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Corporate Governance in Germany: An Economic Perspective

Reinhard H. Schmidt

Center for Financial Studies
an der Johann Wolfgang Goethe-Universität ▪ Taunusanlage 6 ▪ D-60329 Frankfurt am Main
Tel: (+49)069/242941-0 ▪ Fax: (+49)069/242941-77 ▪ E-Mail: ifk@ifk-cfs.de ▪ Internet: http://www.ifk-cfs.de

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Abstract:
A financial system can only perform its function of channelling funds from savers to investors if it offers sufficient assurance to the providers of the funds that they will reap the rewards which have been promised to them. To the extent that this assurance is not provided by contracts alone, potential financiers will want to monitor and influence managerial decisions. This is why corporate governance is an essential part of any financial system. It is almost obvious that providers of equity have a genuine interest in the functioning of corporate governance. However, corporate governance encompasses more than investor protection. Similar considerations also apply to other stakeholders who invest their resources in a firm and whose expectations of later receiving an appropriate return on their investment also depend on decisions at the level of the individual firm which would be extremely difficult to anticipate and prescribe in a set of complete contingent contracts. Lenders, especially long-term lenders, are one such group of stakeholders who may also want to play a role in corporate governance; employees, especially those with high skill levels and firm-specific knowledge, are another. The German corporate governance system is different from that of the Anglo-Saxon countries because it foresees the possibility, and even the necessity, to integrate lenders and employees in the governance of large corporations. The German corporate governance system is generally regarded as the standard example of an insider-controlled and stakeholder-oriented system. Moreover, only a few years ago it was a consistent system in the sense of being composed of complementary elements which fit together well. The first objective of this paper is to show why and in which respect these characterisations were once appropriate. However, the past decade has seen a wave of developments in the German corporate governance system, which make it worthwhile and indeed necessary to investigate whether German corporate governance has recently changed in a fundamental way. More specifically one can ask which elements and features of German corporate governance have in fact changed, why they have changed and whether those changes which did occur constitute a structural change which would have converted the old insider-controlled system into an outsider-controlled and shareholder-oriented system and/or would have deprived it of its former consistency. It is the second purpose of this paper to answer these questions.

JEL Classification: D21, D23; G30, L21, P51

Keywords: Corporate governance, financial systems, complementarity, stakeholders, Germany

* The author is the Wilhelm Merton Professor of International Banking and Finance at the Goethe University in Frankfurt. Address correspondence to Reinhard H. Schmidt, Universität Frankfurt, D-60054, Frankfurt / Main, Germany, Tel. 49-69-798-28269, Fax –28272, e-mail rschmidt@wiwi.uni-frankfurt.de
To a large extent, this paper summarises e arlier joint work with Stefanie Grohs, Andreas Hackethal, Marcel Tyrell and Marco Weiss, to whom I owe a great intellectual debt. Of course, any errors are strictly mine.

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I. The problem

A financial system can only perform its main function of channelling funds from savers to investors if it offers sufficient assurance to the providers of the funds that they will reap the rewards which have been promised to them. [1] To the extent that this assurance is not provided by contracts alone, potential financiers will want to monitor and influence managerial decisions. At least they will want to be sure that some persons, institutions or mechanisms have assumed the role of monitoring and influencing the activities of the firm and its management, and are performing that role in their, the financiers', best interests. If they do not have this assurance they will abstain from providing capital in the first place. Therefore, corporate governance is an essential part of any financial system.

It is obvious that providers of equity have a genuine interest in the functioning of corporate governance. However, corporate governance encompasses more than investor protection. Considerations similar to those which underlie the logical link between equity capital and governance also apply to other stakeholders who invest their resources in a firm and whose expectations of later receiving an appropriate return on their investment also depend on decisions at the level of the individual firm which would be extremely difficult to anticipate and prescribe in a set of complete contingent contracts. Lenders, especially long-term lenders, are one such group of stakeholders who may also want to play a role in corporate governance; employees, especially those with high skill levels and firm-specific knowledge, are another. The German corporate governance system is different from that of the Anglo-Saxon countries insofar as it is based on the notion that it is possible, or indeed necessary, to integrate lenders and employees into the governance of large corporations; and this is one of the reasons why the German corporate governance system has for a long time appeared to be somewhat anomalous. As Rieckers and Spindler also point out in their companion chapter in this book, because of its peculiarities the German corporate governance system was considered to be one of the strengths of the German economy some years ago, whereas nowadays it tends to be perceived as more of a burden.

German corporate governance is shaped by a legal tradition that dates back to the 1920s and regards corporations as entities which act not only in the interests of their shareholders, but also have to serve a multitude of other interests. These views may sound somewhat outdated today, but they have left their mark. A narrow orientation toward shareholder value in the sense of an exclusive commitment of management to shareholders' interests is still not part of

German business culture, nor is it in line with actual practice or with the law (Charkham, 1994).

The German corporate governance system is generally regarded as the standard example of what Franks and Mayer (1994) have called an insider-controlled and stakeholder-oriented system. Moreover, only a few years ago the German corporate governance system was a consistent system in the sense of being composed of complementary elements which fit together well. The first objective of this paper is to show why and in which respect these characterisations were once appropriate. Today, however, it may no longer be appropriate to characterise German corporate governance in this way. It is worthwhile and indeed necessary to investigate whether German corporate governance has recently changed in a fundamental way. More specifically one can ask which elements and features of German corporate governance have in fact changed, why they have changed and whether those changes which did occur constitute a structural change which have transformed the old insider-controlled system into an outsider-controlled and shareholder-oriented system, or have at least deprived the system of its former consistency.

Two of the factors which drive the evolution of financial systems in general, and specifically of national corporate governance systems, are European integration and globalisation. It is often argued that these factors expose countries to the pressure of adopting a 'good' corporate governance system, and very often a good system is assumed to be one that comes as close as possible to the capital market-based Anglo-Saxon model of a financial system and the outsider-controlled model of a corporate governance system.[2]

The past decade has seen a wave of developments in the German corporate governance system. At least from a common-sense standpoint, it can be assumed that these innovations, for which not only this paper but also those by Rieckers and Spindler and by Nowak in this volume provide evidence, are shifting the general structure of German corporate governance towards the Anglo-Saxon model. But common sense may not be enough to substantiate such an assessment. Therefore, the second purpose of this paper is to investigate in detail what the main recent developments in German corporate governance have been and whether they indicate that such a paradigm shift is already happening, or indeed has already taken place.

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[1] This is the starting point for the influential series of papers by La Porta et al. See especially their 1997 article on "legal determinants of external finance", and also Shleifer and Vishney (1997).
[2] See already Walter (1993) and recently chapter 7 of Walter and Smith (2000), Bebchuk and Roe (1999), and Roe (1996).

This paper summarises and extends my earlier work with various co-authors[3] on German corporate governance. Section III summarises the earlier work which attempted to demonstrate the inner logic of the German system, and Section IV extends it and discusses whether recent changes can be qualified as constituting a fundamental transformation.

II. Basic concepts

In this section, we define and briefly explain the core concepts of this paper. They are the concepts of corporate governance and of complementarity and consistency. A corresponding definition of the financial system, of which corporate governance is a part, has already been presented in Chapter 2 of this book.

We use a broad concept of *corporate governance*. In our definition, corporate governance denotes the entire range of mechanisms and arrangements that shape the way in which key decisions are made in (large) corporations. Corporate governance takes in legal regulations and arrangements regarding the way in which the highest-level decision-making rights are distributed in a company; it also encompasses other aspects of company law, the product markets, the markets for capital and labour, and finally, both the formal organisational structure of a company and any informal organisational arrangements which may exist and function alongside the formal structures.[4]

In discussing corporate governance systems – and financial systems (see Chapter 2) – we use the term 'system' in a specific way. A system is not just any collection of elements and their relationships, but one in which there is complementarity between the various elements or at least between the main elements, and possibly also consistency. *Complementarity* denotes an attribute of the relationships between the elements of a system, while *consistency* represents

[3] See especially Schmidt and Grohs (2000), Schmidt (2001) and the references given there, as well as Schmidt and Spindler (2002) with respect to corporate governance systems, and Hackethal and Schmidt (2000), Tyrell and Schmidt (2001) and Schmidt et al. (2002) with a broader focus on financial systems. Mann (2002) is also part of this research programme, which received financial support from the German Science Foundation. The strong role of my various co-authors in this area is the reason why I write 'we' instead of 'I', which is of course not meant to imply that others bear responsibility for any errors I may have made.

[4] See Prigge (1998) on different definitions of corporate governance and their implications. Most of the American literature on corporate governance uses a narrower concept than the one introduced here. For authors like Shleifer and Vishny (1997) corporate governance is mainly concerned with the Berle-Means question of how management can be made to act strictly in the interests of shareholders. This narrower concept reflects a normative assumption, namely that management should act strictly in the interests of shareholders. From a non-U.S. perspective, a statement like this might be the outcome of a discussion or an investigation, but it certainly cannot be taken as a premise, let alone as a premise which is not even made explicit. However, some American authors do apply broader concepts of corporate governance similar to those used in the present text; see e.g. Blair (1995) and Zingales (1998).

an attribute of an entire system in which complementary elements take on specific values maximising a given objective or evaluation function.[5]

Two or more elements of a system are complementary to each other if, and only if

- the positive effects of the values taken on by the elements mutually reinforce each other and the negative effects mutually mitigate each other, i.e.
- a higher value for one element increases the benefit yielded by an increase in the value for the other element (and vice versa), and
- as a result, the 'quality' or the 'workability' or the 'value' of a system depends on the extent to which the values taken on by its (complementary) features are compatible with each other or, put simply, the extent to which the values 'fit together'.

The definition of complementarity implies that there is a potential for securing a benefit if the values taken on by the features or elements of the system are well adjusted to each other. It does not, however, presuppose that this potential is also exploited. This is precisely the aspect covered by the concept of *consistency*: A system composed of complementary elements is called consistent if the various elements – or at least the most important ones – take on values which exploit the potential which complementarity offers, i.e. if these values fit together.

