

Corporate Governance in Germany: An Assessment of the Convergence Hypothesis

Dante Mendes Aldrighi

Department of Economics, University of São Paulo

ABSTRACT

This article focuses on the corporate governance mechanisms in Germany. Emphasis is placed on changes occurring in corporate and financial landscape since the beginning of the nineties. Two interrelated issues are analysed: 1) the extension in which increasing integration in financial and product markets has been affecting the governance pattern of German companies; 2) the claim that this pattern is converging towards that prevailing in the United States. It is argued that, despite outstanding transformations in the way German companies are controlled, there remain some stark contrasts with the Anglo-Saxon model. Thus, the evidence so far is not enough to corroborate the hypothesis that convergence is under way.

KEY WORDS

corporate governance, corporate finance, Germany, financial globalisation

RESUMO

Este artigo focaliza os mecanismos de governança das empresas na Alemanha. É dada ênfase às mudanças que vêm ocorrendo no cenário financeiro e empresarial alemão desde o começo dos anos noventa. Duas questões inter-relacionadas são discutidas: 1) a extensão na qual a crescente integração dos mercados financeiros e dos produtos tem afetado o padrão de governança das empresas alemãs; 2) a hipótese de convergência desse padrão com o que prevalece nos Estados Unidos. Argumenta-se que, a despeito das profundas transformações no modo como as empresas alemãs são controladas, permanecem diferenças marcantes em relação ao modelo anglo-saxão. Assim, a evidência disponível até o momento não é suficiente para corroborar a suposição de que esteja ocorrendo uma convergência.

PALAVRAS-CHAVE

governança corporativa, governança financeira de empresas, Alemanha, globalização financeira

JEL classification

G30, G32, G34

INTRODUCTION

As both Economics of Information and Transaction Costs Economics have underlined, the relationship between financial structure and investment should not be looked at exclusively from the angle of the effects the former causes to the **volume** of investment.¹ Concerning economic growth, capital allocation is as much important as, if not more telling than, capital accumulation. In this regard, financial markets and financial intermediaries play a critical role, inasmuch as screening applicants for funds and monitoring the recipients are unequivocally amongst their most crucial functions. The way capital is provided to finance a project both reflects and shapes the managerial incentives related to efforts and risk-bearing, besides raising peculiar issues of contract enforceability and signalling effects. (STIGLITZ, 1989a) Moreover, distinct types of financing affect differently the incentives and capability of capital suppliers to monitor. Therefore, the financing structure of investment is a key variable in determining both the capital efficiency and the repartition of returns among firms' stakeholders. On that account, corporate finance and corporate governance seem closely intertwined, and, as Levine (1997, p. 697) indicates, "*in terms of long-run growth, financial arrangements that improve corporate control tend to promote faster capital accumulation and growth by improving the allocation of capital.*"²

Since the 1980s, the financial scene has been rapidly and hugely modified around the world. A relentless harsh competition among financial institutions intimately coupled with a broad and acute deregulation of their activities have brought about a continuous integration of financial markets, both within and across national frontiers. Moreover, the increasingly ubiquitous recognition that the public pay-as-you-go pension system could not meet the rising liability associated

1 See, for example, STIGLITZ (1985; 1989a) and WILLIAMSON (1988).

2 For SHLEIFER & VISHNY (1997) "*corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. How do the suppliers of finance get managers to return some of the profits to them? How do they make sure that managers do not steal the capital they supply or invest it in bad projects? How do suppliers of finance control managers?*" This restricted demarcation of corporate governance put forward by these two economists from, respectively, Harvard University and the University of Chicago reflects itself the institutional arrangement of corporate governance prevailing in the United States, usually dubbed as the *shareholder model*, in which workers' interests are not, as a rule, included. Contrariwise, decision-making in the *stakeholder model*, supposed to characterise the predominant arrangement of corporate control in some European countries, notably in Germany, takes into account other interests besides those of shareholders, such as interests of workers, bankers, suppliers, customers, and the local community. See also OECD (1996).

with provision for ageing population has led many governments to strive for offloading this burden on to individuals and companies. Indeed, in a great number of countries, funded pension schemes have rapidly expanded, fostering, in turn, capital markets and non-bank financial intermediaries to supply this type of contractual savings. Simultaneously, individual and institutional investors have been increasingly aware of, as well as sensitive to, the returns from the broad range of alternative investment instruments - made available by the deregulation of financial markets together with the reduction in transaction costs resulting from the spread of information technology. Completing this scene, the preparation for and the actual launch of the European single monetary currency have been another leading force affecting financial markets and institutions - chiefly, but far from solely, those located in Europe.

On the side of the market for products, transformations have also been outstanding. Competition has become increasingly ruthless as a result of deregulation, globalisation, and pressures on companies arisen from financial markets. These forces sparked off a surge of corporate restructuring worldwide, still in course, involving cross-border or domestic mergers and acquisitions (hostile takeovers included), disposal of non-core businesses, and strategic alliances.

How far have these international trends been operating in the German financial landscape and how much have these changes affected the manner German enterprises are controlled? Some commentators have predicted that greater international integration in the product and financial markets is bound to force patterns of corporate governance to converge towards those prevailing in the United States in the near future. This claim is grounded on the belief that the most efficient form of governance (as any other input or technology) will inevitably emerge from severe global competition.³ There are obviously two assumptions underlying this reasoning. First, the superior efficiency of the Anglo-Saxon system of corporate governance, relied essentially on market mechanisms. Second, economic forces are the ultimate determinant of the corporate governance pattern and they will ineluctably eradicate historical and political "hurdles".

This article examines the governance pattern of German enterprises, highlighting changes pervading the financial and corporate landscape since the beginning of the nineties. Two particular and interrelated issues to be addressed are the effects

3 For an in-depth review of this perspective, see COFFEE (1999).

of the increasing competition in financial and product markets on German corporate control mechanisms and whether “convergence” is actually under way. The “governance convergence thesis” is widely referred to and could be translated into the following proposition:

P1: global competition in financial and product markets associated with changes in the German institutional arrangement are laying the groundwork for capital markets and the threat of hostile takeovers to become major effective tools to discipline companies.

If convergence is really taking place in that sense, the impulse must stem probably from efficiency-seeking.⁴ Conversely, if there is no clear move towards convergence, German corporate governance is either (at least) as efficient as its American equivalent or has been thwarted in undergoing changes due to non-economic motives (such as politics, law, path-dependence, or the power of tradition). This reasoning leads on to the two issues mentioned above:

Q1: the relative efficiency of German and American systems of corporate control;

Q2: the types of forces (economic, political, or historical) that ultimately determine the German corporate governance pattern.

The paper is structured as follows. The first section briefly reviews the role of capital markets in Germany in the last years, presenting some estimates of the relative weight of the various sources where German companies have tapped the finance for their investment. Section II turns to the main determinants of the traditional mechanisms of corporate control in Germany. It is shown that the stakeholder model is largely the result of a combination involving the Co-determination Act, the concentrated corporate ownership structure, cross-shareholdings and proxy voting rights. Section III focuses on the purported shortcomings of this model, and the ensuing section contrasts it with the governance model prevailing in the United States. Section V demonstrates how many of these faults have been corrected by shifts in companies’ strategies, by an overhaul of the legal infrastructure regulating corporate governance issues, and by institutional innovations conducted by private entities, such as the organisation of the Neuer Markt by the Deutsche Börse. The article ends summing up the findings of the previous sections about the repercussion engendered by transformations in the market and in the legal environment on

4 Nonetheless, politics might also prompt up convergence in terms of corporate governance irrespective of efficiency gains.

the manner German enterprises are governed, attempting to assess P1 and to shed some light on Q1 and Q2.

This article's essential claims are that: 1) capital markets and institutional investors are growing at a fast pace in Germany, even though there is no strong evidence that banks have lost market share; 2) there still remains a huge gap between the relative importance of capital markets and institutional investors in Germany vis-à-vis the United States; 3) aggregate flow-of-funds data over the period 1991-1998 do not support the view that direct finance has significantly increased its contribution in German corporate finance; 4) important steps have been taken on the course to internationally-acceptable standards of public disclosure of German companies' information as well as to better legal protection for minority shareholders against expropriation from controlling shareholders, executives, and banks; 5) nevertheless, some political and structural barriers hamper a great part of German companies from moving, at least in the near future, to governance patterns similar to those currently existing in the United States - throwing clouds on the feasibility of P1 on the horizon.

I. INSTITUTIONAL INVESTORS, EQUITY MARKETS, AND THE FINANCING OF COMPANIES' INVESTMENT IN GERMANY

Since corporate governance patterns are intimately connected with the securities markets' particular level of development (ROE, 1998, p. 13), it is important to understand the role these markets have been playing in Germany over the last decade. This section concludes that equity markets and institutional investors have indeed gained importance, although not at the expense of banks nor on such a scale to catch up Anglo-Saxon countries.⁵

1. Institutional Investors

Much has been said about the parallel astonishing growth of capital markets and financial assets controlled by contractual savings institutions and investment intermediaries around the world. Indeed, there appear to be symbiotic relationships between these non-bank financial institutions and capital markets with respect to volume, returns, and terms of funds.

5 This section largely draws on ALDRIGHI (1999).

TABLE I - FINANCIAL ASSETS OF INSTITUTIONAL INVESTORS* (AS A PERCENTAGE OF GDP) - 1990-1997

| Country | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 p |
|---------|-------|-------|-------|-------|-------|-------|-------|--------|
| France | 54.8 | 62.4 | 60.6 | 72.5 | 75.6 | 75.9 | 83.2 | 90.6 |
| Germany | 36.5 | 38.2 | 33.7 | 38.1 | 44.1 | 46.1 | 49.6 | 57.4 |
| Japan** | 81.7 | 79.4 | 78.1 | 81.3 | 84.8 | 76.9 | 77.6 | 75.3 |
| Korea | 48.0 | 47.8 | 52.3 | 56.7 | 57.5 | 57.9 | 57.3 | 37.2 |
| U.K. | 114.5 | 126.3 | 115.3 | 164.1 | 149.3 | 164.1 | 193.1 | n.a. |
| U.S. | 123.8 | 137.2 | 141.3 | 151.7 | 149.9 | 166.6 | 181.0 | 202.5 |

* Insurance companies, invest. companies, pension funds and other forms of institutional savings.

** Excluding pension funds.

p: Provisional .

Source: OECD (1998b).

Private life insurance companies, open-end investment companies, and private pension funds in Germany have piled up amounts of funds that have been soared speedily since 1994 - as a share of GDP, this volume leapt from 38.1% in 1993 to 57.4% in 1997 (see Table I). Notwithstanding, in this regard, Germany still falls far behind other OECD countries at both absolute and relative levels (see Table I). German pension system is partly responsible for this gap, since state and company pension schemes retain the lion's share of the funds reserved to retirement, slice which could otherwise be directed to contractual savings institutions. German investment fund industry has progressed at a quicker pace. Proportionally to GDP, its assets jumped from 21% to 40% in 1998.

2. German Public Equity Markets

Since the beginning of the 1990s, securities markets in Germany have exhibited a remarkable expansion that, nonetheless, has been insufficient to pull them out from their modest position relative to the size of the economy.⁶

6 For a detailed analysis of the equity market and the market for corporate bonds in Germany, see ALDRIGHI (1999).

TABLE II - INTERNATIONAL COMPARISON OF EQUITY MARKET
CAPITALISATION - END OF 1997

| Country/Group of countries | DM bn (1) | % of GDP (2) | Ann. growth (%) (3) |
|----------------------------|-----------|--------------|---------------------|
| France | 1209 | 42 | 9 |
| Germany | 1479 | 39 | 11 |
| Italy | 618 | 27 | 14 |
| Netherlands | 840 | 111 | 16 |
| United Kingdom | 3707 | 155 | 12 |
| EU-11 (4) | 5327 | 44 | n.a. |
| Japan | 3737 | 48 | -10 |
| United States (5) | 19028 | 129 | 18 |

(1) Market value of the shares of domestic listed companies at the end of 1997.

(2) Nominal GDP in 1997.

(3) Covering the period from the end of 1989 to the third quarter of 1997.

(4) European Union excluding Denmark, Greece, Sweden and the United Kingdom.

(5) Market capitalisation of the NYSE and Nasdaq.

Source: DB (April 1998, p. 58).

