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The German System of Financing and Corporate Governance - On the way from a bank-based to a market-based model?

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I. FOREWORD

The German financial system has in the past always been seen as the prototype of a bank-based model. The pre-dominant role of the banks in this system is characterized by the tight relationships between banks and industry:

Banks do not only provide loans and other banking servives to the industry but banks are also major shareholders, there exist various reciprocal partecipations between the most important companies as well as between these companies and the banks, the banks exert strong influence on the industry via the delegated voting rights, banks have seats in the Supervisory Boards of the industry and the investment fund managing companies are usually owned by the banks. This system has guaranteed stability in Germany for decades, but has always been critisized as it bears the risk that the banks often find themselves in a conflict of interests.

During the last years the question raised whether Germany is moving from a bank-based to a market-based financial system. German politicians never seem to get too tired to demand a further promotion of the German capital market as a source of financing for the industry as well as a way of investing for the private households. But apart from these voices, which developments have really taken place, how far is Germany on its way towards the anglosaxon model? To find an answer to this question, this paper presents in chapter II the recent developments in the structure of the real economy, the financial intermediaries and the supervision on the financial market. Chapter III deals with the development of the securities market and analyses different aspects which could help to explain why investing in the German securities market has not been as attractive as it could have been. Finally, chapter IV is dedicated to the recent developments and the steps that has been taken to lead Germany towards the market-based model.

Is Germany really on its way towards the market-based model? An answer to this question has to be split in different aspects. On the one hand Germany is moving towards a market-based model as the larger industrial firms change their way of financing tending more to financing by the capital markets, even if the number of the listed companies and the private shareholders is still relatively small compared to the anglosaxon model. In addition, the high concentration of ownership seems to be dissolving, as especially the financial

sector as the top major shareholders tend to sell the stakes they hold in the industry. On the other hand it is not clear if this does not only lead to a reorganisation within the same ownership structure as the banks still seem to play the central role in the corporate governance, holding less shares directly but keeping the control over the voting rights indirectly by holding companies and investment funds. Furthermore, the control powers the banks exert by the delegated voting rights remain relatively untouched.

But the change of direction is obvious. Important legal steps have been taken to promote the market-based model, and courageous legislative projects intending to make the investing in the German market more attractive are just about to be realized in the near future. Other steps must follow.

II. INDUSTRY, FINANCIAL INTERMEDIARIES AND SUPERVISION

A. The structure of german industry

1. Number and legal form of the corporations

The German economy consists most of all in ca. 3.3 million smaller and medium-size enterprises, i.e. enterprises with an annual turnover of up to 50 mio Euro and/or up to 499 employees. This so-called *Mittelstand* builds the heart of the German economy as 99,7% of all enterprises belong to that group[1].

Most of the undertakings have chosen the legal form of corporate enterprises, eventhough in the *Mittelstand* we still find a greater number of partnerships. With a total number of more than 850.000 companies in 2001, the *Gesellschaft mit beschränkter Haftung* (GmbH)/ the private limited company plays the most important role[2]. It is followed by the *Aktiengesellschaft* (AG)/ the stock corporation. In 2002, there were 14.000 Aktiengesellschaften in Germany, compared to the ca. 2 000 Aktiengesellschaften we found until the 1990s the number increased considerably[3]. Even though the number of the Aktiengesellschaften is much smaller than the number of the GmbH the AG`s economic importance is much greater: in 2000, 77% of the 100 biggest German enterprises were organised in the form of an Aktiengesellschaft[4].But only a very small part of them is listed on the stock exchange, in 2002 we found only 729 domestic Aktiengesellschaften listed on the German stock

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[1] Source: Bundeswirtschaftsministerium/ Federal Ministry of Economics..

[2] Hansen, GmbHR 2002, p. 148.

[3] Hirte, p. 21.

[4] Hirte, p.21.

exchanges[5], that is a percentage of ca. 5%. The comparision with the situation abroad shows the less importance the Aktiengesellschaften in Germany have as a form to raise capital from the stock exchange: For example, in the United Kingdom we find ca. 14 000 public limited companies of which almost 2 500 are listed on the stock exchange[6] , 2251 were domestic[7].

2. Governance and control of the Aktiengesellschaften

Germany is known as the prototype of a bank-based model of financing[8]. The system is characterised by the strong concentration of major shareholders, of reciprocal partecipations between these major shareholders and by the important role the banks play.

In contrast to the anglosaxon model the financing by the securities markets and an early going public traditionally plays a much less important role. In Germany the average age of the company when it is first admitted to the stock exchange is relatively high: whereas in the United Kingdom the average age was eight years, in 1995 at the German stock exchanges the companies were ca. 55 years old when they were first admitted[9].

a) Ownership structure

(1) Structure of owners by type

Looking at the type of owner, the majority of the shareholders in Germany is formed by the private non-financial companies or organisations which hold ca 40% of all direct shares. They are followed by foreign investors with 20%, private financial enterprises with 18% and individual investors/ private households with 16%. The public sector holds only 6% of the shares[10].

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[5] Hirte, p.21.

[6] Hirte, p.21.

[7] Turkington/Martin, p.11.

[8] Rudolph, p.2056.

[9] Baums, Verbesserung der Risikokapitalvorsorge, p.3.

[10] FESE, ESSC, Share Ownership Structure in Europe 2002, p.29.

Even though the private financial enterprises hold only 18% of the direct shares, they de facto control most of the larger Aktiengesellschaften. On the one hand by indirect partecipations via non-financial enterprises that hold partecipations in the target company. On the other hand by delegated voting rights either directly or by having controlling voting rights in enterprises that hold partecipations in the target company. Therefore we find a high number of representatives of the banks or of bank-controlled companies within the Supervisory Boards.

Within the 24 non-financial enterprises of the DAX 30[11], the representatives of Deutsche Bank, Dresdner Bank and Commerzbank hold approx. 16% of the ca. 231 positions reserved for those members of the Supervisory Board who are elected by the stockholders[12]. Even if there are authors who stress the point that there are not many direct representatives of the banks in the Supervisory Boards and by that come to the conclusion, that the banks' influence on the corporations would be overestimated[13], one has to keep in mind the role of the banks as a whole: as major shareholders, as providers of loans and other banking services, as reprensentatives of the private investors via the delegated voting rights, as owners of the investment fund managing companies and as part of the network of company interlinkings, the so-called "Deutschland AG". I will analyse the potential conflict of interest that arises for the banks by the various roles they play as well as the consequences following from that later on.

(2) The administrative structure of the Aktiengesellschaft

To understand these phenomenons better we first have to take a short look at the structure of the German Aktiengesellschaft.

The AG is governed by a two-tier board. On the one hand, there is the Executive Board (*Vorstand*) that is responsible for the management and the legal representation of the AG.

On the other hand, there is the Supervisory Board (*Aufsichtsrat*). This organ has the main task to appoint and then to control and monitor the members of the

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[11] The DAX 30 is the leading index of German publicly traded "blue chip" companies.

[12] Baums, Corporate Governance in Germany, p.12.

[13] Röler, p. 335.

