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Andreas Hackethal, Reinhard H. Schmidt, Marcel Tyrell

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The transformation of the German financial system

Andreas Hackethal*
Reinhard H. Schmidt*
Marcel Tyrell*

Until the end of the last decade, German banking and corporate governance and the financial system as a whole were characterized by a remarkable degree of stability. The most important characteristics of the German financial system were bank dominance of the entire financial sector, a strong role of not strictly profit-oriented banks and a stakeholder oriented and insider controlled corporate governance regime. In looking at the German financial system as it used to be, one can easily recognize that it constituted a well-balanced system, as the authors show in section III.

However, the past seven to ten years have witnessed an array of changes in the legal, financial and business environment of German banks and corporations and in the financial system as a whole. Most notably, the role of public banks and the stakeholder orientation of the corporate governance system have come under pressure, and the possible demise of these elements may imply a fundamental transformation of the entire German financial system. These developments are described and analyzed in section IV.

One way of explaining the former stability of the German financial systems is to point out that its main elements were complementary to each other and also consistent. Recent developments, most notably a change in the behavior and the strategy of Germany's large private banks, have already undermined this systemic consistency. Considerations pertaining to the systemic character may also shape the process of a possible transformation. As the authors argue in the concluding section of their paper, it is precisely because of the importance of complementarity, that this possible transformation might not be a gradual process but rather abrupt and possibly also painful and that it might even lead to the adoption of an economically inferior financial system.

Banking system - financial system - corporate governance - Germany

* Andreas Hackethal holds the Chair for Financial Services at the European Business School in Oestrich-Winkel, Germany. Reinhard H. Schmidt is the Wilhelm Merton Professor for International Banking and Finance at the Johann Wolfgang Goethe-Universität in Frankfurt am Main. Marcel Tyrell is a lecturer at the Universities of Trier and Frankfurt. The corresponding author is Reinhard H. Schmidt, email: schmidt@finance.uni-frankfurt.de Earlier versions of this paper were presented at the 22. Journées d'économie monétaire et bancaire, Strasbourg, as well as at the annual meeting of DGF in Augsburg, at a German/Japanese conference in Tokio, at the Max Fry Workshop in Birmingham (all in 2005) and at Université Paris X (Nanterre) in 2006. The authors are grateful to all those who provided feedback and advice. The usual disclaimer applies.

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La transformation du système financier allemand

Cet article introduit tout d’abord le concept d’un système façonné par la complémentarité et la cohérence interne. Il caractérise le système financier allemand avec un accent particulier sur le rôle des banques et la gouvernance d’entreprise telles qu’elles existaient auparavant et il met en avant la cohérence interne et l’équilibre atteint par ce système. L’article décrit et évalue les changements récents, en arrivant à la conclusion que le système n’a pas encore été fondamentalement modifié. Cependant, sa cohérence interne est sous pression, et cette perte de cohérence peut conduire à une transformation radicale et brutale, sans garantie que le système financier qui émergeait alors soit plus efficace.

système bancaire - système financier - gouvernement d’entreprise - Allemagne

Classification JEL: G 32, G 34, G 38.

1 Starting point: a financial system under stress

Until the end of the last decade, German banking and corporate governance and the financial system as a whole were characterized by a remarkable degree of stability. Its most important characteristics were bank dominance of the entire financial sector, a strong role of not strictly profit-oriented banks in the banking sector and a stakeholder oriented and insider controlled corporate governance regime. In fact, the German financial system has long been regarded as the international prototype of a system that is bank-based and insider-controlled. In looking at the financial system as it used to be, one can easily recognize that it constituted a system in the specific sense of the term which we will explain below. Bank dominance and stakeholder orientation are essential elements of this system, and the systemic character is likely to be a main reason for the “stunning degree of institutional stability”\(^1\) of the German financial system.

However, what appears to be stability may also be an indication of rigidity and a lack of ability to adapt to a new situation shaped by the forces of globalization and European integration, thus it may in the final analysis be

\(^1\) See Abelshauser [2003], p. 177 (our translation). Abelshauser, an economic historian, refers not only to the German financial and corporate governance system but more generally to the entire institutional infrastructure that has shaped the German economy for a long time. An equally broad perspective is adopted in the work of several authors who discuss “varieties of capitalism” and compare the German case to that of other countries, such as Streeck [1991], Hall/Soskice [2001] and Amable [2003]. In a recent central bank publication which compares the institutional structure of the financial systems in different countries, the chapter on Germany starts by stating “Germany’s financial system has proved very robust over the past 50 years” (Group of 20, [2005], p. 91).

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the very opposite of stability. There are signs which point in this direction. The past seven to ten years have witnessed an array of changes in the legal, financial and business environment of German banks and corporations and in the financial system as a whole. Most notably, the role of public banks and the stakeholder orientation of the corporate governance system have come under pressure, and the possible demise of these elements may imply the collapse and a fundamental transformation of the entire German financial system.

These developments suggest addressing the following questions:

— Have recent developments now led to a structural change in German banking, corporate governance and in the German financial system as a whole?

— If yes, has there been a convergence to the market-based structures of Anglo-Saxon countries, as it occurred in France in the course of the last twenty years?

— And if no, can we expect such a change to occur relatively soon, and if it occurred would it be a desirable development as numerous observers seem inclined to believe who regard the Anglo-Saxon model as inherently superior to the German model?

One way of explaining the former stability of the German financial systems is to point out that its main elements were complementary to each other and also consistent. Recent developments, most notably a change in the behaviour and the strategy of Germany’s large private banks, have already undermined this systemic consistency. Considerations pertaining to the systemic character may also shape the process of a possible transformation. As we will argue, it is precisely because of the importance of complementarity, that this possible transformation might not be a gradual process but rather abrupt and possibly also painful. Thus while many authors argue that the forces of internationalisation put pressure on countries to adopt a “good” financial and corporate governance system and usually consider the capital market-based Anglo-Saxon model as the “better” model, we consider the quest for consistency as the driving force of change.