German public equity market still gathers a small number of listed corporations and exhibits an underdeveloped market capitalisation relatively to the GDP (see Table II). For most of listed companies, concentrated ownership in the hands of a few controlling shareholders (and often one alone) leaves only a proportion of these companies' shares freely available in the market, making them comparatively illiquid and their prices volatile. Thus, the bulk of the trading is concentrated in a few widely-held large public companies, whose shares are the most liquid.⁷

The relative underdevelopment of the German public equity market has been usually attributed to a series of factors. Beginning with the demand-side, poor legal protection of minority shareholders is said to give managers and controlling

7 In 1995, the three companies whose shares were the most traded in German stock exchanges accounted for a third of the total turnover, the top six representing almost 50%. (COFFEE, 1999) Also in 1995, the 5% most traded listed companies represented 83% of the overall turnover and the 5% largest companies were responsible for 67% of the total market capitalisation. (BECHT & BÖHMER, 1997, p. 17) The DAX 30 turnover index is unrepresentative because one of the requirements to comprise it is that companies have a minimum turnover.

shareholders enormous scope for expropriation (BECHT & RÖELL, 1999; LA PORTA *et al.*, 1997, 1998, 1999). Besides the effect on costs, the high potential for agency problems may impact on the availability and destination of equity finance. Indeed, until recently, only companies owning a high reputational capital managed to go public in German stock exchanges, the primary equity market functioning poorly as a channel to IPOs for fast-growing, young, small-and-medium-sized firms.⁸ Second, given the great influence banks have on companies, creditors' interests may prevail, leaning companies to a sub-optimal level of risk-taking (risky projects being set aside) which makes shareholdings unattractive. Third, risk aversion would lead German investors to prefer savings deposits to shares. Fourth, opaque standards of accounting and poor disclosure requirements entail a huge informational asymmetry between insiders and outsiders. Fifth, the existence of a generous public pension scheme leaves little room for the growth of contractual savings institutions. Sixth, the enormous power German bankruptcy code grants to creditors.

On the supply side, first, banks generally meet firms' long-term financing requirements. Second, the entrepreneurs' marked reluctance to bear the underlying costs of going public, such as the share of control with outsiders, the disclosure of information, and the obligation to set up a supervisory board (COFFEE, 1999; EDWARDS & FISCHER, 1994). Third, even though controlling the business of underwriting and IPOs, German banks would lack incentives to promote them because this activity might depress the "purportedly preferable credit business". (ROE, 1998; OECD, 1995, 1998a)⁹ Fourth, small and medium-sized enterprises predominate in the German industrial structure. Fifth, corporate tax rules are biased against public limited company.

Yet since 1996 several events have helped to reduce the huge gap German capital markets stand vis-à-vis their counterparts in other developed countries. On the demand side, the watershed seems to have been the Deutsche Telekom's privatisation in 1996, whose US\$13 billion listing triggered a shift to shares as an investment vehicle for savers. Rising uncertainties about unfunded state-

8 In 1995, while the average ages of newly-listed firms in the London stock exchange, NYSE and Nasdaq were (in years), respectively, 8, 14 and 13, German companies averaged 55 years old. (OECD, 1995, p. 17) Although focusing on Italy, PAGANO, PANETTA & ZINGALES (1998) provide a thorough analysis of the determinants of IPOs. They show, in particular, that young and small companies suffer proportionally more the consequences of IPOs' "adverse selection costs".

9 Conversely, EDWARDS & FISCHER (1994) attribute the problem to the high underwriting costs, blaming banks' market power in that business.

pension system are deemed to have reinforced this switch. On the supply side, recent alterations in the German corporation tax structure rendered it “one of the most neutral with respect to different sources of finance.” (OECD, 1998a, p. 133)

An important institutional breakthrough was the creation of the *Neuer Markt* in March 1997, the stock market segment specialised in dealing with shares of young and fast-growing companies. The long-standing reproach to the German bank-centred system of finance for investment used to be its unwillingness to shore up financially the development of innovative, small and medium-size enterprises with high-growth potential. In a financial environment lacking a reasonably liquid and developed capital market wherein venture capitalists can reach an exit to cash in their investments in private firms via an IPO, the excessively backward-oriented approach adopted by banks obstructs the growth of young, high-expected-return enterprises. They cannot help having slim track record - sometimes, even running losses.¹⁰ Hence, *Neuer Markt*’s primary aim lies in providing access to the equity market for recently established and innovative enterprises.

TABLE III - NEUER MARKT: INITIAL PUBLIC OFFERINGS

| | 1997 (1) | 1998 | 1999 | 2000 (2) | 1997-2000 (3) |
|-------------------------|----------|--------|--------|----------|---------------|
| Number of IPOs | 14 | 43 | 140 | 11 | 208 |
| Placement volume (euro) | 935.3 | 1820.5 | 7899.2 | 421.1 | 11076.1 |
| Average volume (euro) | 66.8 | 42.3 | 56.4 | 38.3 | 53.3 |
| Median volume (euro) | 43.1 | 28.7 | 37.9 | 33.8 | 36.2 |
| Number of transfers (4) | 2 | 2 | 0 | 0 | 4 |

(1) From March 10th.

(2) Until February 15th.

(3) From March 10th to February 15th.

(4) Number of companies that transferred to *Neuer Markt* after IPO in a different trading segment.

Source: DBG (2000).

The *Neuer Markt* has allowed many innovative undertakings to surmount the traditional shortage of external funding surrounding this activity at the same time it cast doubt over the putative inherent risk-averse behaviour of Germans. This market for risk capital promoted 140 IPOs only in 1999, amounting to almost 8 billion euro (see Table III). Some observers have enthusiastically hailed

¹⁰ As Coffee points out, the poor legal protections for minority shareholders create an additional problem for young firms attempting to persuade loath investors to provide external financing.

the emergence and rapid expansion of the *Neuer Markt*,¹¹ taking it as evidence that the German capital-market gap vis-à-vis the U.S and the U.K. is beginning to be closed.¹² Many reasons have contributed to its success. On the demand side, this capital-market segment has sought to enforce minority property rights through strict governance rules that overcome investors' fears of expropriation (issue to be discussed later). Initially, small retail investors searching for high-expected-return vehicles to their long-term savings fuelled it. Deutsche Genossenschaftsbank, a nation-wide credit co-operative owned by the regional credit co-operatives, pioneered the use of a huge distribution network at the retail level to sell shares from IPOs of companies listed on the *Neuer Markt*. Taking notice of that successful experience and acknowledging the opportunities they had missed, some large German banks, such as Deutsche Bank, so far reluctant, began to bid for *Neuer Markt's* IPOs, followed suit by foreign investment banks, U.S. institutional investors and small-capitalisation funds from Italy, France and Spain.

On the supply side, the impulse stemmed mostly from young, innovative, highly technology- and knowledge-intensive enterprises, but also from already established, medium-sized companies.¹³ Part of the *Mittelstand* are going public

11 According to HARNISCHFEGGER (1999), the *Neuer Markt* "proves that Germany can change its crusty, old-fashioned ways of doing business ... (and) also reflects the changing face of German capitalism". She reported that this segment of the capital market accounted for nearly a half of all European growth bourses, with a capitalisation worth nearly 47 billion euro. From its constitution to February 15th 2000, 208 companies went public in Neuer Markt, raising an overall volume of nearly 11 billion euro (see Table III). Thus, in less than three years, it promoted a number of IPOs amounting to almost 80% of all IPOs of German joint-stock companies in the other three segments of the stock market (official, regulated, and OTC markets) in nineteen years (from 1975 to 1995). (BECHT & BÖHMER, 1997, p. 54) The overall number of IPOs in German stock exchanges leapt from 20 in 1996 to 160 in 1999. (*The Economist*, December 11th 1999) In its first two years of existence, Neuer Markt outperformed by far (more than 400%) the DAX, the main share price index involving the 30 leading blue chips of the Frankfurt bourse. A relevant question rests on the reasons for the clustering of Neuer Markt's IPOs in the last two years. Does it result from expectations of future growth opportunities or from the intent to exploit a "window of opportunities" opened by an extraordinary buoyant market for internet/software companies' IPOs? (See PAGANO, PANETTA, & ZINGALES, 1998, p. 41-42)

12 Evidently a huge gulf separates *Neuer Markt* from its colossal U.S. equivalent, Nasdaq, the electronic bourse which assembles more than 5,000 companies, some of which gigantic corporations such as Microsoft and Dell. However, the German stock market for high-growth, innovative companies shows daily market turnover for its average stock similar to Nasdaq. *Neuer Markt* also promoted IPOs of now highly valued companies, such as Mobilcom, whose market capitalisation is worth DM 5 billion. There were so far 23 IPOs in the Neuer Markt whose placement volume exceeded, each, 100 million euro, one of which (ConSors AG) with a volume of nearly 400 million euro.

13 Companies listed on the Neuer Markt belong mainly to software and telecommunication businesses, despite, more recently, the share represented by biotechnology, internet, environmental technology and special material has tended to enlarge. There are also listings of a handful of companies from conventional businesses (such as films and administration of retirement homes) which, nonetheless, either offer new products or services, or introduce innovative processes.

in the Neuer Markt either to complement the provision of their need for external funds (and, perhaps, to reduce the cost of capital) or to facilitate control transfers (letting to surmount, for example, problems related to family succession). In some trades, such as software and telecommunications, going public has the important additional advantage of facilitating the attraction of talented professionals via compensation packages including share option scheme.

The development of Neuer Markt has also nourished venture capitalists, inasmuch as it provides them an exit for their investments.¹⁴ Both act in a complementary way. Venture capital industry concentrates chiefly on financing the expansion of firms that have already completed their start-up stage (seed and start-up financing is still hard to obtain in Germany). Neuer Markt, in turn, targets young firms already established in the market - admission to it requires that firms have existed as well as published their annual financial statements for at least three years (DBG, 1999). In sum, this thriving segment of the German capital market is a worthwhile “docking station” for venture capitalists, whereas these financiers perform the tasks of spotting firms with a high-growth potential and shaping them to go public in the Neuer Markt.

Another institutional attempt to impel capital markets in Germany is the *Third Financial Market Promotion Law*, brought into effect on April 1st 1998. This act further pushed ahead the deregulation of capital markets and has contributed to reduce the costs of going public and trading securities, therefore paving the way for enhancing the availability of long-term funds.

European Union’s efforts to harmonise regulation regarding securities coupled with the launch of the euro have also helped to greater integration of capital markets within Europe, stepping up competition among their players.¹⁵ Heightened competition is expected to drive down the costs for companies going and being public.

All these changes added to others taking place at the governance level have significantly altered the balance between benefits and costs of both tapping public equity markets for funds and investing savings in them.

14 The 157 venture capital companies operating in Germany at the end of 1998 had available a volume of fund of DM18.6 billion and DM 10.5 billion in capital (DBG, 1999).

15 According to the Investment Services Directive, a securities firm licensed in any country belonging to the EU is authorised to undertake cross border businesses in any other EU’s country member. For this reason, competition in European capital markets involves as well subsidiaries of American securities firms licensed to conduct business in Britain.

3. *The Pattern of Investment Financing of the Producing Enterprise Sector in Germany*

A number of problems arises when one attempts to gauge the contribution made by each particular source for the financing of the non-financial enterprises' aggregated physical investment. Notwithstanding, the methodology based on the concept of *net sources of finance* and applied to flow-of-funds data has been widely accepted.¹⁶ Adopting this procedure to analyse data drawn from the *Financial Accounts for Germany* (DB, July 1999) for the period from 1991 to 1998, some inferences may be made about the financing structure of German companies' investment.¹⁷ First, depreciation starkly predominated among the sources of total net finance. Retained profits contributed with a tiny average fraction, notwithstanding its greater importance in the last two years of the period under review (reversing the negative performance that had prevailed until 1994). Capital transfers were relevant, representing on average 8% of the total financing of the capital formation. Liability related to pension commitments played a modest role, averaging 3% of the overall net finance of the capital formation. As for outside finance, bank borrowing, mainly long-term credit, was the main component (more than 15% of the net financing of the investment). Indirect finance other than bank credits (loans from insurance companies, for example) had a negligible contribution.

Concerning direct finance, net bond sales showed a very irregular proportion - fairly high in 1993 and 1994, negative in 1991 and 1995, and moderately positive for the remaining years. Net equity share issues in turn had a negative contribution, although that may reflect a fairly high level of equity sales disguised by acquisitions of shares from other sectors worth an even higher amount. Hence, it should not be dismissed without more research the claim that equity markets may be taking on a significant role in German corporate investment financing.

4. *Banks*

German banks have tackled adequately the effects coming from intensified competition brought about by disintermediation and the growing importance of non-bank financial institutions. This owes basically to the fact that most of them are organised as universal banks and unconstrained to own other non-

16 See CORBETT & JENKINSON (1997), EDWARDS & FISCHER (1994), and MAYER (1988, 1990).

17 These figures are extracted from ALDRIGHI (1999), who also discusses problems underlying the calculations of the contribution from each source for the financing of corporate investment.

bank financial institutions. Thus, rather than rivals, banks and capital markets have common interests and both are likely to evolve in parallel. In particular, banks' asset-side operations do not appear to have been hit by disintermediation thanks chiefly to the predominance of small and medium-sized firms in the structure of the producing enterprise sector. Being capital markets until recently hardly accessible to these firms, they represented "a sort of captive applicants for borrowings".

In conclusion, the main findings of this section may be summarised as follows. First, German capital markets grew sharply over the nineties, fed especially by open-end investment companies. Second, instead of being dented, large banks have benefited from that growth, mainly because they are organised as universal banks. Moreover, there is no hard evidence as yet that direct finance has crowded out bank finance for German firms' investments. Third, despite their amazing growth, stock markets and institutional investors in Germany still lag far behind in comparison with their counterparts in other OECD countries.

