

Changes in German corporate governance and in the German financial system

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In this presentation we will characterize and assess recent developments in German corporate governance and the German financial system at large

Starting points

- At least until the mid-nineties, German corporate governance structures and the financial system as a whole were characterized by a remarkable degree of stability
- The past seven years have witnessed an array of changes in the legal and business environment of German corporations that are at least partly due to globalization

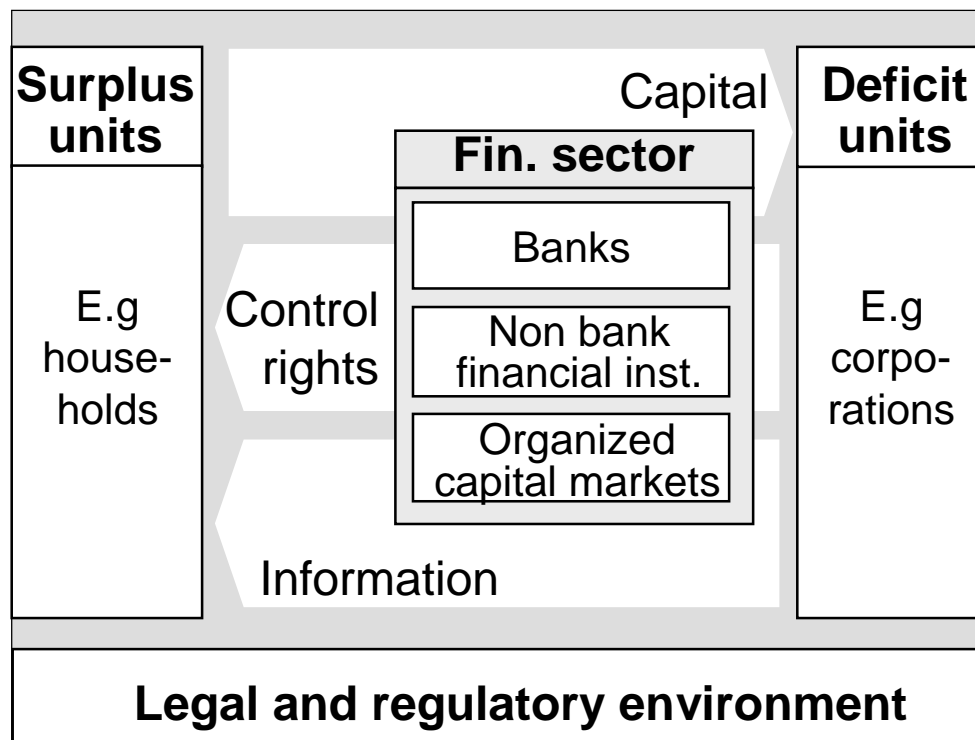
These development suggests to address the following questions

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



We use a very broad definition of corporate governance and treat the corporate governance system as a subsystem of the financial system

Definitions



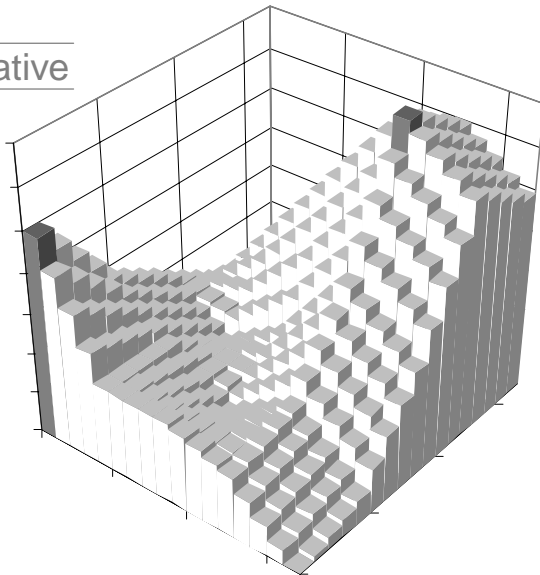
- CG comprises of all mechanisms and institutions stakeholders use in order
 - a) to gain influence upon management decisions and
 - b) to resolve potential disagreements among themselves.
- Because financial capital is typically only provided in exchange for control rights, developments in the field of corporate governance and in the financial system at large are intertwined

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

Complementarity

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

illustrative



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

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

Elements of the traditional German system

**CONTROL
vs. liquidity**

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

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

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

**INTERNAL LABOUR MARKETS
vs. external**

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

**INTERNALIZ. OF INFORMATION
vs. externalization**

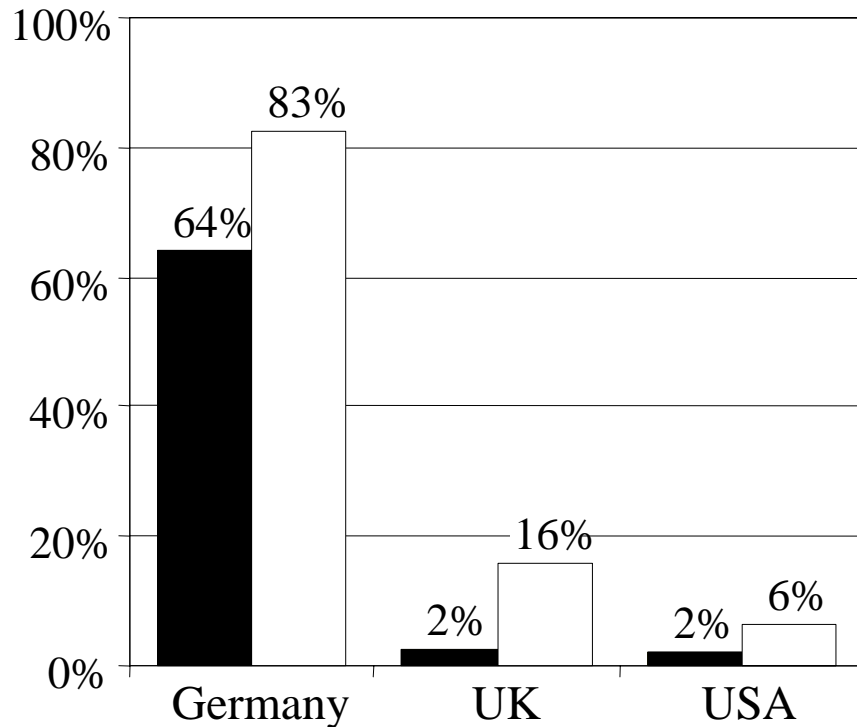
- Conservative accounting rules (hidden reserves)
- Lax disclosure requirements even for listed corporations
- No laws prohibiting insider trading