The paper is structured as follows. In Section 2 we provide some definitions and introduce the concept of a system shaped by complementarity and consistency, on which the main argument of this paper is based. Then, in Section 3, we characterize the German financial system with particular focus on banking and corporate governance as it used to be and point out why it appeared as a well-balanced or consistent system. Section 4 describes and assesses recent changes, leading to the conclusion that the system has not yet changed in a fundamental way. However, its consistency has been challenged and as we argue in the concluding Section 5, this loss of consistency can lead to an abrupt and fundamental transformation, which is largely

2. Very strong statements of this kind can be found in Walter [1993] and Hansmann/Kraakman [2004].
independent of any assumption as to which financial system would in general be better.3

2 Definitions, Classifications and Concepts

2.1. Definitions and classifications

In this paper, we use broad definitions of the terms ‘financial system’ and ‘corporate governance’ and treat corporate governance as an element of the financial system.

The financial system is more than merely the “financial sector”, i.e. the institutions such as banks, investment funds and organized capital markets that specialize in providing capital and other financial services to the real sectors of an economy. In contrast, we define the financial system as comprising both supply and demand, which is determined by the use that non-financial or real sector units make of financial services offered by the financial sector. According to this definition, financial decisions and activities that do not affect the financial sector such as corporate dividend policy and household saving in the form of accumulating real assets are also a part of a country’s financial system.

A simplified but common classification of financial systems distinguishes between bank-based and capital market-based systems. In a bank-based system, banks are important providers of loans to non-financial firms; they play a major role in attracting household savings; they are involved in the governance of other firms; and they often have a strong influence on other parts of the financial sector such as investment companies and stock exchanges. In contrast to banks, organized capital markets are unimportant as a source of funding for firms and as an instrument of corporate governance. Typically, banks are universal banks, and bank financing of firms is not only considerable in volume terms but also long-term.

A capital market-based financial system is the polar opposite. Capital markets are important as places where household put their savings, as a source of firm financing and also as “markets for corporate control”. Bank lending is rather restricted in terms of volume and of loan maturities. Often banks are specialized either by law or tradition, and even if universal banking is allowed, as is now the case in most industrialized countries, banks are

3. This paper builds on the outcome of a research program on the convergence of financial systems in Europe that has been funded by the Deutsche Forschungsgemeinschaft (see Schmidt/Hackethal/Tyrell [2002] for a summary) and later work such as Hackethal/ Schmidt [2005] on banking, and Schmidt/Spindler [2003] and Hackethal/Schmidt/Tyrell [2005] on corporate governance.

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organized in a way which separates investment and commercial banking activities. In capital market-based financial systems non-bank financial intermediaries play an important role and invest a large part of their assets in the stock market.

The financial systems of most European countries have long been bank-based while Anglo-Saxon countries have capital market-based financial systems. Classifying countries according to which type of financial system they have is now more difficult than it used to be, but the classification is sufficient for the purpose of this paper.4

Corporate governance is an integral part of every financial system. It is hardly conceivable that external financing of firms would happen at all if the providers of funds were not assured in some way that their interests are taken into account when decisions are made by the firms they finance. This consideration suggests to define corporate governance as the totality of mechanisms which assure that managers' decisions are made in the interest of shareholders and possibly other providers of capital so that these can expect “a return on their investment”.5

However, this definition is rather narrow and reflects the features of Anglo-Saxon capital market-based financial systems.6 In a broader definition, which is frequently used in Europe and Japan and more appropriate to the situation in these parts of the world, the term corporate governance refers to the totality of mechanisms through which stakeholders can exert influence on how important decisions are taken in firms. Even though this definition emphasizes the aspect of conflicts of interest between stakeholder groups it also includes the monitoring of management as an important aspect.

A widely accepted classification of corporate governance system distinguishes between outsider control systems and insider control systems.7 Outsider control systems, which prevail in the Anglo-Saxon world, do not take account of different interests and are based on market mechanisms and public information. In these systems, the only obligation of management is to act in the interest of shareholders. The dual task of aligning the interests of shareholders and managers and of controlling management is mainly performed by a functioning market for corporate control, by executive compensation tied to the share price and by competitive factor and product markets. Flexible capital and labour markets also serve to protect stakeholders who are not shareholders, since they provide “exit” opportunities and

4. On the potential and the limitation of this classification, see, among others, Allen/Gale [2004].
5. Shleifer/Vishny [1997].
7. See Franks/Mayer [1994] for a lucid exposition of this distinction, which is, however, much older. By now it is generally accepted, even though the extent to which specific corporate governance systems fall under one of these two categories is a matter of dispute, as one can expect from any classification scheme. For a discussion of this and other classifications, see e.g. Prigge [1998].
thus reduce the need of these stakeholders to have “voice” as a means of safeguarding their interests.  

Insider control systems, which used to prevail in most of continental Europe and Japan, are more complex since they leave room for conflict. They are based on internal mechanisms for exercising influence and private or non-public information available to those who are in a position to influence management decisions. Most insider control systems are at the same time stakeholder oriented in the dual sense of treating the interests of different stakeholder groups as genuinely relevant – that is, not only as relevant to the extent that taking their interests into account helps to increase shareholder value – as well as of giving several stakeholder groups an active role in corporate governance.

The dual task of aligning interests and supervising management is performed – and facilitated – by the role and the composition of a supervisory board (or some functional equivalent) which is separated from the management or executive board by equity participations of banks and cross-shareholdings among non-financial firms and by an active involvement of employees in the corporate governance of large corporations.

A stakeholder orientation needs mechanisms for coming to terms with conflicting interests. The main arena in which stakeholder interests are expressed and conflicts are, to a certain extent, resolved is the supervisory board (or some functional equivalent). Long-term relationships between the stakeholders and the firm and repeated interaction between the various influential stakeholder groups serve to harmonize interests and to limit conflicts.

Evidently, there is a correspondence between outsider-controlled corporate governance and a capital market-based financial system as well as between insider-controlled corporate governance and a bank-based financial system respectively.

2.2. Concepts: The systemic approach

The complexity of financial and corporate governance systems requires a system perspective. We find the conceptual framework of “complementarity and consistency” a useful tool for understanding and analyzing these systems.  

Complementarity of system’s elements is given - or a system is characterized by complementarity - if the elements can take on values such that they

8. Hirschman’s [1970] typology of “exit” and “voice” as two ways of reacting to negative developments of an organization is frequently used in the literature on corporate governance; see e.g. Mann [2002].