II. THE GOVERNANCE STRUCTURE OF GERMAN COMPANIES: MAIN CHARACTERISTIC FEATURES

This section concentrates attention on the cornerstones on which corporate governance in Germany has rested. Several peculiarities shape the German arrangement of corporate control, all of which derived essentially from regulation. The most important are: the mandatory internal mechanism of governance, the Supervisory Board; the highly concentrated structure of shareholdings, mostly owned by controlling investors; the proxy voting rights exerted primarily by banks; and the web of cross-shareholdings amongst the largest companies, wherein the four big banks and two insurers stand at critical positions. After examining these characteristics, this section ends showing how their combination results in the stakeholder approach of governance, often dubbed the German model.

1. The Two-Tiered Board Structure and the Co-Determination Act

According to the Joint-Stock Corporation Act, the governance of limited liability companies comprehends three bodies: the board of management (*Vorstand*), the supervisory board (*Aufsichtsrat*), and the shareholders' general meeting. The backbone of this legal framework is undoubtedly the two-tiered board structure, which obliges companies to set up a supervisory board (SB), whose

chief mandatory duty resides both in appointing the members of the management boards (MBs) - as a rule for a five-year term - and in controlling their decisions. At least in legal terms, SB is the mainspring of the German system of corporate control.

The Co-determination Act (*Mitbestimmungsgesetz*), enacted in 1951, established that every joint-stock corporation,¹⁸ regardless of the number of its employees, should have one-third of its SB members elected by employees. In 1976, this law was redefined, matching the number of shareholder and employee representatives for AGs gathering more than 2,000 employees. Both types of representatives are elected for a term of up five years. Generally, two-thirds of employee representatives proceed from the firm, the remainders being outsiders linked to trade unions. Shareholder representatives, in turn, are elected at the shareholders' general meetings. The chairmanship of the SB is, however, a prerogative of the shareholder representatives.¹⁹ The importance of this post derives from the chairman's entitlement to cast the tie-breaking vote in the case of stalemates in SB's decision making. By law, SB's members should be accountable to the interests of the firm as a whole and not to the interests of the groups they represent. The Act also sets the SB size, which varies from twelve to twenty members, according to the company's number of employees.

In AGs engaging up to 2,000 employees, shareholders and employees are represented on the SB in the proportion 2:1. GmbHs whose number of employees is greater than 500 are also obliged to have both a MB and a SB, being SB's membership regarding employee representation subject to the same rules governing that of AGs. Notwithstanding, GmbH's SBs have a more restricted range of assignments than that of their AG's counterparts - for instance, they are not entitled to nominate managers.

A member of a SB cannot perform management activities. Symmetric cross-overlaps between MBs and SBs of two firms are forbidden, albeit no provision prevents any board members from sitting on other companies' boards. Nobody is allowed to accumulate more than ten mandates for board membership.

18 There are two types of limited liability companies in Germany: public company (*Aktiengesellschaft*, AG, literally "joint-stock corporation") and private limited company (*Gesellschaft mit beschränkter Haftung*, GmbH, literally "limited liability company").

19 A two-third majority of all SB's votes is required to elect its chairman. When that majority is not reached, shareholders' representatives hold the right to choose. Consequently, they always occupy the SB chairmanship.

It is necessary a three-quarter majority at the shareholders' meeting to remove the incumbent SB members before the end of their original term of appointment. Shareholders' general meetings may also vote on the dismissal of MB members, which may be carried through by the SB so long as an "important reason" justifies it - such as a clear neglect of duty. Besides the appointment and dismissal of MB members, the scope of SBs' assignments may extend, if the AG's articles of association allow, to the approval or denial of MBs' determined types of decisions other than those related to companies' day-to-day routine. (OECD, 1995)

MBs have the mandatory duty of delivering SB's members updated information about firm's business strategies and financial condition. The enforcement of this legal requirement is evidently crucial for SB's members exercising effectively their mandatory task.

2. Regulation and Large Voting Block-Holders

Overall German financial institutions are, in comparison with their U.S. counterparts, subject to a less stringent regulation concerning ownership and control of non-financial enterprises. Commercial banks encounter no major hindrance to hold equity stakes in other enterprises, except for "some generous prudential rules".²⁰ Similarly, regulations over non-bank financial institutions are comparatively slighter. Life and other insurance companies may allocate up to 20% of their total assets in shareholdings, while the upper limits for mutual funds are 5% worth of their asset portfolio in securities of a single company and 10% worth of the total voting-right equity from one company. Moreover, non-financial enterprises are not legally curbed from owning equity stakes in each other nor antitrust legislation used to be severe – now an issue under EU's control. As a general rule, everyone whose control on a listed company crosses 5%, 10%, 25%, 50% or 75% of its votes should notify the financial authorities (the threshold was 25% until 1994). Legal rules preventing insider trading were adopted only in July 1994 (being effective from 1995), mainly as a result of the imposition of bringing German securities trading supervision rules in line with EU standards.

20 As a proportion of their own capital, they are allowed to hold shares of any unrelated company up to 15% and their total shareholdings in other companies cannot exceed 60%. (PROWSE; OECD, 1995; OECD, 1996).

Bearing in mind this tolerant legal background, small wonder that, in sharp contrast to the United States, the ownership and voting structure of German large non-financial corporations is distinguished by: (i) a high concentration degree and a great incidence of majority-owned listed enterprises;²¹ (ii) a deep bank involvement, both through equity stake or via proxy voting rights; (iii) and a widespread web of cross-shareholdings.

(i) Concentrated Shareholdings, Types of Shareholders, and Controlling Blocks

Large German listed enterprises have typically a relatively high degree of ownership concentration, often implying that the separation of control from ownership is not widely disseminated. (See PROWSE, 1994) Families and non-financial enterprises account for the lion's share of the large ultimate shareholders (see Table IV). Privatisation has contracted the fraction of shareholdings the German government owns whereas foreigners have considerably built up theirs since the end of the eighties. (DB, April 1998, p. 57) Even though the slice of the total equity shares of listed companies held by institutional investors in Germany has augmented at a fast pace in the last few years, it still lies far behind that held by their American and British counterparts - respectively, 20%, 44% and 51% in 1995 (see Table IV).²²

TABLE IV - INTERNATIONAL COMPARISON OF SHARE OWNERSHIP PROFILES - PERCENTAGE OF TOTAL SHARES IN CIRCULATION HELD BY DIFFERENT SECTORS, END-1995

| Sectors | Germany | USA | Japan | UK | France |
|---|---------|-------|-------|-------|--------|
| Non-financial sectors | 61.0 | 51.4 | 53.9 | 33.9 | 80.8 |
| Households | 14.6 | 36.4 | 22.2 | 29.6 | 19.4 |
| Enterprises | 42.1 | 15.0 | 31.2 | 4.1 | 58.0 |
| Public sector | 4.3 | 0.0 | 0.5 | 0.2 | 3.4 |
| Financial sectors | 30.3 | 44.5 | 35.8 | 52.4 | 8.0 |
| Banks | 10.3 | 0.2 | 13.3 | 2.3 | 4.0 |
| Insurance enterprises and pension funds | 12.4 | 31.3 | 10.8 | 39.7 | 1.9 |
| Investment funds and other financial institutions | 7.6 | 13.0 | 11.7 | 10.4 | 2.0 |
| Rest of the world | 8.7 | 4.2 | 10.3 | 13.7 | 11.2 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

Source: DB (January 1997, p. 29).

21 Majority-owned listed enterprises denote those companies where there is one shareholder controlling more than 50% of the total equity outstanding. A controlling shareholder is one that owns an equity stake large enough to ensure him/her the control over the company.

22 Between 1990 and 1996, insurance enterprises increased their share from 4.3% to 8.2% and investment funds from 5.4% to 9.4% (DB, April 1998).

It is remarkably high the frequency of German listed enterprises with at least one single shareholder holding a controlling equity stake. More than 80% of them have at least one shareholder owning a stake of at least 25% of the company's total capital.²³ Most of listed companies are controlled by only one single shareholder, albeit for the relatively small number of listed companies lacking a majority-control multiple blocks are frequent.²⁴

As stressed by Becht & Böhmer (1998), the distribution of firms' largest voting block is concentrated around 25%, 50% and 75% of the votes, for the obvious reason that these percentages are critical in terms of control issues - indicating thresholds for, respectively, a blocking minority, a simple majority, and a supermajority. The control of a blocking-minority enables its holder to veto changes in company strategies and in SB composition, corporate charter amendments, and profit-transfer and control agreements.²⁵ In reverse, supermajority owners are unfettered to decide on all of those issues, in particular on "*SB elections and profit-transfer and/or control agreements (without any requirement to buy out minorities) which tend to give rise to minority dilution opportunities.*" (JENKINSON & LJUNGQVIST, 1999) Simple majority control, in turn, empowers the controlling shareholder to exert command on management (for instance, adding or removing voting restriction), the only counterbalance being dependent on the existence of a blocking-minority.

23 Based on data for 1996 provided by 372 listed industrial companies, BECHT & BÖHMER (1998) show that 82.6% of them had at least one voting blocking minority (that is, an owner controlling at least 25% of the company's overall voting rights) and that there was majority control in more than 50% of them. These figures are clearly underestimates since they do not include proxy voting by banks and cross-shareholdings. Analogously, JENKINSON & MAYER (1992) reckoned that nearly 90% of the 200 largest German listed companies had at least one shareholder holding at least 25% of the company's total equity - representing almost two-thirds of the value of the listed enterprises' overall equity capital, against around 5% in the United States, Japan and the UK. Out of the 558 listed companies in 1991, 41.5% had a single or formally pooled supermajority owner (above 75% of the votes), 30.5% had a single or formally pooled majority owner (more than 50% but less than 75% of the votes), 15.4% had at least one blocking-minority owner (more than 25% but less than 50% of the votes), 6.6% had no blocking-minority control, and only 3.2% were widely-held (no blocks disclosed at all) - information for the remaining 2.7% of the sample being unavailable. (JENKINSON & LJUNGQVIST, 1999) Major ultimate block-shareholders are, in a descending order of importance: non-financial enterprises, families, and banks.

24 BECHT & BÖHMER (1997, p. 38) consider that "*there is little inside competition for control at the firm level*" because most companies are controlled by only one single shareholder. JENKINSON & LJUNGQVIST (1999), in turn, point out to "*the presence of sizeable and often multiple blocks*" in firms with no majority control as well as to the existence of competition among their owners. While the first two authors refer to the whole listed companies, the latter two focus on listed firms whose largest shareholder has a stake smaller than 50% - where ownership is "*certainly not dispersed, but rather fragmented ... (increasing) the scope for hostile stake building.*"

25 Taking into account the low attendance at AGMs (57% on average), a 25% stake may indeed give an enormous leverage. (BECHT & BÖHMER, 1998)

(ii) The Governance Role of Banks

Albeit high from an international viewpoint, banks' stake in non-bank equity is not overwhelming - around 10%.²⁶ Notwithstanding, banks' own shareholdings clearly understate the actual power they can exert over management. That is so because, along with the significant leverage over firms coming from their role as lenders, banks are entitled to exercise by proxy the voting rights belonging to shareholders for whom they provide services of both safe administration and custody of shares. Voting proxy rights coupled with their own equity voting rights confer on banks a significant proportion of the total votes at shareholders' meetings, paving the way for ensuring their representation on the company's SB.²⁷ Nonetheless, as a condition to exercise voting rights by proxy at shareholders' meetings, banks are legally compelled, since 1965, to inform depositors their intention of vote as well as to request instructions from depositors about how they should vote on each item of the agenda to be dealt with at every meeting.

It has been argued (ALLEN & GALE, 1995; LÖHNERT, 1995) that German banks perform a crucial role in the governance of large companies. Managing to obtain a seat on the SB by means of their control of proxy voting rights,²⁸ banks would be empowered to appoint, monitor and dismiss the management of a public company, acting as "delegated exercisers of equity's control rights". However, this thesis has been contested lately.

Edwards & Fischer (1994) argue that, to be true, that claim would require the fulfilment of three conditions. First, banks' proxy voting rights should be correlated with bank's representation on SBs. Second, banks should be able to gather the means to act as delegated exercisers of equity's control rights. Third, they should have enough incentives to deliver this task. As for the latter, these analysts consider it should not be taken for granted since, in their opinion, available evidence fails to buttress that either banks' underwriting provision or their own shareholdings could furnish the appropriate incentive to induce them to act on behalf of shareholders' best interests. Furthermore, they claim that,

26 It should be pointed up that, owing to the importance of cross-firm shareholdings in Germany, this figure certainly underestimates the real portion held by banks. (OECD, 1995)

27 In 1992, nearly two-thirds of the 85 largest German firms with SB had at least one bank representative on it.

28 At the end of 1992, banks had control over nearly 84% of all voting rights on the annual meetings of the 24 largest German firms without a single majority owner - 13% due to their own shares, 10% coming from associated investment funds, and 61% from proxy votes. (OECD, 1995)

since proxy voting rights are concentrated in the hands of big banks, whose ownership structure is widely-held, it is groundless to suppose that the interests of banks' managers coincide with those of the AG's shareholders.²⁹ Even though the Joint Stock Company Act (*Aktiengesetz*) does not permit banks to exert proxy-voting rights at their own shareholders' general meetings (OECD, November 1998), the issue of monitoring AGs' management remains unresolved inasmuch as banks themselves should also be subject to external monitoring if they are actually to act as monitors on behalf of AGs' shareholders. On top of these potential divergences between their double role as shareholder of an AG and simultaneously representative of other shareholders thereof, it could be added that banks may have as creditors interests at odds with those of shareholders they should represent.

