

# Banks and Corporate Governance in Germany: On the Way towards a Capital Market-Based Financial System?

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# Agenda

## Introduction & setting of the problem

Definitions and concepts

Characteristics of the *old* German financial system

- The banking system
- The corporate governance system
- The financial system as a whole

Recent developments and changes

- The banking system
- The corporate governance system
- The system as a whole

Possible future developments



# In this presentation, we will characterize and assess recent developments in German banking and corporate governance in the light of developments in the German financial system at large

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## Starting points

- At least until the mid-nineties, German banking and corporate governance, and the financial system as a whole, were characterized by a remarkable degree of stability
- The past seven years have witnessed an array of changes in the legal, financial and business environment of German banks and corporations.

## These developments suggest to address the following questions

- Have recent developments led to a structural change in German banking, corporate governance and in the German financial system as a whole?
- If yes, has there been a convergence to the market-based structures of Anglo-Saxon countries?
- More generally: Will national financial systems lose their distinctiveness as a consequence of globalization ?

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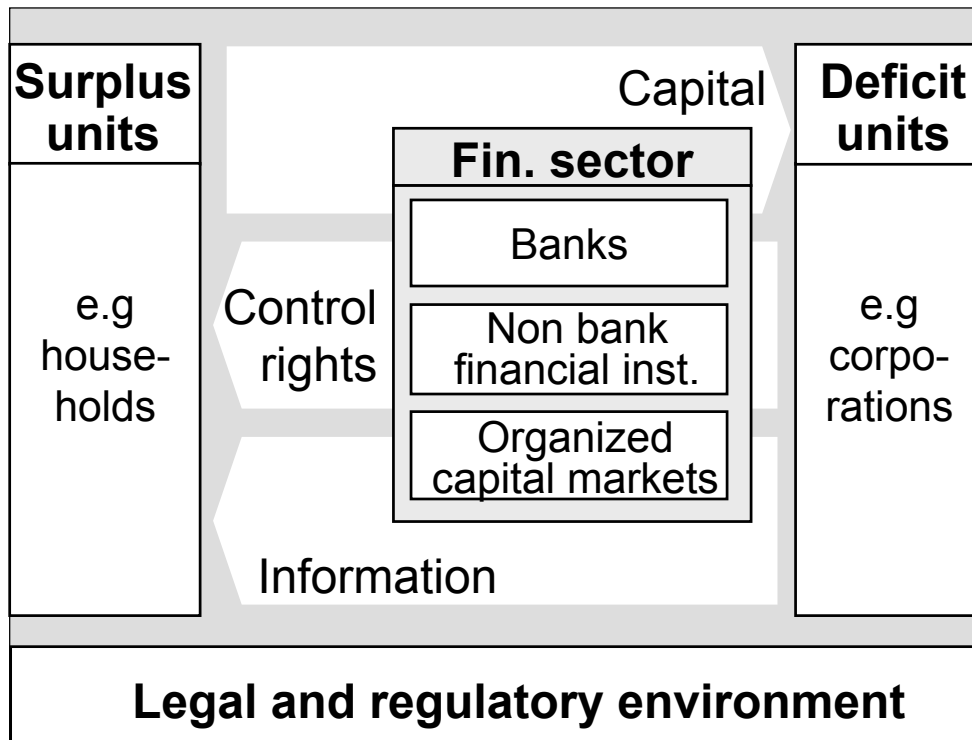
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# We use broad definitions of „corporate governance“ and „financial system“, and treat the corporate governance system as a subsystem of the financial system

## Definitions



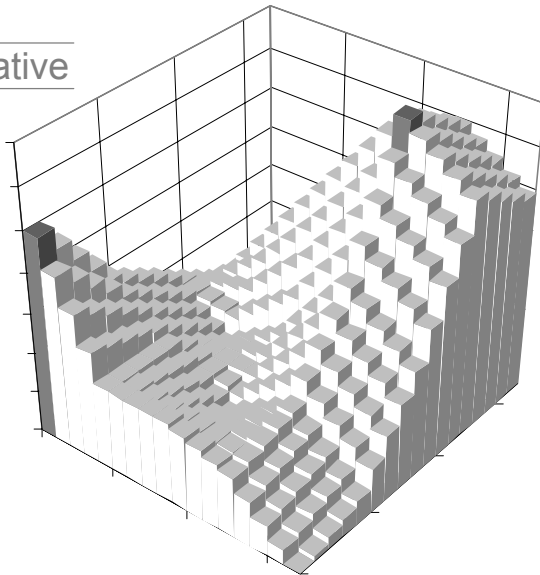
- The “financial system” is more than merely the “financial sector”, i.e. the institutions
- It comprises supply *and* demand, and the use of financial services offered by the fin. sector
- CG comprises of all mechanisms and institutions stakeholders use in order
  - a) to influence management decisions and
  - b) to resolve potential conflicts among each other
- Because financial capital is typically only provided in exchange for control rights, developments in the fields of banking and corporate governance are closely related

# The complexity of real world corporate governance systems requires a systems perspective – we find the conceptual framework of „complementarity“ a useful tool

## Complementarity

„An intervention in part of the system may have ripple effects that are hard to fully anticipate [...] The different parts of the system fit together and changes in one part may undermine the functioning of another“  
- Berglöf/Burkart (2002) -

illustrative



- Complementarity of system elements
  - Elements reinforce each other in their positive effects and mitigate negative effects
- Consistency of systems
  - Complementary elements take on values so that the system constitutes a local maximum
- General Implications
  - Fit between elements is important
  - Multiple “good” systems may co-exist
  - “Middle-of-the-road” systems can be problematic
  - Path dependencies may arise
  - Analysis: Examine *la logique du système*



# Outsider control systems, which prevail in the Anglo-Saxon world, are "simple" and based on market mechanisms and public information

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## Outsider control systems

- The only obligation of management is to serve the shareholders' interests. The objective is only to maximize the market value of the shareholders' equity
- The dual task of aligning interests and controlling management is performed by
  - a functioning market for corporate control with a takeover mechanism
  - executive compensation based on shareholders' value
  - competitive factor and product markets
- There is a correspondence between a capital market-based financial system and an outsider-controlled CG



## **Insider control systems, which used to prevail in continental Europe, are not "simple" and based on internal mechanisms and private information**

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### **Insider control systems**

- In making important decisions, the management must, and does, also consider the interests of other stakeholders. Long-term relationships and interaction serve to harmonize the interests of the different stakeholders and to limit conflicts
- The dual task of aligning interests and supervising management is performed – and facilitated - by
  - the company's "supervisory board" composed of representatives of the different (“important”) stakeholder groups
  - equity participations by banks
  - cross-shareholdings among firms
  - active involvement of employees
- There is a correspondence between a bank-based financial system and an insider-controlled CG-system