9. This approach has first been developed by Milgrom and Roberts in a series of highly stimulating papers that mainly focus on corporate structure and strategy as a field of application. See especially Milgrom/ Roberts [1995]. Amable [2003] discusses institutional complementarities of different varieties of capitalism. We have transferred this approach to financial and corporate governance systems in Hackethal/Schmidt [2000] and Schmidt/Tyrell [2004].

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mutually reinforce each other in their positive effects and mitigate any ne-
gative effects they may have. However, complementarity only indicates the
potential of achieving a benefit arising from the elements being well adjus-
ted to each other. A real system can be characterized by complementarity
without this potential being realized. The additional concept of consistency
addresses this aspect: A system of complementary elements is termed
consistent if all elements, or at least the most important ones, take on values
that fit together well.

Complementarity has important implications. First and foremost, the fit
between the values which individual elements take on is very important, and
there is a certain economic pressure towards consistency. Second, multiple
“good” systems constituting local maxima with respect to some suitable
valuation function may co-exist. Third, “middle-of-the-road” systems that
combine features which appear attractive in different systems are problemat-
ic. Fourth, there may be path-dependence in how systems develop over
time, a feature that makes the success of piecemeal reforms unlikely.10 Fi-
nally, complementarity suggests a methodological rule: Instead of analyzing
financial system elements in isolation, it is crucial to understand “la logique
du système”.11

It is a theoretical question whether a given set of institutional features is a
system of complementary elements, and mainly an empirical question
whether a given system is also consistent. Among others, Aoki (2001) has
shown that financial systems and corporate governance systems are sys-
tems in the sense of being composed of complementary elements. As we
will argue in the next section, the German financial system has also been
largely consistent until quite recently.

3 Characteristics of the traditional
German financial system

3.1. General features of the old German
financial system

The German financial system has for a long time been bank-dominated.
Banks were the main actors in the financial sector, providing the lion’s share
of external financing of firms and attracting a considerable part of the finan-
cial savings generated by households.

10. On path dependence, see Bebchuk/Roe [2004] and the extension in Schmidt/Spindler
[2003].
11. This rule shows an important methodological - as well as substantive - similarity
between the concept presented here and the approach of the French “école de régulation”,
see Boyer/Saillard [2002].
Since the beginning of the 20th century, the big private universal banks also played an important role in the governance of large corporations. In addition to their power as lenders, their influence was based on three factors: depository voting rights, blocks of shares, and seats on supervisory boards of other corporations.

During the early years of the 20th century before and after World War I and then again for a long period after World War II, top managers of the big private banks seemed to regard themselves as bearing a special responsibility for the development of German enterprises and tried to act accordingly; and many politicians and even the general public largely shared this view. Together with large insurance companies, which had multiple close links with the big banks, these banks had built up the dense network for capital and personal links between Germany’s largest corporation that is often referred to as “Deutschland-AG”. Not surprisingly, banks also dominated the stock markets, in whose governing bodies they were represented, as well as other elements of the financial sector.

Banking regulation in Germany has always been rather restrictive concerning entry into the banking business and very liberal in so far as it allows banks to operate as true universal banks. For a long time, special disclosure rules permitted banks to build up hidden reserves and to draw them down as required from time to time. Regulation and disclosure rules greatly contributed not only to the importance of banks but also to the stability of the German financial system as a whole in the years after World War II.14

Given the strong role of banks it is not surprising that Germany’s organised capital markets have long been neglected. They were fragmented institutionally, almost irrelevant as a source of enterprise financing and completely irrelevant as a force in corporate governance. The big banks seem to have used their clout to prevent the stock market from becoming an effective competitor for the banks in their functions as providers of loans to large enterprises and as collectors of household deposits.15 That hostile takeovers were virtually unknown in Germany had its root in the refusal of banks to provide the necessary funding for public takeover bids since hostile takeovers would only have undermined the close bank-client relationships.

An additional characteristic of the old German financial system is that for a long time firms had ample opportunities for self-financing, not least in the form of internally accumulated pension reserves. Together with a generous pay-as-you-go pension system, this fact in turn contributed to the low level of stock market development: There was no need to have pension funds, and therefore such funds did not exist, did not supply capital to the market

12. For the time after World War II, this group includes Deutsche Bank, Dresdner Bank and Commerzbank.
13. Fohlin [2005], who is quite critical on the role of the banks in the pre-war period, admits that the big banks were rather active.
14. See Allen/Gale [1995] on the importance of this feature of a financial system: it permits the banks to smooth the income of the real sector of the economy and thus reduces inter-temporal risk.
15. An additional factor which contributed to the "underdevelopment" of German capital markets was the policy of the Bundesbank which feared that liberalised stock markets might endanger its policy of monetary stability; see Fischer/Pfeil [2004].

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and did not require and demand the services of well developed stock exchanges.

The features of the traditional German financial system described so far already show a great deal of complementarity, consistency and stability. This impression will become even stronger when we now discuss banking and corporate governance in more detail.

### 3.2. Characteristic features of the German banking system

Even though the big private commercial banks have shaped the entire financial system and even the entire German economy over a long period of time, it would be wrong to assume that they are the largest banking group in the country. Germany has a so-called three pillar banking system composed of public savings banks, private commercial banks and cooperative banks. They are all universal banks and generally subject to the same regulatory regime.

In terms of total bank assets, the largest group is the savings bank group. At the end of 2005 it comprised 463 local savings banks and 12 Landesbanken (regional or state banks) and accounted for 35% of total German banking assets. Savings banks mainly cater to a local business and household clientele and they still benefit from having a huge stock of stable and cheap deposits. Landesbanken are big public sector commercial and investment banks and act as central banks to the savings banks in their respective regions and as the house bank of the respective state in which they are located.

The private commercial banks are the second largest banking group. The so called “big banks”\(^\text{16}\) hold almost two thirds of the domestic assets of all private commercial banks but less than one fifth of all German banking assets, even though this clearly underestimates their economic importance. The third largest banking group is the cooperative group. At the end of 2005 it consisted of 1,293 small local cooperative banks and two large second tier organisations, which are big universal banks in their own right.

Table 1 shows the number of institutions and banking outlets as well as total bank assets in the three groups mentioned above and in a fourth group which comprises banks with a special status such as mortgage banks and other special purpose banks like the development bank KfW, which is owned by the federal state.