Concerning banks' capability to effectively monitor management, doubt is generally cast on the grounds of both firms' scarce information released by the MB to the SB and the limited spectrum of managerial resolutions SB members are enabled to veto. As for the condition that representation on SBs parallels the rights of proxy vote banks control, Edwards & Fischer (1994) consider it is unfulfilled because they find only a weak relationship between these two variables.³⁰ In conclusion, they state that "*the argument that German banks perform a corporate control function is, therefore, one which lacks both a solid theoretical foundation and convincing empirical support.*"

However disputable the monitoring role of banks, their influence over companies, arisen chiefly from control of proxy votes, is above doubt. In this respect, it is noteworthy the very high proportion of the attending votes at the German DAX companies' AGMs cast by banks - in particular, by the "big 3" banks. (See BECHT & BÖHMER, 1998)

29 That is indeed an important point. For example, Deutsche Bank AG, a widely-held company whose largest shareholder (Allianz) holds a 5% stake in its equity capital, has got 24.4% of Daimler-Benz's total outstanding equity. Similarly, Commerzbank AG has no shareholder holding stake over 5%, although it owns controlling interests in a couple of AGs. Differently, the other two big banks, Dresdner Bank and HypoVereinsbank, have among their largest shareholders, not accidentally, Allianz, which directly owns, respectively, a 22% and 17% stake in these two banks (figures drawn from BECHT & BÖHMER, 1997).

30 They rebut the conclusion reached by Cable's pioneering empirical work on such issue, which put forward a positive influence of bank control of equity voting rights on the profitability of AGs.

(iii) Companies' Equity Stakes and Cross-Shareholdings

German large corporations, notably banks and insurance companies, usually have a significant portfolio of equity stakes in other companies. In 1995, Deutsche Bank, Allianz Holding, HypoVereinsbank, Dresdner Bank, and Commerzbank owned direct stakes in, respectively, 23, 19, 15, 11, and 8 AGs. Direct stakes, however, by and large underestimate voting power inasmuch as this may be leveraged through some legal devices, the most important of which are banks' proxy voting rights. In fact, those five financial institutions hold voting blocks in, respectively, 24, 25, 15, 14, and 7 AGs. (BECHT & BÖHMER, 1997) Commerzbank and Deutsche Bank, for example, despite their dispersed ownership and liquidity, have concentrated voting power thanks to their proxy voting rights. Consequently, this separation between ownership and control gives enormous room for self-controlling. (BECHT, 1999)

In addition, some large corporations have long engaged in an extensive and intricate web of cross-shareholdings and/or cross-voting-power.³¹ At the hub of the web lie Allianz, Munich Re, Deutsche Bank, Dresdner Bank, and Bayerische Vereinsbank. Allianz Holding is the largest ultimate voting blockholder in Deutsche Bank (5%), Dresdner Bank (22%), Munich Re (25%), HypoVereinsbank (17%), Basf (12%), Bayer (5%), and Veba (11%) whereas the largest voting blockholders in Allianz are Munich Re (26%), Bayerische Vereinsbank (15% + 1500 votes), Deutsche Bank (10% + 1500 votes), and Dresdner Bank (10%). Munich Re's voting rights, in turn, are in the hands of Allianz (25%), Bayerische Vereinsbank (9.9%), Deutsche Bank (9.9%), and Dresdner Bank (9.9%). Allianz AG and Munich Re, besides their 25% cross-shareholding and being among the most important blockholders of German listed companies, also concentrate voting power owing to their shareholdings in the big banks and in regional banks.³² For example Bayerische Hypotheken- und Vereinsbank's largest voting block-holders are Viag (10.83%), Allianz (9.2%), and Munich Re (5.4%). Controlling jointly a majority of voting rights in each other, German large banks and insurance companies manage to evade outside control.

31 A company is said to have cross-shareholding if it holds shares "in its controlling shareholder or in the companies along that chain of control." (LA PORTA *et al.*, 1998, p. 12) Companies linked by cross-holdings of shares are legally subject to a 25% cap when voting in each other's AGMs. According to KESTER (1992), among the 100 largest corporations in Germany, there were 88 cross-shareholding arrangements (including those involving banks). Half of the 770 non-employee representatives on SBs in the 100 largest companies in 1992 were linked to other companies and 20% consisted of representatives from banks and other financial institutions. (OECD, 1995, p. 93)

32 Merrill Lynch estimated that "Allianz's combined shareholdings in DAX 30 companies was worth a total 128 billion euro last month. Together with fellow Bavarian insurer Munich Re, it is said to control nearly a quarter of the index." (*Financial Times*, March 7th 2000)

3. The Stakeholder Model

The combination involving mandatory employee representation on SBs and cross-shareholdings is decisive to understand the predominance of the stakeholder approach of corporate control in Germany - hence it is sometimes called the German model of corporate governance. The stakeholder model means that the decision-making process in a company also considers the interests of groups other than shareholders - such as employees, creditors, suppliers, customers and communities.³³ Seen as nexus of multiple partners connected by deep-seated relationships, firms are expected to build consensus when taking decisions on important issues. It is argued that the large scope for stakeholders' active and direct participation in companies' decisions contributes to better monitoring.

It is argued that there are some important advantages in an organisational arrangement wherein shareholders' property rights have no overwhelming primacy over other stakeholders' interests. Investments in firm-specific assets (especially in human capital) are fostered and transaction costs reduced owing to the "*greater trust, loyalty and commitment among the various parties.*" (OECD, 1995) Moreover, pressures to maximise profits over the short-term are less demanding, attenuating the bias for myopic strategies. Edwards & Fischer (1994) and OECD (1995) highlight this point: cross-shareholdings among companies and representation on each other's SBs help improve efficiency due to economies on transaction costs. Shoring up long-term implicit contracts among companies would facilitate co-ordination and circumvent hurdles associated with incomplete contracts and difficult and costly enforcement of contracts.³⁴

33 According to SCHNEIDER-LANNÉ (1992, p. 11), in addition to enforcing the efficient use of the company's assets, "*corporate control also has to ensure that the interests of the other stakeholders, such as the company's employees, clients, buyers, suppliers, and the community at large are looked after.*" She adds (p. 15-16) that "*the objectives of German companies, however, do not stop at maximisation of the return on investment. Their philosophy is based on 'the concept of the interest of the company as a whole', a key concept of German corporate culture... The creation and maintenance of jobs with attractive working conditions has special priority. There is also a growing sense of responsibility towards the environment. In Germany the enterprise is considered to be embedded in society, and since it profits from society it also has obligations towards it. This commitment is rooted in the German constitution which says that ownership entails obligations.*"

34 As for the effects on competition occasioned by these arrangements, KESTER (1992) reckons they are immaterial since inter-firm relationships usually take the form of vertical linkages, horizontal competition tending to be preserved.

III. SOME ALLEGED DEFICIENCIES OF THE GERMAN CORPORATE GOVERNANCE SYSTEM

Except for the “power of the banks”, corporate governance was hardly debated in Germany until the beginning of the nineties. (SCHNEIDER-LANNÉ, 1992, p. 11) This absence is partly explained by the fact that agency problems attendant the separation between ownership and control were not, and remain not being, so widespread in Germany, inasmuch as there is a predominance of companies legally organised otherwise than as public limited liability firms. But, on the other hand, the lack of discussion itself reflected some grave shortcomings of the model of corporate governance in that country.

Over the last decade, this model has been blamed for numerous faults. Main criticisms have revolved around five major issues: 1) the ineffectiveness of SBs in monitoring management; 2) the poor legal protection of investors; 3) the neglect of efficiency concerns and shareholders’ interests; 4) companies’ unsatisfactory disclosure requirements; 5) and the absence of a market for corporate control. Below the soundness of these claims is evaluated.

1. *The SBs’ Poor Monitoring Role*

Some analysts claim that SBs are ineffective in monitoring MBs.³⁵ They argue that SBs are too big; the frequency of their meetings is low; the information flow, fed by MBs, is scanty, biased, and untimely delivered (important documents are often available to SB’s members just at the meetings); their members face varied forms of conflicts of interest (banks, for example, tend to favour creditor interests; members sit on too many boards); and they lack enough incentive to exert accurately their function. The result is, so the argument goes, feeble control on MBs, SBs being merely a placebo. Even though that is still an open question, a significant part of the pinpointed faults, as discussed later, has been addressed by recent legal changes.

If a number of deficiencies actually prevents SBs from performing their fiduciary duty, why have not they been removed yet? Roe (1998) advances a suggestive hypothesis for explaining the long permanence of what he considers the faults pervading German SBs. For him, improvements in SBs’ performance (attainable

35 ROE (1998) and COFFEE (1999) question the efficacy of SBs while SCHNEIDER-LANNÉ (1992) asserts that “experience has shown that the SB is certainly an effective body of control”.

by, for instance, better release of information, fewer members, and meetings more frequent) are hindered by controlling shareholders who deliberately weaken SBs because as they prefer to leave labour ill-informed. He argues that the predominance of block-holdings in the ownership structure of German listed companies stems essentially from the mandated co-determined structure, otherwise a widely-held ownership would either imply unbound MBs or weak equity representation vis-à-vis labour in the boardroom - both alternatives translating into lower firm value.³⁶ The concentrated ownership, in turn, debilitates SBs because monitoring can be performed through informal meetings between blockholders' representatives and managers. He advocates that therein lies the crux of German corporate governance, not in SBs' formal meetings. This public choice hypothesis could also help to understand why securities and corporate laws (and their enforcement) are so deficient in Germany.

2. *"Strong Block-Owners, Weak Minorities":³⁷ The Legal Scope for Expropriating Minority Shareholders*

Although the existence of block-shareholders coupled with interwoven shareholdings may provide better monitoring and economies on transactions costs, it also gives management and controlling shareholders vast latitude to expropriate minority shareholders.

In the first place minority shareholders in Germany lack satisfactory legal protections. Rules are poor, unclear and, of uncertain and costly enforcement (courts have shown little consistency in ruling litigation, with a bias in favour of controlling shareholder). In the event of transfers of large block-holdings, there is virtually no mandatory bid requirement. Minorities are seldom offered a buy-out and when such offers are made, prices are set at a significant discount

36 He argues that "capital" would have incentives to prevent labour representatives from accessing firm's information flows because better information might lead either to conflict increase or internal rent-seeking favouring labour, both of which resulting in a reduction in the firm value.

37 This now much-cited slogan traces back to the book Roe wrote in 1994. Its title "*Strong managers, weak owners*" denotes the gist of corporate governance problem in the United States. Quite the opposite, the main agency-problem in continental Europe seems to concentrate on the minorities' exploitation by controlling investors. (JENKINSON & LJUNGQVIST, 1999; BECHT & RÖELL, 1999)

to the price paid to the block-shareholder.³⁸ If left with too little residual amounts of shares, minority shareholders will encounter liquidity loss and controlling shareholders' greater discretionary power. Besides price, unequal treatment occurs, too, with respect to information, where asymmetries between controlling investors and minorities are quite common. Evidently, the high potential for minority exploitation reflects on the cost of equity finance.

In this regard, the German voluntary takeover code is illustrative. Comparatively with other countries, it is excessively friendly with controlling shareholders and of little help for improving minorities' protection. Similarly to the British rule, it comprises a mandatory bid clause establishing that a party purchasing more than 30% of another listed company's total voting equity should make an offer to the rest of shareholders. Notwithstanding, the code leaves ample room for unequal treatment when sets the minimum share price of the public offer. (JENKINSON & LJUNGQVIST, 1999)

The fertile legal ground for leveraging voting power vis-à-vis share ownership in Germany is an outstanding facet of the comparatively loose legal environment regarding protection for minority investors. Although the concentration of voting power via the detachment of voting rights from ownership may be a legitimate mechanism for creating incentives to monitor without harming liquidity,³⁹ large voting blockholders are granted, however, the incentives and power to reap private benefits at the expense of minorities - especially through circumventing the one-share-one-vote principle.

Among the legally-underpinned devices available in Germany for enhancing voting power, the following are noteworthy.⁴⁰ First, the Stock Corporation Act permits the issue of non-voting shares (preferred shares) up to the outstanding volume of ordinary shares. Nonetheless, if the firm issuing this class of share

38 Notwithstanding the absence of mandatory bid obligation in the United States as well, minority shareholders are, as a rule, bought out at a premium to the block price. As JENKINSON & LJUNGQVIST (1999) remark, stronger protection for minorities in the United States is the main reason accounting for the rarity of that form of minority abuse in that country. Conversely, there are enormous scope for a super-majority block-holder expropriating minorities in Germany, such as agreements ensuring the transfer of profits made by the controlled company to him/her; making minorities bear a disproportionate burden in the case of losses; and taking advantages from purchases and sales of assets. For a detailed description of these and other expedients, see JENKINSON & LJUNGQVIST (1999, p. 18-20) and BECHT & BÖHMER (1997, p. 38).