Source: Hackethal/Schmidt (2000)



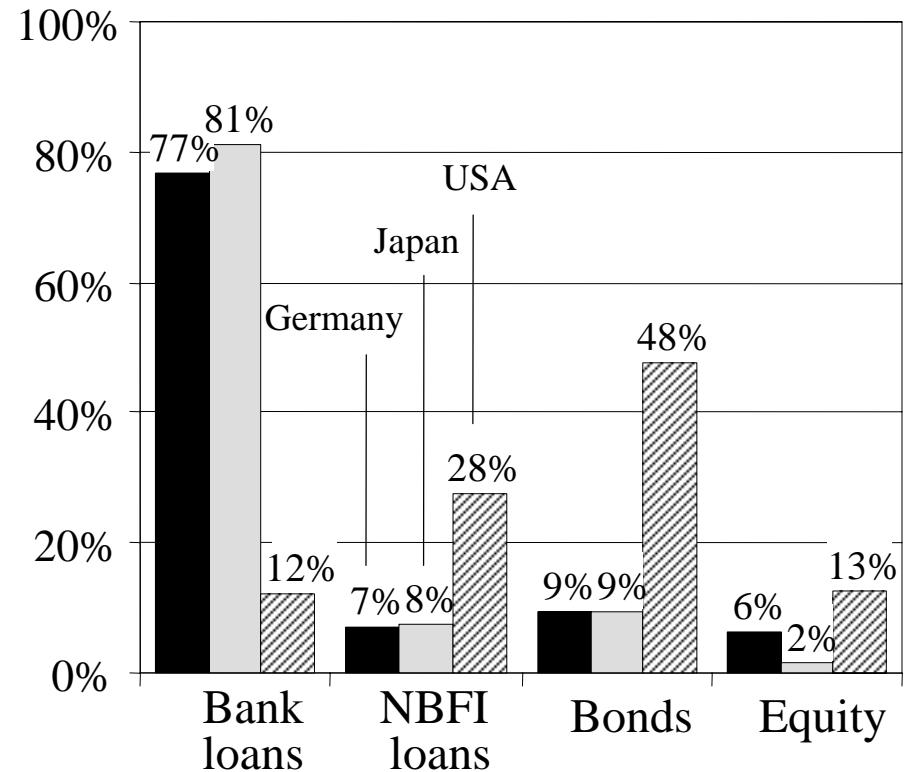
Differences in the CG structures of bank-based and market-based financial systems are reflected in ownership structures and financing patterns

Fraction of listed companies with shareholders who control majority of voting rights (black) and who possess veto rights (white) - mid 1990s -



Source: Barca/Böhmer (2001)

Breakdown of external long-term finance - average gross flows 1990-94 -



Source: Hackethal/Schmidt (2002)

Due to the many trade-offs, it is difficult to assess which type of system is superior in disciplining management and generating financial returns

Market for corporate control and executive turnover in four countries
- various years -

	# of hostile takeover bids	Block transfers	Executive turnover
Germany	4	10%	12,0%
France	n.a.	10%	11,0%
UK	148	9%	9,0%
USA	150	7%	n.a.

Sources: Number of takeover bids are taken from JP Morgan (2001) and Lipton (2001) who reports number of deals with US targets over \$100m. Block transfers (exceeding 10% of total equity) Germany (89-94): Köke 2001, France (89-91): Dherment-Ferere et al (2001), UK (89-94): Franks et al (1999), US (80-89, threshold 5%): Bethel et al 1998, Executive turnover: Dherment-Ferere et al (2001)

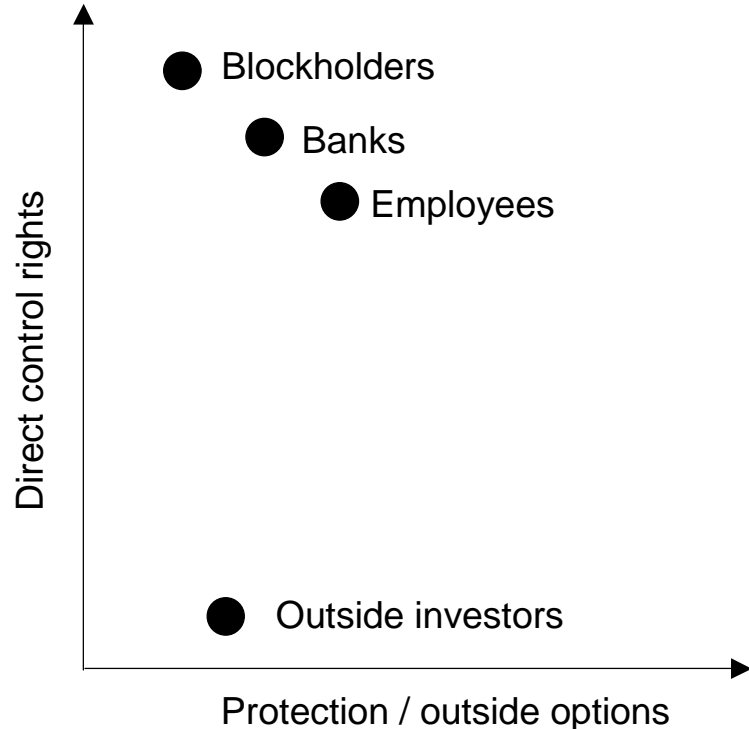
Real annual returns on domestic security portfolios in four countries
- 1960-2000 -

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

Source: Dresdner Bank (2001) and own calculations

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

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



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



Since 1990, the legal context for German corporate governance has been overhauled - primarily to facilitate raising of equity by corporations