Executive Board. This form of monitoring includes the issue if the measures taken by the Executive Board were legitimate, expedient and economically reasonable. The Supervisory Board also has the right to dismiss the members of the Executive Board.

At the basis we find the *Hauptversammlung*, the Annual General Meeting of the shareholders. Its main task is the election of the members[14] of the Supervisory Board and the formal approval of the activities of the members of the Supervisory and the Executive Board, other main responsibilities of the Annual General Meeting are to take decisions with fundamental significance like the alteration of the AG`s articles, capital-related corporate action, the dissolution of the company etc. It may decide on regular management issues only at the request of the Executive Board[15], § 119 AktG / Stock Coporation Act.

(3) Concentration of ownership

The ownership of the larger industrial firms in Germany is characterised by a considerable degree of concentration, i.e. by the existence of major shareholders. *Boehmer* found out that large stockholders controlled ca. 47% of the market value of all listed firms in Germany's official markets in 1996 , this figure has to be seen as a minimum figure, as it could be even considerably higher via e.g. undisclosed indirect shareholdings[16]. He further analyzed that about 2/3 of this 47% was controlled by banks, industrial firms, holdings and insurance companies[17]. In another recent study *Köke* analysed the ownership structure of German industrial firms in the period 1993-1997[18]. He found out that in many of the analysed cases the majority of the equity shares was held by a few investors being interlocked with each other by partecipation pyramids and ring interlinkings. As the system of reciprocal partecipations between the leading companies covers all of Germany, i.e. as this net of interlinkings includes most of the important companies, it has become popular to speak of the "Deutschland AG"[19]. This high degree of interlinkings finds its origins in

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[14] Due to the rules on the co-determination, a part of the members of the Supervisory Board is elected by the employees and not by the Annual General Meeting if the AG exceeds a certain number of employees.

[15] § 119 AktG / Stock Corporation Act.

[16] Boehmer, in: McCahery, p.283.

[17] Boehmer, in: McCahery, p.283.

[18] Köke, p. 279 following.

[19] Rudolph, p.2056.

the period after the Second World War when loans were transformed into partecipations[20].

As current legislation does not provide disclosure duties that would give a clear picture of ownership and control –as it will be shown more into detail below- the dimension of the interlinkings is not transparent[21]. It seems that the big banks, the insurance companies and the most important industrial firms are linked together in serveral ways, most of all in the less transparent form, the ring partecipation[22]. A ring partecipation exists if company A holds partecipations in company B, B in company C and C in A. *Boehmer* analyzed that in 1996 the five top private[23] shareholders, i.e. the private shareholders controlling the greatest market value were all financial sector institutions, namely Allianz, Deutsche Bank, Münchner Rück, Dresdner Bank and Bayerische Vereinsbank[24]. *Boehmer* illustrates the interlinkings (in 1996) between these top five private shareholders. The following table is taken from *Boehmer`s* study in which he called these relations "Minimum ownership relations" because they include only direct stakes held by companies that are majority-controlled by the top five. Even though serveral other links between these top five companies through companies in which they hold only minority stakes are not included, the table gives a good idea of the minimum of interlinking. One has to keep in mind that true control exceeds these ownership figures, as e.g. delegated votes are not considered in this table.

[20] Hillebrandt, p.711.

[21] Adams, p. 148, Boehmer,p.14, Emmerich/ Sonennschein/Habersack, p.78.

[22] Emmerich/Sonnenschein/Habersack, p.78.

[23] Number one of the shareholders in 1996 was a government agency controlling Deutsche Telekom, but this was transitory as the stakes were sold within the privatisation of the Deutsche Telekom, see Boehmer, p. 15.

[24] Boehmer, p. 38.

Ownership relations between the top five private shareholders in 1996

Target	Shareholder						
	Allianz	Dt. Bank	Münch-ner Rück	Dresd-ner Bank	Bayeri. Vereins bank	Other firms controlled by the top five	Stakes controlled by the other four
Allianz		10.00%	25.00%	10.00 %	10.00%	5.00%	60.00%
Deutsche Bank	5.03%		1.50%				6.53%
Münchner Rück	25.00%	9.90%		9.90%	9.90%	5.00%	59.70%
Dresdner Bank	10.18%	10.00%	2.30%			31.36%	53.84%
Bayerische Vereins-bank		5.21%	5.40%				10.61%

Source: Boehme, Who controls Germany?, p.39

If this highly concentrated ownership structure is going to change, time will show. In a recent study *Wojcik* analysed blockholdings in German enterprises in the years 1997-2001. He comes to the conclusion that the level of ownership concentration fell significantly, cross-holdings started to dissolve, and financial sector institutions, including the most powerful ones, lost their position as blockholders[25]. According to his study, the number of direct holdings as well as the number of voting blocks increased from 1997 to 2001 by 10% rsp. 25%, whereas the mean and medium size of a direct holding fell by approximately

[25] Wojcik, p.1.

10% and the mean and median size of a voting block fell by 10% as well[26].But if this really leads to a change concerning the control of the company is questionable as *Wojcik* found out that major shareholders own a decreasing percentage of shares directly, but they control voting rights indirectly from a growing percentage of shares[27]. Further on, *Wojcik* stresses that " the tendency behind these figures could be that the owners of corporate Germany spin off parts of their ownership stakes to separat but dependent entities, such as holding companies and investment funds. Second, it implies that direct holdings misrepresent control of voting rights, and they do so to a growing extent"[28]. The percentage of voting rights typically controlled by the largest shareholder is still very high: it declined from 65% in 1997 to 60% in 2001[29]. As to the interlinking between the major shareholders, the "Deutschland AG", *Wojcik* found out that the top institutional owners lost some of their powers as holders of voting blocks in the listed companies between 1997 and 2001, as the German big banks and insurance companies tend to sell the stakes they have in the industry.But this deconcentration only referes to their external holdings, while the crosss-holdings in the core, among the top owners themselves, remained to a great extent as they have always been[30]. *Wojcik* does not deal with the role of the investment fund managing companies, which are usually owned by the credit institutions. But he stresses that it is "very likely that ...(the banks) transferred some of their holdings to investment funds and then started managing them as parts of diversified asset portfolios"[31]. Following this idea the consequence would be that as long as the investment funds holds the share the credit institution that owns the investment funds keeps the control by the voting rights. The dimension of control the banks exert via the investment fund managing companies remains intransparent, as the voting stock of a investment fund managing company, is not attributed to anyone, nor to its clients nor to the parent bank owning the investment fund managing company, as § 10 I a KAGG/ Act on investment fund managing companies exempts these companies from the disclosure duties of § 22 WpHG/ Act on Securities

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[26] Wojcik, p.13.

[27] Wojcik, p.13.

[28] Wojcik, p.13.

[29] Wojcik, p.13.

[30] Wojcik, p.19.

[31] Woycik, p.19.

Trading. It does not seem improbable that the banks which had to face losses with the participations they held in the industry could be interested in transferring their shares to their own investment fund managing companies instead of selling them on the stock market to a price which would not be favourable due to the low economic performance of the company. It does not seem impossible either that the investment fund managing company could be tended to buy the stocks even if they are not in the interests of their clients to support their parent company, i.e. the bank.