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# Well known characteristics of the German *Banking System*

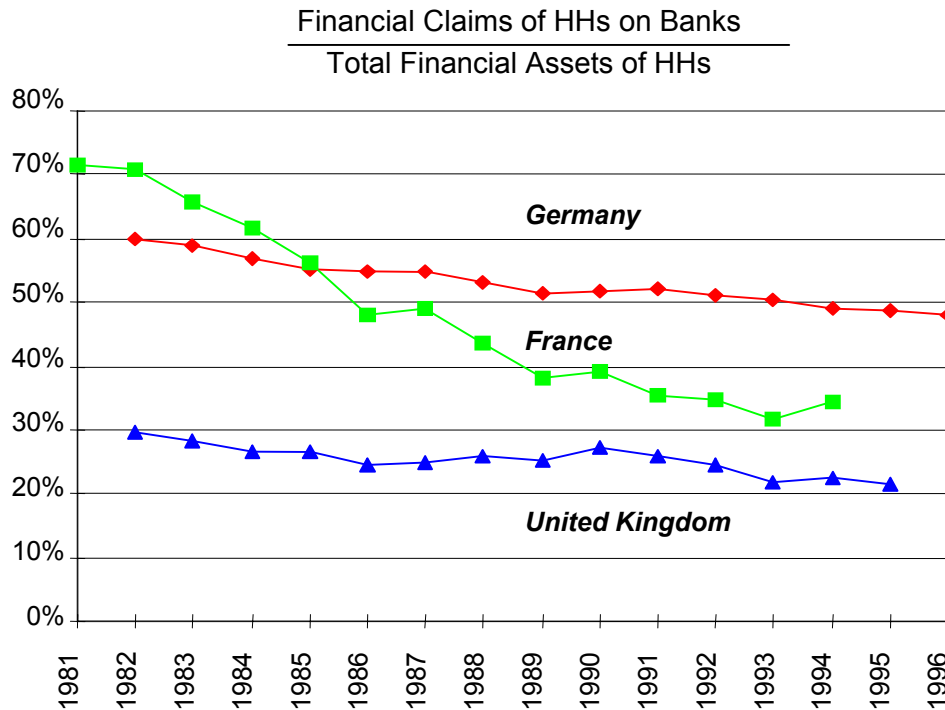
## Characteristic features of the GBS

- The three-pillar system
- A strong role of the Savings Banks Group
- Typically banks are true universal banks
  - with close ties to their (enterprise) clients and *Hausbank* relationships
  - and a limited profit orientation (and profitability)
- Unusual size distribution and low concentration of banks
- A high number of banks and banking outlets
- Limited competition and – in the case of big banks in particular – low profitability
- Until very recently low level of international entry into the German market (But: consider actual developments)
- A high degree of structural stability

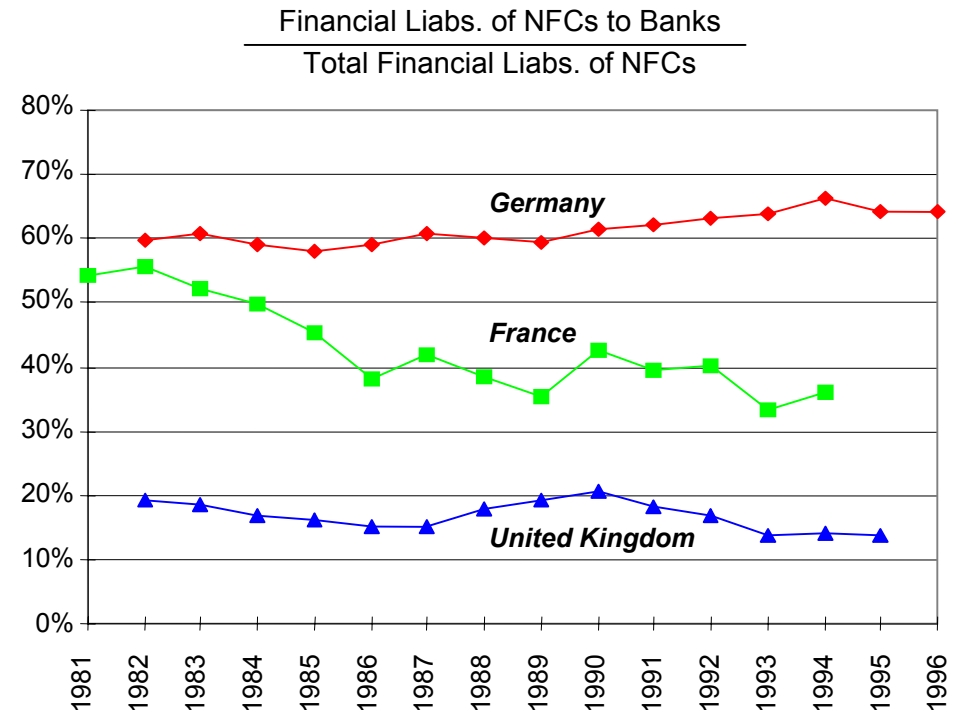
**Partial intermediation ratios measure the role of *banks* as collectors of household deposits and as providers of funding to firms:  
Largely stable in G and UK – and with stable differences between countries**

**The role of banks as financial intermediaries**

**Asset-IR of Households with Banks**



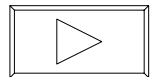
**Liability-IR of NFCs to Banks**



# The corporate governance system of large German companies used to be a rather balanced and consistent insider-control system