1990	Prospectus Act	requires	More protection for minority shareholders	intentional acts and
1990	1 st Financial Market Promotion Act	(i) dra (ii) removal of some anachronistic taxes (eg capital transfer tax and stock exchange turnover tax) (iii) at	Hurdles for rent-seeking by insiders	nds
1994	2 nd Financial Market Promotion Act	(i) est (ii) pr (iii) crim (iv) requires corporations that are quoted on the official market to report changes in major holdings or voting rights	More externalization of information	er investigations and
1998	3 rd Financial Market Promotion Act	(i) reduces transaction costs for raising capital on the stock market in an attempt to simplify capital raising for SMEs (ii) ex (iii) as	Strengthening of institutional investors	
1998	Equity Raising Relief Act	allows	Strengthening of supervisory boards	GAAP
1998	Corporation Control and Transparency Act	(i) red (ii) an (iii) a spec (iv) simp (v) re	Weakening of inside shareholders	petition a court to appoint board s that supervisory
		(i) re (ii) ba (iii) exerc (iv) proxy (v) man (vi) pro (vii) voting (viii) re	Less control rights for banks on AGMs	and by abstaining from ers prior to making use of erships of their
1999	New Insolvency Code	(i) in (ii) co (iii) courts may "cram down" a dissenting creditor group	Less control rights for banks in bankruptcy proceedings	, as well as maximum es is not permitted on for quoted companies
2000	Tax Reduction Act	(i) (ii) ex	Incentives to dissolve interlocking shareholdings	holder's income tax by the nal income tax base

Minority investor protection has been strongly increased and the role of supervisory boards has been elevated

2001	Law gov. Registered Shares and Simplif. of Voting	(i) fac (ii) au (iii) al	Facilitation of proxy voting for (foreign) investors	Is ting)
2002	Takeover Act	- WpU (i) up four weeks (ii) t reason (ii) the	More protection for minority shareholders	bs- und Übernahmegesetz” the remaining shares within
		(ii) t reason (ii) the three months prior to the offer or any higher price paid by the purchaser (or any affiliated company) in the same period	Reduction of management discretion	the target must publish a rage share price of the last
		(iii) (iv) all	Strengthening of supervisory board	riate cash payment GM or subject to the
2002	Corporate Governance Codex	(i) summarizes current enacted statutory regulations for the management and supervision of German listed companies and thereby aims at making (ii) pre (iii) es	Increasing visibility of firms' approaches to CG	ns to disclose deviations
2002	4 th Financial Market Promotion Act	(i) establishes the BAFin as a comprehensive financial services authority (ii) makes market price manipulation punishable as a criminal act, if an intentional false statement about a fact significant for the valuation of a see (iii) st (iv) in to 'lock' the shares on specified accounts, thus making illegal sales impossible (v) (vi) pr false, c (vii) specifies in more detail ad-hoc disclosure requirements	Reduction of management discretion	l by BAFin) erent market segments. d enables stock exchanges
		(v) (vi) pr false, c (vii) specifies in more detail ad-hoc disclosure requirements	More protection for minority shareholders	be disclosed immediately willfully making untimely,
2002	Transparency and Disclosure Act	(i) pub (ii) the (iii) cc (iv) auditors must report to the supervisory board on any objections they may have (iv) obliges corporations to prepare a cash flow statement, a schedule of changes in equity and segment reporting	Augmentation of supervisory board	Governance Codex d key strategic measures

Legal reforms have increased formal outside investor protection...

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

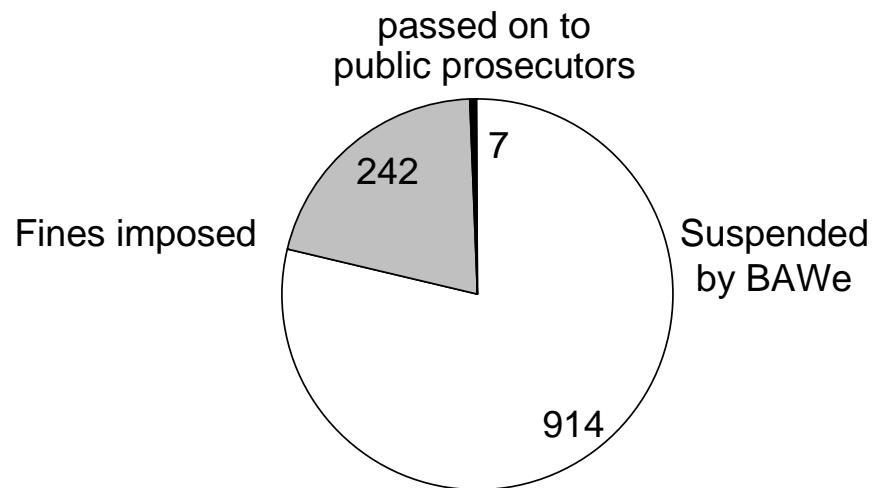
	1998		2002	
	USA	UK	Germany	Germany
1. One-share-one-vote	1	1		1*
2. Proxy by mail allowed	1	1		1
3. Shares not blocked before meeting	1	1		1**
4. Cumulative voting or proportional representation	1			
5. Oppressed minorities mechanism	1	1		
6. Preemptive rights		1		
7. Possibility of calling an extraordinary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

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

...BUT enforcement is viewed too lax by many commentators

Indicators for capital market law enforcement in Germany

Concluded proceedings to impose administrative fines
1995-2001



Source: BAFin (2002)

Outcome of insider investigations
1995-2001



Source: BAFin (2002)

Institutional investors have been gaining importance as shareholders of German corporations....