Even though one has to agree with *Wojcik* that it is very likely that the financial service institutions have transferred their shares to their own investment fund managing companies these are only suspicions as the issue has not been analysed so far. There is a need for further studies on the topic.

b) The control via delegated voting rights

In the cases the credit institutions hold the majority of the voting rights (directly or by controlling major shareholders) in the Annual General Meeting, they can appoint the members of the Supervisory Board and by that have an indirect influence on the composition of the Executive Board. A much more important role plays the influence the banks have indirectly by the delegated voting rights from shares deposited in trustee accounts (*Depotstimmrecht*), by the lending of votes among banks (*Stimmenleihe*) and by shares held by investment companies owned by banks.
Often discussed is the issue of the delegated voting rights (*Depotstimmrecht).* A shareholder can delegate his voting rights. Normally, the shareholders that are not interested in the management but see their shares only as a form of capital investment, authorise the credit institution at which they have deposited their securities[32] to vote for them. Even though the banks now have to inform their clients that there are other possibilities to delegate the voting rights (§ 135 II 5 AktG) –by an association of shareholders or a or professional representatives- and that the delegation of the voting rights to the bank can be withdrawn

[32] Most of the securities are embodied in a *Dauerglobalurkunde*/ permanent single document for all the shares, which the investor cannot deposit himself at home, § 9 a I 1 DepotG/ Act on the Depositing of Securities, in addition the depositing and administration of the securities "at home" takes much effort, for that reason the securities are as a rule deposited and administered by a credit institution.

(§ 135 II AktG) at any time, the banks de facto have a monopoly in that field. The bank makes a proposal to the client how to vote. The client can give the bank different instructions, in that case the bank has to follow these instructions, otherwise it has to vote as proposed before, §§ 135 V, 128 II AktG. But the majority of the clients does not give any voting instructions[33], so that the banks can vote in the way they consider the best.
As a general rule, the banks approve the proposals of the management, also because of the interlinkings the banks have with the Supervisory Boards[34]. To avoid conflicts of interests between the banks as representatives of the shareholders via delegated voting rights and the same banks as shareholders of the company, the KonTraG / Act on Control and Transparency in Enterprises introduced in § 135 I 3 AktG the limitation that a bank holding a direct or indirect partecipation of more than 5% in the company cannot exert the delegated voting rights unless it has special instructions from its client for every single item of the agenda[35]. This restriction does not apply if the credit institution does not exert its own voting rights. Furthermore, to inform the client about the circumstances that could lead to a potential conflict of interests for his credit institution, the credit institution when asking for special instructions has to disclosure to its client personal links with the company, § 128 II 6 AktG, as well as the credit institution has to disclosure a participation of more than 5% held directly in the company or a participation in the issuing of securities for the company within the last five years, § 128 II 7 AktG.
I will analyse the consequences of the influence the banks exert via the delegated voting rights later on showing potential conflicts of interests and presenting different proposals that have been made to solve this problem.

As the banks do not have to report their delegated voting rights the dimension of this instrument of control over the governance of the companies remains quite unclear[36]. An overview over the situation in 1992 gives the study of *Baums*[37] from which I took the following table. The table shows that in 20 of

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[33] Hansen, AG1995, p. R 458.

[34] Hansen, AG 1995, p. R 461.

[35] § 135 I 2 AktG provides another restriction: In its own Annual General Meeting the credit institution is allowed to exert the delegated voting rights only if given special instructions by its clients for every single item of the agenda..

[36] For the intention of the legislator, see *Bundestagdrucksache* 12/6679.

[37] Baums, AG 1996, p.11.

the 24 biggest German enterprises the banks together with the investment funds managing companies depending on them had the simple majority of votes.

Voting rights shares of the banks in the Annual General Meetings of the 24 biggest German enterprises with mostly widespread shareholdings in the year 1992

	Enterprise	Own voting rights	Bank-dependend Investment Funds Managing Companies	Delegated voting rights	Total
1	Siemens		9,87	85,61	95,48
2	Volkswagen		8,89	35,16	44,05
3	Hoechst		10,74	87,72	98,46
4	BASF	0,09	13,61	81,01	94,71
5	Bayer		11,23	80,09	91,32
6	Thyssen	6,77a	3,62	34,98	45,37
7	VEBA		12,62	78,23	90,85
8	Mannesmann		7,76	90,35	98,11
9	Deutsche Bank		12,41	82,32	94,73
10	MAN	8,67a	12,69	26,84	48,20
	Dresdner		7,72	83,54	91,26

11	Bank				
12	Preussag	40,65	4,51	54,30	99,46
13	Commerzbank		15,84	81,71	97,55
14	VIAG	10,92	7, 43	30,75	49,10
15	Bayr. Vereinsbank		11,54	73,15	84,69
16	Degussa	13,65a	8,65	38,35	60,55
17	AGIV	61,19	15,80	22,10	99,09
18	Bayr. Hypo	0,05	10,69	81,38	92,12
19	Linde	33,29	14,68	51,10	99,07
20	Deutsche Babcock	3,22	11,27	76,09	90,58
21	Schering		19,71	74,79	94,50
22	KHD	59,56a	3,37	35,03	97,96
23	Bremer Vulkan		4,43	57,10	61,53
24	Strabag	74,45	3,62	21,21	99,28
	Average	13,02	10,11	60,95	84,09

Source: Baums, AG 1996, p. 11.

a : Voting right exercised indirectly.

There are no recent studies on delegated voting rights. As delegated voting rights do not have to be reported, their dimension is relativley difficult to investigate.

As the study of *Baums* illustrates, in general, the voting rights are distributed over the different institutions and groups of institutions. In single cases the credit institutions have a veto minority or a majority.

Voting Shares of the banks in the Annual General Meetings of the 24 biggest German enterprises with widespread shareholdings sorted by groups (year 1992)

	Enterprise	Deutsche Bank	Dresdner Bank	Commerz bank	Total Big Banks	Ba-varian Regional Banks	Spar-kassen	Cooperative Banks	Other Banks	All Banks
1	Siemens	17,61	12,44	4,52	34,57	12,74	11,80	4,51	31,86	95,48
2	Volks-wagen	5,93	6,71	2,43	15,07	4,35	9,37	4,46	10,81	44,05
3	Hoechst	9,00	32,81	27,68	69,49	4,47	8,34	2,94	13,23	98,46
4	BASF	18,58	17,61	4,16	40,35	12,29	12,87	3,10	26,11	94,71
5	Bayer	18,98	17,93	4,75	41,66	7,42	8,44	2,16	31,63	91,32
6	Thyssen	7,20	9,93	2,01	19,13	4,65	5,80	2,43	13,36	45,37
7	VEBA	13,00	25,28	3,70	41,98	6,97	12,99	5,26	23,65	90,85
8	Manne-smann	15,94	18,76	4,09	38,76	8,34	13,99	5,54	31,47	98,11
9	Deutsche Bank	32,07	14,14	3,03	49,24	5,58	5,55	2,22	32,14	94,73
10	MAN	7,11	9,48	2,30	18,89	6,33	6,37	1,49	15,13	48,20

