081.5
1998	1256.1	703.5	1959.6	59.7	1.6	354.5	339.3	289.6	985.1	30.0	3280.6
1999	1265.7	764.3	2030.0	53.1	1.2	361.7	473.2	631.6	1467.7	38.4	3826.2
2000	1234.8	820.8	2055.6	56.7	1.3	366.3	438.9	408.5	1215.0	33.5	3622.9
2001	1262.4	879.5	2141.9	58.4	1.3	379.4	347.3	429.4	1157.4	31.6	3667.6

Source: Deutsches Aktieninstitut, *DAI Factbook*, May 2003; Table 07.1-2 for 1950–1990 and Table 07.1-4 for 1991–2001.

[a] The basis of reporting changed in more recent years so that data for 1991–2001 are not completely consistent with earlier years.

[b] Total financial assets includes other assets, such as pension fund and other claims, that are not shown separately in the table.

Table 5
Merger and acquisition transactions with German companies, 1985–2002 (millions of dollars)

Year[a]	Value of transactions	Number of deals
1985	923	19
1986	1,188	25
1987	1,527	62
1988	4,219	113
1989	7,443	204
1990	15,124	347
1991	12,858	933
1992	16,282	849
1993	13,471	764
1994	9,590	1182
1995	16,667	1767
1996	13,949	1547
1997	51,560	1492
1998	51,713	1013
1999[b]	317,575	1626
2000	106,012	1725
2001	74,192	1130
2002	46,051	902

Source: Thomson Financial, *SDC M&A Transactions*.
[a] Year is based on announcement date.
[b] The Vodafone acquisition of Mannesman accounted for $212,785 million of the 1999 total.

large block of shares, defined as 25% or more of the shares (Gordon, 2002). By 1999, the number of firms satisfying these dispersed ownership criteria had grown to one quarter of all publicly traded firms. Although the capital gains tax reform of 2002 set the stage for further unraveling of block shareholdings, data reveal little impact as of 2003, probably due to the weak stock market. To be sure, given that reporting requirements on block holdings only refer to certain thresholds (cf. footnote 13), companies could quietly unravel their positions just short of passing these thresholds, without reporting. The only company that had publicly announced a large-scale portfolio restructuring as of 2002 was Allianz. Incremental changes in corporate networks will only become apparent over time.

5.2. *The market for information*

While difficult to measure, there has been a trend within Germany for corporations to provide more information, and for an increased role for information analysts. After the first four large German companies shifted to International Account Standards (IAS) in 1994, the number of companies using IAS or US GAAP grew to 138 in 2003.[26] This was partially triggered by the *Neuer Markt* (which required IAS or GAAP reporting), but many established companies switched voluntarily. Of the 75 largest German companies (ranked by 2001 sales), 22% reported using IAS or GAAP.[27] This has greatly improved transparency,

[26] *Worldscope*, July 2003.
[27] Company rankings obtained from *Compustat GlobalVantage*.

and has made German corporate data internationally comparable. In the long run this shift may prove a most crucial step towards more market-based governance in Germany.

The role of credit analysts has grown significantly, pushed in part by the suggested Basel II rules requiring larger allocations of capital for loans to companies without credit ratings. Standard & Poor's, Moody's and Fitch opened offices in Germany in the 1990s, where they have met competition in new German firms, including EuroRatings AG, GDUR Mittelstands-Rating AG, U.R.A. AG, and RS Rating Services.[28] Their focus on small and medium-size companies has caused some of the big banks to consider entering this business for their large clients. While still in its infancy, the rating industry is already beginning to challenge the big banks' erstwhile monopoly on information and opening up the market for information.

5.3. Banks and corporate governance

As corporations decrease their dependency on bank loans, the benefits for a bank of a direct involvement in corporate governance are less obvious. The *KonTraG* and *TraPuG* laws introduced restrictions on proxy voting by banks with large ownership stakes. What is more, the increase in direct voting by shareholders on the internet has greatly reduced the power banks used to derive from proxy voting. As a result, one might expect a decline in bank ownership positions in companies, a disengagement by banks in supervisory boards, and diminished enthusiasm by banks to handle proxy votes.

As mentioned, ownership data do not yet attest to a large-scale liquidation of large bank positions, though the depressed stock market and data insufficiencies inhibit a full evaluation as of 2003. Fig. 4 suggests, however, that bankers have indeed reduced their supervisory board activities. A look inside the 25 largest publicly traded German companies (ranked by 2001 sales) reveals that in the early 1990s, these 25 companies had an average of 2.2 bank executives on their supervisory boards; only one company had a banker-free board. In comparison, in 2001 these same companies listed an average of 1.3 bankers as supervisory board members, with 28% of companies (seven in total) having no bankers at all.[29] This demarcates a huge decline in direct bank influence through board membership.

Finally, although some of the big banks have announced plans to phase out proxy voting activities, this is difficult to ascertain as data are not publicly reported. Given that a bank's benefits from proxy voting differ according to how close a client is to the bank (in terms of loan volume as well as ownership and supervisory board composition), we can expect a shift in proxy voting to occur slowly, and to differ across firms.[30]

Thus, similar to the analysis of the legal situation, the data point to some areas of significant change, or the beginnings of such change, but they remain silent on a few aspects of governance that would indicate a true convergence with the market model. What is clear is that large German firms have become much less dependent on bank financing, and important shifts away from bank monitoring and towards the market are readily observable.

[28] *Frankfurter Finanzmarkt-Bericht*, Number 40, September 2001, p. 4.

[29] Board membership data were obtained from corporate annual reports. Base years for each company are 1990, 1991 or 1992, depending on the earliest year it reported identify of supervisory board members.