39 The reason is that, other things being equal, the higher the ownership concentration, the lower the share liquidity. (BECHT, 1999)

40 For a through empirical analysis of these devices, see BECHT & BÖHMER (1997).

fails to pay the preferred dividend in two subsequent years, the German corporate law determines that preference shares must be converted in ordinary shares. Second, some companies (such as Allianz AG and Munich Re) have issued “registered shares”, whose transfers require consent from the MB. Third, until recently, AGs could have in their articles of association provisions stipulating an upper limit to the voting power some single shareholders were enabled to exert, irrespective of the amount of equity s/he held. Conceived mostly as a way to bar unsolicited takeovers, voting caps may notwithstanding be easily evaded - for example, by depositing shares with friendly parties. (BECHT & BÖHMER, 1997, p. 53)⁴¹ Fourth, multiple voting rights, however unusual, were issued by Siemens and a few formerly state-owned enterprises.⁴² Fifth, proxy voting rights are the easiest, and thus the mostly used, expedient to consolidate voting power. Last but not least, block-shareholders may engage in cross-shareholdings, voting pacts, pooling contracts and pyramids to expand their voting powers beyond cash-flow rights in a way that is harmful to minority investors. Cross-shareholdings may favour “*inefficient ‘voting cartels’, where involved management teams vote in favour of each other at the respective AGMs.*” Voting pacts or pooling contracts are agreements among blockholders whereby they pool their votes. Devoid of any special legal status, pooling contracts are a widespread practice within German groups. (BECHT & BÖHMER, 1997, p. 15-16, 53; JENKINSON & LJUNGVIST, 1999) Sometimes, they are breached due to fears that a new controlling coalition emerges to dilute their powers. Encountering no relevant legal hurdle to set up coalitions, block-shareholdings may build voting majority or supermajority empowering their members to exploit minorities. For example, super-majority allows them to celebrate contractual control arrangements or to launch “a binding tender offer to minority shareholders below the market price”.

Pyramid schemes also appear to be a fairly common occurrence within German corporate scene, allowing ultimate controlling shareholders to have control rights in excess of their cash-flow rights and, thus, to obtain private benefits at other

41 According to *The Economist*, voting caps were instituted in the seventies as a means to prevent German companies from the influence of investors enriched by oil revenues who had bought large chunks of their shares. Nonetheless, a glance at the main German listed companies wherein the Kuwaiti Government has a significant stake (such as Hoechst, Daimler Benz, and Metallgesellschaft) reveals that they have not resorted to that device at all.

42 Since the *Law on Control and Transparency in the Corporate Sector* (KonTraG) took effect in May 1998 (to be discussed in detail below), voting caps and multiple voting rights are forbidden. Voting caps previously existing have to be phased out by May 2000 whereas enterprises that had issued shares with multiple voting rights have to extinguish them by May 2003.

shareholders' expenses.⁴³ As a rule, the ultimate control belongs to families or other firms having a relatively dispersed-held ownership. The departure from the one-share-one-vote rule together with the opaqueness characterising such schemes inevitably reverberate on the cost of raising equity capital, imposing a discount on the share price. Noteworthy is that pyramids are somewhat unusual among DAX companies, in part because their shares are required to have a minimal degree of liquidity and free-float to gain membership in the index.

Putting all these aspects together, the upshot is a rather consistent institutional arrangement ensuring a few shareholders leveraged (and often furtive) control and enormous discretion for expropriating minorities - as though this arrangement would have been tailor-made to reach such purposes.

3. The Slackness as Regards Shareholders and Profit

The drawbacks of the stakeholder model are as clear as its advantages. Co-ordination of interests that hardly ever are immediately harmonious, and sometimes not at all,⁴⁴ requires complex, time-consuming negotiations. Past commitments and consensus-building impose severe constraints, implying that responses to external shocks (such as sudden changes in market and technology) may be sluggish. Furthermore, reactions may not be optimal if maximisation of shareholder value is taken as the benchmark - as is it in the U.S. approach of corporate governance, which is now rapidly conquering international ascendancy. The clumsy question of how far companies should be accountable to their different stakeholders, left by companies' multiple foci, makes the German approach inherently contentious, not least when companies' financial links together with their marketing and production strategies become increasingly global.

43 A firm is said to have a pyramidal ownership structure if there is at least one publicly traded company between the firm and its controlling shareholder in the chain of voting rights. For example, if C has a controlling interest in a publicly traded firm B which has, in turn, a controlling interest in A, C controls A and A displays a pyramidal ownership structure. See LA PORTA, LOPES-DE-SILANES & SHLEIFER (1998) and LA PORTA, LOPEZ-DE-SILANES, SHLEIFER & VISHNY (1999). This device for concentrating voting power has deleterious effects in terms of liquidity and incentives.

44 For example, the choice among projects involving different mixtures of return/risk is likely to set apart debt-holders, who are primarily concerned with bankruptcy risks, and shareholders, willing to support high-expected-return/high-risk investments.

However, although this model appears in point of fact to be unfit to cope with rapid changes in markets and technologies, it may enable firms, as indicated above, to deal efficiently with several types of market failures, reaping benefits largely exceeding its underlying costs. Hence, an argument put forward by Mayer (1997) seems to be persuasive. He reckons that the stakeholder model is particularly good for activities whose technological and managerial best practices are more stable, allowing consequently their slower and smoother changes to be timely met by companies' stakeholders engaged in long-term implicit contracts.

4. *The Low Corporate Transparency*

German patterns of companies' disclosure requirements have long been criticised. With respect to accounting standards, they are generally blamed for requiring too little information to be released and for relying more on a realisation principle in the treatment of companies' assets rather than on an accrual principle, as the British ones do. This means that, instead of periodic revaluation of fixed assets, these are recorded at historical prices (less depreciation). Though this legal procedure may be warranted for prudential purposes, the consequent build-up of "*hidden reserves*" leaves vast leeway for management allocating profits over time, "*which, in practice, is used for smoothing profits.*" (OECD, 1995) This additional discretionary power in the hands of managers is seen as a serious fault by foreign investors.⁴⁵ Opaqueness also prevails regarding companies' liability to employees owing to pension commitments. Firms are not obliged to make provisions for that purpose, which may lead them to be under-funded with respect to future pension obligations.

Notwithstanding improvements brought about by the transposition of the EU Transparency Directive, there remains by and large the traditional view of treating ownership and control issues as "*private, sensitive and not for the eyes of the general public.*" (BECHT & BÖHMER, 1997) For this reason, figures about companies' ownership composition in Germany should be taken with caution. The new piece of legislation concerning block-holding size disclosure, forcing shareholders to notify to the authorities when their stakes crossed the thresholds of 5%, 10%, 25% and 50%, may be easily bypassed either through splitting up

45 Having been just listed on NYSE, Daimler-Benz exhibited, according to the German accounting rules, a DM168 million profit for the period over the first half of 1993 whereas, following the GAAP, it yielded a loss of DM949 million. (OECD, 1995)

a large block of shares in smaller blocks and distributing them to friendly parties (including banks) or by undisclosed option contracts. (JENKINSON & LJUNGQVIST, 1999, p. 12)

5. *The Rarity of Hostile Tender Offer in German Corporate Scene*

The threat of takeovers is presumed to discipline the management team because, if they fail to run the company efficiently, shareholders' exit is sparked off, resulting in downward pressure on its share price. As a consequence, the company becomes an easy prey to hostile bidders who deem themselves capable of enhancing its value, profiting from the replacement of the bungling managers.⁴⁶

Needless to say, a number of requisites should be met so that hostile bids may function effectively as the governance tool just described: firms should be listed on a stock exchange; a big chunk of their voting shares should be available for trading; potential bidders should have access to company's in-depth and updated information; and laws and the infrastructure to enforce them should not give rise to uncertainties about both the extension and observance of the rights of all parties concerned. In the light of all these requirements, it is hardly surprising that unsolicited tender offers are so rare in Germany.⁴⁷

First, the great majority of German enterprises are sheltered from the threat of hostile takeover simply because they are private companies, that is, their shares are not publicly traded. Second, and the most important, the concentrated ownership structure makes unlikely the operation of the market for corporate control. According to the Stock Corporation Act, the SB is entitled to replace the management team before the end of the term for which they were originally appointed so long as an "important reason" justifies this measure and, in addition, the request be approved by simple majority of its members. If all employee representatives support the incumbent MB, a raider may reach a simple majority of the SB's total votes providing s/he manages to win over all

46 For a critical analysis of the role of hostile takeover as a means of disciplining firms, see STIGLITZ (1985).

47 FRANKS & MAYER (1998) thoroughly analyse the circumstances surrounding the only three cases of hostile tender offers launched in Germany from the end of the Second World War to 1996, as well as the critical role banks played in their outcome. Two other hostile bids were attempted thereafter. The first, in 1997, involved Krupp AG (an engineering and steel group) as the raider and Thyssen AG as the target. The attempt failed mainly due to pressure from trade unions and politicians, who managed afterwards to transform it into a friendly merger. (BOWLEY, November 20th 1998) This bid "was possibly Germany's first ever truly Anglo-US tender offer; being open to all shareholders and offering a 25.5% premium." (JENKINSON & LJUNGQVIST, 1999) The second will be discussed ahead.

shareholder representatives, once the SB's chairman, a shareholder representative, has a double vote when deadlocks occur. If any of the incumbent shareholder representatives on SB do not uphold the proposal for dismissing the MB (indeed, the event more probable), the bidder will not be able to carry it out unless s/he replaces part of the SB before the expiration of their appointed term, for which it is necessary a three-quarter majority at a shareholders' meeting. Given the ownership structure prevailing in German companies - in which, as seen above, 82% of the listed companies have at least one controlling shareholder whose equity stake in the company's voting capital exceeds 25% - the condition for a hostile bidder to gain control over the SB is hardly satisfied. This occurs because the shareholder who owns a stake of at least 25% in a listed company is entitled to "*block various decisions at the shareholders' general meeting, and is likely in most cases to give the holder the effective control of the votes at this meeting.*" (EDWARDS & FISCHER, 1994) In particular, shareholdings above 25% entitle their owners to block statute changes. This prerogative renders her or his stake worth more than its market price, weakening therefore the incentive to hostile takeover bids.

Third, as public disclosure requirements have usually been flimsy in Germany, those within, or closely linked by long-term business relationship with, a company may have a massive informational advantage over outsiders, reducing incentives to hostile bids. The predominantly insider composition of the board (their members are mostly stakeholders potentially better informed about the company) is likely to make it easier to tackle management inefficiencies by internal channels, since SB members have, at least formally, the duty and the means to monitor executives. Fourth, until recently, controlling shareholders and managers were able to avail themselves of the wide range of legally-underpinned devices (such as non-voting shares, restrictions on share transferability, voting caps, and multiple voting rights) to obstruct hostile takeover bids,⁴⁸ though these devices on their own were not enough to impede the deal.⁴⁹ Fifth, hostile stake-builders

48 As banks' voting power proceeds mainly from their proxy-voting rights, voting caps does not reduce it. Consequently, banks may have an incentive to exercise their proxy-voting rights in order to shore up these restrictions, inasmuch as their position is strengthened.

49 As EDWARDS & FISCHER (1994, p. 192-193) observe, "*it is possible for a group of non-related shareholders to pool their votes in order to avoid the voting restrictions because, in contrast to the UK, there are no limitations on the activities of shareholders working in concert.*" Obviously, legal devices for deterring hostile takeovers are essentially used by firms with no block controlling more than 25% of all votes. Amongst majority-controlled listed companies, few have resorted to this sort of takeover defence. But in some cases of hostile stake-building, voting restrictions were important obstacles. According to JENKINSON & LJUNGQVIST (1999), Dresdner Bank attempted to promote a "contingent charter amendment" whereby its MB would be empowered to impose a 10% voting cap in the case of hostile bids, requiring only the SB's consent. A court aborted this manoeuvre.

frequently have to face judicial battles, whose courts' rulings last for years and are excessively unpredictable. Moreover, unlike Britain, there is no "squeeze-out" provision in German company law forcing minority shareholders to accept a bid once this has achieved a 95% acceptance. (*The Economist*, November 20th 1999)

Two other stumbling-blocks to hostile takeover bids in Germany are the absence of a liquid secondary market for corporate bonds and the big stakes held by many states, or by the banks they own (*Landesbanken*), in large companies. State stakes can, and often do, block hostile or friendly takeover bids that are likely to shed jobs.⁵⁰ As for the availability of finance for structuring the bid, Hoffmann-Burchardi (1999) finds that access to present and future financing has significant influence on bidding activity.⁵¹

Regarding banks' behaviour towards hostile takeovers, the widely accepted view that relationship banking protects companies lacks full support. There are several occurrences wherein "house-banks" upheld predators. As Jenkinson & Ljungqvist (1999) assert, proxy voting rights place banks in a privileged position, enabling them to know about stake-building and, thus, choose the best strategy to undertake - if to be neutral, to defend the target company, or to support the raider.