Table 1 suggests a number of characteristic features of German banking. The high number of banks indicates that bank concentration seems to be

\(^{16}\) This term is also used by official central bank statistics. In addition to the three banks mentioned above, the group of big banks also includes HVB, a big bank that has emerged from the merger of two regional banks located in Bavaria and was recently acquired by the Italian banking group Unicredit.

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rather low in comparison to other European countries. However, this impression can be misleading since the local savings banks and the primary cooperative banks operate under a relatively strict regional principle and therefore hardly compete for local markets within the respective groups.17

Then there is the preponderance of the public banks, especially that of the savings bank group. It suggests that there is much state influence on the banking sector in Germany. However, almost all local savings banks are owned by the respective municipalities. Therefore, the federal government and those of the states (Länder) do not have any influence on their operations, and also that of the municipal authorities is severely restricted by law and in practice.

A corollary of the size of the savings bank group and that of the cooperative banking group is the relatively small market share of the big banks in comparison to other European countries. Since neither the savings banks nor the cooperative banks are by their design and statutes strictly profit oriented, a feature which in former years also applied for the private banks, the overall level of profit orientation in German banking is limited. This may be a reason why profitability has always been relatively low in the German banking sector. Surprisingly however, over the five-year period from 2000 to 2004 the profitability as measured by average post-tax returns on equity of the local savings banks (4.9%) and cooperative banks (5.1%) exceeded that of the big private banks (-1.2%).

Typically, banks in Germany are universal banks. They have the right to offer all kinds of banking services and they also use this right in ways which

17. However, if one considers the entire savings bank and cooperative bank groups as two complex institutions bank concentration in Germany does not differ from that in other European countries.

Table 1. The structure of the German banking system as of end 2005

<table>
<thead>
<tr>
<th>Number of banks</th>
<th>Number of outlets</th>
<th>Domestic assets (in € bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local savings banks</td>
<td>463</td>
<td>14,801</td>
</tr>
<tr>
<td>Landesbanken</td>
<td>12</td>
<td>618</td>
</tr>
<tr>
<td>Local credit cooperatives</td>
<td>1,293</td>
<td>13,357</td>
</tr>
<tr>
<td>Cooperative central banks</td>
<td>2</td>
<td>12</td>
</tr>
<tr>
<td>Big private banks</td>
<td>4</td>
<td>2,454</td>
</tr>
<tr>
<td>Regional private banks</td>
<td>247</td>
<td>2,421</td>
</tr>
<tr>
<td>Private and public mortgage banks</td>
<td>50</td>
<td>2,903</td>
</tr>
<tr>
<td>Special purpose banks</td>
<td>18</td>
<td>27</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>2,089</strong></td>
<td><strong>36,593</strong></td>
</tr>
</tbody>
</table>

*Source: Deutsche Bundesbank*
correspond to their respective sizes. A characteristic feature of German banking, which is related to the universal banking tradition, is that banks have close ties to the enterprises they finance. There are still the so-called “house bank relationships” between firms and banks. In a series of interesting studies, Elsas and Krahnen have shown that (1) many firms still have a house bank, i.e. one bank enjoying a preferred status among the set of banks with which the firms maintain banking relationships. Thus, house bank status does not imply exclusivity. (2) In almost all cases, there is no question which one among a firm’s banks is the house bank. (3) More importantly, house banks seem to behave differently from other banks when a firm experiences difficulties, probably because the house bank has more and better information than the other banks. If a firm’s financial situation becomes weaker, all the banks reduce their combined lending exposure, whereas the house bank increases its lending or at least maintains its level.18 Thus, German banks seem to offer a kind of liquidity insurance to their established long-term business clients. This behaviour may explain why German firms use more bank loans for external financing than firms in most other countries, as has been shown by Hackethal and Schmidt (2004).

3.3. Characteristic features of the German corporate governance system

At the macroeconomic level, corporate governance is a crucial determinant of innovation, growth and economic welfare. Sound corporate governance increases the extent to which firms obtain critical resources and shape the effectiveness of their use.19 Similar considerations apply at the micro level. Firms need external resources. This exposes the providers of these resources to risk. However, the risk they bear is not just given by technological and market factors. It also depends on decisions that are made later by those who are in a position to make important decisions. Thus, there is a moral hazard problem. All long-term contracts are inevitably incomplete creating the danger of moral hazard and especially of a “hold up” in the course of formal and informal contract renegotiations,20 and since the results of these renegotiations depend on governance rules, these rules are of crucial importance.

Most obviously, this moral hazard problem makes external equity financing difficult. If potential providers of equity, i.e. owners or shareholders, have reasons to doubt that the governance regime provides some protection for them, they would hardly be prepared to invest and to become “residual claimants” and thus a firm’s primary risk-bearers. But the situation of banks

18. For a summary of their findings, see Elsas/Krahnen [2004]. The existence of house banks has been questioned in the still best-known English-language book on German finance and banking by Edwards/Fischer [1994]. Thus the Elsas-Krahnen studies can be regarded as a refutation of the Edwards-Fischer proposition.
19. See e.g. Shleifer/Vishny [1997].
and employees is not all that different if banks provide sizable long-term loans and if employees develop and apply a great deal of firm-specific knowledge. Both large long-term loans and firm-specific knowledge have for a long time been characteristic features of the German economy. Therefore, granting governance rights to all those who are expected to provide valuable resources and in this context to undertake specific investment with sunk-cost features, i.e. to shareholders, long-term lenders and core employees, reduces the risk perceived and borne by these parties and makes it easier for firms to obtain their resources. This is the economic rationale of a stakeholder-oriented corporate governance system.

If more than one group of stakeholders has governance rights the question naturally arises whether the rights of different stakeholder groups work in a similar direction - or are complementary - or rather have antagonistic effects. The answer to this question depends on how governance is implemented in a specific case like that of a given country.

One characteristic of the governance of large German corporations in the legal form of a joint stock corporation is the dual board structure. There is the board of management (Vorstand) which has the obligation to determine and implement the corporate strategy, and the supervisory board (Aufsichtsrat) which appoints, dismisses and monitors management. But apart from these and some other functions which clearly have an indirect effect on how management operates, the supervisory board is not involved in determining business strategy and policy. Its role differs in a fundamental way from that of a British or American unitary board or a French conseil d’administration. Nevertheless, even the indirect influence of a German supervisory board is quite strong.