Corporate ownership by sectors (%)

Sector holdings in total equity of nonfinancial corporations
- various years -

	Households	Companies	Banks	NBFI	Foreign	Other
1990						
Germany	18	43	11	12	13	4
2000						
Germany	12	35	11	26	14	2
Japan	18	24	12	20	18	8
France	21	35	12	9	20	3
UK	20	4	2	36	37	1
US	39	10	2	39	9	1

Source: DAI (2001) and Davis (2002), who finds no significantly positive impact of the increase in institutional holdings on ROE, stock price and dividend payouts of German corporations for the 1970-1998 time period



...BUT ownership concentration among families and companies remains very high and the expected „deluge“ of hostile takeover bids in the wake of Vodafone /Mannesmann has not happened so far

Ultimate ownership by sectors (in %)

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

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

Source: Faccio/Lang (2001)

* Share of total voting rights controlled by largest shareholder (5% threshold)

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

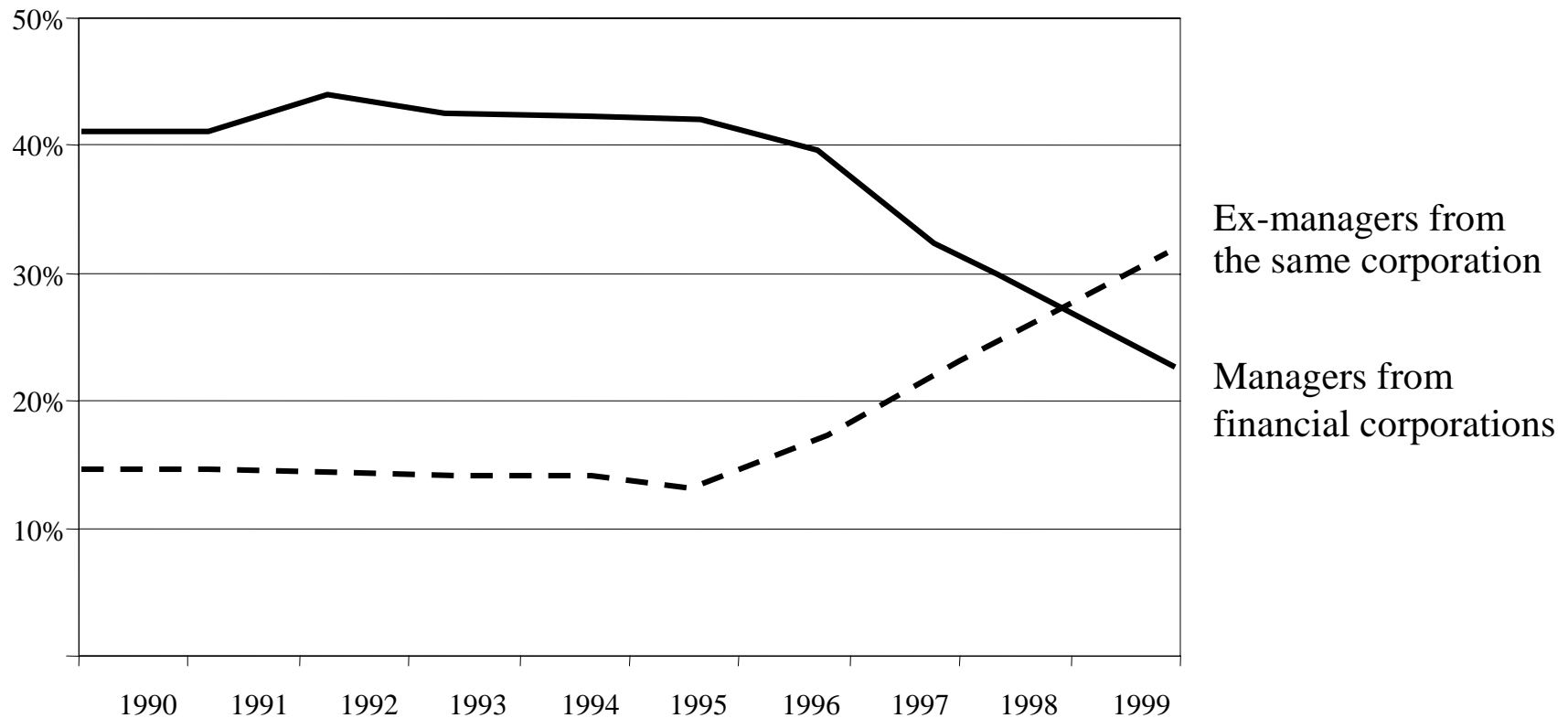
Cross shareholdings among German financial institutions (in %)

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

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

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

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

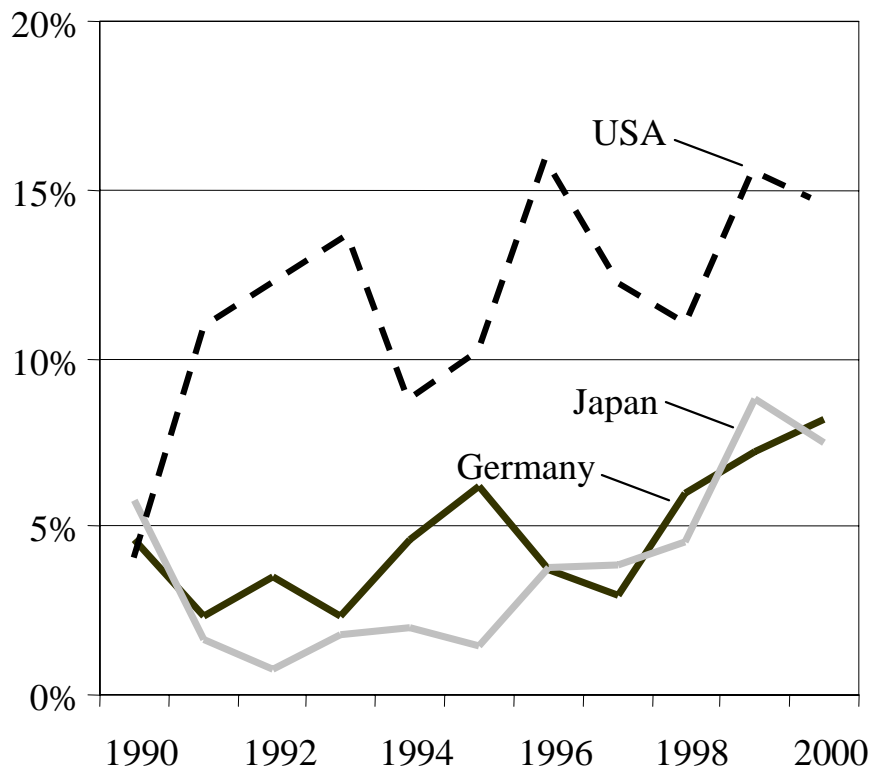


Source: Höpner (2001); Deutsch (1997) reports that the number of seats of bank managers on supervisory boards of the top-100 German corporations had already decreased from 114 in 1986 to 99 in 1993.