The difficulties in carrying out a hostile takeover in Germany is paradoxically well illustrated by the recent, successful Vodafone AirTouch's hostile bid for

50 During the Krupp's attempt to takeover Hoesch in 1991, WestLB, a bank whose one of its major shareholders is the state of North Rhine-Westphalia, had an ambiguous attitude. The bank, which at once owned a 17% stake in Hoesch and 10% of the voting capital in Krupp (where it had a representative on the SB), did not publicly support the bid. This was probably because the *Land* "wished to maintain a low public stance in a merger that potentially involved extensive restructuring and a loss of jobs." (FRANKS & MAYER, 1998, p. 1391-92) Other instances of state banks holding stakes in large companies are the state of Bavaria - the largest ultimate owner of Viag AG, holding 32.63% of its voting capital; WestLB (controlling, via a holding, 29.1% of Preussag); and the state of Niedersachsen, controlling 20% of Volkswagen AG. (BECHT & BÖHMER, 1998)

51 The wave of hostile takeovers in the United States in the eighties largely tapped the market for junk bonds (high-risk bonds).

52 Without enough support from shareholders, the Mannesmann's board accepted the bid and the call, imposed by the bidder, for its CEO to resign.

Mannesmann, the biggest ever in history (roughly US\$190 billion).⁵² Making up the tiny group of large companies with a dispersed-held ownership structure⁵³ and with more than two-thirds of their voting equity capital held by foreigners, Mannesmann clearly cannot be taken as representative of the majority of German enterprises. Furthermore, resistance against the deal was not so strong because the takeover embraced only Mannesmann's mobile-phone division, wherein unions lack control - not the engineering operations where labour has a great deal of influence. (*The Economist*, February 12th 2000)⁵⁴ Though the success of this unsolicited bid is indisputably a breakthrough in the German corporate setting - it emerges indeed as "Germany's first properly contested takeover" - it should not be seen, for all the idiosyncrasies surrounding it, as foreshadowing a smooth and fast transition to an active market for corporate control, although it may spark off a surge of bid for the few German widely-held firms.

On the other hand, hostile takeovers in Germany are facilitated by the slack regulatory environment. Three components of that arrangement deserve to be highlighted. First, the widespread practice of issuing bearer shares, which makes it difficult to identify the true shareholders (albeit the fact that shareholders can own small stakes without revealing their identities may complicate the task of winning them over). Second, the traditionally lax and poorly enforced disclosure rules concerning block-holding size.⁵⁵ Third, the fragile regulation over collusion, including those under the scrutiny of the Cartel Office (which should be notified whenever a voting block reaches 24.9%). All of them contribute to render hostile stake-building attractive since they make it easier to conduct open-market purchases and accumulate stakes in a "clandestine" way (that is, without the knowledge of other market participants), preventing, therefore, the emergence of free-riders.⁵⁶ Adding these factors to the poor legal protection for minority investors, the opportunities for reaping high returns from takeovers are large.

53 Out of 32 companies composing the DAX index, Mannesmann along with Commerzbank are the only which have "no known blockholders". (BECHT & BÖHMER, 1998; EDWARDS & FISCHER, 1994, p.) Curiously, Mannesmann's statute establishes a 5% voting cap to any single shareholder.

54 Being a conglomerate based chiefly on engineering and automotive divisions until 1990, Mannesmann has shifted its core since then to the mobile phone business.

55 Before 1995, shareholders had to notify to the authorities only when their stakes crossed the thresholds of 25% and 50%.

56 Benefits coming from free-riding for minority investors are likely to be tiny in comparison with the risk of expropriation. (JENKINSON & LJUNGQVIST, 1999)

Moreover, takeover deterrents largely used in the United States, such as poison pills, are unlawful in Germany (share buy-backs became legal only in 1998).

Hence, hostile bids in Germany are not as scarce as hostile open-tender offers. According to Jenkinson & Ljungqvist (1999) and Franks & Mayer (1998), the frequency of outsiders accumulating “hostile stakes” with a view to gaining control is high relatively to the number of firms actually vulnerable to hostile acquisition.⁵⁷ Jenkinson & Ljungqvist (1999) attribute the greater incidence of unwanted control transfers to the relatively concentrated ownership structure and to a regulatory regime that hardly protects minority investors and leaves large room for an investor building a big stake secretly. They assert that there exists a relatively dynamic market for trading stakes, whose existence is accounted “both for liquidity reasons and for friendly as well as hostile stake-building”.

Such hostile stakes are gathered usually through coalitions of large investors,⁵⁸ whose motivation may stem from either incumbent managers’ poor performance or from reasons other than “efficiency” - for instance, the intent of expropriating minority shareholders or, when the stake-builder operates in the same industry of the target, of gaining market power by acquiring some influence (not control) on it. Most of the control transfers lead to management replacement and turnover of SB members.

Summarising this section, it seems that legal investor protection and companies’ transparency have been indeed the Achilles’ heel of the German system of corporate control. As regards the neglect of efficiency, the stakeholder arrangement is arguably better equipped to deal with industries wherein technological and organisational changes are gradual whereas it has less competence in handling rapidly changing conditions. SBs’ ability to exert their mandatory duty along with the harmful consequences coming from the fact that hostile takeovers are scarce in Germany, in turn, appear to be controversial claims.

57 In their study on hostile stake-building in Germany, JENKINSON & LJUNGQVIST (1999) found 17 cases of hostile stake-building over a eight-year period (from 1987 to 1994). They emphasise that, as a proportion of the number of companies potentially vulnerable to hostile attack (64), this figure is not far from the average incidence of hostile tender offers in the United Kingdom (3-4% per annum).

58 Hostile stakes can be built via three means: 1) open market purchases; 2) purchases of blocks from existing shareholders; 3) coalitions with existing shareholders.

IV. CONTRASTING GERMAN AND AMERICAN MECHANISMS OF CORPORATE GOVERNANCE

The specificity of the German model of corporate control is further grasped if it is juxtaposed with the system predominating in the U.S., rested chiefly on market mechanisms - especially the market for corporate control, but also the capital and product markets. Why do markets in the U.S., unlike Germany, play this leading role in governing companies? At least two reasons should be stressed, both of which related to legislation. First, securities laws in the United States are primarily concerned with the protection of shareholders and companies' transparency. American Securities and Exchange Commission's rules aim fundamentally at enforcing the public disclosure of all companies' price-sensitive information as well as preventing insider trading.⁵⁹ Such stringent requirements allied with other laws ensuring equal treatment for all shareholders have helped to shape the American listed companies' current dispersed ownership structure. The consequent high liquidity of securities markets is likely to contribute to scrutinise managers' performance.⁶⁰ Monitoring by large shareholders - who would have relatively more incentive to provide it - is legally curbed since close contacts with managers would transform their status into insiders, rendering them legally responsible for executives' decisions. Furthermore, until November 1999, the so-called Glass-Steagall Act restrained banks from engaging in investment banking - such as trading or holding shares of other non-bank companies, or promoting underwriting and IPOs. This regulatory restriction is undoubtedly decisive to understand why banks in the U.S. have kept companies at arm's length.

Contrariwise, as shown above, the legal arrangement in Germany favours large shareholders and banks. For this reason, the demand for good securities law was low until recently, capital market has been traditionally shallow, ownership

59 Allegedly to mitigate informational asymmetry, public disclosure requirements imposed by the American watchdog for listed companies are high. Whereas insider trading in Germany was considered an offence only in 1994, in the United States most of its forms were declared illegal 60 years before, even though the enforcement of this law has been ever since far from perfect. As a means of avoiding insider trading, controlling shareholders must wait six months between purchase and sale of shares. In addition, conversations among large shareholders are prohibited.

60 On the claim that ownership dispersion is a pre-requisite for liquid stock markets, see BECHT (1999).

61 See ROE (1998). Regarding the proportion of listed companies with the largest shareholder holding less than 5% of the shares, it is 1.1% in Germany against 53% for NYSE's companies. The median for the largest ultimate outside voting blocks for listed industrial companies was 52% in Germany (11% for companies comprising the DAX30), and 0% for both NYSE and NASDAQ. (BECHT & RÖELL, 1999)

concentrated, and monitoring exerted mainly by extra-market mechanisms - such as SBs, large shareholders or creditors.⁶¹ It is noteworthy that investors controlling more than 10% of the voting rights in a German company are not treated as insiders, in stark contrast with what happens in the United States. In this respect, Germany and the United States reveal two opposite choices with respect to the trade-off between liquidity and monitoring. Thus, as underscored before, while the key agency problem in the United States resides in the leeway managers have to expropriate dispersed, passive shareholders, in Germany the conflict of interest rests principally on the potential controlling shareholders have to exploit minority shareholders.

Second, bankruptcy rules in the United States show a bias in favour of shareholders and managers, instead of protecting creditors and employees, as the German commercial law does.⁶² U.S. legislation on bankruptcy also constrains the American banks' ability to exert control over major corporations because it imputes legal responsibility on banks having affected their client-companies' decisions, based on the legal precept of equitable subordination. Moreover, in the case of bankruptcy, this clause sets that investors holding credit claims on firms in which they also own an equity stake may have downgraded the status of their credits (e.g. they may be reclassified as subordinated debt) if any influence on firms' administration is configured. Only in the course of a bankruptcy process, U.S. legislation concedes a major role for banks.⁶³

62 According to OECD (1995), *"the German bankruptcy code tends to protect creditor interests, at least in comparison with the United States and France: creditors can either demand outright liquidation or have a virtual right of veto in relation to any plans drawn up by bankruptcy courts and firms for keeping the firm going through debt rescheduling; secured creditors can sell assets on which their claims are secured, independently of either the bankruptcy or the settlement procedure, even if these assets are essential for the continuation of the business. Most insolvencies lead to bankruptcy and in out-of-court settlements banks act primarily to secure their credit (fewer German firms get into distress situations perhaps because the governance process allows banks to intervene at an early stage in a faulty development)."* See also EDWARDS & FISCHER (1994). Nonetheless, the new Insolvency Statute, which entered into force on January 1st 1999 is expected to bring about significant changes since the new legal tool of the 'insolvency plan' made available for the debtor's reorganisation *"in many respects is modelled on the reorganisation plan under U.S. law ("Chapter XI")"*. (FMJ, 2000)

63 Another distinction that could be mentioned lies with competition. ROE (1998) claims that competition in product and capital markets play an important role in monitoring managers in the U.S., unlike Germany, where competition in these markets has been traditionally weak, so that only block-holdings and SBs are left as disciplinary mechanisms of management.

V. RECENT CHANGES IN GERMAN CORPORATE GOVERNANCE

This section is concerned with the foremost reactions to the changing economic and financial conditions. First, the emergence of Neuer Markt is analysed, and its startling performance is partly ascribed to fresh governance rules. Then, focus is shifted to the repercussion of competition in global financial and product markets on companies' strategy and to the responses of politicians and governmental authorities to these challenges. Finally, the section turns to some important faults still remaining at the corporate governance level in Germany. The refurbishment of the legal and institutional infrastructure underpinning securities markets and investor rights clearly reveals the Germans' awareness of global institutional competition for attracting companies and investors.

1. *The Neuer Markt and the Rise of New Governance Standards*

An important part of the answer to the so far Neuer Markt's astonishing success resides unequivocally in its compliance with what are generally accepted as good corporate governance rules. Investor protection has been the mainspring of its efforts. Its endeavour to eschew from the faults believed to plague German stock markets for large, traditional companies has been decisive to its success in attracting venture capitalists, innovative entrepreneurs, as well as individual and institutional investors.

To begin with, however operating as a regulated market (as a new trading segment of the Deutsche Börse Group), Neuer Markt is constituted as an entity subject to "private law". Thus, listing requirements are set up by the Deutsche Börse, its "market organiser", which is freer to set rules and procedures "in line with international standards", that is to say, meeting international investors' demands (notably the protection of minority rights). (DBG, 1999)⁶⁴ In this regard, Neuer Markt's purported distinctive features may be assembled into three groups: 1) high standards of transparency imposed on firms; 2) mechanisms to foster liquidity; 3) investor protection, especially to avoid unfavourable treatment of small shareholders.

64 German capital markets' other segments operate under public law, which makes it difficult to adjust their rules to the rapid changes in the financial and corporate environment.

With respect to transparency, firms are required to disclose updated, detailed and comprehensive information about their plans and financial condition. Disclosure rules required in the Neuer Markt are tighter than those binding in the first segment trading. When applying for going public in the Neuer Markt, companies have to submit to the Deutsche Börse an “accurate and complete” issuing prospectus, both in a German and English version, containing “all factual and legal matters which are necessary for the evaluation of the shares offered”. This is the key requisite for the admission process.⁶⁵ The prospectus must include all the relevant financial accounts for the last three years and observe either the International Accounting Standards (IAS) or the American Generally Accepted Accounting Principles (GAAP). Once listed, companies have to publish quarterly and annual reports conforming to the IAS or the US-GAAP and in German and English versions. In addition, they have to inform the issuer’s overall shareholdings in the hands of SB’s and MB’s members.