Taken together the concepts of complementarity and consistency suggest a number of implications which are particularly relevant to the topic of this paper. First of all, if complementarity prevails, there is a distinct possibility that multiple 'good' systems will coexist. In the case of corporate governance, two consistent systems or two types of systems are known. They come close to the typology of insider-controlled and outsider-controlled systems (Franks and Mayer 1994). Secondly, if there are two or more consistent or (locally) efficient configurations of system elements, 'middle-of-the-road systems' can be quite 'bad'.[6] Thirdly, systems characterised by complementarity have specific ways of changing over time; there may be path dependence, and changes, when they occur, may be abrupt and far-reaching (Schmidt and Spindler 2002). It is precisely because of these implications that the concepts of complementarity and consistency help us to assess the efficiency of systems and to understand how they develop over time. Finally, the concepts provide an understanding of the 'fundamental' structure of a system and therefore also a notion of what might be a 'fundamental' or 'structural' change in that system (Hackethal and Schmidt 2000).

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[5] Formal definitions of these terms and relevant sources are extensively discussed in Hackethal (2000) and Hackethal and Schmidt (2000). The concepts of complementarity and consistency have already been introduced in Chapter 2 of this book.

[6] Note however that this need not be the case; it is not an implication of complementarity and consistency that middle-of-the-road systems *are* 'bad', but only that they *can be* 'bad'.

III. German corporate governance from a systemic perspective

1. Corporate governance from a systemic perspective

Firms are pools of resources. Pooling and employing resources in a firm can generate rents and quasi-rents. How large these rents will be depends on decisions which have to be made in the future. However, in part these residual decisions influence not only the size of the total rent, or the size of the proverbial pie which can be shared by the providers of the resources, but they also influence the distribution of the rent among them, i.e. how big a slice of the pie each one gets. Thus, the providers of the resources have something 'at stake', which makes them stakeholders, and as such they have a 'natural' interest in monitoring as well as influencing management and its decisions.

Shareholders are an important group of stakeholders. Few would question that they are also the most important stakeholder group. But also employees, especially those who have undertaken firm-specific investments in their human capital or have built a house at the firm's location and cannot relocate easily, are stakeholders in this sense; so are creditors who have extended not fully secured loans. If too much is at stake, potential providers of critical resources might be worried that future decisions could violate their interests, and they might therefore abstain from contributing their resources to the pool. This is a precautionary reaction which others may want to avoid, and they may therefore agree that those stakeholders who might be exposed to moral hazard are given a governance role (Schmidt 1997; Tirole 2001; and Hart 1995). Formally speaking, governance problems arise from the incompleteness of the contracts which tie together a corporation and its various providers of resources or its stakeholders and which at the same time create a network of relationships and interdependencies between the stakeholders.

Essentially, corporate governance is about the distribution of decision and control rights; it is about governing and monitoring management, which typically has important residual decision rights; it is about influencing business policy; and it is about protecting stakes which are exposed to the risks arising from the incompleteness of contracts and markets and the asymmetric distribution of information and decision rights.

If one wants to characterise a corporate governance system like that of large corporations in Germany in economic terms, one has to find answers to the following three sets of questions:

(1) Which *stakeholder groups* are able to influence – and do actually influence – the important decisions which need to be taken in a corporation and on its behalf?

(2) Which *instruments* do the various stakeholder groups, including those who are not active in influencing and controlling management, have at their disposal? How do they use their instruments, and in what way are these instruments effective? In other words, what are the *mechanisms* through which the individual stakeholder groups can and do participate in corporate governance?

(3) How and to what extent do these two building blocks, i.e. the roles on the one hand, and the arrays of instruments and the mechanisms for using them on the other, fit together? Are they *complementary and consistent*? Are they really 'a system' in the sense defined above?[7]

Real corporate governance systems differ with respect to the answers to these three sets of questions. They can distribute influence among several stakeholder groups, or concentrate it in the hands of just a few; they can give active and non-active stakeholders few instruments of influence, or many; and they can distribute those instruments in a way which is largely consistent or rather inconsistent.

Monitoring management is a key issue in corporate governance. For various reasons, many decisions, including very important ones, need to be delegated to professional managers. Blind faith in managers is not a sound basis for securing business success. Rather, it makes sense for management,[8] as the main decision making body, to be exposed to strong market pressures, or to be given general directions by the stakeholders and also to be monitored by them to a certain extent. However, whether this is really better in terms of its effect on the success of the company and on the benefits for all resource providers, depends in no small measure on which groups of stakeholders have the right to actively exercise influence and control, and also on which instruments or weapons the various groups of stakeholders have at their disposal to monitor, control and influence management and to protect their claims.

Note that stakeholders' actively exercising influence over management, and especially the presence of different stakeholder groups with this capability, is not a feature of all corporate governance systems. In an ideal market-based or outsider control system no group has – or needs – the power to actively exercise influence, because market signals provide direction to management, because management is monitored by anonymous market forces, and because stakes are protected by complete and easily enforceable contracts and markets which provide exit opportunities for all stakeholders. In an insider control system, in contrast, markets play a less important role, as contracts are incomplete or unenforceable and some markets are

[7] If they are consistent, we call such a system a corporate governance regime (Mann 2002).
[8] In this paper we mostly use the term 'management' to refer to top management.

imperfect, which makes it important to have the power to exercise active influence and control.

The economic effectiveness of control depends in a crucial way on the consistency of the governance system, because its elements are complementary. There are at least two systemic aspects or types of complementarity which need to be kept in mind in the present context.

The first systemic aspect, or the first respect in which complementarity and consistency are important, is related to the set of instruments or the arsenal of weapons which a given group of stakeholders has at its disposal and which it can use to protect its claims. How effective each individual instrument can be depends on which other instruments this group has, how they can be used and how they are in fact used. Each individual stakeholder group has an interest in ensuring that its arsenal is composed of weapons which reinforce each other in their effectiveness both in influencing management and in the distributive fight with other stakeholder groups.

The second systemic aspect refers to the interaction of the various stakeholder groups and their arsenals. There are different stakeholder groups with different arsenals of weapons to influence management and to protect their interests. Like the instruments or weapons in each arsenal, the various arsenals are complementary to each other. They may support each other, or they may be mutually destructive. Thus, the various groups may tend to cooperate or they may tend to act antagonistically towards each other, not only in their joint efforts to monitor management, but also in pursuit of their own respective interests. One group may strive to gain benefits for itself largely at the expense of other groups, or it may do so in a way which impinges less on the interests of others.

This characterisation of the two systemic aspects has made reference to a standard of evaluation for the weapons and the arsenals without making this standard explicit. It is important to distinguish between two standards. One standard is the overall effectiveness of corporate governance as a determinant of the rents that can be distributed to all parties involved, which is measured by asking: What is the contribution to the overall quality of corporate governance, and indirectly to corporate success, of assigning certain rights and opportunities to certain stakeholder groups? We call this standard 'productive relevance'. A good corporate governance system provides instruments and assigns an *active* role to those stakeholders – and only to those – that have incentives and strategies for using their instruments in such a way that management is made to follow a business policy which benefits all groups of stakeholders or at least affords them so much protection that they all

find it attractive to contribute their respective resources to the pool that is called the firm. The second standard is the size of the *share* of the rent, or the slice of the pie, which a given stakeholder group can secure for itself by using its instruments. We call this the 'distributive relevance'. The importance of distributive relevance should be self-evident. The focus of the discussion in this paper is therefore on productive relevance.

2. *Characteristic features of German corporate governance*

The starting point for our analysis of German corporate governance is the legal structure and the division of roles in a German joint stock corporation ('Aktiengesellschaft').[9] The Stock Corporation Act ('Aktiengesetz') gives the management board ('Vorstand') considerable power. According to Sect. 76(1), it has to manage the company in its own responsibility ('in eigener Verantwortung'). Most scholars of corporate law interpret this as saying that not only shareholder interests, but a wider array of interests should determine how a large company is to be managed. This is sometimes expressed as management having to act in the interests of the enterprise ('im Unternehmensinteresse').[10] Thus stakeholder orientation is consistent with German company law. As Rieckers and Spindler discuss in their chapter in this book, it would even be against the law if the management board considered strict and exclusive shareholder value maximisation as its goal. However, this does not call into question the fact that shareholder interests are very important in a legal sense and that they may also be the most important element in a complex set of related objectives.

Stakeholder orientation is also consistent with the distribution of power in large German corporations. As a complement to the strong role of the management board, corporate governance power in Germany is vested in the supervisory board. The supervisory board does not have the formal right to give specific instructions to the management, but management is required to report to the supervisory board at regular intervals and must seek its approval for certain classes of important decisions.[11] Moreover, one of the main functions of the supervisory board is to appoint and to dismiss the members of the management board, whose regular term is five years, and to determine management remuneration. For this reason alone

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[9] The following exposition is intentionally brief and necessarily incomplete; an extensive discussion of the legal aspects of German corporate governance law is not intended. Interested readers are referred to the chapter by Rieckers and Spindler in this volume and to Kübler (1998).

[10] For a critical discussion of this extremely vague concept in economic terms see Schmidt and Spindler (1997) and the references provided there.

[11] An older empirical study by Gerum et al. (1988) demonstrated that in the past the approval of the supervisory board was not important in practice. However, a recent amendment to the law may change this situation in the near future.

it can be safely assumed that in its decisions the management board will tend to give due consideration to what the supervisory board and its members think.

Evidently, the composition of the supervisory board is of crucial importance. It determines which stakeholder groups – alongside, or as a counterweight to, top management – can be active and have power. Three groups of stakeholders deserve special attention.