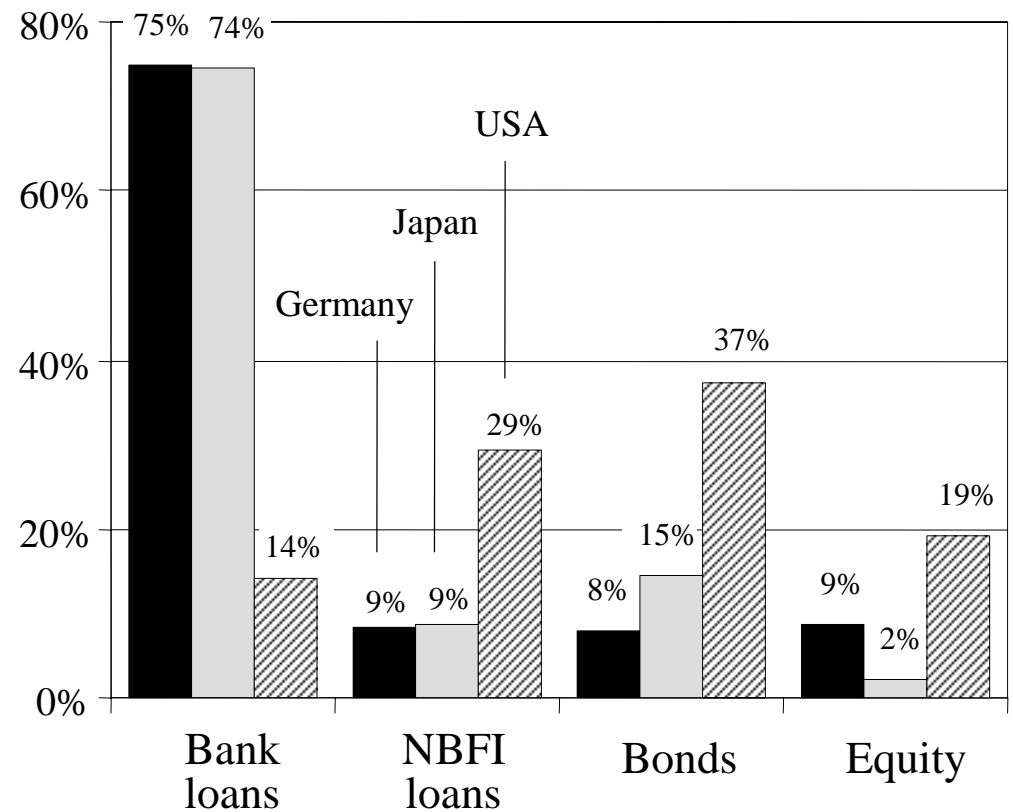
Equity has increased its importance as a source of finance... BUT bank loans are still by far the most important source for German firms

Financing patterns of nonfinancial companies

New equity raised over total investment
- gross flows 1990-2000 -



Breakdown of external long-term finance
- average gross flows 1995-2000 -

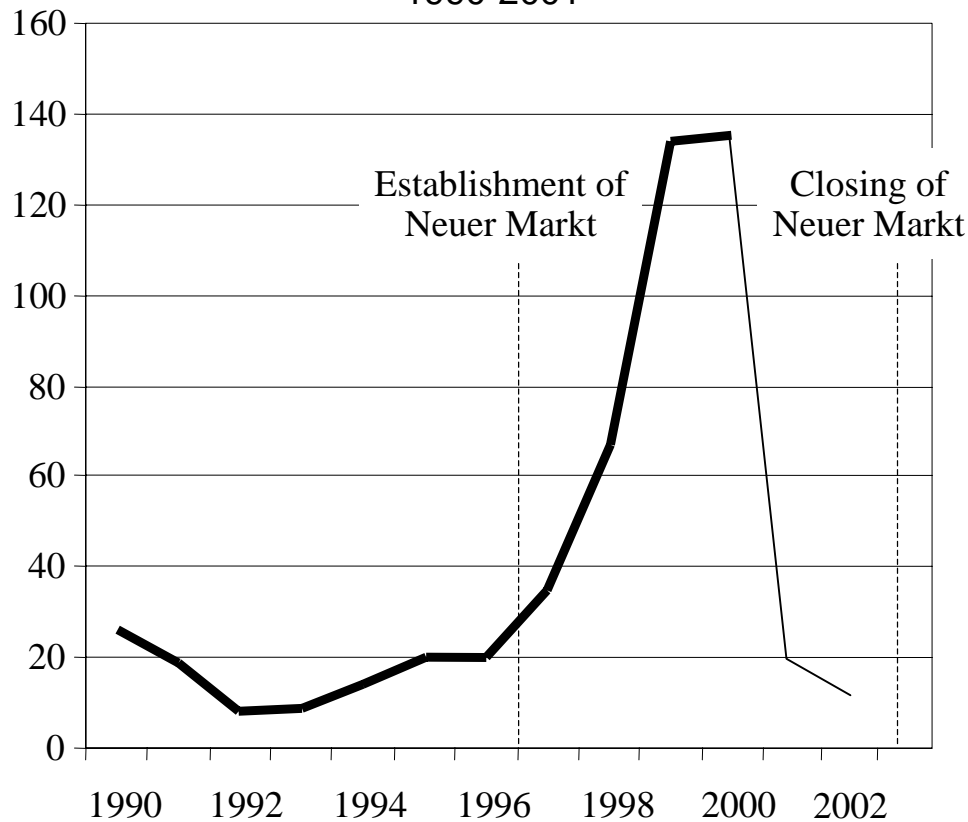


Source for both figures: Hackethal/Schmidt (2002)