The rationale of these informational requirements is straightforward: since young, innovative firms are a risky investment, finance will be available on the condition that providers of funds have easy and low-cost access to reliable information, which enables them to assess the risk they will face. The adoption of international standards of accounting and the requirement of an English version for the prospectus and for the annual and quarterly reports aim evidently at widening the base of investors, wary of German accounting rules. Entrepreneurs, on the other hand, are willing to exchange transparency for the availability of equity financing and lower risk premium, besides the benefits of risk-sharing and diversification.

As regards provision of liquidity, DBG sets two requirements for admission to the Neuer Markt. One is that companies must guarantee a free float of at least 25%. The other is the condition that firms nominate two “designated sponsors” for trading their shares on the Neuer Markt. The sponsors’ essential function is to boost liquidity in specific shares by announcing “*either voluntary or on request ... binding bid and offer limits for the equities sponsored.*” In other words, they commit themselves to buy at a bid price and sell at an offered price. The greater volume of trading resulting from the intervention of this idiosyncratic financial intermediary helps reducing the risk and cost of liquidity as well as the bid-offer margins.

65 Its overarching contents cover topics from prospectus responsibility to the requirements of in-depth information about issuer’s shares, capital, business, financial accounts, MB and SB, and risk factors. On Neuer Markt’s prospectus contents, see DBG (1999, § 4.1).

Last, discrimination against small shareholder is curbed in three ways. First, with a view to matching voting power and cash flow rights, exclusively ordinary shares are admitted to the Neuer Markt (unless statutory provisions force the issuer to issue only shares whose acquisition requires approval). Second, companies should agree to observe the Takeover Code. Third, the existing shareholders are obligated to refrain from offering or selling shares, directly or indirectly, within a period of six months from the date of admission to the Neuer Markt.

2. Changes in Corporate Strategy

It seems unequivocal that greater international integration of capital markets along with harsh competition in the product-market have spurred a profound overhaul in companies' strategies. The struggle for funds in the international arena has forced German enterprises and financial institutions to comply with a broad range of expectations and requirements (as a rule carved out in the Anglo-American mould) posed by international capital providers.⁶⁶ This demand has been even tougher for those enterprises planning cross-border mergers and acquisitions, inasmuch as gearing to the American way of doing business will make it easier and cheaper to fund these international deals by means of their own shares.⁶⁷ Given the prevalent complaints raised against German putative obfuscated accounting practices and the importance international investors have granted to maximise the so-called "shareholder value",⁶⁸ it is expected that

66 In the words of the Ministerial Counsellor of the Federal Ministry of Justice (FMJ, 1998), *"national capital markets are no longer isolated. Our quoted companies raise finance internationally. German stock corporations are in direct competition with other demands for venture capital worldwide. The shareholder structure is becoming more international. The influence of foreign institutional investors and their expectations are growing."*

67 The merger of Daimler-Benz with Chrysler (now Daimler-Chrysler), *"in what was essentially a stock for stock exchange"*, was preceded by the listing of the German company on the New York Stock Exchange in 1993. (COFFEE, 1999, p. 76) So did Veba in October 1997 with a view to easing U.S. acquisitions. About this, Veba's chairman said *"it was a step into the Anglo-Saxon culture that we consciously wanted to make."* (*Financial Times*, May 11th 1999) Against the tide, the takeover of Bankers Trust by Deutsche Bank was entirely paid in cash rather than accomplished by share swaps.

68 The meaning of **shareholder-value** looks quite clear among Anglo-Saxon investment bankers and fund managers. For them, companies should: focus on their core competencies ("corporate clarity") and pursue no other goal than profit-maximisation (stakeholder values being an anathema); return money to investors by means of share buybacks; and provide detailed, timely public disclosure of all relevant information, and in accordance with international accounting standards. Listing on the New York Stock Exchange is seen as a special bonus, reason for which nine German companies have already done it to date. Curiously, the distribution of dividends matching the opportunity cost of shareholders' funds has not been praised lately as a shareholder's right to which companies should meet. As a rule, they have not met it recently. The forbearance certainly comes from the booming stock markets delivering exuberant capital gains.

companies intending to raise money or make forays abroad align their accounting and managerial patterns to those adopted in the United States.

Globalisation has prompted individual and institutional investors to be increasingly conscious of, as well as highly reactive to, the returns of every investment instruments, compelling German enterprises to improve their profitability.⁶⁹ Restructuring their mechanisms of control has been considered an important way of reaching this goal.

The change in investors' behaviour has also dented the long inertia favouring banks on raising cheap funds from traditional forms of savings - reason for which they managed to supply low-cost external finance to companies. Sharp competition for funds and businesses has obliged German large banks to be more permeable to the *modus operandi* of global financial markets. Instead of the traditional drift to diversification embracing a broad range of businesses, often relied on cross-subsidisation, German large banks have currently been echoing mantras of shareholder-value maximisation (especially of focus on core activities) in unison with international institutional investors, investment banks, and media specialised in finance and business.⁷⁰ Benefits associated with the potential for enhancing business relationships and with the financial stability this type of diversification seems to provide may be a disincentive to big banks sell out their long-standing holdings in other companies. Indeed, there is still little hard evidence as yet that they are effectively engaged in disposing of their shareholdings in non-financial enterprises.⁷¹ Nonetheless, a major "outside" hindrance to this scrapping is presumably ready to be jettisoned. Companies are currently subject to a punitive 50-60% capital-gains tax should they opt for the disposal of their stakes in other companies. On December 21st 1999, the finance ministry announced a tax package proposing among other things to exempt sales of share stakes from capital gains tax after January 2001. Without the

69 As said by the Ministerial Counsellor of the Federal Ministry of Justice (FMJ, 1998), "*The inflexible structure of shareholdings in Germany is gradually falling away. At the same time, a better stock market culture is developing. It is being fed by the demand side: investment behaviour is changing. A generation of heirs is investing in shares. The return on German share investment is becoming more attractive.*"

70 Deutsche Bank, for example, announced in December 1998 that it was set to spin off its US\$24bn industrial stakes into a separate holding, entirely under its control, which would manage these investments as a portfolio whose value should be maximised. It is estimated that the total value of shareholdings German companies hold in other companies "certainly runs to more than US\$106 billion" (on January 3rd 2000), of which Allianz owns 40%, 20% are in the hands of Deutsche Bank, 14% with Dresdner Bank, 11% with Hipo Vereinsbank, and 2% with Commerzbank. Munich Re is another large holder of minority stakes in industrial companies. See *The Economist* (January 8th 2000), OECD (1998a), FMJ (1998), and Bowley (December 17th 1998).

71 In fact, according to DB (April 1998, p. 57), banks increased their fraction of the total outstanding of domestic shares at nominal values from 13.4% in 1980 to 15.2% in 1990 and to 15.4% in 1996.

mountainous tax burden they would have to pay if they realise their hidden reserves (the difference between the market value of the shares and their book value), big banks as well as other large non-bank financial institutions (as Allianz, the mammoth insurer group, and Munich Reinsurance) are left only with strategic concerns when deciding their scope of investments. What is more, if the proposal really turns into law, it may lead to an unwinding of the cross-shareholdings (worth roughly US\$252 billion) that cement “insider” relationships and help shelter German firms from hostile takeovers and bankruptcy.

Intense global competition in the product markets combined with increasing pressure coming from the financial markets have, in addition, triggered a wave of restructuring throughout German corporate scene in the last few years. As a consequence, mergers, acquisitions, spin-offs, and divestments have been shifting German companies from diversification to both specialisation and concentration.⁷²

3. The Overhaul of the Legal and Institutional Setting Supporting German Corporate Governance

Conscious of the rapid changes under way and zealous both to lift Frankfurt as the European financial centre and to prevent German stock exchanges from

⁷² The suppression of trade and financial barriers together with the European single market and single-currency zone are some of the leading forces heightening global competition and pressurising companies to be more efficient in Germany. To tackle the challenge posed by these changes, German conglomerates and companies belonging to different sectors have been gripped by restructuring initiatives. Krupp and Thyssen concluded their merger last year. Daimler-Benz and Hoechst pioneered the jettisoning of non-core activities in the mid-nineties – perhaps a first stepping-stone on the path to their subsequent cross-border mergers with, respectively, Chrysler and Rhône-Poulenc. The ex-state-owned conglomerates Viag and Veba announced in 1999 their merger (worth DM 122 billion) and the intent to focus on energy and chemicals, disposing of divisions turning over up DM 50 billion. Indeed, even before the merger, Viag had released its plan to get rid of its logistic and other minor activities (equivalent to one-third of the group revenues) with a view to concentrating efforts on power, telecommunication and its other industrial interests, while Veba had manifested the intention to focus on energy markets (so had done RWE, another conglomerate). A couple of months before that merger, *The Economist* (July 17th) reported that the shares of Viag, Veba and RWE were been traded at a 20-25% discount to their break-up value. In fact, the major German large conglomerates (*Mischkonzern*) have embarked on selling off non-core businesses. Siemens has announced recently its plan to get rid of non-core businesses - the businesses planned to be sold or floated on the equity market engage roughly a third of the total number of its employees. The company is particularly keen to dispose of its semiconductor division (amounting to nearly one-seventh of its whole businesses). Hoechst has also rendered public its strategy of focusing on life sciences. Nonetheless, the most radical change came from the conglomerates Mannesmann and Preussag, which moved from their former heavy-industry base into, respectively, new technologies (mobile phone) and package tourism (*The Economist*, July 17th 1998; Bowley, November 20th 1998; Barber, June 1st 1999). According to Heribert Meffert, from the University of Münster, diversified conglomerates accounted for two-thirds of all German enterprises, whilst today they represent only one-quarter. (*Gazeta Mercantil*, October 12th 1999)

losing trading and liquidity to American or other European rivals, German financial authorities and politicians have not spared efforts to actively promote capital markets and reform corporate governance mechanisms in Germany. After the successful flotation of a significant fraction of Deutsche Telekom's shares in 1996 (for many analysts, a turning-point awakening the interest of a multitude of savers in purchasing shares as an instrument of savings), several legal changes have been enacted by the German parliament, with the aim of gearing the legal framework surrounding both capital markets and corporate governance to the changeable financial environment.⁷³ These moves towards a regulatory level playing field have been partly motivated by the transfer of a great deal of authority from national regulators to EU's agencies and committees together with stronger international integration of financial markets.⁷⁴ Shareholder activism too cannot be left out among the prime forces conducting to the revision of German rules of corporate governance.

Among the fairly extensive pieces of legislation focusing on streamlining capital markets and investors' protection that have been sanctioned in the last few years, two laws deserve to be underlined.⁷⁵ The first, the *Law to Ease Capital Procurement*, taken effect on April 24th 1998, authorises listed German companies to follow internationally mainstream accounting standards for disclosing their consolidated financial statements. The objective lying behind this law is clearly the removal of the above-mentioned serious hurdle obstructing German enterprises' ability to obtain finance from global capital markets.⁷⁶

73 Discoursing upon the passage of the law on corporate governance reform, the Ministerial Counsellor from the Federal Ministry of Justice depicts clearly the thorough awareness German official authorities have about the changing financial environment scenery. He stated: "*for the legal and political framework, this means that against a background of institutional competition, there is growing pressure for changes and adaptation of our company law, stock market law and accounting law.*" (FMJ, 1998)

74 For example, the Investment Services Directive has prompted competition among regulators since companies in Europe may choose where to list.

75 Other important laws could be mentioned: 1) the Securities Trading Law (Wertpapierhandelsrecht), which, in July 1994, transposed the EU Transparency Directive. It took the first steps to reduce the gap between German and international standards of securities trading supervision, including the prohibition of insider trading, disclosure requirements for shareholdings higher than 5% of the total equity capital, and the creation of a supervisory authority. This law is part of the "Second Financial Market Promotion Law"; 2) the "Third Financial Market Promotion Law", discussed above; 3) the law governing small non-listed stock corporations; 4) the deregulation of the stock corporation law; 5) the permission of non-par value shares. (FMJ, 1998)

76 This law was conceived to last until the end of 2004, bridging the gap to a more comprehensive and global-minded reform on corporate accounting rules.

The other, the Act on Corporate Control and Transparency (the *KonTraG*), which came into force in April 1998, appears to be the most ambitious attempt to amend the legal arrangement on which German corporate governance affairs rest. Conceived after “*wide-ranging talks with the parties concerned and with academics*” and seeking to fix some of the “shortcomings” pervading the former arrangement, the *KonTraG* attempted to set governance rules in line with other OECD countries’ standards, lest Germany be left behind in the institutional race for attracting companies and investors. Those who proposed this law refrained from inflating it with “*strict legal directives*”, opting instead for “*control to be provided by the existing SBs and the markets*”. (FMJ, 1998)

Besides tightening public disclosure requirements, the *KonTraG* improved the dual-tier governance structure, trying to secure that SBs effectively scrutinise management and both SBs and MBs become more accountable to the interests of minority shareholders. (FMJ, 1998) Thus, the law laid down a host of regulations defining mandatory duties and affecting the incentives and strength of all stakeholders (SB members, management, banks, block-holders, and minority shareholders). Below the main changes are pinpointed.