## The basic structure of corporate governance

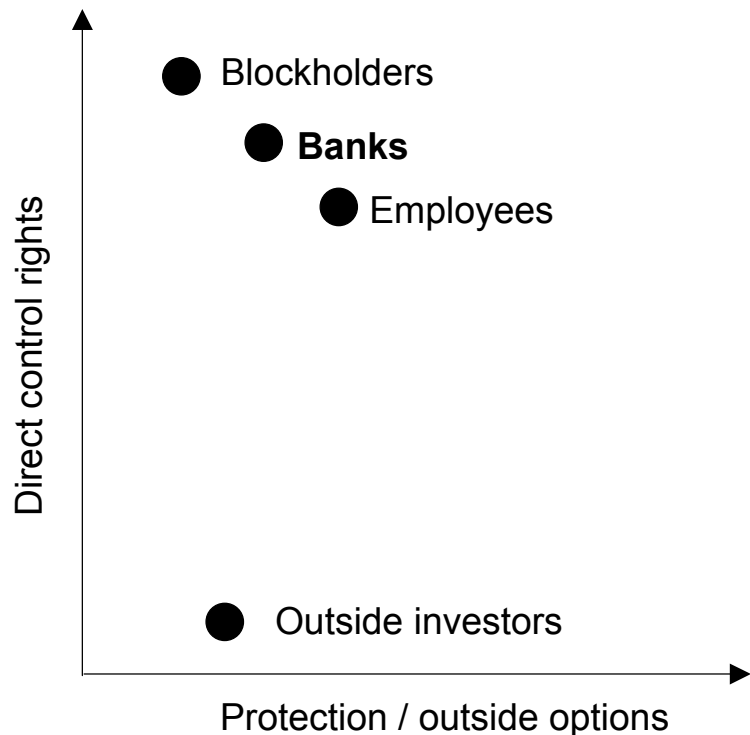
- The (former) governance system of big corporations in Germany can be regarded as "pluralistic" and a relatively equally weighted coalition of *and in itself a consistent system of complementary elements*
  - (Top-)Management
  - Shareholders (blockholders only)
  - Employees (and unions)
  - Big banks
- The stakeholder groups have the right to pursue their own interest to a certain extent, but de facto act in a "consensus-oriented network" – with an implicit agreement that "the firm" should prosper and survive – stable growth over profits!
- **With (big) banks playing the role of the central coordinator**



- Control over liquidity
- Internal vs. external labour market
- Relationship vs. arm's length

**According to the concept of complementarity, the attributes of core elements and their interrelationships determine consistency and system performance**

## Insider control system with the supervisory board as the center of power



- **Firm-specific investments** by all important stakeholders (large shareholders, banks, employees)
- Incomplete and implicit contracts in conjunction with ex post **control rights** for all insiders
- **Balance of power** among insiders and vis-à-vis management fosters long-term cooperation
- **Available rents** compensate for monitoring cost and specific investments
- **Limited exit options** serve as binding mechanism

# Characteristics of the German Financial System at large

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## Characteristic features of the GFS

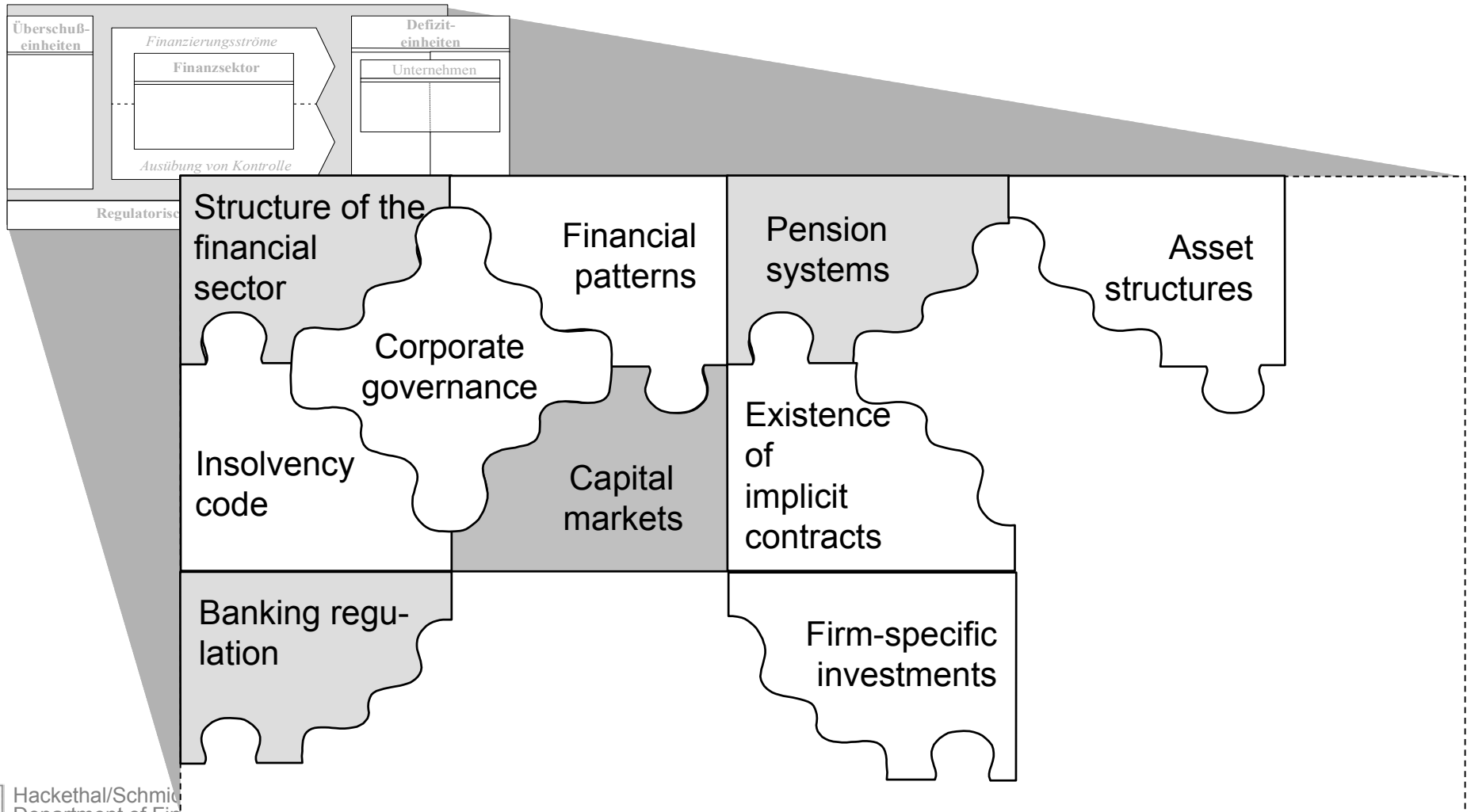
- The dominance of banks within the financial sector
- The corresponding „underdevelopment“ of German capital markets (as a primary market and an instrument of corporate governance)
- The strong role of banks in asset accumulation and external enterprise financing – see financing patterns in Germany
- Banks active in corporate governance
- The lack of crises – or the resilience to change – in the German financial system
- The traditional PAYE pension system
- The liberal approach to regulation and supervision for banks and capital markets
- .... and many more

**Is this system (still today) stable?**

**And if so, what could explain its stability – or resilience to change?**

One way of explaining the stability of banking / financial systems is to point out that its main elements are "complementary" to each other and also consistent – or simply to check if they fit together

## Illustrating complementarity and consistency



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## The situation of German banks deteriorated consistently until 2003 – a year of an „almost crisis“