The main arena in which corporate governance is implemented in German corporations is the supervisory board. But how are supervisory boards composed, how do they operate, and which board members are powerful? The legal basis is again the company law. By law, half of the positions in the supervisory board are determined by the general assembly of shareholders, while the other half is determined by the labour side.

The formal rules on who elects supervisory board members are not enough to understand the German corporate governance system. It is also crucial to know how share ownership is distributed and who the people are who sit on supervisory boards. Share ownership in Germany is highly concentrated. Other corporations, founding families and banks and insurance companies hold large share blocks in the majority of listed corporations. Moreover, a considerable number of supervisory board members elected by the shareholders are former members of the same corporations’ management boards or other business leaders or bank representatives.

22. For an extended analysis, see Schmidt [2006].
23. However, the “capital bench” has a slightly stronger position since in the case of a tie the chairman casts the deciding vote and the chairman is determined by the shareholder side.
24. For empirical evidence, see Becht/Böhmer [2001].
These structures of ownership and supervisory board composition are consistent with the legal rules which determine what the management board and also the supervisory board are expected to do: Both boards are supposed to act “in the interest of the firm”. This vague legal term is interpreted by most lawyers as meaning that not only do shareholder interests count but also those of several stakeholder groups, making it an important part of the tasks of management and the supervisory board to strike a balance between the interests of the different stakeholders and not simply maximize shareholder value.

Taken together, these stylised facts suggest that the (former) corporate governance system of large German companies bases on a “governing coalition”, which is composed of four groups. One group is top management, the others are shareholders, employees and banks and insurance companies. The power basis of the latter three groups are not only their supervisory board seats but often also other long-term relations with the corporation such as their roles as lenders and the codetermination of employees at the floor-shop level. In the case of shareholders it is important to point out that only block holders are part of the “governing coalition”, while small shareholders are not included. They are in fact not even well represented on German supervisory boards.

The parties which used to make up the “governing coalition” largely shared long-term objectives. In accordance with their legal mandate, most German top managers used to see their role as being responsible to various stakeholder groups and not only to shareholders. Thus, they would typically not aspire to maximise shareholders’ wealth but rather to assure stability and growth of the firm. This is in line with the long-term or “strategic” interests of those who own blocks of shares, of the banks who are mainly interested in the firms’ ability to repay loans, and of labour representatives who care most for secure employment and career prospects for staff members. This common interest, which in all likelihood “genuine shareholders” would not share, has been the basis on which a high degree of consensus among those who have influence could emerge.

3.4. Complementarity and consistency of the old regime

The feature of German corporate governance suggests that they form a consistent system composed of complementary elements: The legal mandates of the two boards, the division of functions between them, the composition and the functioning of the supervisory board, the distribution of power within this board and not least the common interest in stable growth are elements that fit together well and tend to mutually reinforce their respective effectiveness. Under the aspect of consistency, it is important to add that

25 To the extent that management is monitored and possibly also disciplined by the supervisory board, its interests are of course opposed to that of the supervisory board.

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a market for corporate control in the form of hostile public takeover bids did not exist in the old regime. If it existed, it would put a strong pressure on management to maximise shareholder value. With this pressure in place and anticipated by the others, the implicit contracts between management and shareholders on the one side and banks and employees on the other side would no longer be credible. As a consequence, these two groups of stakeholders would lose their interest in playing an active role in governance. In particular, they would hardly have a motive to contribute the specific knowledge they can rightly be expected to have, and to strive for consensus.

Complementarity and consistency are not only given within the governance system as it used to exist in Germany but also between the governance system and the rest of the financial system. Stakeholder-oriented and insider-controlled governance is consistent with the dominant role of banks in the financial sector, extensive financing with bank loans and a relatively weak role of capital markets in the financial sector and little capital market financing, the pension finance regime, the lender-friendly German accounting rules and the general consensus-orientation in the entire financial system.²⁶

To conclude this brief and necessarily highly stylized and even idealised exposition of the old German financial system, we wish to emphasize two things. Firstly, given the high level of complementarity and consistency it is not surprising that the German financial system has been very stable for a long time. Secondly, the big private banks seem to have occupied the central position in the system, and therefore a possible change in their role warrants special attention when we now look at recent developments.

4 Recent developments in the German financial system

4.1. Developments in the German financial system at large

Around the turn of the millennium, the German financial system has been exposed to a number of developments which point to the possibility of a fundamental transformation from a bank-based to a capital market-based system. Since we will discuss changes in banking and corporate governance in detail in the following subsections, this introductory section only offers a short glimpse at the general financial landscape.

The last three years of the past century were characterized by a stock market rally. As in other countries, share prices in Germany increased more

²⁶. For further details see Hackethal/Schmidt [2000] and Schmidt/Tyrell [2004].
than twofold until March 2000, creating the expectation that the transition to a market-based system would occur almost by itself. As part of this development,

— the first big takeover case in Germany occurred with Vodafone taking over Mannesmann, making it clear to everybody that in principle hostile takeovers are possible in Germany as they are in other countries;
— merger talks between Deutsche Bank and Dresdner Bank were at an advanced state, possibly leading to a situation in which several big banks would no longer uphold a system of mutual support and at the same time mutual control;
— there were talks about merging Deutsche Börse AG and the London Stock Exchange, which foreshadowed a further strengthening of the role of the stock market in Germany, which had already greatly improved its efficiency as a secondary market;
— a far-reaching tax relief for profits from the sale of share blocks was announced, intended to induce an unravelling of the network of crossholdings in Germany;
— induced by a complaint by the private banks placed with the European Commission, Landesbanken and savings banks came under pressure because of the public guarantees they enjoyed so far;
— a shareholder-friendly takeover law was in preparation, which would, among other things, facilitate hostile takeovers and create an active market for corporate control;
— a far-reaching pension reform was announced and enacted, which puts much more emphasis on capital-based pensions and was expected to boost the interest in, and the importance of, the stock market; and
— stock-based and stock option-based executive compensation schemes were introduced in many corporations aligning managers’ interests with those of small shareholders much more than in the past.

All of this happened in an environment in which the catchword of “shareholder value orientation” was used widely and with general approval by almost all commentators and in which the banks that were involved in capital market operations aspired to become almost full-fledged investment banks, considering retail banking and financial intermediation as an outdated business model.