11	Dresdner Bank	4,72	44,19	4,75	53,66	10,49	6,93	1,87	18,32	91, 26
12	Preussag	9,86	6,35	1,89	18,10	2,66	66,04	5,02	7,64	99,46
13	Commerz bank	13,43	16,35	18,49	48,27	7,43	14,50	5,83	21,52	97,55
14	VIAG	4,60	7,14	1,70	13,44	15,43	4,93	2,05	13,25	49,10
15	Bayr. Vereins-bank	8,80	10,28	3,42	22,49	35,62	5,65	2,63	18,31	84,69
16	Degussa	6,45	25,13	2,27	33,86	4,59	6,37	2,06	13,76	60, 65
17	AGIV	3,92	9,37	1,37	14,66	2,12	10,22	2,14	69,95	99,09
18	Bayr. Hypo	5,90	10,19	5,72	21,81	34,62	15,06	1,39	19,25	92,12
19	Linde	23,65	13,08	21,21	57,93	11,67	6,60	1,42	21,45	99,07
20	Deutsche Babcock	15,66	12,50	3,21	31,38	11,44	10,35	5,04	32,38	90,58
21	Schering	14,10	19,94	6,65	40,69	9,73	6,48	2,87	34,73	94, 50
22	KHD	66,41	5,49	2,07	73,97	4,23	4,39	3,47	11,90	97,96
23	Bremer Vulkan	6,62	10,88	7,13	24,63	5,62	8,81	8,34	14,12	61,53
24	Strabag	5,25	2,27	2,27	9,80	1,45	2,04	0,51	85,49	99,28
	Average	13,95	14, 93	5,87	34,74	9,59	11,00	3,28	25,48	84,09

Source: Baums, AG 1996, 12.

B. Overview over the financial intermediaries

1. Credit institutions

a) Definition

Credit institutions in Germany are enterprises which conduct banking business comercially or on a scale which requires a commercially organised business undertaking. § 1 I *Kreditwesengesetz* / Banking Act[38] provides a catalogue of 11 different types of businesses which enumerates as a numerus clausus what has to be understood by banking business, i.e. :

1. the acceptance of funds from others as deposits or of other repayable funds from the public unless the claim to repayment is securitised in the form of bearer or order debt certificates, irrespective of whether or not interest is paid (deposit business),
2. the granting of money loans and acceptance credits (lending business),
3. the purchase of bills of exchange and cheques (discount business),
4. the purchase and sale of financial instruments in the credit institution's own name for the account of others (principal broking services),
5. the safe custody and administration of securities for the account of others (safe custody business),
6. the business specified in section 1 of the Act on Investment Companies *(Gesetz über Kapitalanlagegesellschaften)* (investment fund business),
7. the incurrence of the obligation to acquire claims in respect of loans prior to their maturity,
8. the assumption of guarantees and other warranties on behalf of others (guarantee business),

[38] As last amended on 21 August 2002 (Federal Law Gazette I, p. 3322).

9. the execution of cashless payment and clearing operations (giro business),
10. the purchase of financial instruments at the credit institution's own risk for placing in the market or the assumption of equivalent guarantees (underwriting business),
11. the issuance and administration of electronic money (e-money business).

To be credit institutions the enterprises have to run at least one of the enumerated banking businesses. But it is also possible to get a licence to run all eleven kinds of banking business. As will be shown later on, in Germany exist three types of banks. All three of them are allowed to run any of the banking businesses enumerated by § 1 I *Kreditwesengesetz* / Banking Act.

The Banking Act knows two different forms of credit institution; the "classic" *Einlagenkreditinstitute* / depot credit institutions, which run the depot and the credit business and the *Wertpapierhandelsbanken* / securities trading banks which do not run neither the depot nor the credit business but are specialized only in the securities business.

German universal banks cannot run the investment business, e.g. with special sections within the bank, § 2 II lit.c KAGG / Act on the investment fund managing companies. The investment business has to be run within a legally independent company. Usually the investment fund managing companies are subsidiaries of the banks.

At the end of 2002[39] there were 81 investment fund managing companies in Germany, 2001 there were 84. Domestic companies managed 5814 special fonds, i.e. non-mutual fonds (2001: 5817) and 1380 mutual funds (2001: 1281).

1.350 foreign investment funds were allowed to distribute their shares in Germany in 2002, that is an increasement of almost 10 %. Most of them are from Luxembourg and Ireland[40].

[39] BaFin, Annual Report 2002.

[40] BaFin, Annual Report 2002.

b) The three-pillar-system

All three pillars of banks are universal banks, i.e. they offer "under one roof" loans, saving deposits and all kind of security business.

(1) Public banks

(a) Sparkassen

In Germany the field of banking, stock exchange and private insurance companies is subject to the so-called *konkurrierende Gesetzgebung*/ concurrent legislation[41], art. 72 and art. 74 Nr.11 *Grundgesetz*/ German Constitution. That means that the *Länder* / the German States have the legislative competence if and as far as the *Bund*/ the Federal State has not used it. The *Bund*/Federal State is only allowed to issue rules if and as far as a federal regulation is necessary. That is only the case if the common interest in having homogenous circumstances and legal and economic unity nation-wide is concerned. For the field of the *Sparkassen* and *Landesbanken* the *Bund* has not issued any regulations.

The *Sparkassen* are subject to the public law of the *Land* in which they are located. The *Sparkassengesetz* / Act on the Sparkasse of the *Land* and the *Satzung*/ statute of the municipality is the legal basis for the establishment and the operating of the *Sparkasse*. This legal frame describes the public tasks of the *Sparkasse* and the kinds of business that the Sparkasse is not allowed to do.

The public task of the *Sparkassen* is to promote public asset formation by collecting saving deposits and providing loans for small and medium-sized businesses and lower-income groups. Due to this public task the realisation of profits is not a main target of the *Sparkassen*[42]. That is why *Sparkassen* are

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[41] The constitutional principle concerning legislative powers is that the *Länder* are competent, art. 70 *Grundgesetz*, although the reality tells a different story. The *Grundgesetz* provides for three different types of legislative competence: *Ausschließliche Gesetzgebungszuständigkeit*, art. 71 Grundgesetz, means that the Federal State has the exclusive competence in the fields listed in the catalogue of art. 73 *Grundgesetz*, *konkurrierende Gesetzgebungszuständigkeit.* art. 72 *Grundgesetz* enables the Länder to act if and as far as the Bund has not issued regulations in the fields listed in Art. 74 Grundgesetz, Rahmengesetzgebungskompetenz concerning the fields of art. 75 *Grundgesetz* gives the Bund the competence to issue a "frame work" and the Länder to regulate the details.

[42] See e.g: § 3 III *Sparkassengesetz*/Act on the Sparkassen of the Land of Nordrhein-Westfalen: „ The realisation of profits... is not a principal purpose of the business."

profit-oriented only when it comes to the formation of their own capital resources, because *Sparkassen* are not allowed to get capital from outside but have to meet their needs of capital resources by increasing their contingency funds. Additional profits that the Sparkasse made can be distributed to the municipality that runs the business for purposes of public utility.