The first group consists of the shareholders. Within this group it is important to distinguish between blockholders and other, 'dispersed' shareholders. In 1990, the fraction of shares held directly by individual households stood at 18 percent. By 2000, it had fallen to 12 percent. The decline in direct ownership largely corresponds to the growth of indirect holdings via investment funds.[12]

Almost all large German corporations have one or a few major shareholders, which may be other companies, wealthy families or banks and insurance companies. According to a study, which is based on the most detailed investigation of share ownership concentration to date,[13] in the mid-1990s two thirds of all listed companies in Germany had one blockholder with a stake exceeding 25%. A share of 25% gives a blockholder the power to veto important decisions, since in Germany many key decisions require a change in the corporate bylaws which in turn require the consent of more than 75% of the votes at the general meeting. Voting power was even more concentrated than share ownership in the mid-1990s. In more than four fifths of German listed corporations one blockholder had more than a quarter of the voting rights.

It is not easy to determine exactly which individuals or entities are 'really' the ultimate owners of share blocks, since in many cases wealthy families use corporations as legal vehicles to bundle their shares, and corporations can hold shares in other corporations via various subsidiaries within their group of companies. Nevertheless, it seems clear from the data (Böhmer and Becht 2001) that –in contrast to what is generally assumed about German ownership structures –the most important blockholders are other business enterprises. These blocks of shares held by other corporations are not part of the complex structures of groups of companies which Rieckers and Spindler explain in their chapter; instead they are blocks of shares in 'unrelated' firms.

The second largest group of blockholders are wealthy families, often those of the company's founder or founders. Financial institutions follow as a distant third. Especially the big

[12] It is important to note that investment funds in Germany are managed by investment management companies almost all of which are closely related to banks or groups of banks, or to insurance companies.

commercial banks (Deutsche Bank, Dresdner Bank, Commerzbank and Hypo-Vereinsbank) and a few large insurance conglomerates (Allianz and Munich Re) used to have large portfolios of sizable equity participations in corporations from various industries. What makes it very difficult to properly assess the extent to which financial firms, as blockholders, have the potential to influence corporate management is not only the fact that until quite recently they held shares in non-financial corporations, but also the fact that there were many instances of complex cross-shareholdings among the big financial firms.[14] As will be discussed later, the complex web of cross-shareholdings within the financial sector is currently being dismantled.[15]

All large German corporations are subject to mandatory co-determination, and almost all of them are heavily dependent on banks as lenders and as active players in corporate governance. In the standard case of a large publicly held corporation, employee representatives make up half of the membership of the supervisory board. On paper, only a certain fraction of the employee representatives on the board are selected by the respective labour union or unions, whereas in practice most board members representing the labour side are union-affiliated. Typically, the chairperson of the supervisory board, who has a second vote in the case of a tie, will be a representative of the capital side, while his or her deputy will come from the labour side.

The governance role of banks and their potential to exercise influence emanates from four sources. One is lending: measured in terms of flows, bank loans constituted close to 80% of long-term external funding to business in Germany in the 1990s.[16] The second source of the German banks' power to exercise influence is the fact that they traditionally exercise depository voting rights on behalf of their clients. Third, banks (and insurance companies) themselves own shares in the companies concerned. And fourth, they hold seats on the companies' boards. Due to the depository voting rights of the various big banks and probably also to their tradition of mutually supporting each other in their governance roles, the number

[13] See Böhmer (2001) and Böhmer and Becht (2001).

[14] There exist various versions of a graphical representation of the almost unbelievably complex network of cross-shareholdings among the 'big players' in the so-called *Deutschland AG* (Germany Inc.'). Dr. Jens Massmann, now with Price Waterhouse Coopers, claims that he produced this graph while he was a research assistant of Professor Adams. For one version see Adams (1999).

[15] Besides Böhmer, the distribution of shareholdings and especially blockholdings is discussed in Deutsches Aktieninstitut (2001), Davis (2002), Faccio and Lang (2002), and Adams (1999).

[16] This fraction is about the same in Japan, and stands in a sharp contrast to that in the United States (12%). See Hackethal and Schmidt (2002) for the methodology employed to determine these fractions and for further results. The chapter by Elsas and Krahnen in this book contains more information on the influence of banks on corporations resulting from their close relationships.

of board seats and especially of chairs held by bankers far exceeds the number which one might expect merely on the basis of their shareholdings.[17]

Thus there are three groups of powerful and 'influential' stakeholders – blockholders, employee and/or union representatives, and banks. They are represented on the typical German supervisory board, and they play an active role there. Moreover, former top managers of the respective companies are occupying an increasing number of seats on supervisory boards. One can consider this group as representing, at least indirectly, the current management. These three to four groups constitute what one might call the 'governing coalition' in most large German corporations. Still today, small shareholders and institutional shareholders who are not affiliated with banks do not play an important role on German supervisory boards; they are not part of the coalition. This answers the question of who the active and influential stakeholders in German corporate governance are. We now turn to the second question: How can and do they bring their interests to bear?

As Rieckers and Spindler (in this volume) also acknowledge, the members of the supervisory board have a dual obligation. One the one hand, they are obliged to act in the best interests of the firm – whatever this may mean precisely – while on the other hand they have a certain amount of leeway to further the interests of their specific constituencies. Thus there is a mixture of shared and divergent or even conflicting interests at work. This situation raises the important question of how the supervisory board can influence and monitor the management board at all.

Monitoring and control are made difficult by the fact that the task of management – namely to act in the best interests of the enterprise – is not at all well defined. But at the same time, monitoring and control are made relatively easy by the fact that the groups which form what we have called the governing coalition have a largely similar long-term objective. It does not consist in the maximisation of shareholder value, but rather in ensuring stability and growth, or stable growth: banks want their loans to be secure; employee and union representatives want job security and advancement opportunities for the staff and the protection of the human capital; families as blockholders want the family name and family involvement to last; top managers of other firms want stable structures in the entire German economy, and ex-top managers will probably wish to protect their successors and the firms to which they have dedicated an important part of their life. The common interests of the powerful groups may amount to what some legal scholars call 'the interests of the enterprise'.

[17] On the role of banks, especially the traditional large banks ('Grossbanken'), in the governance of many large

The members of the active groups of stakeholders can act on the basis of much better information than the general investing public can ever have at their disposal, as Leuz and Wüstemann explain in their chapter in this book. Membership of a supervisory board is an important source of privileged and valuable information.

One last element of what the German corporate governance system used to be needs to be added even to the briefest of accounts: In the past there has *not* been an active *public* takeover market that could function as a market for corporate control. However, this does not imply that there has been no market for control at all. In Germany, this market took the form of a market for blocks of shares. As Franks and Mayer (2001) report, this market is active and at times quite hostile to incumbent management. Again, the participants in this market belong to the governing coalition, and therefore one might expect that adherence to the goal of making their firms successful from the perspective of several stakeholder groups would be advisable for incumbent managers, and it might be more advisable than 'mere' shareholder value orientation.

3. *German corporate governance as a 'system'*

Our brief description of the characteristics of German corporate governance, as it was in the mid-to-late 1990s and as it may still be today, provides a first glimpse of its fundamental features and its 'inner logic'. It is a system based on stakeholder orientation as opposed to one-sided shareholder orientation. It is an insider control system as opposed to an outsider control system. Its functioning rests on internal, non-public information as opposed to public information. Evidently, these features of the system are complementary and consistent.

(1) The set of active participants in the corporate governance of large publicly traded German corporations is compatible with the distribution of power and influence. There are several influential groups, and they are forced by the institutional design of the German *Aktiengesellschaft* (stock corporation) to use the supervisory board as the forum for their cooperation.
(2) Moreover, these two features make the system stakeholder-oriented, and this conforms to the legal norm that the management shall be committed to serving 'the interests of the enterprise'.
(3) The influential stakeholder groups can exercise their influence through the supervisory board, and they can do this on the basis of information which would be much too detailed to be presented to the general investing public.

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corporations, see e.g. Emmons and Schmid (1998), Seger (1997), and Prigge (1998).

(4) Under this general rule, it is consistent that banks as long-term lenders and employees are part of the 'governing coalition'. At least some of their investments are relationship-specific or firm-specific. This shows that at least in principle the strange feature of mandatory co-determination and the traditional 'power of banks' are not inconsistent with the logic of this system.
(5) As has been explained in Chapter 2 of this book, the German corporate governance system is also consistent with the general features of the German financial system.

One can take this analysis further and compare the ways in which the members of the governing coalition and their respective constituencies participate in the firm and its governance.[18] Not market forces and outside opportunities – or 'exit' according to Hirschman's (1970) well known dichotomy – but internal mechanisms or 'voice' provide influence and protection for each of the three groups of active stakeholders, and this is why they find it in their interest to be active in governance. Blockholders as the most important group of shareholders seem to prefer control over liquidity.[19] German banks as lenders seem to prefer long-term lending and complex relationships to arm's length lending. For core employees and especially for staff with considerable firm-specific human capital there are advantages in a system in which internal labour markets are more important than external ones, and co-operative labour relations and co-determination predominate over adversarial relations and relations in which loyalty does not play much of a role.

The concept of complementarity suggests why each of the three stakeholder groups has an observable preference for its specific mode of participation in a firm:[20] The choice of the other groups suggests what is best for each group. For instance, the fact that important shareholders opt for control instead of liquidity and that banks engage in long-term lending relationships instead of arm's length lending makes it easier and more attractive for employees to rely on internal promotion and low-powered financial incentives, to act as partners in a co-determination regime and to invest in firm-specific human capital. The willingness of banks and core employees to support long-term relationships with the corporations makes it easier and more attractive for shareholders to take a long-term view and creates incentives to become blockholders in the first place; and long-term lending is less risky and therefore more attractive for banks in a situation in which the shareholder structure is stable and in which employees have reasons to be loyal.

[18] The following is based on Hackethal and Schmidt (2000).
[19] See Bolton and von Thadden (1998).
[20] But see Hackethal (2000), who explains why the respective modes of participation are advantageous, and provides evidence to the effect that these modes are indeed preferred and chosen.