As regards information, 1) management are required to release to SBs detailed information concerning enterprises’ planning; 2) candidates to a seat on the SB must report their main activities (including memberships on other SBs); 3) listed companies’ and banks’ annual reports and balance sheets must detail clearly all germane links every member of their SBs and board of directors has with other enterprises; 4) SBs have to meet at least four times a year (against twice before); 5) banks and listed companies are required to include in their annual reports and balance sheets any stake worth more than 5% in other joint-stock companies; 6) companies and banks are obligated to inform shareholders about the available options for taking part in ballots - such as transferring their vote to a proxy, or shareholders’ groups; 7) banks have further to inform shareholders whose shares are deposited with them about banks’ own stake in the company as well as whether any of their executives takes a seat on its SB.

Among the constraints placed on management and large shareholders with the purpose of curbing them from obtaining private benefits at the expense of minority investors, the following are noteworthy: 1) the suppression of both plural voting rights and maximum voting rights; 2) the prohibition for companies linked by cross-shareholdings from exercising voting rights on each other’s general meetings convened for the election of SB members (preventing management, therefore, from “controlling” themselves); 3) constraints imposed on banks owning a stake larger than 5% in a company for exercising proxy voting rights in its general meeting

Regarding incentives, shareholders' annual general meetings are set free to offer stock options as a form of compensation for companies' senior executives,⁷⁷ whereas the enforcement of penalties for "serious neglect of responsibilities" against members of both the SB and the board of directors has become easier.

As for mandatory duties, responsibility for contracting independent auditors was transferred from MBs to SBs while MBs were given the additional duty of ensuring "adequate risk management and internal revision systems". Each SB member, in turn, is forbidden to hold more than 10 posts at any one time (chairmanship counting as two posts).

Another important deregulatory measure is the permission for companies to buy back their shares. Enacted with a view to both stimulating the stock market and enhancing companies' flexibility, it also equips managers with an additional defence tool against hostile bids. Together with the obvious appeal of capital gains for investors, share buy-backs allow companies to exploit financial markets' opportunities (the cost differential between debt and equity finance) and to choose what they reckon to be their best capital structure. The removal of the 50% capital-gains tax on selling equity stakes in other companies is due to leave the repurchase of companies' own shares especially attractive.

A new mandatory law (§23 German Stock Corporation Act) was laid down soon after the introduction of the KonTraG with the purpose of bringing Germany further in line with the OECD Principles of Corporate Governance. It ensures the full voting rights for every ordinary share, the transferability of shares at any time, and the participation and exercise of proxy voting rights at general meetings (notably at those for the election of SB's members). This law also reduces the scope for MBs diluting minorities' voting power by determining that increases in capital without shareholder participation rights, for "either an acquisition or a share placement near the prevailing market price", are limited to 10% of the capital outstanding (including repurchased shares). (GPCG, 2000)

77 The inclusion of share options in executives' compensation package, the widespread means of supposedly reducing agency costs in American and British corporations, has been increasingly mimicked by German companies - Deutsche Bank and Daimler-Benz, now Daimler-Chrysler, were the pioneers in this respect, followed later by, among others, Siemens and SAP.

4. *Some Remaining Shortcomings*

Small shareholders continue lacking legal protection in the event of takeovers. The takeover code stipulates two specific clauses, in addition to general rules of conduct directed to prevent market manipulation.⁷⁸ One is that investors purchasing 30% (50% before 1997) of the target company's overall shares should make a "reasonable takeover bid" for the remaining shareholders. The other is that companies should commit themselves to refrain from defensive measures if subject to a public tender offer. (HOFFMANN-BURCHARDI, 1999). Notwithstanding, instead of making it legally binding, the government has preferred to rely on self-regulation and leave its enforcement voluntary. Despite code's laxity, companies have been so far reluctant to adhere to it,⁷⁹ including some comprising the stock market index (DAX). Given that the decision to observe it is at the discretion of the company's MB, it is unlikely that companies with controlling shareholders adhere to it voluntarily, since this would increase the company's risk of being taken over. (HOFFMANN-BURCHARDI, 1999)⁸⁰

Concerning the recommendation for reducing the size of SBs, trade unions' strong opposition has managed to block it to date. Their fear is that therein lies a strategy to dilute the power of workers on the board. (OECD, 1998a) As for corporate transparency and disclosure, though improvements were made and are still in progress, there is much to be done, especially with respect to information about companies' holders of voting power.

CONCLUDING REMARKS

As this paper attempted to demonstrate, momentous changes are at work at the governance level in German companies. The main driving force lying behind them is, indisputably, the fierce competition financial and non-financial

78 This code was laid down by the German Stock Exchange Expert Committee of the Federal Ministry of Finance in October 1995.

79 One year after coming into force, the Takeover Code had a too low adherence rate - nearly one-third of all listed companies. (JENKINSON & LJUNQVIST, 1999, p. 21) The major sanction against offenders is the prohibition against companies of going public in the Deutsche Börse.

80 Despite European Commission's efforts, an agreement on a takeover directive to be followed by all EU's members has failed to date. Even if it goes through in the near future, its implementation in each member country will surely delay. A company law applying to all EU's countries seems to be much more distant.

enterprises have had to face in markets that no longer are circumscribed to domestic borders. Producing enterprises have been urged to restructure their businesses not only as a consequence of competitive pressures coming from rivals in the ever more global product markets but also for the necessity to fit to the changing attitudes of their financiers. There seems to be a rising number of German shareholders breaking with tradition of “patient investors” and increasingly embracing the “shareholder value” tenet. German banks, in turn, look relinquishing their traditional practices of granting preferential loans to enterprises with which they were interlocked connected (mostly through equity stake links) for the reason that slender profit margins deriving from cross-subsidies affect their ratings and, therefore, the cost of raising capital out of either shareholders or bondholders. By the same token, banks as shareholders are either ready to diminish their stakes in German companies or requiring higher returns on the capital they poured into them. Besides, the fear of competition from American and European rivals, which are stubbornly determined to enhance their shares in the rapidly expanding German market for high-return financial services (such as asset management, mergers and acquisitions, life insurance, pension funds, and underwriting), has forced German financial institutions to step up profitability.

In the light of this background, small wonder the wave of restructuring, mergers, acquisitions, divestments and alliances that has swept German industrial and financial environment.

Acknowledging the implications that a wait-and-see approach could occasion, German policy-makers, politicians and businessmen have strove to suit the institutional and legal framework to the new financial and corporate panorama. In a fairly short period, legislation concerning financial markets as well as corporate governance has been significantly overhauled with the purpose to promote capital markets and ensure that shareholders’ interests are taken into account. The emergence of Neuer Markt represents another remarkable institutional innovation that helps to secure financing for developing innovative, young businesses and at once provides a new outlet for household savings and funds managed by institutional investors.

The presumed ingrained habits and practices of German businessmen and savers also appear to have been abandoned. German individual and institutional investors have been ever more conscious of the cost of opportunity of their own money and willing to move from time and savings deposits towards riskier and higher-yield assets. As shareholders, both have no longer been reluctant to “exit” if firms do not comply with their expectations. On the other hand, an increasing number of German firms have approached to the U.S. style of business

administration. They are prioritising shareholders' interests rather than other stakeholders', granting share options as a component of their executives' compensation package, focusing on core activities, making share buybacks, and providing more transparent accounting (some have even listed on the NYSE).

Furthermore, as a consequence of looming changes in the unfunded pension schemes, individuals have shouldered a greater share of the financial burden needed to ensure an appropriate retirement. This has augmented the resources available to institutional investors, who have enlarged the volume and proportion of their portfolio channelled to the stock market, including its small-capitalisation segment. Adding to its positive impact on risk-sharing opportunities, this shift is expected to upgrade the mechanisms of corporate control, contributing to render management more liable to shareholders.

Turning to the hypotheses raised at the beginning of this paper, P1, it seems that, though outstanding changes in corporate strategies as well as in legal and accounting rules have undeniably rendered German companies in several respects akin to their American counterparts, there remain some structural and legal hurdles obstructing the closing of the huge gulf still separating German and U.S. patterns of governance. Moreover, this gap may not be wholly bridged on the grounds of efficiency motives. Starting with this last point, the subject of Q1 and Q2, it is reasonable to think that a competition among different systems of corporate governance is taking place, out of which only the most efficient system(s) will survive. In this regard, some of the features that have been shaped German corporate governance system may undergo no stunning transformation by the mere reason that they have proved to be efficient. For example, comparing with U.S. enterprises, many German firms are likely to be better equipped to avert the penchant towards short-term horizons that liquidity risk and pressure for high returns impose. The strong commitment and trust linking stakeholders clearly facilitate the adoption of longer-term strategies (such as investment projects in R&D, learning-by-doing, and technical change) besides granting them the appropriate incentives to invest in firm-specific assets. (STIGLITZ, 1989a, 1989b) These implicit contracts turn out to be particularly efficient in industries where technological and management patterns are well defined and known and whose changes proceed slowly. (MAYER, 1997)⁸¹ Thus, the relative efficiency of the so-called German model to cope with some market failures

81 Moreover, despite the room for expropriating minorities, large block-holders may provide oversight over management, a good that is undersupplied in the American stock market, where investors lack the incentives to monitor owing to the free-rider problem (see BECHT, 1999).

(such as asymmetrical information, incomplete or unenforceable contracts, and lack of coordination) is likely to circumscribe the reach of changes.

Along with efficiency issues, some political forces and deep-seated structures appear to be major roadblocks on the way to convergence. Needless to say, the legal system defining the available set of corporate governance practices enshrines a given allocation of rights among company stakeholders. Changing this system would inevitably entail political struggles. One and arguably the most important of these political hindrances is the *Co-determination Act*. Entitling employee representatives, at least *de jure*, to have voice and power on the SB, this law may be a stumbling block to the quest for shareholder value (hostile takeover bids included), let alone going public. Against the German political background, wherein labour is traditionally a powerful player, divesting it of the right to the co-determined control of management is surely no easy task. Combined with socially embedded values taking companies “as social institutions, not just as the property of their shareholders”, the Co-determination Act makes the consensus-led, stakeholder model somewhat resistant to economic shocks. Unless something especially severe affecting the whole economy saps this model (like an impressive loss of competitiveness coupled with mounting unemployment rates), it is unlikely that its dominance will be disputed.

Strong opposition from unions and some politicians against reforming the state pension system is another way through which politics may constrain the spread of the shareholder model in Germany and prevent its capital markets from catching up with those in the Anglo-Saxon countries. The ensuing effect would be the permanence of contractual savings intermediaries, more liable to shareholder value, as a subordinate player. Given the intimate association between capital markets and private pension funds (DAVIS, 1998), the future of both hangs critically on the pace and depth of restructuring the pay-as-you-go state retirement scheme.

As for the structural reasons resisting to the closure of this gap, the paucity of listed companies coupled with their concentrated ownership structure wherein single controlling shareholders predominate seem to be the most important. The concurrence of these factors makes it difficult the functioning of the market for corporate control. An additional obstacle lies in the ownership of large equity stakes by Länder or other governmental institutions in both producing enterprises and banks. Fearful of arousing political opposition, they would hardly ever support hostile raids, inasmuch as such bids are motivated, as a rule, by the goal of promoting job-loss restructuring in the target-firm. Furthermore, the intricate web of cross-holdings casts uncertainties over the outcome of hostile bids since controlling block-holders may have strategies focused on the group rather than

on an individual firm. This allied with companies' representatives on each other's SBs tend to favour the stakeholder approach.

This structural, path-dependent hurdles may end up being swept away by economic forces. Increasingly harsh competition in product markets - especially within the EU area - as well as in global capital markets is likely to urge (cross-border and domestic) mergers and acquisitions in key industries (financial services included, of course). In particular, availability and terms of financing may be decisive to define competitiveness in the product markets. The run-up to the anticipated market concentration is expected to lead German firms to streamline their asset portfolio. Focus on some few core activities and disposal of peripheral activities, practices highly valued by global investors, may place large German corporations in a better position to undertake acquisitions or mergers - either in cash or through share swaps. The repeal of the tax on capital gains earned from the realisation of hidden reserves, releasing large corporations, especially banks, from the current locking-in effects, should reinforce the incentives to jettison their non-controlling stakes in other enterprises. In this respect, the fact that the four big banks and the two big insurance groups stand at the hubs of the complex web of cross-shareholdings (holding controlling interests in a great number of public limited companies) may catalyse and accelerate a startling overhaul of German large corporations' ownership structure. If they opt for relinquishing their stakes in other companies, liquidity in the market for blocks of shares may be strengthened, prompting the market for corporate control. A less concentrated shareholding structure may also be stimulated by the parallel development of venture capital and exit channels (like Neuer Markt).

On balance, it seems incontestable that far-reaching changes have led a great portion of large German companies to emulate in several respects their American counterparts. In addition, stronger competition in the product and capital markets is likely to deepen and widen this move, enlarging the range of governance mechanisms working in German corporate landscape. All the same, if it is true that some large steps have been taken towards convergence, there still remains a long and sinuous way to go. Consequently, the completion of this journey cannot be taken for granted.

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