Most of the *Sparkassengesetze*/ Acts of the *Länder* concerning the *Sparkassen* provide quantitative and qualitative restrictions for their *Sparkassen* concerning high-risk transactions, especially limits for loans (beyond that limit the loan has to be financed consortially with the responsibel *Landesbank*), limits concerning the acquisition and holding of stakes. All other banking business, i.e. all banking business that is not expressis verbis forbidden by the *Land* Law can be effected by the *Sparkasse.*

Sparkassen cannot expand their business, they are limited to the area of the municipality which operates them (the so-called *Regionalprinzip*). They cannot open branches outside this area.

(b) Landesbanken

As the *Sparkassen* also the *Landesbanken* were established to fulfill a public task. The main public functions of *Landesbanken* and *Sparkassen* are to help the state and its municipalities to perform their public functions, to carry out the banking business of the municipalities and the municipal associations, together with their public bodies, institutions and foundations and the trusteeship of government development functions[43].

The 12 *Landesbanken* are central banks for the *Sparkassen*. Further they are the State Bank for the Government of the Land. Seen from their range of business they are commercial banks offering all kinds of banking service. As the *Sparkassen* focus on local markets, the *Landesbanken* act in wholesale and international markets. Recently, this last aspect has been causing discussions as the *Landesbanken* where suffering losses from highly risky businesses which were hard to justify with the public task they have.

Also the *Landesbanken* are established by law of the *Land*, details of the organisation and the operation of the business are regulated in statutes.

[43] Domanski, p.18, fn.20.

Landesbanken are organised with a two-tier system of governance, i.e. the daily business is effected by the *Vorstand/* management board which is controled by the *Aufsichtsrat/* supervisory board (also called *Verwaltungsrat,* Administrative Council).

The *Landesbanken* are owned by 50% of the *Land* and by 50% by the regional association of the *Sparkassen*. Now there is a tendency towards mergers, e.g. the *Landesbank* Schleswig-Holstein owns the majority of the *Landesbank* Hamburg.

One of the strongly discussed particularities of the *Landesbanken* and *Sparkassen* were two forms of statal guarantees provided to these public banks: *Anstaltslast* and *Gewährträgerhaftung*

Anstaltslast means that the state has to guarantee the functioning of the bank by providing capital if the bank cannot maintain itself anymore.

Gewährträgerhaftung provides an unlimited liability of the state for all debts of the bank.

Both guarantees were seen as subsidies not conform to art. 90 Treaty of the European Community. After long consultations between the German government and the European Commission a compromise was found. *Anstaltslast* and *Gewährtträgerhaftung* have to be abolished until 18th July, 2005. The state is still allowed to give capital to the *Landesbank* but only under market-driven conditions. For that reason the *Länder* are developing new models separating the public task from the competition business.

The profitability of the *Landesbanken* is lower than for the average of all banks. An explanation could be that 30% of all loans are given to the public sector where the margins are narrower[44].

Recently, the *Landesbanken* have distanced themselves from the motives that led to their establishment by persuing business policies similar to those of the private banks, trying to focus on major clients and the investment banking. To give an example, the WestLB financed aircrafts all over the world and the construction of the London Wembley Stadium. High risk businesses made the WestLB lose 4 Milliard Euro within two years[45].

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[44] Domanski, p.32.

[45] Interview with Thomas Fischer, CEO of the WestLB, Der Spiegel 13/2004.

(c) Other public banks

There exist five more public credit institutions with sectoral tasks (providing loans to the middle-sized or agriculture businesses etc.), most of them founded after the war (for reconstruction etc.). Many of them have been privatised by now[46].

(d) The public banks as an instrument of political influence

The *Sparkassen* and *Landesbanken* serve the public sector as a very powerful instrument to carry out political influence on the economy. The *Länder* use especially the *Landesbanken* to pursue their structural interests. The WestLB, the *Landesbank* of the Land North Rhine Westphalia, may serve as an example. In the point of view of the German anti-trust commission, the *Land* North-Rhine Westphalia uses its *Landesbank* as an instrument of industrial policy, as it sees the WestLB`s activities that lead to a concentration in the tourism sector as motivated by the *Land*`s political interests[47]. According to the anti-trust commission, the *Land* North Rhine Westphalia is interested in supporting the airport of Düsseldorf. To strengthen the airport, the WestLB holds a partecipation of 34% in the airline LTU which has its seat in Düsseldorf. To support the airline business the WestLB holds (direct and indirect) partecipations in the tour operator TUI. The takeover of the transportation enterprise Hapag-Lloyd AG by the Preussag AG (in which the WestLB holds an indirect partecipation of 30%) strengthens these close ties. Another example for economic-political influence via the *Landesbanken* could be the acquisition of shares to prevent a take-over that could lead to dismissals, as it happened in the case of Horten, a major department store chain in the 1980s. In the point of view of the anti-trust commission, the WestLB acquired a partecipation of over 25% to prevent a take-over by British investors[48].

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[46] Claussen, p.26.

[47] See Monopolkommission, p.93.

[48] See Monopolkommission, p.93.

The three-pillar structure in German banking has been subject to discussions for a long time[49]. Especially the 1980s saw an intense debate on the question whether to privatise the public banks or not, but any attempts in that direction were blocked by the *Länder* fearing to lose the most powerful instrument they possess to exert political influence on the economy[50].

Recently, this discussion was taken up again. In its Financial System Stability Assessment, the IMF brought up the thesis that the recently shrinked level of profitability in the German banking sector is a result of the role of the public sector banks. In the point of view of the IMF the public banks` public task which aims at public welfare tends to foster the misallocation of resources and leads to efficiency losses with potentially negative economic consequences, such as welfare and stability losses. Hence, the IMF made various recommendations concerning the German public banks sector, among others to transform the status of the *Landesbanken* into private-law corporations to enable them to raise capital on the capital markets, the elimination of existing legal and other barriers to consolidation within and across the three pillars of the German banking industry in order to facilitate a market-oriented restructuring process, a modification and on the long-term a reduction of the institutional protection schemes in the public and cooperative banking sectors, improvements in transparency and corporate governance at the public banks and a review of the extent of public sector involvement in the banking sector[51].

The discussion is not a new one. The three-pillar system has always been subject to discussion but preserved ist characteristics for decades. Discussing these issues, one has to keep in mind that the decline in profitability recently has been a problem for all categories of banks, as it is to a certain degree a result of the stagnation of the German economy and the declining earnings and the high number of loan defaults resulting from this stagnation[52].

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[49] For example, the German anti-trust commission has been in favour of the privatisation ever since, see Monopolkommision, p. 92.

[50] Gros-Pietro/ Reviglio/ Torrisi, p.298.

[51] IMF, Financial System Stability Assessment, Deutsche Bundesbank, Monthly Report 12/2003, p.43.

[52] Deutsche Bundesbank, Monthly Report 12/2003, p.44.