If, in contrast, the most important shareholders preferred liquidity and banks opted for arm's length lending, it would be better for employees to rely on external instead of internal labour markets, to act in an adversarial way in wage bargaining and to avoid even the appearance of being involved in anything which might resemble a co-determination regime, as the examples of the U.K. and the U.S. clearly show. Lending at arm's length would be more appropriate for banks if employees and shareholders were less committed; and one could expect shareholder structures to be less stable and shareholders to be more short-term oriented if employees and banks as lenders were less relationship-oriented.

In the case of Germany, control by blockholders, relationship lending by banks and internal labour markets supported by co-determination form a consistent set, which conforms to the stakeholder system of governance and to internal mechanisms of control based on privileged information for those who actively participate in governance. On a general level, the traditional German system of corporate governance appears to be a well designed institutional arrangement, or a consistent system of complementary elements.

However, there are also conflicting interests, and it is necessary to leave room for them. What mechanisms are in place to minimise the pursuit of particular interests and the level of conflict, and thus to ensure that the common interest prevails? The answer lies in at least four features of the traditional German corporate governance system.

(1) As has already been mentioned, the governing coalition is composed of groups with largely similar long-term objectives. Note that until today the typical small shareholders as well as independent institutional investors, who are only interested in dividends and share price appreciation, are either not represented on the supervisory boards of large corporations or, if they are represented, hardly have any influence. Their interests would be more difficult to reconcile with those of lenders and qualified staff, or with those of managers, unless the latter group were compensated with sizable stock option programmes.

(2) The participants of the 'governing coalition' seem to benefit from a situation which allows them to work together when they perform their job of monitoring management and of providing directions to management. But it seems that they can also reap private benefits of various kinds, and the expectations of these benefits may motivate them to be active players in corporate governance. For this reason, and because of the small number of active participants in the coalition, free riding among the coalition members is not to be expected.

(3) The instruments through which the individual groups can pursue their specific interests are consistent in the sense that their use tends to hurt other groups only to a limited extent. Examples of this kind of consistency include the following facts: in Germany wage bargaining is strictly separated from all issues of co-determination; dividends are limited to accounting profits determined under the conventional 'cautious' German accounting standards; and at least in the past, certain big banks were expected to play a supporting role in the event of a financial crisis in those companies for which they had traditionally been the main banker.

(4) Seen as social groups and even as individuals, the members of the 'governing coalition' not only interact on the supervisory board of a single corporation; rather, they are likely to meet again next month at the board meeting of another big corporation. This repeated and multi-faceted interaction creates a sense of cohesion and joint responsibility for the common task of monitoring management and giving general directions of the kind described above; and it offers many opportunities to conclude and honour implicit deals and thus balance interests over the longer term.

(5) Since there is room for conflict on the supervisory board, there is a possibility that, on a short-term basis, the balance of power might shift from one coalition of groups to another. Consequently, even the preferences within the board with respect to medium-to-long term strategies might occasionally change without such changes being justified by changing business conditions and prospects. Under these circumstances it could be difficult to design and implement a long-term strategy if the supervisory board had the right and the duty to directly influence the policy and strategy of corporations. The German system takes account of this potential problem by denying the supervisory board the formal right to intervene in the business decisions of the management.

At first glance, it might appear as if the traditional German corporate governance system were inimical to 'small' shareholders and therefore simply not good by international standards. This assessment is clearly right in the sense that these shareholders have no active corporate governance role. In the past investor protection was indeed rather weak in Germany. Moreover, analysis of the entire German corporate governance system suggests that there is no mechanism which would ensure that shareholders' interests were the sole or at least the dominant concern of those who run big corporations. This too is indeed the case. However, giving shareholders a *much* stronger role might be incompatible with the inner logic of the system of stakeholder orientation and restricted profit orientation. This is why even the

absence of a public takeover market, which is generally perceived as a characteristic weakness of the German corporate governance system, is consistent with the fundamental structure of this system. If it existed and functioned very well, a market for corporate control based on public tender offers would put management under too much pressure to act in a shareholder value-maximising way and might thereby prevent it from honouring the implicit agreements with the other stakeholder groups, which, as we have seen, are an essential element of the system as a whole. Moreover, it would imply that banks and employees, in their capacity as stakeholders, would face the danger of a new owner possibly breaking the largely implicit contracts after a successful hostile takeover (Shleifer and Summers 1988). Both effects of an active takeover market could be anticipated by the other stakeholders. If banks and employees anticipated these possible effects of a takeover threat, they would probably not enter into relationships which would be dangerous for them.

However, one should not throw the baby out with the bathwater. The 'purely investing' public has not fared badly in the normal course of affairs in Germany. The financial rewards for investing in shares in publicly traded corporations have been in line with those available in other countries. In a comparative analysis of global stock markets, Jorion and Goetzmann (1999: 961) make the point that 'Germany experienced a steep run-up in stock market prices, 6 percent in real terms, over the period 1950 to 1996'. Table 12-1 shows that the performance of domestic portfolios in different countries over the past 40 years did not support the view that German shareholders who were not blockholders were in a relatively weaker position.

Table 12-1: Real annual returns on domestic security portfolios in four countries (1960-2000)

	Stocks	**Bonds**	**50:50**
Germany	5,1%	4,1%	4,6%
France	5,2%	3,0%	4,1%
UK	5,5%	2,9%	4,2%
USA	5,9%	2,4%	4,2%

Source: Jorion and Goetzmann (1999) and own calculations

4. *An assessment*

In the preceding subsection, we presented a rather one-sided and positive view of the traditional German corporate governance system. It used to be a largely consistent insider control system with all of the typical strengths of such a system, allowing management to take a longer-term perspective in its planning and strategies. Because of the need to conclude incomplete and implicit contracts, it offered the advantage of flexibility, and it created

stronger incentives to undertake relationship-specific investments, including those in firm-specific human capital, than a market-based and purely shareholder-oriented outsider control system. However, there can be no doubt that this system also had its weaknesses. Critics maintain that its centrepiece, the supervisory board, does not function in the way in which it was supposed to function. As we will see later, this concern was the main motive for the efforts in the late 1990s to strengthen the German corporate governance system. Among the chief weaknesses of an insider control system, which relies heavily on informal contracting, are its lack of transparency and its anti-competitive effects. It also leads to a systematic neglect of the stock market, and it offers opportunities to abuse power. Even more importantly, there is a real danger that such a system is inimical to all reforms, even those which might improve its functioning without altering its fundamental structure.

Unfortunately, there is no way of determining in general terms whether an insider control system is better than an outsider control system, either universally or in the specific case of Germany.

There have been several attempts to identify by econometric methods the effects of certain features of the German corporate governance system on various measures of corporate performance. For instance, the effect of ownership concentration has been studied and found to be positive (Gorton and Schmid 2000a; Edwards and Nibler 2000; and Edwards and Weichenrieder 2003); the effect of co-determination has been analysed and found in some studies to be slightly negative (Gorton and Schmid 2000b; Seger and Schmid 1998; cf. Sadowski et al. 2001); and the effect of bank ownership – or more generally the effect of banks' playing a strong role in the governance of non-financial firms – has been analysed and found to be slightly positive (Gorton and Schmid 2000a). However, for almost every study showing one effect, there is a competing study which points in the opposite direction. This is not all that surprising when one considers that none of these studies take into account how the various elements of the German corporate governance system are related to each other. As Börsch-Supan and Köke (2002) argue, the econometric studies on the effects of certain features of corporate governance have so far not been able to come to grips with the econometric problems which they aspire to overcome. Most importantly, in the view of the present author, they have so far largely failed to take into account how the different elements and features of such a system interact.

Instead of drawing econometric inferences, one can use simple descriptive statistics. For instance, Table 12-2 shows that although Germany does not have a really active public market

for corporate control, management turnover is not lower in Germany than in other comparable countries with different governance systems. One can interpret this as indicating that management is not under less control and pressure in Germany than in countries with much more hostile takeover activity.

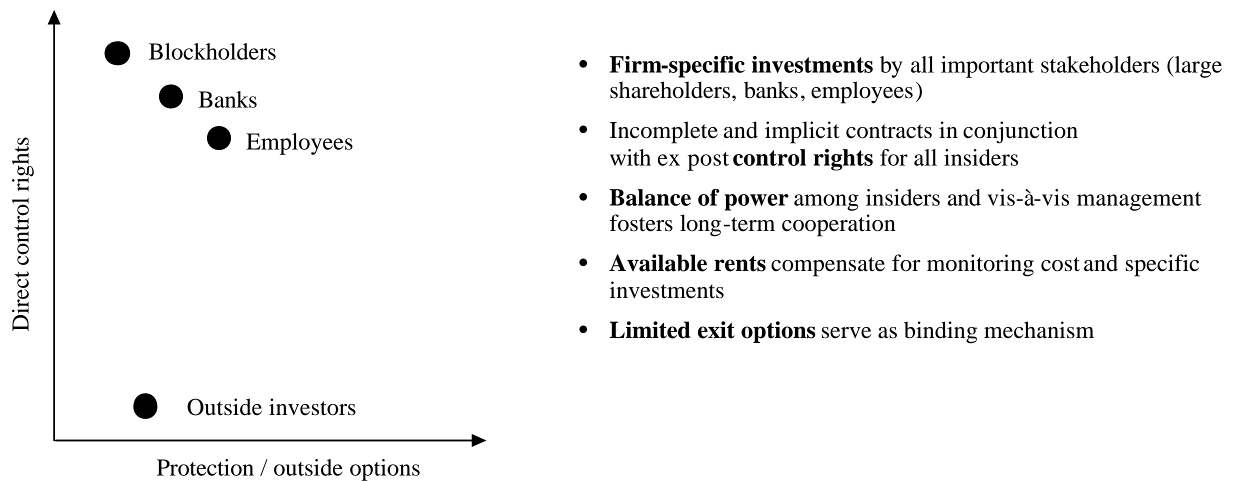
Table 12-2: Market for corporate control and executive turnover (various years)[21]

	# of hostile bids	Block transfers	Executive turnover
Germany	4	10%	12%
France	n.a.	10%	11%
UK	148	9%	9%
USA	150	7%	n.a.

In summing up, one can say that the traditional German corporate governance system was, and perhaps still is, a consistent insider control system. For insiders, exit options are typically not good. The insider control system encourages firm-specific investments by lenders, employees and large shareholders and – as a necessary counterweight – gives control rights to the providers of important and often firm-specific resources. It allows for a certain balance of power among the different groups of insiders and vis-à-vis management and thereby fosters long-term cooperation. It helps to create rents which can serve to compensate those who undertake firm-specific or relationship-specific investments and who are – and need to be – active monitors of management for the risks of their investment and for their monitoring costs. Where does this compensation come from? In part it comes from the economic benefits of having a smoothly running and relatively efficient system. But in part it may also come from the 'exploitation' of those shareholders who are not insiders, i.e. the small shareholders and possibly also some institutional investors. There is no doubt that shareholder protection has been weak in Germany for a long time. At first glance this may appear simply to be a weakness of the system. However, in functional terms, it may have been necessary since with a very high level of investor protection in place it might not have been possible to compensate the active stakeholders for their monitoring effort and thereby to provide them with incentives to monitor management. Figure 12-1 is an intuitive representation of how we see the structure of German corporate governance in the recent past and why we tend to think that it used to be consistent and have positive economic effects. Later on we will present a similar graph in order to show how we assess the changes which have been taken place recently.