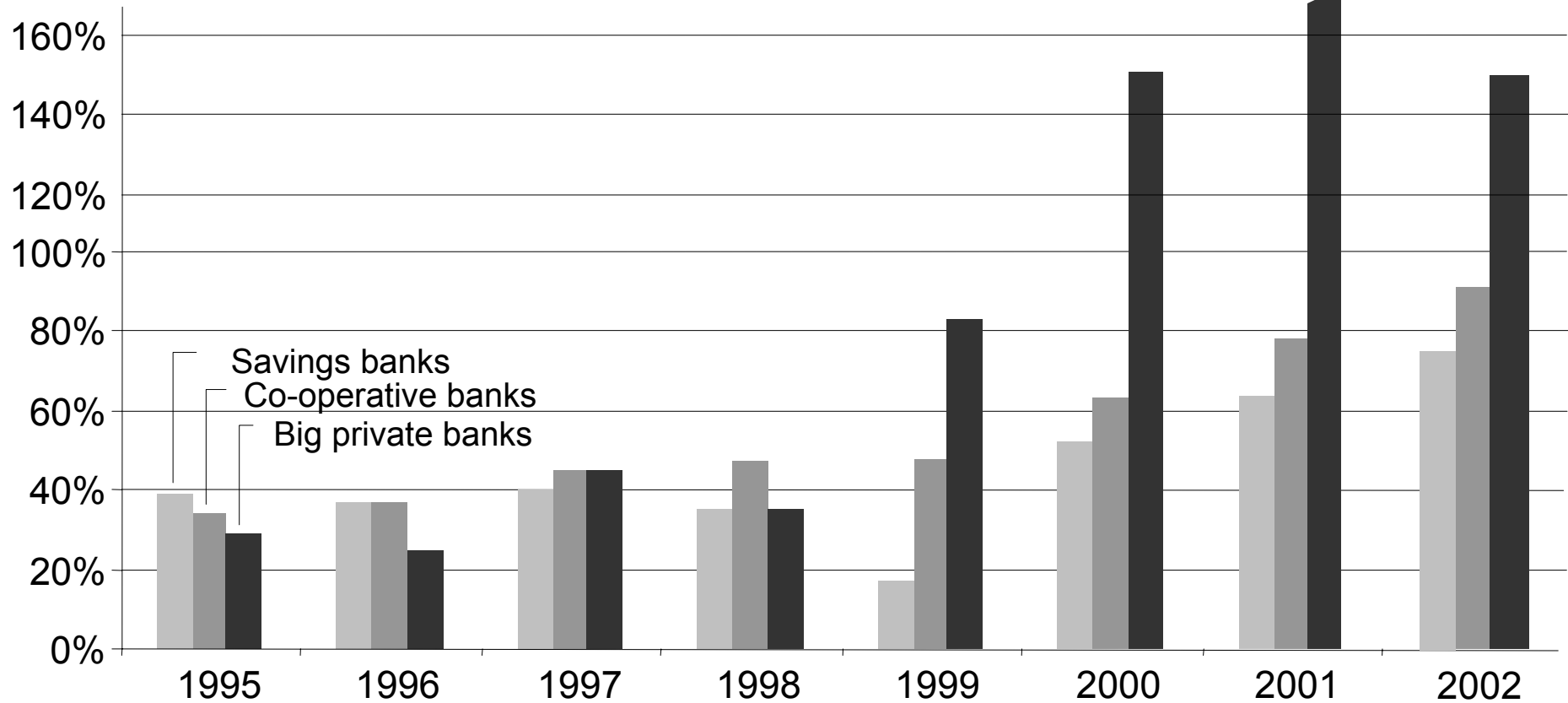
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### Some observations

- Since many years, the return on equity of German banks has not covered their cost of capital
- With only a few exceptions, both big banks and Landesbanks are concerned – despite various cost cutting initiatives
- Net interest margins have dropped (almost) everywhere, indicating an intensification of competition and requiring banks to seek alternative sources of income
- Fee income from capital markets-related business no longer supports the bottom line of German banks
- Especially big banks were severely hit by loan defaults ...
- ... and reacted by restricting business lending