But most of all, it does not seem very probable that the *Länder* give up their resistance against a privatisation and by that give away an important economic-political instrument. It is against this background that the strong resistance of the *Land* Mecklenburg-Vorpommern against the selling of the Sparkasse of the city of Stralsund has to be seen. The city of Stralsund was the first owner of a Sparkasse that in December 2003 tried to break the taboo by examinating the possibility to sell the assets of its Sparkasse to a private bank[53]. That would have meant a crack in the three-pillar-system[54]. Such a deal always seemed to be impossible because of the fact that this type of bank is subject to public law which does not provide for the selling of a *Sparkasse*. The idea of the city of Stralsund was the one of an asset deal, the Sparkasse should sell most of all its clients to a private bank, later the city of Stralsund wanted to wind-up its Sparkasse. The city of Stralsund interpretating the Act on the *Sparkassen* of the Land Mecklenburg-Vorpommern argued that it was up to the city to decide whether to wind-up the *Sparkasse* or not, the government of the *Land* interpretating the Act in a different way found that such a decision could not be taken without its approval. As the political debate became very emotional the attempt was stopped by modifying the law in the sense that due to the new Act a city cannot decide alone about the winding-up of its *Sparkasse*. By that, there was no possibility left to sell the *Sparkasse* of Stralsund in the planned way. But it seems to be only a matter of time since new attempts will be made to tear down the three-pillar-structure.

Despite from the fact that the public banks can serve the *Länder* as an economic-political instrument in the way described above, the public sector is interested in keeping up the public bank system to provide loans to the smaller and medium-sized companies which still rely on the bank loans as the most import instrument of financing. The role of the public banks in this aspect has become even more important recently, as the private sector tends to restrain from granting loans due to the small interest margins and the high number of loan failures in the last time. So far the withdrawal of the private credit

[53]The recent interest of the private bank sector could be seen as a change in the business policy of the private sector. For years, the private banks focussed on the major clients and investment banking, neglecting the retail business. After suffering bigger losses in that field, they seem to ri-discover the retail business and hence to show interest in the public banks which have the bigger market share.

[54] Der Spiegel, 8.12.2003, p.90.

institutions could be compensated by a higher grade of engagement from the side of the Sparkassen and co-operative banks[55].

The state has always supported the competition within the three-pillar-system on the one hand to provide the smaller and medium-sized enterprises and the not so well-off parts of the population with financial services via the public bank sector, on the other hand to balance the concentration of economic power within the private sector[56].

(2) Private banks[57] :

The 4 major banks -Deutsche Bank, Hypo-Vereinsbank, Dresdner Bank and Commerzbank- are *Aktiengesellschaften* (AG), i.e. they are established under the rule of private law. All are universal banks (offering all kinds of banking services) and *Allfinanzkonzerne* (comprehensive financial service providers).

In addition to these "big four" there are 223 regional banks. 87 of them are owned in majority by foreign banks. Some of them are nowadays not anymore limited to a certain region but active in all of Germany.

Last but not least, there are 58 smaller private banks with a market share of only 5 ‰. They take care of wealthy private clients.

(3) Co-operative banks

Volksbanken und Raiffeisenbanken have a market share of 16%. They have a high rate of mergers. The number of the *Volksbanken und Raiffeisenbanken* declined by 50% during the 1990s[58].

The aim of this type of credit institution is "organised self-help", i.e. to promote the business of the members. Every member has to hold a stake and is obliged to limited subsequent payments. Credit business is also possible with non-members. The co-operative banks have ca. 15 mio members and 30 mio clients, most of them middle-sized and agriculture businesses or private clients.

The central institution of all the co-operative banks is the DZ-Bank Deutsche Zentral-Genossenschaftsbank AG (only *Land* Nordrhein-Westfalen has an

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55 Bundesfinanzministerium, Monatsbericht 12/2003, p.41.

56 Gros-Pietro/ Reviglio/ Torrisi, p.300.

57 All figures: 12/2000, Deutsche Bundesbank, Bankenstatistik.

58 Domanski, p.34.

own central institution for the cooperative banks- the WGZ bank), shareholders are the *Volksbanken und Raiffeisenbanken*, directly or via holding companies. Before 1998 the DZ-Bank was a public corporation, then it was transformed into an *Aktiengesellschaft.*

c) Number of credit institutions in 2002[59]

In 2002, there were 2.521 credit institutions with 50.867 branches (of which 12.667 branches belonged to the Deutsche Postbank AG). This table is headed by the Co-operative banks (1.480 institutions) and the *Sparkassen* and *Landesbanken* (532 institutions).

Credit institutions	**Number**
Commercial banks (complex groups)	73
of which Landesbanken	12
Sparkassen	520
Co-operative banks	1.480
Foreign banks	89
Mortgage and ship mortgage banks	23
Real estate credit institutions	28
Credit institutions with special tasks	12
Other private, regional or guarantee providing banks	132
House building and saving companies	41
Investment fund managing companies	81
Securities trading banks	42
Total	**2.521**

Source: BaFin Annual report 2002

[59] BaFin, Annual Report 2002.

At the end of 2002, there were 1176 enterprises in the securities trading business (credit institutions and financial service institutions) from the European Economic Area operating in Germany using the "European Passport". In comparision to that, 170 German financial services institutions announced to the BaFin that they wanted to build up a branch in a member state of the EEA or to provide cross-border services[60].

d) Market share

The public banks have the biggest market share in business volume: 38% of all transactions in the credit business are effected by this sector, most of them, 35%, by the *Sparkassen* and *Landesbanken*.
The *Sparkassen* and *Landesbanken* and the co-operative banks also have the biggest market share concerning deposits.[61].

	Sparkassen / Landesbanken	**Co-operative banks**	**Private banks**
Branches	16713	15379	5476
Deposits and loans taken up in € billions	936,6	428,8	655,2
Saving deposits in % of balance sheet	30,5	31,5	5

Source: Der Spiegel, 8.12.2003, p.91

[60] BaFin, Annual Report 2002

[61] Der Spiegel, 8.12.2003, p.91.

2. Financial service institutions

a) Definition

Besides the credit institutions there exist financial service institutions. § 1 I a *Kreditwesengesetz* / Banking Act defines them as enterprises which provide financial services to others commercially or on a scale which requires a commercially organised business undertaking, and which are not credit institutions. Financial services are

1. the brokering of business involving the purchase and sale of financial instruments or their documentation (investment broking),
2. the purchase and sale of financial instruments in the name of and for the account of others (contract broking),
3. the administration of individual portfolios of financial instruments for others on a discretionary basis (portfolio management),
4. the purchase and sale of financial instruments on an own-account basis for others (own-account trading),
5. the brokering of deposit business with enterprises domiciled outside the European Economic Area (non-EEA deposit broking),
6. the execution of payment orders (money transmission services),
7. dealing in foreign notes and coins (foreign currency dealing), and
8. the issuance or administration of credit cards and travellers' cheques (credit card business) unless the card issuer also provides the service underlying the payment transaction.

b) Number of financial service institutions[62]

At the end of 2002, there were 757 financial services institutions in Germany (2001: 828). In addition to that, there were 3897 so called *gebundene Agenten* / bound agents. They do not have a licence as a financial service institution but work as brokers on account of and under the responsibility and control of another institution which is licenced. Many agents chose this way because of

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[62] BaFin, Annual Report 2002.

the various legal requirements and costs they would have to face if they applied for a licence. By controlling the institutions they are connected to, the BaFin controls these bound agents in an indirect way.