[21] Number of takeover bids are taken from Lipton (2001) who reports number of deals with US targets over $100m. Block transfers (exceeding 10% of total equity) Germany (89-94): Köke (2001), France (89-91): Dherment-Ferere et al. (2001), UK (89-94): Franks et al. (2001), US (80-89, threshold 5%): Bethel et al. (1998), Executive turnover: Dherment-Ferere et al. (2001).

Figure 12-1: Insider control system with the supervisory board as the center of power



IV. Developments in German corporate governance

In this section we attempt to discuss the developments that appear to have taken place in corporate governance in Germany during the last decade as a consequence of a series of political measures. We start by looking back over the past 30 years, then address recent developments and conclude with a conjecture concerning the possible future course of events.

1. The longer-term development of German corporate governance in the past

Looking back over the last 30 years, but ignoring for the moment the last half-decade, we find a surprising degree of stability in the German corporate governance system. In the European context, or indeed anywhere in the world, hardly any other country exhibits so much stability in this area (Schmidt and Grohs 2000). The legal structure of the joint stock corporation has remained almost untouched, the role of banks has hardly changed, and co-determination has not been seriously questioned. On a more general level, the specific mixture of conflict and cooperation between the various groups which play an active role in corporate governance in Germany has remained the same over decades. Finally, there has also been no change in the fact that small shareholders' interests tend to receive relatively little attention.

This unusual degree of stability calls for an explanation. One might be inclined to assume that change did not occur because the traditional system was not at all bad for all parties and that the players have understood its merits. This may indeed be the case, and the consistency of the system, which we have tried to demonstrate here, may have contributed to the success on which the stability may be partly based. But this cannot be the whole story. There is also a specific effect of complementarity and consistency on the propensity of a system to develop

and to adapt to new circumstances. Complementarity and consistency prevent changes, especially gradual changes; they are a cause of path-dependence, as Schmidt and Spindler (2002) have argued in a response to Roe (1996) and Bebchuk and Roe (1999). In reality, reforms typically start as partial reforms; as long as there is not an extreme problem, reforms are not 'revolutions'. If complementarity is strong and if a given system is largely consistent and therefore does not function too badly, partial reforms will rarely succeed even though they may seem to hold the potential for improvement. The reason for this resilience is that partial reforms would tend to reduce consistency, which comes with a cost in terms of economic efficiency, and this inconsistency may weigh more heavily than the benefits which the reform in question could bring if it were not part of a complex system.

However, instead of the seemingly positive features of stability and relative efficiency one could also diagnose stagnation, even ossification and an inability to reform in the German corporate governance system. If this negative assessment were appropriate – an issue which we are not in a position to decide – the German system might be one which faces extinction under the pressure of European integration and the globalisation of financial markets.

2. Recent developments and their isolated assessment

Recent developments, to which we now turn, indicate that possibly something is being done to counter the danger of an ossification of the German corporate governance system. We will now look at individual aspects and areas of change which relate to corporate governance in Germany, and we start by discussing those developments which hold the greatest potential to contribute to a structural change of the German system, i.e. to its transformation into a 'modern' capital market-based and outsider controlled system.[22] It is not our intention here to offer a broad and balanced description of the developments to be discussed. Rather, this section is highly selective in that it focuses exclusively on the possibility that the German system has already changed in a fundamental way or that a transformation of the traditional relationship-based insider control system into a market-based outsider control system is imminent.

The presentation of the individual developments is immediately followed by an assessment of the relevance of each development to the topic of this paper. But note that such an assessment is necessarily ad hoc, as it ignores the wider systemic perspective. Accordingly, in the next section we will assess these developments in a systemic context.

[22] This section draws on Schmidt et al. (2003).

a) The political debate

The potentially most important – and certainly most topical – recent developments have taken place in the political arena. Four influential groups of high-level experts have recently deliberated on the basic issues of corporate governance in Germany and have produced four documents: the 'Frankfurt principles' and the 'Berlin principles', two sets of corporate governance principles named after the places where they were elaborated; the report of a high level 'Government Commission on Corporate Governance' published in 2001; and the Corporate Governance Code issued by the so-called Cromme Commission early in 2002.[23]

The two sets of principles reflect different philosophies. The 'Frankfurt principles' seem to have been prepared under the premise that much more – or perhaps even exclusive – shareholder orientation and capital-market orientation are desirable and that more elements of the Anglo-Saxon governance model should be introduced in Germany. But surprisingly this premise and its implications are not even mentioned in the published 'principles'. The 'Berlin principles', in contrast, retain the traditional stakeholder perspective as their normative basis. Top management, i.e. the managing board ('Vorstand') is seen as the main actor here, and it is regarded as having a commitment to a broader set of 'legitimate' interest groups than merely the shareholders. Moreover, it is acknowledged that in order to fulfil its mandate, the managing board needs to have, and should have, considerable freedom to determine what it sees as being in the overall interests of the respective corporation or rather the respective enterprise.[24]

According to several statements by its chairman, Professor Theodor Baums, the 'Government Commission' had the political mandate to come up with recommendations supported by all committee members. This seems to have led it to leave aside the crucial but controversial question of what might be the best model of corporate governance for Germany. In its introduction the published report even states explicitly that the fundamental structure of corporate governance in Germany, i.e. the law-based approach, the dual board system, mandatory co-determination, considerable autonomy of the management board and the reliance on internal mechanisms of corporate governance, need not be altered.

In its refusal to take an explicit stand on the 'fundamental issues', the 'Corporate Governance Code' of the Cromme Commission goes even further. Indeed, the very composition of the

[23] See Grundsatzkommission Corporate Governance (2003), Berliner Initiativkreis (2003), Government Commission on Corporate Governance (2001), and German Corporate Governance Code (2002).

[24] See Schmidt and Spindler (1997) on the distinction in the German legal tradition between 'the interests of the corporation', i.e. of the association of the shareholders, and 'the interests of the enterprise'.

Commission made this outcome seem virtually inevitable. It included fervent advocates of the old German model as well as outspoken 'modernists'.

All in all, in their widely publicised attempts to address 'the corporate governance problem' in Germany, the four groups of experts appear to have come to a rather simple conclusion: There does not seem to be a need to modify the basic structure of corporate governance in Germany. Of course, all shareholders should be treated fairly and small shareholders in particular should certainly be treated better than in the past, but none of the expert groups has made an attempt to reinstate shareholders as the supreme, let alone the only, authority in corporate governance matters.[25]

b) Investor protection and capital market law

One of the main functions of capital market law is to protect investors, especially 'small' and 'unsophisticated' investors, from the hazards which might be entailed in buying, holding and selling shares and other financial instruments; another is to attract institutional investors to the national capital market. Before 1990, there was no capital market law in Germany in the strict technical sense of the word. In 1994, insider trading was legally prohibited and a Federal Authority supervising certain elements of stock market activity was created; and in 2001 a mandatory bid was incorporated into the new German take-over law. These are just the most important regulatory changes of the past decade, and without doubt they are important innovations. In combination with the institutional improvements at the level of the German stock exchange system, these developments have greatly improved the quality of investor protection. The traditional assessment that the German capital markets are 'underdeveloped' no longer appears justified today.[26] Also the devastating rating of German investor protection by LaPorta et al. does not seem to apply any more.[27]

However, the new supervisory authority which came into existence in 1995 did not have the broad mandate of the SEC – to oversee all relevant aspects of stock market activity – and it

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[25] This assessment refers only to the documents' conclusions regarding 'the fundamental problem'; it should not be misinterpreted as implying that these documents did not have useful roles of their own or that they did not succeed in fulfilling these roles. The report of the 'Government Commission' contains a wealth of specific proposals on how the German Stock Corporation Act can and should be modernised; the Cromme Commission seems to have had the function of helping foreign investors to understand the nature of the German corporate governance system from a legal point of view and even encouraging them to appreciate that it is not so bad after all; and all four documents have the common function of making managers, supervisory board members and others aware of their respective obligations.

[26] See the chapters by Nowak, Rieckers and Spindler and Theissen in this book for details underpinning this assessment.