## Especially big banks suffer from high write-offs on their asset portfolio

### Net valuation expenditure over operating results

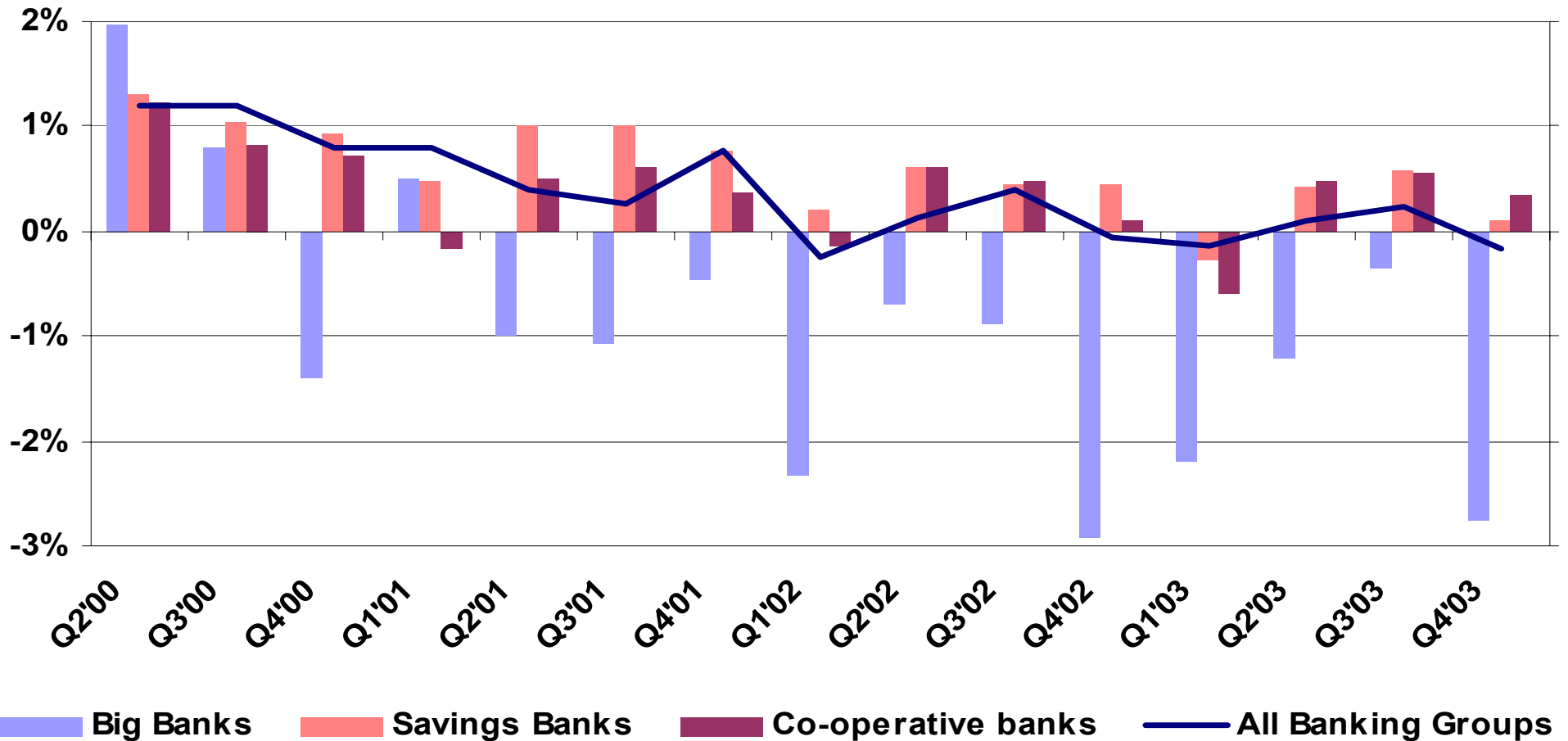


Source: Deutsche Bundesbank (monthly report, Sept. 2003)



# Big banks pull out of the loan business

## Quarterly growth in loans granted to customers per banking group



Source: Deutsche Bundesbank

## Recent and long-term developments in corporate governance

### Major changes to the German corporate governance system cannot be expected

- Recent developments
  - Focus on CG in the political arena: much talk, little action
  - In investor protection and securities law
  - In corporate law
  - Accounting and disclosure
  - Takeovers and hostile bids – Mannesmann/Vodafone; Takeover law
  - Ownership and direct influence
  - Shareholder orientation
  - Pension reform
  - Financing patterns and bank-client relationships
- Long-term development – extreme stability / rigidity
  - With respect to the „governing coalition“, which leaves small shareholders out
  - With respect to the ways in which it/they operate

Almost always:  
Change – BUT  
(see next slide)



## The changes – and the BUTs

### How far reaching were the changes? They do not support the belief in fundamental change

- In the political domain, CG has become a hot topic  
BUT central issues – dual board, § 176(1) and codetermination – not touched
- The legal context for German CG has been overhauled  
BUT in fact mainly internal governance mechanisms were strengthened
- Legal means of outsider investor protection improved  
BUT enforcement is still lax
- Institutional investors gained importance as shareholders  
BUT ownership concentration of families and companies remains high
- After Mannesmann/Vodafone, hostile takeovers are now acknowledged as possible  
BUT the expected wave has not materialized
- Equity has increased its importance as a source of finance  
BUT bank loans still dominate external financing
- IPO activity boomed until 2000  
BUT market capitalization is still low
- Better minority protection has reduced the value of control rights  
BUT this value is still much higher than in the US and the UK



**Financial institutions have unraveled cross-shareholdings among themselves...  
BUT no *general* wave of disinvestment could be observed so far**

**Cross shareholdings among German financial institutions (in %)**

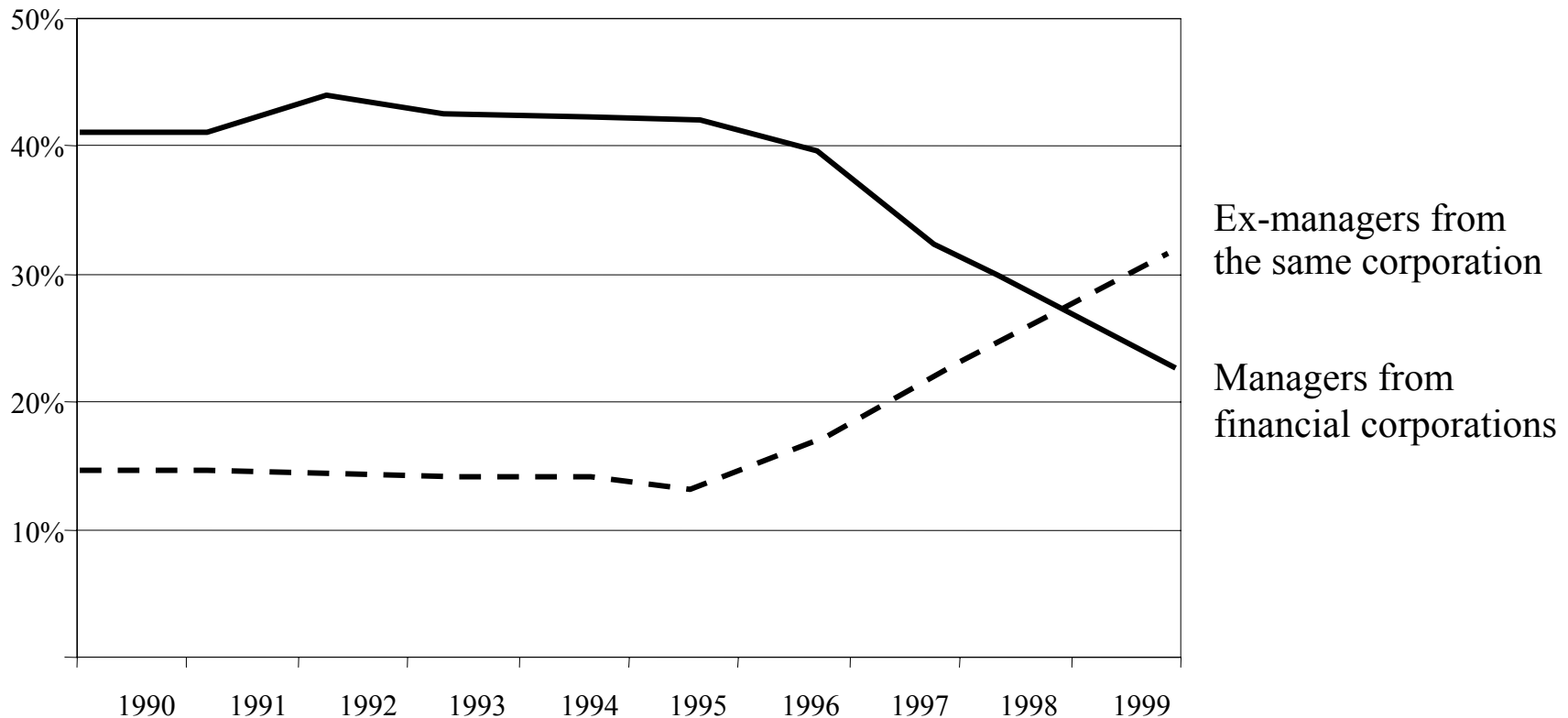
		Deutsche	Commerz	Allianz/ Dresdner	HVB	Munich-Re
Deutsche	1992			10 ↓		10
	2002			3		0 ↓
Allianz/Dresdner	1992	6 ↓			18 ↓	37 ↓
	2002	5			14 ↓	24 ↓
HVB	1992			15 ↓		0
	2002			5		13
Munich-Re	1992	2 ↓	2	26 ↓	5	
	2002	0	10	20	26	