Germany has witnessed a large number of IPOs in the late 1990s... BUT market capitalization is still low compared to the US and the UK

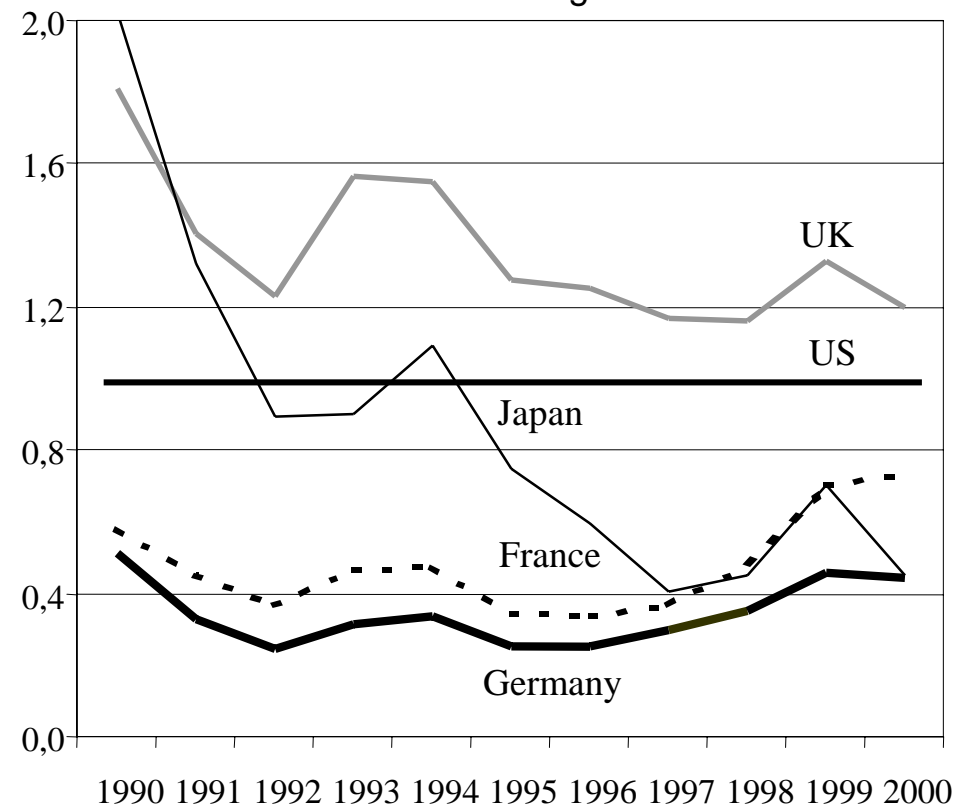
Importance of listed corporations

Number of IPOs in Germany
- 1990-2001 -



Sources: DAI (2001), OnVista (2002)

Market capitalization over GDP
- relative to US figures -



Source: DAI (2001)

Measures to make labor markets more flexible have been initiated... BUT employee participation remains unchanged

Protection and control rights of employees

Recent labour market reforms -examples -

- Hartz-commission proposals
 - aims to facilitate casual labour jobs and may expand the cheap wage sector
 - neutralises some protection against redundancy
- Recent proposals to reduce dismissal protection

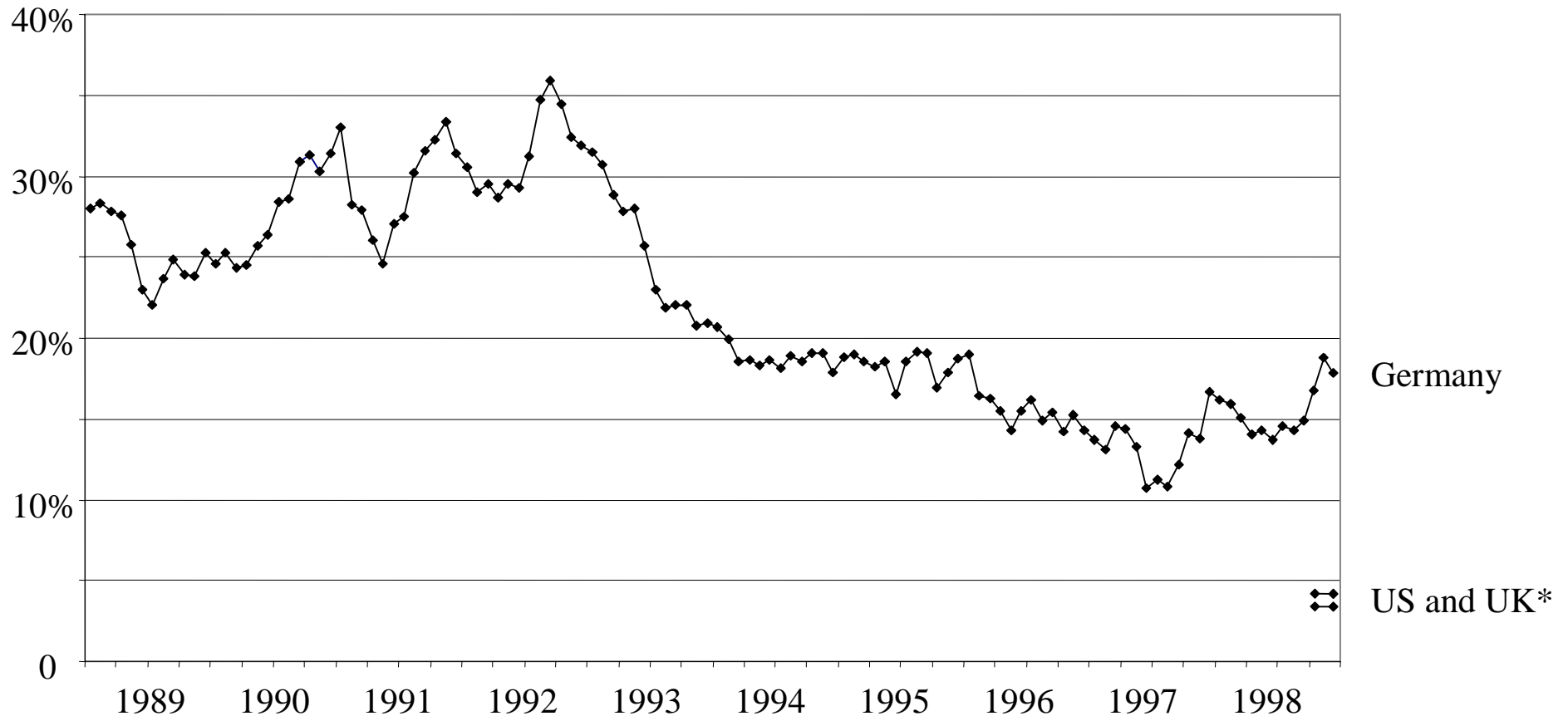
Importance of works councils in Germany - figures in thousand -