The decrease of institutions is due to the decreasing demand for financial services on the one hand and to the often small own capital resources these institutions provided. That is why many financial services institutions failed or could survive only by effecting other forms of business, e.g. the brokerage of insurance contracts.

3. Financial enterprises

Financial enterprises are enterprises acting on the financial sector which do not have to fulfill the requirements on solvency, because there is no need for the protection of their clients. As far as the securities business is concerned, they offer only secondary services as e.g. investment consultance. As they are not seen as securities services enterprises in the definition of the *Wertpapierhandelsgesetz (WpHG)*/Securities Trading Act the requirements how to organize and run the business according to §§ 32 following of the *WpHG*/ Securities Trading Act do not play any role for them. Nevertheless, they are subject to the insider trading control by the BaFin. As well as credit and financial services institutions, also the financial enterprises have to disclosure every securities transaction to the BaFin, § 9 *WpHG*/ Securities Trading Act.

4. Insurance companies

a) Number of Insurance Companies in 2001[63]

	Insurance companies running business			not running business
	Federal Supervision[1]	Supervision of the Länder[2]	Total	
life insurance	110	4	114	18
pension pools	154		154	4
funeral expenses funds	45		45	4
health insurance	55		55	
damage and accident insurance companies	238	8	246	15
re- insurance companies	43		43	5
total	**645**	**12**	**657**	**46**

Source: BaFin Annual Report 2002

b) Pension funds

A pension fund is a legal entity that offers company pension provisions. The employee has a claim for benefits against the pension fund which is obliged to pay him a life-long pension in either case (or a payment schedule with a combination of capital payment and pensions payment). Besides old-age

63 BaFin, Annual Report 2002.

provision also risks of disability and provisions for surving dependents can be covered by pension funds.

The reform of the pension system has promoted the private and company retirement provisions by tax priviliegies and boni. The accordant *Gesetz zur Reform der gesetzlichen Rentenversicherung und zur Förderung eines kapitalgedeckten Altersvorsorgevermögens (AVmG)/* Act on the reform of the social pension fund and the promotion of a capital-based old-age provision asset became effective on January 2002. This law introduced pension funds onto the market to multiply the number of opportunities for old-age provision. By the *Hüttenknappschaftliche Zusatzversicherungs-Neuregelungsgesetz (HZvNG) /* Act on the new regulation for complementary insurance of 21 June 2002 the pension funds have been subject to amendments. The business possibilities of the pension funds have been adjusted to the private old-age provision promoted by the state by tax privilegies: now payment schedules are also allowed for pension funds.

In 2002 the BaFin gave the licence to run the business to 18 pension funds, most of them in form of an *Aktiengesellschaft*[64].

64 BaFin, Annual Report 2002.

C. Supervision

1. The creation of the BaFin

Since 1st May 2002, the supervision on Financial Services Institutions in Germany is exerted by the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin)/ Federal Authority for the Supervision of Financial Services which has been established by § 1 *Finanzdienstleistungsaufsichtsgesetz* (FinDAG)/ Act on Financial Services Supervision[65]. The BaFin has its seat in Bonn and Frankfurt/ Main, § 1 II FinDAG.

The BaFin is a merger of the former three authorities in charge of supervision, i.e.:

- *Bundesaufsichtsamt für das Kreditwesen* (Federal Office for Banking Supervision)
- *Bundesaufsichtsamt für den Wertpapierhandel* (Federal Office for Securities Trading Supervision)
- *Bundesaufsichtsamt für das Versicherungswesen* (Federal Office for Insurance Supervision).

With the creation of a integrated supervision Germany reacted to the development on the financial markets with the blurring of the different products and services offered by banks, insurance companies and other financial intermediaries. The services offered by banks, insurance companies and investment fund managing companies overlap most of all in the field of investment products and asset management. As it became difficult to distinguish which service belonged to which sector, the traditional supervisory system with three separated bodies for banking, insurance and securities trading supervision beared the risk of supervisory loopholes rsp. of an inefficient duplication of supervision[66]. Keeping in mind the strong

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[65] FinDAG, 22nd April 2002, Federal Law Gazette I, 1310.

[66] Artopoeus, in: Integrierte Finanzdienstleistungsaufsicht,p.273.; Claussen, AG 1995, p.167.

relationships between the financial intermediaries – e.g. the top five banks and the top three insurance companies are very closely interlocked by direct ownership and voting control, jointly they report control over 14% of all listed firms[67]- it is not only the distinction between the different financial services offered that is blurring. The same is true also for the distinction between the financial intermediaries who offer these services. Against this background, the concentration of regulative and supervisory powers in one[68] instead of three bodies can be seen as an advantage. Especially the monitoring of cross-sector financial corporate groups- like for example the Allianz/ DresdnerBank- has become difficult within the old 3-bodies structure. Within these groups the risks of banking, insurance and securities trading accumulate but each of the former supervisory bodies could only get an isolated view of the state of the group, none had an overview over the total situation and the solvency of the whole corporate group[69].

The creation of the single body structure had also the aim to avoid a distorsion of competition between the different financial intermediaries[70].

Despite of this merger it is not justified to speak of one single regulator and supervisor as regulation and supervision still involve other bodies as will be shown below.

Mergers and acquisitions between the companies are not controlled by the BaFin but by a separate Federal Body, the *Bundeskartellamt*/ Federal Antitrust Authority.

2. Regulation and Supervision on Credit Institution and Financial Services Institutions

Two bodies are in charge of the supervision on credit institutions and financial service institutions.: the BaFin and the Deutsche Bundesbank. (Federal Central Bank).To describe their roles in brief terms: The Deutsche Bundesbank is the

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[67] Boehmer, Who controls Germany.

[68] Speaking of the BaFin as the "one" regulator and supervisor, one nevertheless has to keep in mind the strong position of the Deutsche Bundesbank in that field.

[69] Artopoeus, in: Integrierte Finanzdienstleistungsaufsicht,p.273.

[70] Bayer, p.284.

right arm of the BaFin , it fulfills most of the operational tasks, e.g. it evaluates the documents, reports, annual accounts and auditor`s reports submitted by the institutions whereas the BaFin has to decide if legal requirements are met by the institutions and -if this is not the case- can take administrative action.

a) The structure of the authorities

(1) The BaFin

President and Vice-President of the BaFin are nominated by the Federal government and appointed by the Federal President. The President conducts the business and administrates the assets of the BaFin, he manages and controlls all operations, § 1 I Satzung/articles BaFin[71]. He and the BaFin are subject to directives from the Ministry of Finance that is in charge of the control of the legitimacy and merits of the actions taken by the BaFin, § 2 FinDAG. The Vicepresident is the President`s permanent substitute, § 6 I 2 FinDAG.