Source: Adams (1999) and JP Morgan (2002)



## Banks have withdrawn from many supervisory board chairman positions... ... BUT have mostly been replaced by other insiders

### Affiliation of supervisory board chairmen of 40 large German corporations (in %)

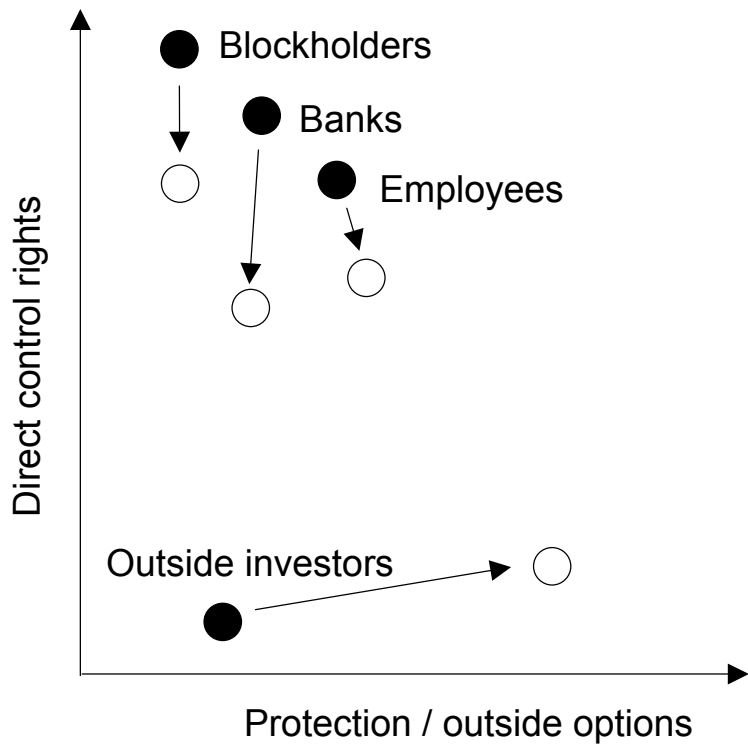


Source: Höpner (2001); Deutsch (1997) reports that the number of seats of bank managers on supervisory boards of the top-100 German corporations had already decreased from 114 in 1986 to 99 in 1993.



**Thus we conclude: Although outsider protection has increased considerably, the discrepancy in direct control rights between insiders and outsiders remains large**

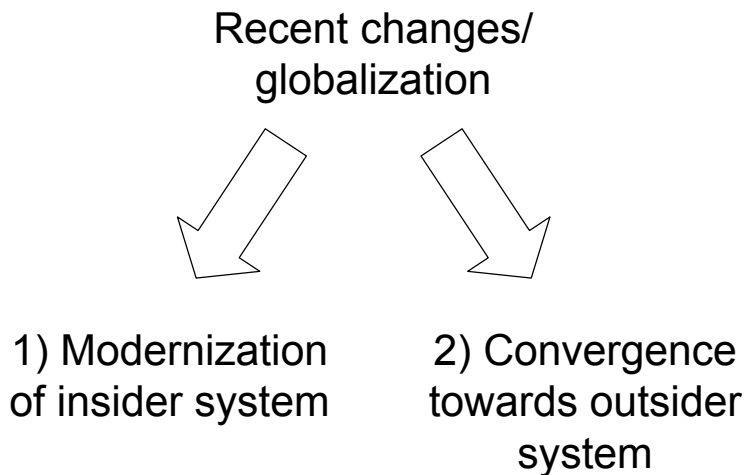
## Impact of changes on core elements of the German corporate governance system



- **Firm specific investments:** no clear trend discernible
- **Control rights for insiders:** simultaneous reduction
- **Balance of power:** intact
- **Available rents:** Lower but arguably still sufficiently high
- **Outside options:** slowly increasing

# We tended to interpret recent developments as a modernization of the German financial (and CG) system as opposed to a convergence towards a capital market-based system

## Implications and caveats



- Until recently, the „BUTs“ made us inclined to conclude that the logic of the system was still the same as before
- We viewed recent developments as efficiency enhancing, aimed at modernizing the financial (and CG) system and making capital markets more attractive
- Perhaps the system had already been weakened more than we believed
- This appears even more likely after
  - the „locust coup“ at Deutsche Börse AG
  - HVB being taken over by Uni-Credito?
- *Decreasing incentives, possibilities and willingness of big banks to play their old roles may indicate a disintegration of the old system*



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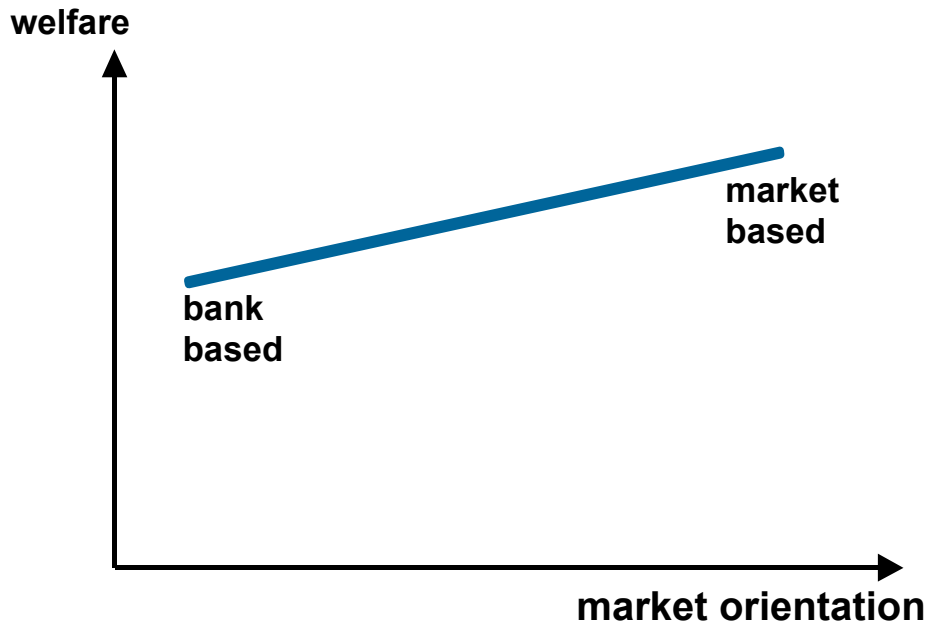
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**Possible future developments**