[27] See e.g. LaPorta et al. (1998) and our reassessment of the current situation along their lines in Appendix A. It is important to note here that many German experts find the LLSV assessment inappropriate on a purely factual basis even for the time to which these authors refer explicitly.

largely lacks enforcement powers.[28] This limits the effectiveness of legally mandated investor protection,[29] and this fact alone makes it difficult to argue that the new elements of capital market law already constitute, or at least pave the way for, a capital market-based system of corporate governance.

c) Developments in corporate law

In a process which is still going on, the law governing joint stock corporations has been modified to a considerable extent. The most important part of this modernisation process is the 'Law for the Strengthening of Control and Transparency' (KonTraG) of 1998. The main intention of the law was to improve the effectiveness of supervisory boards and to strengthen them in their role as monitors of top management. The KonTraG has led to a certain shift of power in favour of the supervisory board, thus limiting the powers of the management board. Moreover, it curtails the influence of banks. However, it did not address the questions of how the board is to be composed and what the respective legal obligations of the management and the supervisory boards should be. As this law has a clear and exclusive focus on improving internal governance mechanisms, it would also be inadmissible to claim that the KonTraG has contributed to a paradigm shift from insider to outsider control. On the contrary, it is an important step towards strengthening the corporate governance system in its old format.

Accounting rules are a part of corporate law in Germany. Since 1998, corporations are permitted to use international accounting standards for their group accounts, and in a few years' time, listed companies will even be obliged to adhere to these standards. It may be true that American or International Accounting Standards ensure greater transparency. But even this claim seems hard to really substantiate. Furthermore, Wüstemann (2001) argues convincingly that the adoption of international accounting principles needs to be distinguished from the adoption of American-style disclosure. SEC disclosure rules go much further than those implied by US-GAAP. While many German top managers seem to be strongly in favour of American accounting standards, which tend to increase profits and possibly bonuses and the value of stock options, they seem less enthusiastic about the idea of having to conform to the far-reaching SEC disclosure rules. The adoption of these rules and requirements has not even been considered in Germany so far.

[28] The Bundesaufsichtsamt für den Wertpapierhandel, BAWe, (since 2002 incorporated into the new Bundesanstalt für Finanzmarktaufsicht, BAFin) is not allowed to pursue violations of the insider trading prohibition and has to transfer cases of presumed violations to the public prosecutor. Since 1995 there have been only two convictions (Bundesaufsichtsamt für den Wertpapierhandel 2001: 57).

[29] A more general criticism of the lack of enforcement is presented in Ehrhardt and Nowak (2002).

Mandatory co-determination constitutes one of the most remarkable peculiarities of German corporate governance and is a backbone of the stakeholder-oriented insider control system. Co-determination has not been challenged greatly during the past decade. This may be a matter of political correctness, but it seems more likely that co-determination owes its durability to the fact that it has worked reasonably well within the traditional system.[30] Another commission (Kommission Mitbestimmung 1998) composed of experts from the business community, unions and other sections of society has recently given a clear endorsement to the fundamental structure of German co-determination. Indeed, last year the law on works councils was actually tightened and at the same time streamlined. A recent newspaper article reports that, contrary to widespread expectations and fears, this seems to have had beneficial effects.[31]

d) Takeovers and hostile bids

The Mannesmann-Vodafone take-over battle of 1999 and 2000 was indeed a hostile one, and it was consummated in the form of a public tender offer, not in the form of block sales.[32] Its ultimate success seems to have marked a watershed and given a clear and simple signal of 'modernisation': hostile take-overs in the form of an offer to the broad shareholding public are possible in Germany.

For a number of reasons, the success of Vodafone in its attempt to take over Mannesmann does not imply that the curtain has risen on an active public market for corporate control in Germany.[33] First of all, the battle over Mannesmann does not seem to have had anything to do with sanctioning and ultimately removing bad management. Especially from a shareholder perspective, the former Mannesmann management had been remarkably successful long before the take-over bid by Vodafone and was even more successful after the bid. Secondly, many observers expected the outcome of the Mannesmann-Vodafone case to unleash a wave of tender offers, possibly governance-related and hostile. So far, there has been hardly a ripple since February 2000, and certainly no wave. Thirdly, several of the reasons which had always made hostile tender offers difficult in Germany, especially the legal structure of German joint stock corporations and co-determination as a part of it, still apply.

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[30] This applies particularly to shop floor level co-determination; see Frick and Lehmann (2001) and Sadowski et al. (2001).
[31] Frankfurter Allgemeine Zeitung 2002.
[32] Block sales have always been customary in Germany, and they can indeed be quite 'hostile' towards the incumbent management. See Franks and Mayer (2001) and Jenkinson and Ljungqvist (2001).
[33] See Höpner and Jackson (2001) for details and empirical material, as well as the chapter by Schmid and Wahrenburg in this book.

An important recent legal development is the adoption of a German take-over law in 2002. It was enacted immediately *after* the narrow defeat of the EU take-over directive in the European Parliament (EP) in 2001. The main point of controversy which had led to the decision of the EP was that the defeated EU directive strictly prohibited incumbent management from taking measures against a take-over bid which it considered not to be in the interests of 'the company' or of those constituencies to which management has a legal commitment.[34] The German law contains most of the elements of the EU directive, including a mandatory bid rule, but stops short of disallowing all counter moves. Thus it is evidence of an attempt to balance improved investor protection with the old conviction that not only shareholder interests matter.

This concludes our overview of recent political and regulatory developments. For reasons which we have not explained here and which are covered in other chapters of this book, these developments can be assessed as having many positive effects. They are bold steps towards improving investor protection and the functioning of the capital markets, but they do not constitute a decisive move towards introducing a capital market-based system of corporate governance in Germany.

e) Ownership and direct influence

The degree of ownership concentration and the extent of cross-ownership in the German business world are still very high by international standards (Ulrich 2002). It seems that they have decreased in the recent past, but these changes have not affected the extent of non-financial corporations' participations in other non-financial firms nearly as much as the shareholdings of financial institutions. In particular, there is a clear trend towards unravelling the overly complex web of participations within the financial sector itself.[35]

The corporate tax reform law of 2000 abolished the tax on profits from the sale of equity participations. This tax reform took effect at the beginning of 2002. Before that date it had generally been expected that the new legislation would encourage firms to sell off their big share blocks on a large scale. But so far, this has not happened. This reluctance may well be a consequence of the stock market situation in 2002 and early 2003, but it may also be due to a reluctance on the part of big corporations to fully relinquish their old roles.

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[34] Germany is expected to fight once again the new takeover directive draft (see The Wall Street Journal Europe 2002: A3)

[35] See Appendix B based on Faccio and Lang (2002) for details. Our view seems to be shared by Deutsch et al. (2001), a group of researchers at Deutsche Bank. Developments in the past few weeks before this book went to press support the observation that financial institutions are tending to reduce their crossholdings.

Supervisory board composition has changed slightly in recent years. The number of positions and especially chairmanships held by top bankers has decreased during the last decade, while – interesting enough – the role of managers of other companies and especially that of former managers of the same company has increased. Höpner (2001) provides data which show that the retreat of bankers from corporate boards is matched almost one to one by the arrival of former members of the management board, a trend that is particularly pronounced in the financial sector. Thus the role of management seems to have been strengthened – hardly a move towards greater capital market control. The fraction of seats on supervisory boards held by genuine shareholder representatives has not increased, while the fraction of shares held directly by households has reached an all-time low.[36] Institutional investors are not (yet) active in German corporate governance as far as board representation is concerned. Thus, once again, the facts do not support the proposition that the insider control system is giving way to a market-based system.

f) Shareholder orientation

There are strong indications that in the course of time at least the professed degree of shareholder orientation has increased in most German companies. While the stock market was booming, firms and experts were almost euphoric about shareholder value. In part this may be due to increased informal pressure from institutional investors. As social and political analysts who study the German system argue, it may also be a consequence of the introduction of stock option programmes in most large corporations, or a complement to the introduction of new concepts of value-based internal management, or simply a fashion among managers.

It is, however, extremely difficult to distinguish rhetoric from fact in this area. For instance, Deutsche Bank, whose former CEO Rolf E. Breuer has for a long time been one of the most outspoken advocates of a re-orientation of German corporate governance towards more emphasis on shareholder interests and capital markets, nevertheless seems to support a moderate form of stakeholder orientation as the relevant principle of corporate governance. In its own corporate governance principles, Deutsche Bank (2002) proclaims that its board and management consider themselves responsible to four stakeholder groups, among which the shareholders are only the *primus inter pares*.

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[36] Deutsches Aktieninstitut (2001: chart 08-1-1°).

g) Pension reform

The recent German pension reform (see the chapter by Maurer) seems to have followed the general tendency in the late 1990s to assign increasing importance to the stock market and to the interests of shareholders, and may have thus contributed, at least indirectly, to a change of the governance regime. To a certain extent this may have indeed happened, and it might gain momentum in the years to come, as we will argue in the concluding chapter of this book. But based on the plans presented so far, the extent to which the German pension system will in the future rely on capital-funded private pensions stops far short of the British or American levels. We therefore doubt that the pension reform will have a 'structural' impact on German corporate governance in the medium term.

h) The financing of business

For a long time, the pattern of firm financing in Germany has been remarkably stable. Bank financing was the dominant source of long-term external financing for German companies, and large corporations were the favourite clients of the big banks. At a general level, the role of bank financing does not seem to have changed so far.[37] But there is a need to differentiate. Two aspects merit particular emphasis. Firstly, large corporations, on which most discussions of corporate governance focus, have become increasingly independent of permanent long-term bank financing. Secondly, especially the big banks, which have traditionally played an important role in the governance of the very large corporations, seem to be reducing their corporate lending activities. These two developments together might motivate the big banks to reduce their active involvement in corporate governance. Moreover, competition in the banking sector seems to be becoming stiffer, and this might undermine the willingness of the big banks to act in a co-ordinated way in their governance roles. Taken together, these developments might ultimately be the most important ones when it comes to identifying a possible fundamental change in the German corporate governance system. We will return to this point below.

In summing up, one can say that indeed much has changed which appears to be more or less closely connected to corporate governance in Germany. Especially investor protection and the institutional basis for the monitoring of management seem to have improved considerably. However, some of the developments which appear to be relevant may not in fact stand up to empirical scrutiny, or they may not last; other developments which clearly do have empirical

[37] See Hackethal and Schmidt (2000 and 2002) for details.

reality are unlikely to have an impact on the German corporate governance system; and still others are not significant enough to support the claim that a fundamental shift is taking place.