	Works councils	Members	Full-time members
1994	40	220	n.a.
1998	36	200	11
2002	40	220	20

Source: Frankfurter Allgemeine Zeitung, 19/9/02, p. 12

Increasing minority protection has reduced the value of control rights... BUT the value is still remarkably higher than in the US and the UK

Difference between of voting and preferred stock prices in Germany (1989-1998)

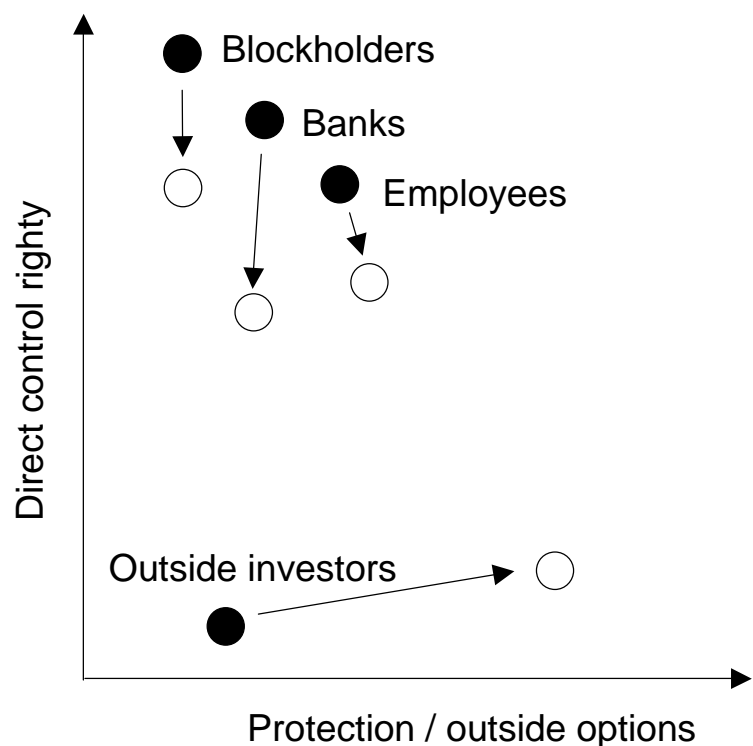


Source: Humboldt University, Institut für Bank- und Börsenwesen

*Nenova (2000) and Dyck/Zingales (2002) both report that average premia for USA and UK corporations are below 5%.

Although outsider protection has increased considerably, the discrepancy in direct control rights between insiders and outsiders remains large

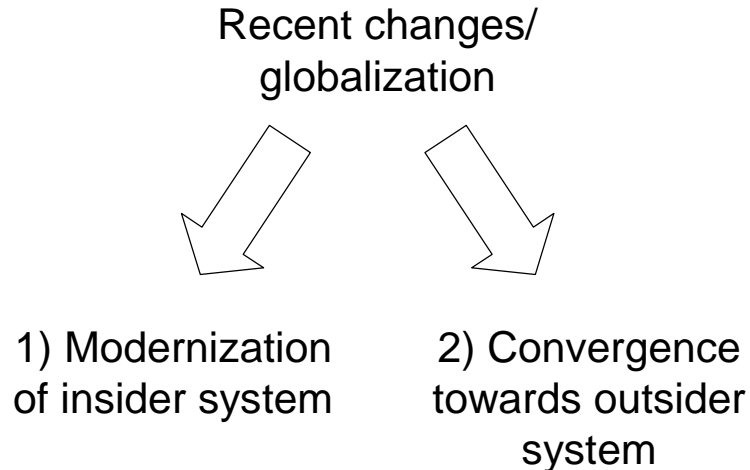
Impact of changes on core elements of German corporate governance system



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

We interpret recent developments as a modernization of the German insider system as opposed to a convergence towards an outsider system

Implications and caveats



- The „BUTs“ make us inclined to conclude that the logic of the system is still the same as before
- We view recent developments as efficiency enhancing measures to modernize German CG and to make capital markets more attractive
- But perhaps the system has already been weakened more than we believe
- Decreasing incentives and possibilities of big banks to play an important role may indicate a disintegration of the old „governing coalition“
- It is impossible to predict when „quantity turns into quality“
- However, what appeared like an irreversible trend in early 2000, has not continued since then

Backup slides



In 12/2000, less than 20% of German households carried equity shares or shares in investment funds in their portfolio

Household portfolios

	Bonds	Equities	Banks	NBFI	Other	
Germany 1970	8%	10%	59%	15%	8%	
Germany 2001	10%	9%	35%	37%	9%	Insurance 25%
Japan 1998	2%	4%	60%	28%	6%	Mutual funds 12%
France 1998	2%	30%	29%	31%	8%	German stocks 2%
UK 1998	1%	15%	21%	55%	8%	Foreign stocks 2%
US 1998	6%	23%	13%	50%	8%	Bonds 3%
						Other (MM, real estate) 5%

Source: Bundesbank (2001) , Davis (2002), BVI (2002)