In March of 2000, the stock market bubble burst, stock prices started to fall almost precipitously and for a long period bringing stock market capitalization and direct shareholder ownership back to their former low levels. The ambitious merger projects fell through. Many of the far reaching changes such as that of the pension system and of the takeover law turned out to be more limited in scope and importance than had originally been expected. Shareholder value ceased to be the generally acclaimed maxim. All in all, the smooth system transformation which had appeared to be around the corner did not materialize, or so it seemed at least in the early years of the new millennium. Not much later, the so called new market for young technology-oriented stocks, a symbol of the boom years, was closed, and
the situation of German banks, especially those that had turned to capital market-related activities, deteriorated consistently until 2004.

4.2. Recent developments in German banking

We now take a closer look at developments in the banking sector focusing on the years after 2000. Looking back, one can see that for many years German banks have not earned a return on equity which would have covered their cost of capital, irrespective of how one defines this benchmark. With only a few exceptions, both big private and public banks were affected by this trend despite various cost cutting initiatives.

Net interest margins have dropped everywhere, indicating an intensification of competition and requiring banks to seek alternative sources of income. However, even the increasing fee revenue from capital market-related business did not suffice to support the bottom line of German banks. This again affected all big banks more than smaller ones, and those that were most hit reacted by scaling back their commercial lending operations which they considered to be largely unprofitable and overly risky.

Almost as much as the years of the stock market boom, the ensuing difficult years for the banking sector may in themselves have pointed to a structural change. But do these developments really indicate that the role of banks in the German financial system has changed; has the banking structure changed, and have the peculiarities of the German banking system disappeared? Some more observations help to answer these questions.

First of all, the structure of the banking sector has not changed. Over a long period of some 30 years, the distribution of market shares among the "three pillars" has remained almost stable. As an implication, the role of private banks and especially that of the so-called big banks remained low by international standards. Bank concentration has hardly changed except for the fact that many very small cooperative banks merged.

Despite a worldwide trend in banking towards diversification, bank revenues in Germany are still largely interest-related. German banks have followed the international trend, but with a lesser intensity than their peers in other countries. This shows the enduring focus on their role as financial intermediaries and suggests that banks remain important lenders to the enterprise sector, a fact which is also supported by a comparative analysis of the financing patterns of non-financial firms in different countries.

In spite of an economic environment which does not seem favourable for banks, there are no strong indications that banks have lost their overall importance in the financial sector and even the entire German economy. The ratio of bank assets to GDP has continually increased over the years; total staff of the banking sector has remained at the level of ten years earlier; long-term bank loans are still the most important source of external financing for German firms; and banks – and their asset management units - are still the most important collectors of household savings in Germany.

One can sum up the developments in the banking sector by identifying more continuity than change. Thus, the recent statement of the now retired CEO of one of Germany’s largest banks that "no stone has been left untur-
ned” in German banking does not seem to be fully supported by the facts. However, it represents the situation in the group of big private banks quite appropriately. As far as banking in general is concerned, the easily observable indicators of a transition to a capital market-based system are as yet weak despite the turbulence of the past decade, while the role of the big banks seems to be fundamentally changing. This suggests that there may be more forces of a less visible kind which justify the expectation of more change and less continuity in the near future.

4.3. Recent developments in German corporate governance

As it seems at first glance, there was even more change in the field of corporate governance than in banking during the past decade. The potentially most important developments took place in the political arena. Corporate governance has become a “hot topic”, now also attracting the attention of policy makers and the general public. Several groups of high-level experts have recently deliberated fundamental issues of corporate governance and produced statements and reports including that of a high level “Government Commission on Corporate Governance” from 2001 and the Corporate Governance Code issued by the so-called “Cromme Commission” early in 2002. All in all, in their attempts to address “the corporate governance problem” in Germany, these groups seem to come to a rather simple conclusion: There does not seem to be a need to modify the basic structure of corporate governance in Germany. Of course, all shareholders should be treated fairly and in particular small shareholders should certainly be treated better than in the past and management control should be made more effective, but none of the expert groups has made an attempt to reinstate shareholders as the sole and supreme authority in corporate governance matters. Most importantly, the dual board structure and mandatory codetermination, which are core elements of the insider control system, were not addressed in the experts’ reports and recommendations.

Investor protection has been strengthened by introducing first elements of capital market law in Germany. The legal prohibition of insider trading and the creation of a Federal Authority supervising certain aspects of the stock market activity in 1994 and the introduction of a mandatory bid into the new German takeover law of 2001, to name just the most important regulatory changes of the past decade, have improved the quality of investor protection. Viewed in isolation these innovations seem to be simply positive. However, they also need to be looked at in a broader context, as we will discuss later.

28. Nevertheless, it is not at all clear that German shareholders fared badly in the past and that management control in Germany has been less effective than in other countries. For a summary of the evidence see Hackethal/Schmidt/Tyrell [2005].
29. In the introduction of the Report of the Government Commission (Regierungskommission [2001]) it is clearly spelled out that these two topics were not addressed in an effort to reach the unanimity of the expert group that the government wanted to see.
Moreover, the newly created supervisory authority which is now a part of the integrated financial services authority created in 2001 has not been given the broad mandate of the SEC and largely lacks enforcement powers. This fact limits the effectiveness of legally mandated investor protection, and that by itself would make it difficult to assess the new elements of capital market law as introducing a capital market-based system of corporate governance. Private benefits of control seem to have decreased but are still much higher than in the Anglo-Saxon countries.

The law of joint stock corporations has been modified to a considerable extent. The most important part of this modernization is the "Law for the Strengthening of Control and Transparency" (KonTraG) of 1998. The KonTraG has led to a certain shift of power to the supervisory board, thus limiting the powers of the management board. Moreover, it curtails the influence of banks. However, it did not address the questions of how the board should be composed and what the legal obligations of the management board should be. As this law has a clear focus on improving internal governance one can also not qualify it as contributing to a paradigm shift from insider to outsider control.

Mandatory codetermination, another peculiarity of German corporate governance, is a backbone of the stakeholder-oriented insider control system. Codetermination has not been challenged greatly during the past decade. This may be a matter of political correctness, but it rather seems that codetermination has worked reasonably well within the traditional system.