We could leave it at that and conclude by saying that in our view the proverbial glass, which others may regard as being half full or half empty (depending on their point of view), is in fact still three quarters full. However, as we said before, looking at the individual developments may provide a distorted picture. In the final analysis, the effects that a given change in the relevant factors, elements and features may have depends very much on other – stable as well as changing – elements of the entire governance system. This is the level at which our main question needs to be answered, and to this we now turn our attention.

3. Assessing recent developments from a systems perspective

a) The general proposition

In section III we intentionally painted an idealised and almost 'idyllic' picture of German corporate governance as it existed until the mid-to-late 1990s. In section IV.2, we discussed individual recent developments. We tried to show that even when they are looked at in isolation, most of them do not seem to have a direct effect on the *fundamental structure* of German corporate governance. Can this assessment be sustained when we look at the entire system 'as a system'? To answer this question, we invoke the concept of 'productive relevance' from section III.1. This concept refers to the role that certain facts and instruments which are in place or have been given to certain stakeholder groups play in making the *entire* corporate governance system function for the benefit of all stakeholders or, as German lawyers might say, 'in the interests of the enterprise'. Productive relevance is evidently a feature which can only be assessed with reference to the entire corporate governance system of a country and to the way in which it functions.

The overarching question of this section is this: Is the fundamental way in which corporate governance seems to have functioned in the past, its 'inner logic', changing, or has it already changed, or is it likely to change, as a consequence of the developments described above? Structural or fundamental change can only be brought about by introducing new elements of a new system one at a time so that the new system can finally 'take over' (Witt 2001) or, alternatively, by undermining the functionality of the old system.

We first look at a possible transition based on the introduction of new elements or features of the governance system. Have they already led to a fundamental change, or are they likely to lead to such a change? At this general level the answer seems to be a straightforward No. The

'governing coalition' of blockholders, labour representatives and banks which supported the insider control system and benefited from the way it functioned does not seem to be affected in an essential way by the recent developments. Stakeholder orientation has not been replaced by radical shareholder orientation. Those who are active in governance still seem to act on the basis of privileged private information. In spite of the enormous improvements in its capacity as a secondary market, the stock market has not taken over an important role as a primary market and as a market for corporate control. The official proclamation of the end of the *Neuer Markt* epitomises clearly that Germany has not yet become a shareholder society, and the downturn of the stock market since early 2000 may have interrupted any development in that direction for quite some time. Among the most important developments, we have singled out the strengthening of the supervisory board in its capacity as a monitor of management. This development even points in the opposite direction, indicating as it does that the insider control regime has been made more effective. Moreover, many of those elements in the larger economic system which support the traditional governance system, such as labour law, labour relations and the overall financial system, have largely remained unchanged in Germany so far.

However, one important reservation needs to be made at this point. The more far-reaching recent developments include not only the strengthening of the role of the supervisory boards, but also considerable improvements in transparency and investor protection. Clearly, transparency and investor protection are crucial elements of an outsider control system. Do changes in these fields play a *constructive* role in inducing a transformation of the German system? We think that they do not, because our reconstruction of the mechanism according to which insider control systems function shows that those shareholders who only invest and only expect dividends and share price appreciation in return do not play a governance role at all in Germany. Improvements in investor protection will probably contribute to a change in 'distributive relevance' as defined above, but not in productive relevance. Creating more transparency and more protection for these investors does not exert pressure on management to adjust its strategies.

b) The uneasy case of investor protection

As stated above, structural or fundamental changes in a system composed of complementary elements can also be caused by undermining the functionality of the old system, thereby greatly increasing the pressure to adapt to new circumstances. We now turn to this possibility.

Have the recent changes weakened Germany's insider control system to such an extent that it might cease to function and therefore create space for the introduction of a new system?

One topic which is clearly relevant in this context is investor protection. In the public and political debate the presumed fact that small investors have for a long time been insufficiently protected in Germany[38] is considered a problem. But even if this is the case, what exactly is the nature of the problem here? First of all, it is certainly a problem for those individuals who are adversely affected by the relative lack of protection. Exploiting them is simply unfair and politically unacceptable. Secondly, it may be a public policy problem which stands in the way of all efforts to achieve a broad-based distribution of share ownership in the German population. Thirdly, it may also create a financing problem for firms, insofar as it makes it difficult for them to raise equity capital from the general public. However, it is not necessarily a problem of corporate governance, since investors who do not have any other role and seek only dividends and share price appreciation simply do not have productive relevance in an insider control system. As the history of the so-called economic miracle in Germany shows, a lack of investor protection may also not be a problem as far as the competitiveness of the German economy and the individual firms is concerned. The economic advantages of a governance system based on consensus and co-operation among those who do wield power, 'undisturbed' by small shareholders in pursuit of their specific objectives, might well outweigh the difficulties of raising outside equity from relatively unprotected investors.

But how large are the possible benefits of having an insider control system for all stakeholders, including small investors, and how would these benefits need to be shared between on the one hand the active players, who in the German case are the traditional governing coalition, and on the other hand, the – possibly "free riding" – non-influential small shareholders, in order to keep the system operating? Or, to rephrase the same question: How much shareholder value orientation, as opposed to profit-based growth and stability orientation, how much investor protection and how much transparency is compatible with the functioning of a stakeholder-oriented insider control system? How important is it for the continuous involvement and the active monitoring efforts of those who are active players in the internal corporate governance that management pursues stability and growth enhancing strategies rather than value-maximising strategies? How much do their co-operation and involvement rely on their ability to earn 'private benefits' or, as one could also put it, their ability to exploit small shareholders?

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[38] Empirical support can be found in the work of Wenger, see e.g. Wenger and Hecker (1995).

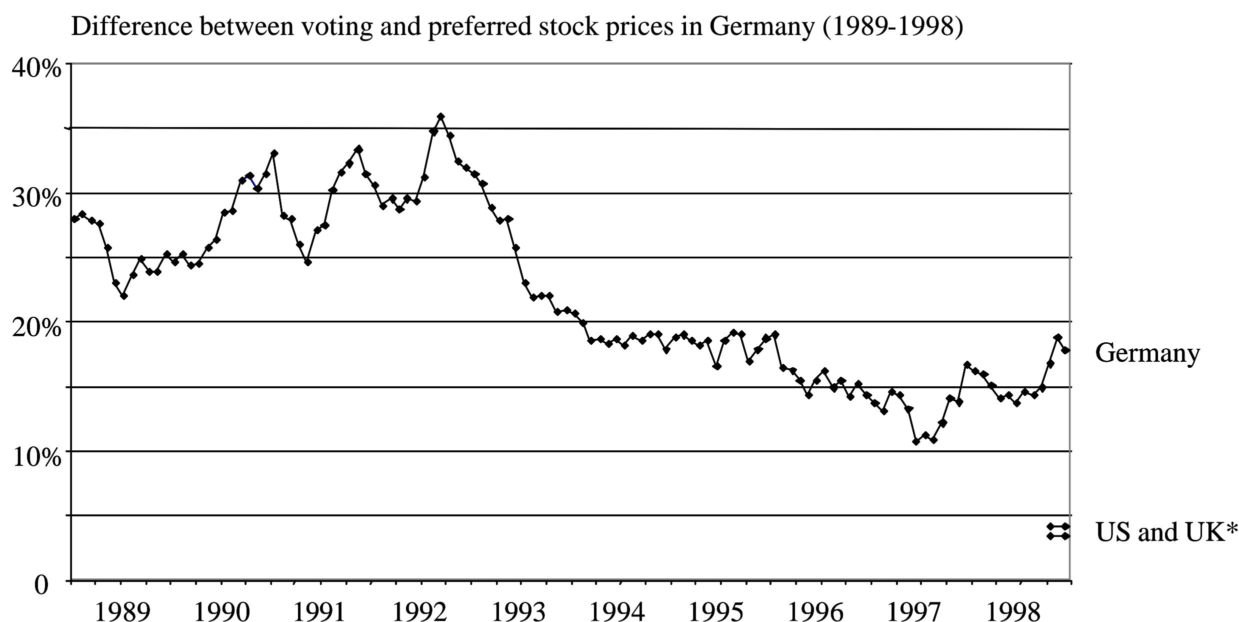
We simply have no answers to these questions. Optimists might think that the economic benefits of a functioning insider control system of corporate governance that accrue to all stakeholder groups are enough to ensure their continuing involvement in either an active or a passive role, so that the 'rewards' reaped by the active players for their activism are financed with the value created by their activity and therefore, in the final analysis, do not hurt shareholders. However, sceptics will question this view: they will merely see excessive private benefits on the one side and expropriated current shareholders and reluctant potential shareholders on the other. Nostalgia may lead one to think that in the past the net benefit was large enough to ensure the co-operation of all parties in their respective roles, whereas nowadays, as a consequence of the highly publicised changes that have taken place in the overall economy, including globalisation, liberalisation and increasing shareholder demands, the surplus left over for distribution may simply no longer be large enough to compensate active stakeholder-monitors and keep the old system viable.

c) The diminishing role of banks in German corporate governance

In the past, private benefits have existed in Germany, and as it seems, they have decreased in recent years. Figure 12-2 shows the development of the value of control rights during the course of the 1990s. There is a marked decline, but control premia, which are generally regarded as an indicator of the size of private benefits, remain substantial.

The decline in the value of control rights can be interpreted as empirical evidence showing that investor protection has improved. However, the considerations in the preceding subsection imply that those who play an active – and perhaps beneficial – role in corporate governance might require a certain compensation, and this compensation might come in the form of private benefits. More transparency and better investor protection might lead to a reduction of this compensation and ultimately even to less willingness on the part of those with an active role to continue playing this role.

Figure 12-2: The value of control rights in Germany



Source: Humboldt University, Institut für Bank- und Börsenwesen
*Nenova (2000) and Dyck/Zingales (2002) both report that average premia for USA and UK corporations are below 5%.