Legal reforms 1/2

1990	Prospectus Act	requires publication of a sales prospectus for securities that are offered to the public for the first time (liability limited to intentional acts and gross negligence)
1990	1 st Financial Market Promotion Act	(i) drafting of investment and conduct guidelines for mutual funds (ii) removal of some anachronistic taxes (eg capital transfer tax and stock exchange turnover tax) (iii) abolition of some restrictions regarding business areas and investment possibilities of trust companies and mutual funds
1994	2 nd Financial Market Promotion Act	completely overhauls German capital market law. The new Securities Trading Act (i) establishes the Federal Securities Supervisory Office BAWe (ii) prohibits insider trading (the BaWe has to pass cases on to a public prosecutor, who may (or may not) conduct further investigations and criminal prosecution) (iii) implements current reporting duties ("ad-hoc-disclosure") (iv) requires corporations that are quoted on the official market to report changes in major holdings of voting rights
1998	3 rd Financial Market Promotion Act	(i) reduces transaction costs for raising capital on the stock market in an attempt to simplify capital raising for SMEs (ii) extends the permissible range of futures exchange products that can be purchased by investment companies (iii) approves pension plan investment funds designed for private pension schemes
1998	Equity Raising Relief Act	allows listed group parents to prepare exempting consolidated financial statements in accordance with either IAS or US GAAP
1998	Corporation Control and Transparency Act	(i) requires corporations to implement adequate risk management and internal revision systems (ii) allows shareholders who collectively hold at least five percent of total shares or a nominal value of 500K EURO to petition a court to appoint a special representative (cost to be born by shareholders) in case of dishonest or fraudulent behavior of the management board (ii) simplifies the use of stock option programs and liberalizes share buybacks by the company in the open market (iii) restricts the maximum number of supervisory board seats per person to ten (doublecounting chairmanships), requires that supervisory boards of quoted stock companies meet at least four times a year, requires supervisory boards to appoint auditors (iv) banks must rule out potential conflicts of interest by appointing a management board member as compliance person and by abstaining from exercising proxy votes in companies where they hold more than five percent of the shares; they must consult shareholders prior to making use of proxy votes and submit alternative proposals on how to exercise the voting rights and they have to disclose board memberships of their managers and employees (v) prohibits deviations from the one share–one vote principle by abolishing multiple voting stock, caps on voting rights, as well as maximum voting rights for listed stock; the use of voting rights in the election of supervisory board members of affiliated companies is not permitted (vi) revenues for auditors per client is restricted to 30% of total revenues and auditor liability is increased to DM 8 million for quoted companies (vii) makes segment reporting and cash flow statements mandatory for consolidated financial statements
1999	New Insolvency Code	(i) introduces insolvency plans as the German equivalent to chapter-11-procedures in order to facilitate reorganizations (ii) courts may allow debtor to stay in possession of his assets and to present an insolvency plan (iii) courts may "cram down" a dissenting creditor group
2000	Tax Reduction Act	(i) replaces full imputation system where the corporation tax paid by the company had to be credited against the shareholder's income tax by the "half-income system" in which half of the distributed profits of a corporation will be included in the shareholder's personal income tax base (ii) exempts capital gains from the sale of cross-corporation shareholdings from corporate tax base



Legal reforms 2/2

- 2001 Law gov. Registered Shares and Simplif. of Voting
- (i) facilitates to exchange anonymous bearer share equity for registered shares
 - (ii) authorizes electronic notices of meetings and other actions, as well as electronic tabulation of vote counts at AGMs
 - (iii) allows web voting (ballots transmitted by remote investors have to be cast by proxy broker physically at the meeting)
- 2002 Takeover Act
- Right after the fall of the EC Directive on July 4, the Government approved its own Takeover Act (“Wertpapiererwerbs- und Übernahmegesetz” - WpÜG), that governs public offers to acquire securities of a German stock corporation
- (i) upon reaching a threshold of 30% of the voting stock, a shareholder has to make an unconditional tender offer for the remaining shares within four weeks
 - (ii) the offer document must contain enough information to present a true and fair view of all relevant circumstances, the target must publish a reasoned opinion on the offer
 - (iii) the consideration (cash or liquid stock) for the stock of the target company must not be less than the weighted average share price of the last three months prior to the offer or any higher price paid by the purchaser (or any affiliated company) in the same period
 - (iv) upon reaching a threshold of 95%, a shareholder may "squeeze out" minority shareholders by offering an appropriate cash payment
 - (v) allows management to take measures to repel a hostile attack by relying on resolutions passed in advance by a SGM or subject to the approval of the supervisory board (if measures are compatible with prudent and diligent management)
- 2002 Corporate Governance Codex
- (i) summarizes current enacted statutory regulations for the management and supervision of German listed companies and thereby aims at making the German CG system understandable to international investors
 - (ii) presents standards for good and responsible governance that go beyond legal requirements and obliges corporations to disclose deviations
 - (iii) establishes a standing committee that monitors developments and adapts codex annually
- 2002 4th Financial Market Promotion Act
- (i) establishes the BAFin as a comprehensive financial services authority
 - (ii) makes market price manipulation punishable as a criminal act, if an intentional false statement about a fact significant for the valuation of a security, as well as every other deliberate deceptive measure that influences this valuation, has been made (monitored by BAFin)
 - (iii) stock exchanges are granted flexibility in setting own regulatory standards and trading mechanisms for their different market segments.
 - (iv) imposes stricter disclosure transparency on installed lock-up provisions in the offering prospectus for all IPOs and enables stock exchanges to ‘lock’ the shares on specified accounts, thus making illegal sales impossible
 - (v) requires all sell and buy transactions of management and supervisory board members as well as their affiliates to be disclosed immediately
 - (vi) provides a private action mechanism under which shareholders can privately (but not collectively) sue issuers for willfully making untimely, false, or misleading statements as well as for non-disclosure of material information
 - (vii) specifies in more detail ad-hoc disclosure requirements
- 2002 Transparency and Disclosure Act
- (i) publicly listed firms must explain whether and to what extent they have adhered to the provisions of the Corporate Governance Codex
 - (ii) the management report shall report in writing to the supervisory board on the company's business performance and key strategic measures
 - (iii) companies can choose the form and degree of public access to their annual general meeting
 - (iv) auditors must report to the supervisory board on any objections they may have
 - (v) obliges corporations to prepare a cash flow statement, a schedule of changes in equity and segment reporting