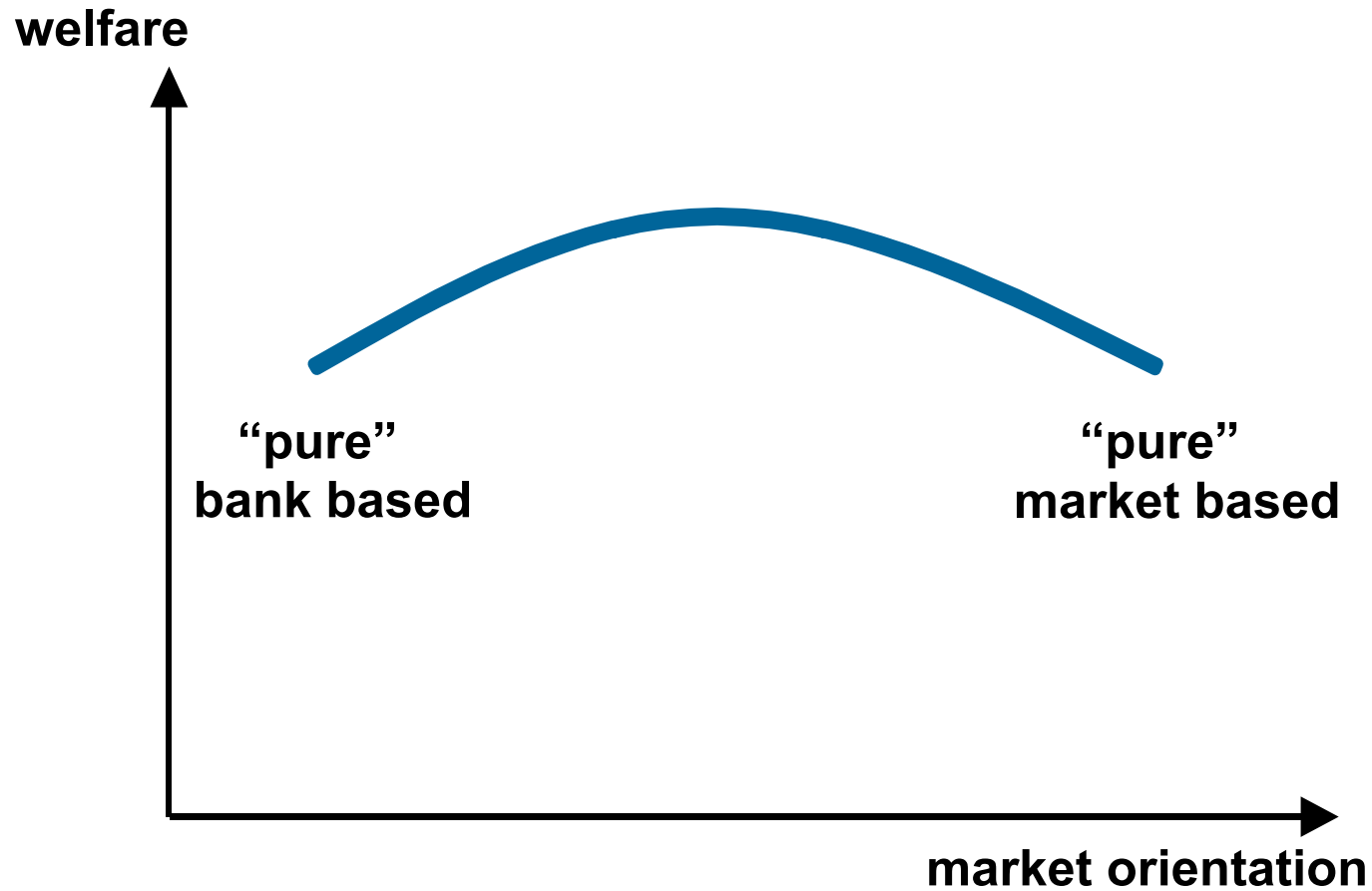
# One position concerning how financial systems and the role of banks in these systems develop is that of a „natural development“ – from banks to markets

## The simple modernization view



- Evidence as well as theory „argue“ against this view – it is much too simple, even if we add „path dependence“
- There is no „natural development“
- Superiority cannot be proven
- And if it existed, why would modernization require much time?

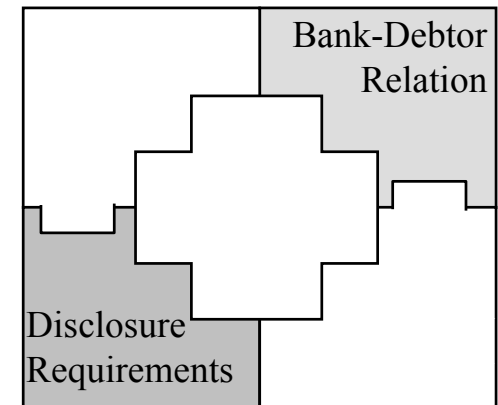
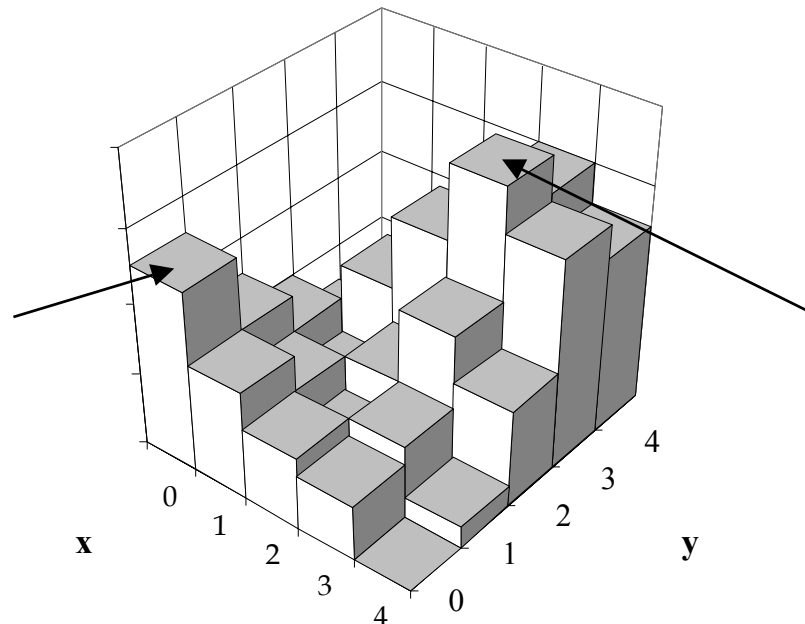
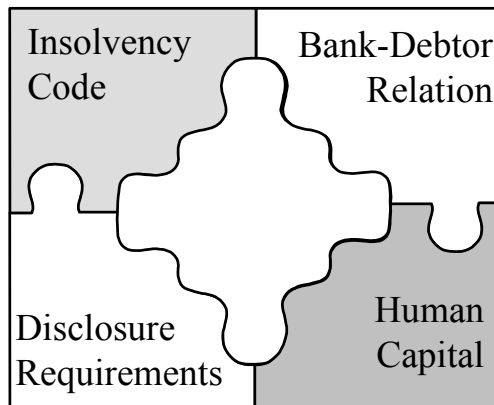
**Scenario 1 is based on the assumption that synergy generates progress: Adding stronger market-orientation w/o destroying the established relationship-orientation may be possible.**