In a capital market-based and outsider-controlled governance system, the market for corporate control plays an important role. The Mannesmann-Vodafone takeover battle of 1999 and 2000 was indeed a hostile one, and its ultimate success seems to have given a clear and simple signal of modernisation: Hostile takeovers are possible in Germany. But the success of Vodafone in its attempt to take over Mannesmann has so far not led to the wave of hostile takeovers which many observers had expected and hoped for.

A highly relevant recent legal development is the adoption of a German takeover law in 2002. It was enacted immediately after the narrow defeat of the EU takeover directive in the European Parliament in 2001. The German law contains most of the elements of the EU directive, including a mandatory bid rule, but stops short of disallowing all counter moves. This can be taken as evidence that attempts are made to make more investor protection compatible with the traditional view that not only shareholder interests matter, i.e. with the traditional stakeholder orientation.

One of the most important factors which used to support the traditional German corporate governance system were close capital and personal links among the large corporations in Germany. Traditionally, big banks and insurance corporations were in the center of this network. Perhaps the most

30. A more general criticism of the lacking enforcement is presented in Ehrhardt/Nowak [2002].
32. This applies particularly to the so-called floor-shop level codetermination; see Frick/Lehmann [2003].
evident sign of change is that this network now seems to be considerably less dense than it used to be. At least this is the impression one gets from the graphical representation provided by the Max-Planck Institute in Cologne which regularly provides data on corporate networks to the German Monopolies Commission. However, there is also contradictory empirical evidence in a recent paper by Kogut/Walker [2003]. Using different methods to identify links between corporations, they suggest that links between German companies are still strong even though they may now be less evident than they used to be.

But irrespective of methodological details, all observers agree that the thinning out of the network mainly concerns the capital links within the financial sector and between the financial sector and the rest of the economy. The big banks are reducing their investments in other companies.

Supervisory board composition has also changed. The number of board seats and especially that of board chairs held by top bankers has almost constantly decreased during the last decade, while - interestingly enough - the role of managers of other companies and especially that of former managers of the same company has increased and the number of seats on the supervisory boards held by genuine shareholder representatives stagnated. As Höpner [2003] reports, the decrease in the number of top bankers holding the position of a board chairman is compensated one-to-one by an increase in the number of chairs held by former managers of the same corporations. One group of insiders merely replaces another. Thus, again the facts do not support the proposition that the insider control system is giving way to an outsider control system.

4.4. A preliminary conclusion

In summing up, one can say that much has indeed changed, which appears to be closely connected to corporate governance in Germany. Especially investor protection and the institutional basis for the control of management seem to have improved. Nevertheless, some of the developments, which appear to be relevant, only seem to exist but are not real or will not last; others exist but will hardly have an impact on the German corporate governance system, while still others are there, yet lack significance to support the assessment of a fundamental shift.

As we mentioned above, individual developments need to be analyzed in a broader context. This holds in particular for the improvements in the field of investor protection. They may have consequences for the consistency of the entire insider-controlled German corporate governance system for the following reason. Better protection of outside shareholders tends to reduce the private benefits of control, and this in turn might make it less attractive for the powerful actors, the controlling insiders, to continue playing an active governance role.

33. For details see Höpner 2003.
The only feature of corporate governance which has definitely changed is the involvement of the big banks in corporate governance. They are increasingly withdrawing from their former role. They are reducing their shareholdings and withdrawing from corporate boards.

Here we see an interesting parallel to the development in banking and corporate finance. For a long time, bank financing was the dominant source of long-term external financing of German companies, and large corporations were the favourite clients of the big banks. Their risk exposure due to large scale financing of business seems to have been a major reason for being involved in corporate governance. At a general level, the role of bank financing has not changed so far. But there is a need to differentiate. Firstly, the large corporations have become increasingly independent from long-term bank financing. Secondly, especially the big banks have reduced their corporate lending activity. These two developments together might motivate them to also withdraw from their traditional governance functions. Moreover, competition in the banking sector seems to be getting stiffer and the big private banks are directing their strategic focus to different business areas (e.g. investment banking for Deutsche Bank, bankassurance for Dresdner Bank, mortgage and SME-banking for Commerzbank). This might undermine the willingness of the big banks to act in as coordinated a way as they used to do when it was necessary for the traditional system to function.

5 Implications and Possible Future Developments

In the last section we have argued that, looked at one by one, the recent developments in the German financial system do not show that the structure of the German financial system has already been fundamentally transformed to become capital market-based and outsider-controlled instead of maintaining its old character of being bank-based and insider-controlled. The evidence is mixed, and one might even be inclined to say that continuity is more visible than change. One could interpret recent developments as representing a modernization of the old system as opposed to a convergence towards a capital market-based system.

However, it may not be sufficient to look at individual developments in isolation if one wants to fully understand their implications. It may even provide a wrong picture. The impact of a given change of relevant factors may depend very much on other - stable as well as changing - elements of the entire financial system. This is the level at which our main question as to whether there is or may be a fundamental transformation of the financial system as a whole needs to be answered, and to this we now turn our attention.

The question is this: Can the assessment that stability dominates be sustained when we look at the German financial system as a whole and “as a system”? We search for an answer by invoking three views on how financial systems develop in general and apply this to the German case.
One position concerning how financial systems and the role of banks in these systems and corporate governance systems develop is that of a “natural progression” from a bank-based and insider-controlled system to a capital market-based and outsider-controlled system. This is the most widely held view, shared by most practitioners and politicians as well as by some eminent scholars such as Rajan/Zingales [2003]. The international experience of the last 15 years makes this position plausible since it seems to demonstrate the economic superiority of the capital market-based systems of the U.S. and the U.K. However, if one looks at the debate of only fifteen years earlier, one finds the opposite assessment expressed by influential authors such as Michael C. Porter.

Some support for this view is provided by Raymond Goldsmith’s 1985 historical account of how financial systems have developed in the past. However, Goldsmith’s famous study was written before the advent of modern econometric techniques and before large scale data bases were available. More recent and more sophisticated empirical work of a group of researchers associated with the World Bank does not support the underlying conviction that capital market-based financial systems are in some well-defined sense better than bank-based systems and that there is a “natural progression”. Most importantly, if there is not the assumed “pull” of the allegedly superior system, the view discussed here loses much of its appeal.34

Equally, recent theoretical arguments question the assumption of a “natural progression” based on economic superiority. Among others, Allen and Gale [2000] have developed a set of models which correspond to the “agnostic” position of empirical researchers and point out that both systems have specific strengths and weaknesses and that a general comparative assessment is not possible. The final argument is that if the capital market-based system were indeed superior one would require some argument showing why the transition to this system should take time and occur more or less gradually.