[30] Interviews with bank executives, Frankfurt, 2002.

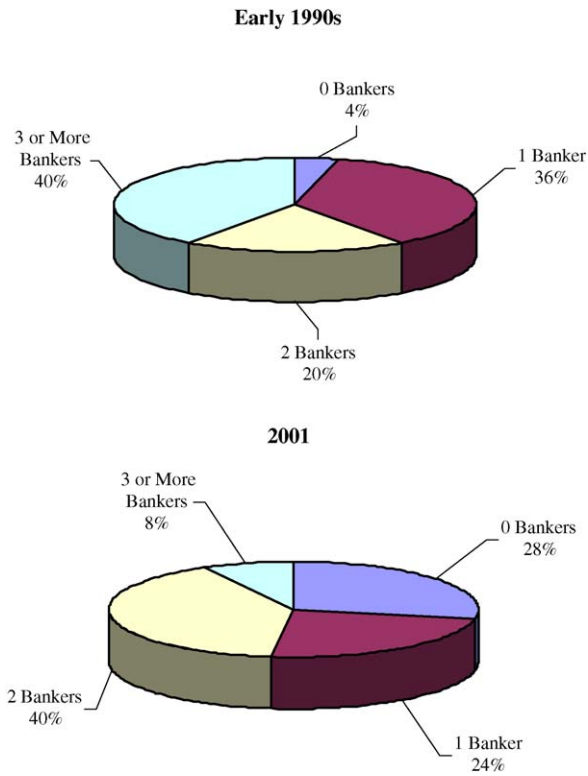

Fig. 4. Bankers on supervisory boards of the 25 largest German companies.

6. Conclusions

This paper has analyzed the case of Germany in the context of the ongoing debate about convergence in corporate governance. We use a functional perspective of governance that emphasizes how the three main functions of governance are provided: (1) protection of resource providers; (2) information management; and (3) performance monitoring. Based on a review of the logic and incentive structure of Germany's bank-based system observable in full strength until the early 1990s, we analyzed two main areas where change would manifest itself: the legal system and corporate data. We were particularly interested in whether the following phenomena have occurred: disintermediation (i.e. the growth of capital markets); a growing market for information; and a decline in the role of banks in the monitoring process.

Data reveal a downward trend in banks' governance activities. As large corporations are relying less on bank lending, and as banks suffer reduced margins in lending as well as stricter capital requirements, the economics of the German governance system have changed. No longer does it pay for the house bank to keep a tight lid on corporate information; rather, as a lead underwriter it is in the bank's interest to provide complete information about the company. The diminished activism of banks as governance agents is reflected in a

significantly reduced number of bank executives on corporate boards as well as supervisory board chairmanships. Finally, legal changes and the internet have combined to make the proxy voting system unattractive for some banks. Thus, there is clear data evidence of change away from the banks.

The analysis of legal change supports the notion of a change towards the market. Disclosure requirements and investor protection have both been strengthened, and public access to information has grown together with the importance of a variety of information intermediaries. Interestingly, this growth has been fueled in part by the banks themselves, as they have begun to offer research reports and analyses to all customers. An increasing number of large firms report financial results according to International Accounting Standards or the US GAAP. Overall, transparency has increased.

However, in 2002 Germany balked on a decisive step towards a market for corporate control, by boycotting the EU Takeover Law and introducing its own, more protective, takeover legislation. Thus, while information on large German firms has greatly improved, the actual use of this information in the market for hostile takeovers can still be thwarted, given the rigidity of the law and court application in a civil code system. The prosecution of Mannesmann supervisory board members for eventually succumbing to the Vodafone acquisition and collecting "golden handshakes" may well discourage other German executives from subjecting to acquisitions in the future.

Moreover, with the steep decline of the stock market and the collapse of the *Neuer Markt*, the capital market momentum within Germany stalled. The abolition of what used to be a de facto sales tax on shareholdings has opened the door for banks and institutional investors to unwind their block ownership positions, but depressed stock prices have reduced the financial incentives for these and other M&A transactions. Households that have aggressively moved funds into direct investments have again adopted a more cautious stance.

In sum, we find that while Germany has stopped short of a "market-based" system, it has clearly moved away from the pure bank-based model; in terms of Fig. 1, this move is away from a focus on bank monitoring and towards a more diversified system based more on generally available information and external management control. We doubt that, as of 2003, Germany had reached an equilibrium that constitutes a new model. This is because bank intervention in mismanaged companies and the market for corporate takeovers are substitutes. As banks reduce their house bank function of intervening with poor management, the need for a market for corporate control grows. By granting management great latitude in defending hostile bids, the Takeover Law of 2002 has created a governance void. The performance monitoring function of governance is not fully performed.

If the German system is not in equilibrium, one wonders which direction it is likely to take, towards a renewed role for inside monitors, or towards more market orientation. It is possible that the great losses of the stock market in the late 1990s have caused households to revert to their previous conservatism, which could stall the momentum towards improved disclosure, protection of minority shareholders, and other elements of a market-based system. It would also discourage expansion and growth of the German stock market, continuing to cast a pall on M&A activity, and discourage unwinding of ownership positions by banks.

At the same time, there is enduring pressure for Germany to uphold the movement toward a market-based system, by way of economic globalization, the EU, and the big banks themselves. A new equilibrium for Germany will probably differ in important ways

from what some Germans refer to as the "cold capitalism" of the US. However, international financial markets and global competition will continue to challenge domestic protectionism; the EU will continue to push for uniform regulations, with "the market" being the most likely smallest common denominator across the Union; and an aging society will push more households towards diversified investments for retirement. The German system has moved away from the banks, and global pressures on large firms and banks will continue to undermine domestic political resistance against change.

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