Are there already signs of core players reducing their involvement or their willingness to co-operate in the governing coalition? There are indeed such signs. Deutsche Bank is actively reducing its corporate governance role. It has given up several board seats and has introduced the rule that its own top managers should avoid chairmanships of the boards of other corporations. Deutsche Bank has also undertaken several steps to reduce its own shareholdings and cross-ownerships. There are various reasons for these moves. One is that, like other big banks, Deutsche Bank is also substantially cutting back on its lending to large corporations, and at the same time is trying to become what might almost be described as an investment bank. The new Deutsche Bank simply no longer benefits much from its traditional governance role. This old role, which consisted in being the main bank or house bank of the leading German corporation in each industry, even seems to stand in the way of the current strategy. Another reason for the partial withdrawal of the big private German banks from their governance role in other corporations may be that recent reforms have restricted the scope for banks' active involvement in the governance of non-financial corporations.

Competition and rivalry in the banking sector have increased. This trend also tends to undermine the banks' old established practice of acting co-operatively in governance matters and in cases where big non-financial enterprises run into financial difficulties. The conflicts between the various big banks in the recent Holzmann and Kirch insolvency cases suggest

that this traditional model of behaviour is no longer valid, and with it a key element of the old governance system may be about to vanish.

There are also indications that some of the core players of the traditional system are already looking for different ways of protecting themselves as an alternative to playing an active governance role. For example, changing practices of financing indicate that especially the big banks are tending to opt out of the system. It is an open, but extremely important question whether the aggregate effects of these attempts, which are certainly inspired by the changing economic environment, will, under changed circumstances, be as consistent with each other as their efforts to secure their interests have been in the past. And more directly, it is an open question whether this partial withdrawal of the banks from their former role reduces the 'productive relevance' of their involvement.

Traditionally, the big banks have been the incarnation of the proverbial *Deutschland AG* ("Germany Inc."), which many observers now consider to be an outdated model and which they are happy to see disappear. The banks have indeed been the spider in the web of power and influence in Germany for several decades. However, even if this may not be politically correct, in functional terms one can also see their traditional role more positively: It seems to have been their role to keep the governing coalition stable and working and thus to assure at least a certain level of control over management. It remains to be seen what will happen if the big banks should really give this role up, as they seem to be doing already. One possible consequence would be a – hopefully rapid – transition to a – hopefully well functioning – full blown market-oriented corporate governance system along Anglo-Saxon lines. But the necessary conditions for this to happen are not in place and not even in sight.

A more probable consequence in the medium term is that the effectiveness of the existing governance system will decrease and *no* new system will replace it any time soon. In spite of all political declarations and ambitions, monitoring of management might effectively be reduced, and instead of 'better governance' and more investor protection we might see an emerging control vacuum. The fact that today more chairpersons of large German corporations are former CEOs of the same corporation than ever before and that former top managers are systematically replacing bankers as board members suggests that the power of management is steadily increasing, a development which is not exactly what one would regard as a move toward good governance. The emphasis on shareholder value orientation, which some management teams seem to endorse to a large extent, could intensify and reshape the conflict between management and the remnants of the old control system, and a less co-

ordinated and less powerful group of stakeholders would have little means of opposing the increasing autonomy of management and protecting their stakes. If the providers of critical resources see things this way, they might be inclined to reduce their exposure to the risk of being exploited by management, which they can do by reducing relationship-specific investments.

The growing instability of the German business environment and especially the enormous increase in the level of average top management compensation packages in recent years suggest that we may have already reached this point and that the old Berle-Means problem is reappearing in a more modern guise. However, this is not the only scenario of how corporate governance in Germany might develop. A further scenario will be briefly sketched in the concluding section.

V. Concluding remarks

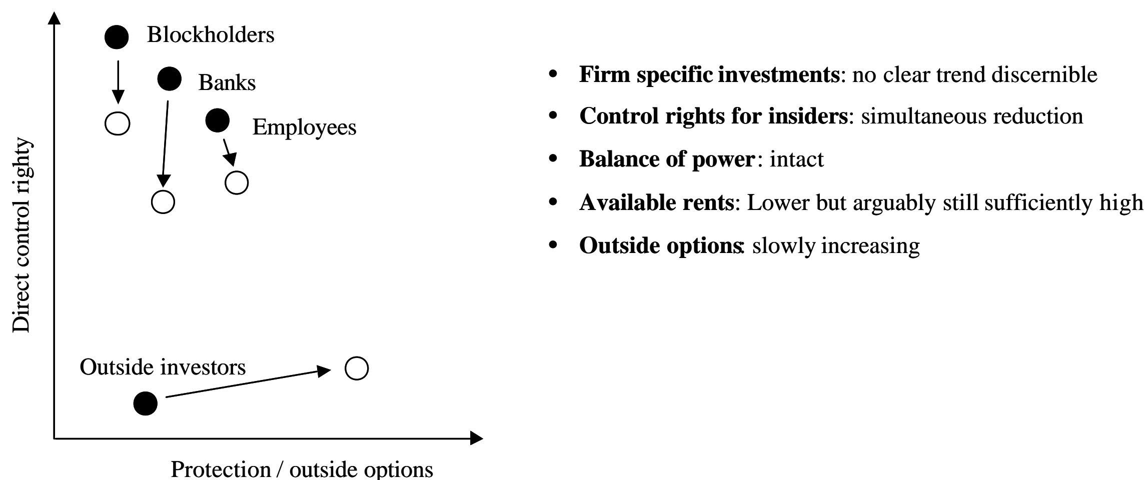
In this paper we have tried to demonstrate that German corporate governance was – and possibly still is – a system, in the sense of a consistent configuration of complementary elements. It was and is an insider control system with a clear stakeholder orientation. Governance was, and possibly still is, exercised by a coalition of active stakeholder groups. To a certain extent, this system seems to have functioned well because of features such as cross-ownership and shareholder concentration, and multiple relationships between the stakeholders and the companies in question. However, there are many reasons to regard these very features as highly ambivalent. The German corporate governance system of the past can also be seen as a system which functioned mainly in the interests of the active stakeholders and also at the expense of others, notably the general investing public.

The past decade has witnessed several important reforms of German corporate governance as such or elements of it. Seen in isolation, these reforms have gone a long way, without challenging the fundamental structure of German corporate governance. Some reforms have even helped to improve the traditional system. This assessment is confirmed when one looks at the recent developments in a systemic context: The fundamental structure – i.e. the set of incentives, restrictions and opportunities for the various stakeholders to secure their interests, among other things by controlling and monitoring management, and the way in which they complement each other – seems to be intact. A transition to a more modern capital market-based outsider control system is not yet in sight. While most other observers tend to think that the proverbial glass formerly filled with the strange brew of typically German corporate governance is already half empty because of capital market-friendly reforms and that it is in

the process of becoming ever more empty, we think that it is still almost full. That is, the old system may still be largely intact.

However, the cautioning word 'largely' needs to be taken seriously. In economic terms, the old system was - and possibly still is - a fragile equilibrium. This consideration suggests a different scenario. The reforms of the past decade and other pertinent developments may already have undermined the stability of the traditional German system of corporate governance. For instance, the willingness of big banks to finance hostile takeovers is simply inconsistent with the traditional role of bankers on the supervisory boards of corporations which may be targets in bank-financed takeover contests. If this is really the case, the traditional German system might soon simply cease to function as well or as badly as it did in the past. Figure 12-3, which is drawn in analogy to figure 12-1, shows how one can see the current situation: The governing coalition seems to have become weaker, and the opportunities available to the passive investors seem to have increased. This leaves less 'private benefits' for those with an active role in governance and might make them unwilling to continue playing their traditional role.

Figure 12-3: Impact of changes on core elements of German corporate governance system



A possible breakdown of the traditional system would not imply that a market-based governance system is already in place and functioning, thus superseding the old system. It might therefore create a lack of any form of functioning governance. One can call this situation a systemic 'crisis' (as do Schmidt and Spindler 2002). As a functioning corporate governance system is probably indispensable in any modern economy, such a crisis would create the urgent need to restore some form of order or to regain some kind of consistency. In principle, both the return to the traditional system and a rapid or even immediate transition to

the alternative of a market-based outsider control system would be ways to regain consistency. We simply do not know which of the two alternatives would be better. Therefore we leave this question open. However, the two alternatives would not be equally attainable if one started from a governance crisis. The traditional German corporate governance system relied to a large extent on compatible mutual expectations, on long-term cooperation and on implicit deals with a give and take between parties that know each other and to a certain extent trust each other. Recent developments in the real world of German business suggest the basis for this kind of cooperation has disappeared. Since mutual trust cannot easily be restored, as Schmidt and Spindler (2002) explain, the only real option would be the transition to the Anglo-Saxon model of market-based corporate governance – not because it is better than the alternative, but rather because the old system cannot be restored.

APPENDIX

A. Rating of German investor protection

Shareholder rights as measured by LaPorta et al approach (1 = protection is in the law)

	1998			2002
	USA	UK	Germany	Germany
1. One-share-one-vote	1	1		1*
2. Proxy by mail allowed	1	1		1
3. Shares not blocked before meeting	1	1		1**
4. Cumulative voting or proportional representation	1			
5. Oppressed minorities mechanism	1	1		
6. Preemptive rights		1		
7. Possibility of calling an extraordinary SGM with less than 10% of the share capital	1	1	1	1
Total	**6**	**6**	**1** ⟶	**4**

Source: LaPorta et al (1998), own investigations   * Excluding German-style preferred stock   **Registered shares

B. Ownership concentration in Germany

Ultimate ownership by sectors (in %)

Share of listed corporations with shareholders controlling more than 20%
- late 1990s -

	<20%	>20%			Average voting rights*
		Family	Bank/Ins.	Other	
Germany	10	65	9	16	55
France	14	65	11	10	48
UK	63	24	9	4	25

Source: Faccio/Lang (2002)
* Share of total voting rights controlled by largest shareholder (5% threshold)

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