The second view is based on the assumption that the dichotomy of bank-based and capital market-based financial systems is not generally valid. It only represents a specific historical situation in which it may have been impossible to combine the strength of both system types. Financial innovation changes this situation and may generate new options including some which permit the combination of the strengths of a bank-based-system with those of a capital market based system. The strength of the former is that it invokes the benefits of relationships, as is the backbone of relationship lending and house bank relationships. That of the latter is that it opens up the possibility to tap a large resource base and to optimally allocate risk. Seen from the situation of today, what might some time soon emerge would appear as “hybrid systems”. The main example of how the strengths of both systems can be combined successfully is securitization.35 The World Bank [2001] also argues that a synthesis – or a “hybrid system” – is a perspective

34. A great deal of this work has recently been compiled in Demirgüc-Kunt/Levine [2004].
35. For an exposition of how securitization functions and an explicit reference to the issue discussed here, see Franke/Krahnen [2005].
that is attractive and possibly also empirically relevant because it strengthens both efficient capital allocation in a short term perspective and competition as a determinant of long-term welfare.\(^{36}\) However, so far there are only very few convincing examples showing that a synthesis can be viable and economically attractive. Moreover, the step from one financial instrument such as collateralised debt obligations to an entire financial system has so far not even been discussed. Finally, there are strong theoretical arguments that speak against the possibility of having a “hybrid model”.\(^{37}\)

The third view \(^{38}\) builds on the concepts of complementarity and consistency presented in Section 2 of this paper. We argue that financial systems are shaped by strong complementarities and that consistency of a financial system is extremely important in welfare terms. Inconsistent systems imply welfare losses which can be substantial. Assume for the moment that welfare differences between different financial systems can be quantified (by an outside observer who has nothing to do with policy making). Let \(\delta\) be the welfare difference between a consistent capital market-based system and an equally consistent bank-based system, and let \(\beta\) and \(\gamma\) be respectively the welfare differences between a consistent bank-based system and some given clearly inconsistent system and between a consistent capital market-based system and some inconsistent system. As we argued above, we find it difficult to say in general terms whether a consistent bank-based or a consistent capital market-based system is superior. Therefore we assume that the \(\delta\) is not large and can even be negative. But we are agnostic in this respect and only for the sake of simplicity assume here that \(\delta > 0\).

If complementarity is an important feature of a given system, \(\delta\) is smaller than both \(\beta\) and \(\gamma\). In other words, starting from a situation of inconsistency, the possible welfare gain that could be achieved by re-establishing consistency – if this were possible – is larger than the welfare gain that could possibly be achieved by “jumping” from one consistent system to another one. Or again in other words, the valley which separates the two peaks is deeper than a possible difference in height of the two peaks (or local maxima).

In this case, which we find plausible, complementarity would prevent an efficiency-induced convergence if the possible transformation process started from a consistent system. This has two reasons. One is that no one knows which system is really better or which local maximum is also the global maximum. The other reason is that the transition from one consistent system – say the bank-based one – to the other one would cause severe,\

\(^{36}\) In a paper that is more closely focused on corporate governance Vitols [2004] offers a similar argument. In his view, there is the possibility of combining the positive sides of ownership concentration and of more recourse to capital markets. The condition under which this may be achievable is that the degree of ownership concentration is lower than it used to be in Germany but higher than in the Anglo-Saxon countries. As he reports, ownership concentration in Germany has developed towards this new optimum in the course of the last ten years.

\(^{37}\) See e.g. Boot/Thakor [2000].

\(^{38}\) We have developed this view in earlier papers; see Hackethal/Schmidt/Tyrell [2005], Schmidt/Tyrell [2004] and for the case of corporate governance systems Schmidt/Spindler 2003.
though temporary, welfare losses or, in other words, would require passing through a “deep valley of tears”.

Now we return to the discussion of the German financial system. As we have argued, it used to be a largely consistent bank-based system. Recent developments have undermined its consistency. The most important development which had this effect is the retreat of the major private banks from their former roles as important long-term lenders, as active participants in the corporate governance and as players in the financial system that contributed to keeping the competition from the capital market at bay.

Of course, this change in the strategy of some large banks is not an autonomous move of the banks. In withdrawing from their former central coordinating role in the German financial system they merely reacted to developments which can be attributed to European integration and even more to globalization. Thus, indirectly, integration and globalization and the adoption of some elements of the capital market-based financial system have introduced inconsistencies into the German system. What could be the consequences?

Quite clearly, there is the possibility of marching through the “valley of tears”, as the French financial system seems to have done for some 15 years after 1983. This may be justified if, but only if, there were some evidence that the Anglo-Saxon financial system is indeed better. But this evidence does not exist (δ may be negative or very small). Moreover, with advanced integration and globalization the valley of tears may now be even deeper than it was only a few years ago (β and may be very large).

For those who believe that a bank-based and insider-controlled system is superior (δ < 0), the question arises if there is a possibility to return to what was once the consistent German financial system, and more specifically if such a possibility also exists in a situation in which inconsistency has reached a high level and the efficiency and stability of the financial system is threatened. We call this situation a crisis. Especially in a crisis, the return may prove impossible. The reason for this assessment is to be found in the peculiarities of the German system and the ways in which it functioned: House bank relationships and the subtle balance of the old stakeholder regime are features which are to a great extent based on trust, implicit contracts, consistent expectation, repeated interaction, reputation based mechanisms of cooperation and coordination and – above all – a certain moderation of short-term profit orientation. Re-establishing these core building blocks of the German system as a reaction to a crisis situation, in which inconsistency has reached a high level, would be impossible since trust, confidence etc. cannot be imposed by fiat, i.e. they cannot be imposed at all.

Inconsistency in the financial system of an economically important country above a certain level is not tolerable – β and γ are likely to be large – and therefore something would have to be done to regain consistency in a crisis situation. Since the return to the former financial system is precluded, the only option is the transition to the Anglo-Saxon system. It would not be a smooth transition, it would have to be fast, and it would occur independently of the question which system is better if there were no “crisis”.

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