# Complementarity among its elements leads to stability – and inflexibility – of systems

## Complementarity and change

- Remember the definitions of complementarity and consistency
  - Elements of a system are called complementary if they mutually increase positive effects and mutually decrease negative effects on the system's objective function
  - A system is called consistent if its complementary elements take on values, so that the configuration represents a local maximum



# Complementarity precludes convergence. The alternative: from a systemic 'crisis' to convergence towards the 'easier' system

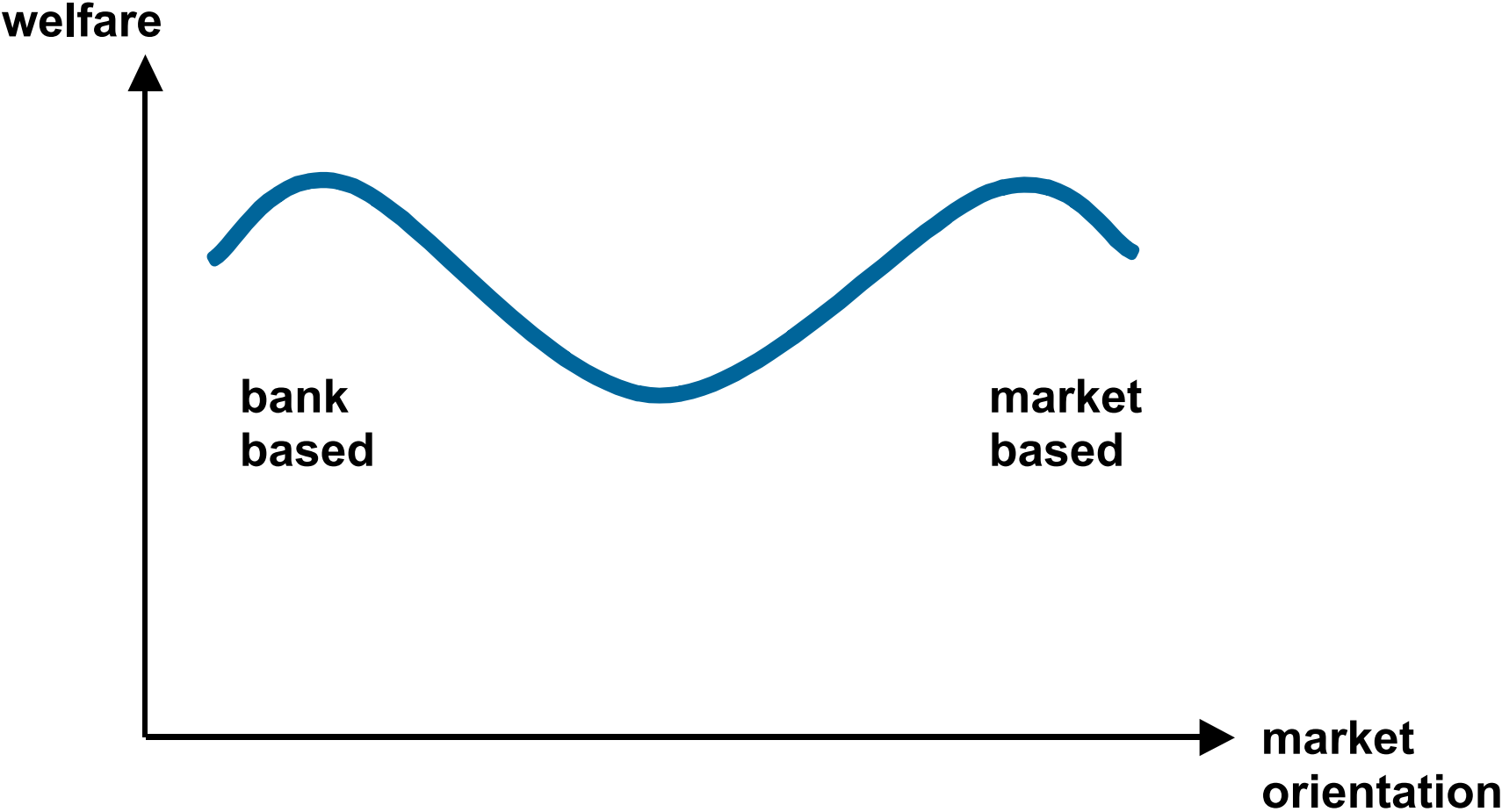
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## An alternative scenario inspired by the concept of Complementarity & Consistency

- In contrast to most observers, I tend to think that a different scenario is at least highly likely
- Innovations and globalization lead to an interpenetration of the old systems, to destabilisation and eventually to a crisis
- In a crisis there is a need for quick efficiency gains – thus there is pressure to generate a consistent system
- But for re-establishing the traditional German system you would need consistent expectations and reputational mechanisms. These mechanisms cannot be (re)constructed quickly in a 'crisis'
- And this fact alone is why one could expect a non-gradual transition to the Anglo-Saxon system – independently of the question which system is better outside the 'crisis'



# Scenario 2: The movement from bank-based to market based causes frictions – and a valley of tears



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**Merci de votre attention!**



# Until the middle of the 1990s, the German corporate governance regime was a consistent system of complementary elements with balanced insider control

## Elements of the traditional German system

### **CONTROL vs. Liquidity**

- Concentration of share ownership
- Representatives of block holders on supervisory boards
- Limited protection for minority shareholders

### **RELATIONSHIP LENDING vs. arm's length lending**

- Creditor-oriented insolvency law
- Reorganization capability of banks and liquidity insurance
- Universal banking and participations in debtor firms
- Proxy voting and supervisory board mandates

### **INTERNAL LABOUR MARKETS vs. External**

- Firm-specific human capital
- Strong dismissal protection, imperfect external job markets
- Work councils and representation on supervisory boards
- Low-powered compensation schemes

### **INTERNALIZ. OF INFORMATION vs. externalization**

- Conservative accounting rules (hidden reserves)
- Lax disclosure requirements even for listed corporations
- No laws prohibiting insider trading

Source: Hackethal/Schmidt (2000)