The BaFin has an Administrative Board that monitors and supports the President and the Vice-President, § 7 I 2 FinDAG. To fulfill its tasks, the president has to inform the administrative board on a regular base about the business conducted, § 7 I 3 FinDAG. The administrative board consists in representatives of the Federal Ministry of Finance (Chairman, Vice-Chairman and 2 more members of the Administrative Board), of the Federal Ministry of Economics, of the Federal Ministry of Justice, members of Parliament, representatives of credit institutions, of insurance companies, of investment fund managing companies, the Bundesbank is allowed to particpate with a representative without voting rights, § 7 III FinDAG. The members of the Administrative Board from the financial sector are nominated by associations of the credit and insurance enterprises as well as by the Federal association of investment fund managing companies, they are appointed and dismissed by the Federal Ministry of Finance, § 3 I 2, VI Satzung/articles BaFin. The chairman and his substitute are elected for five years, the other members for four years.

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[71] The *Satzung* of the BaFin, i.e. the articles of this public authority has been defined by a Rechtsverordnung/ ordinance of the Federal Ministery of Finance (Rechtsverordnung of 29 th April 2002 Federal Law Gazette I, p. 1499), that was empowered to do so by § 5 III 1 FinDAG.

They can be re-appointed. The administrative board takes decisions with the majority of the votes, in case of a stalemate the President has the casting vote, § 7 IV FinDAG.

The general task of the Administrative Board is to controll and support the management of the BaFin, § 7 I 2 FinDAG. In particular, its tasks are the approval of the budget and the annual accounts and the endorsement of the President (in agreement with the Ministry of Finance). It also has to be heard before the modification of the articles or the modification of cooperation with other institutions (except from institutions involved in supervision), § 4 I Satzung/ articles BaFin. The President has to report to the Board. The Administrative Board has a right of information and the right to be heard by the President, § 4 II Satzung/articles BaFin. The Board meets whenever necessary, at least once a year, with the participation of the President, § 6 Satzung/ articles BaFin .

The BaFin also has an Advisory Council of 24 members appointed for five years by the Federal Ministry of Finance consisting among others in representatives of science, credit institutions, insurance companies, Bundesbank, unions, associations of medium-sized enterprises and consumer protection associations. The members can be re-appointed. The Advisory Council has the task to give recommendations to the BaFin when asked by the President, the Ministry of Finance or ¼ of its members, § 8 FinDAG, § 8 Satzung/articles BaFin.

(2) The Deutsche Bundesbank

The Bundesbank`s decision-making body is the Executive Board, it conducts and administers theBundesbank, § 7 I 2 Bundesbankgesetz(BundesbankG)/ Bundesbank Act.. It comprises the President, the Vice-President and six other members. The members of the board are all appointed by the President of the Federal Republic, § 7 III 1 BundesbankG. The President, the Vice-President and two other members are nominated by the German Federal Government and the other four members are nominated by the *Bundesrat* (upper house of parliament representingthe *Länder* / the German Federal States) in agreement with the Federal Government, § 7 III 2 BundebankG. Members shall be appointed for eight years or in exceptional cases for a shorter term, but not for less then five years, § 7 III 4 BundesbankG. The Executive Board shall deliberate under the chairmanship of the President or the Vicepresident. It

takes its decision by a simple majority. In case of a stalemate, the chairman shall have the casting vote, § 7 IV BundesbankG.

The Bundesbank consists in its headquarter in Frankfurt am Main and nine Regional Offices (formerly known as Land Central Banks) which are now responsible for one or more *Länder*. Each Regional Office is headed by a President who is subject to directives from the authority of the Executive Board of the Deutsche Bundesbank, § 8 II BundesbankG. Subordinated to the Regional Offices are 66 branches located in the larger towns in Germany. They carry out the Bundesbank`s business with the credit institutions and the public authorities in their respective areas and are subject to the authority of their Regional Office, § 10 BundesbankG.

b) *Regulation*

The BaFin issues guidelines (*Richtlinien*) concerning ongoing supervision. These guidelines shall be issued in agreement with the Bundesbank. If no agreement can be reached within an appropriate period, the Federal Ministry of Finance shall issue such guidelines in consultation with the Bundesbank., § 7 I KWG/ Banking Act. The guidelines are no secondary legislation but administrative rules by which the administration binds itself to treat similar cases in the same way, they do not give a direct right to the concerned enterprises, the companies have only the right to claim to be treated in the same way as their competitors. The BaFin can also issue general instructions which lay down rules for the providing of financial services and the limiting of risks. These instructions can have the legal form of an ordinance (*Rechtsverordnungen*), i.e. then they are binding as secondary legislation and give a direct right to the concerned enterprises.

Effecting the ongoing monitoring of credit and financial services institutions, the Bundesbank shall pay heed to the guidelines (*Richtlinien*) issued by the BaFin, § 7 II 1 KWG/ Banking Act.

c) Supervision

(1) The BaFin

§ 6 II KWG/ Banking Act provides that the BaFin has the general task to protect the assets committed to the credit and financial service institutions, to ensure proper banking and financial service business and to prevent greater damages for the economy as a whole.

To give the authorisation to start a financial service business the BaFin examines most of all if the enterprise provides sufficient capital resources, if it has two CEOs (4-eyes-principle) who have to be both personally reliable and qualified and if the business plan which the institution has to present provides for a sound business performance, §§ 32, 33 KWG/Banking Act. In the case all requirements are met there is a legal claim to start and carry on business. The *BaFin* does not check if there is a need for another financial service business at the market.

If the requirements to run the business are not met anymore, the BaFin takes regulatory measures, especially general decrees (*Allgemeinverfügungen*) and administrative acts (*Verwaltungsakte*), including auditing orders, § 7 II 4 KWG/ Banking Act. As a rule, the BaFin shall base its regulatory measures on the Bundesbanks`s audit findings and appraisals, § 7 II 5 KWG/Banking Act. The BaFin itself will carry out audits of banking operations (on its own or together with the Bundesbank) only in exceptional cases[72]. These regulatory measures concern the licensing, monitoring and the withdrawal of an institution`s authorisation and any kind of order to institutions and their managers that are appropriate and necessary to stop and prevent violations of regulatory provisions or overcome undesirable developments at an institutions which could endanger the safety of the assets entrusted to the institution or could impair the proper conduct of its banking business or provision of financial services (§ 6 III KWG/ Banking Act). Examples for these administrative actions the BaFin can take are: interdiction of the new allocation of loans, the interdiction of the distribution of dividents, the interdiction of new deposits,

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[72] For details see agreement about the cooperation between BaFin and Bundesbank of 31st October 2002 and the supplementary *Aufsichtsrichtlinie*/ supervision guideline of the Federal Minitery of Finance of 10th october 2003, both available under www.bafin.de.

the dismissal of a CEO, withdrawal of the licence, the imposing of administrative fees or as ultima ratio the filing for insolvency, §§ 45-46b, §§ 56-60 KWG / Banking Act.

(2) The Deutsche Bundesbank

The Bundesbank has a far-reaching involvement in the ongoing monitoring of credit and financial services instititions co-operating with the BaFin, § 7 KWG / Banking Act. .

Generally, the Regional Offices are responsible for carrying out these monitoring operations, § 7 I 4 KWG / Banking Act. They analyse and evaluate the reports and announcements submitted by the institutions, § 7 I 3 KWG. They also conduct on-site prudential audits to assess the appropriateness of the institutions` capital base and risk management procedures and evaluate the audit findings, § 7 I 3 KWG / Banking Act. In this context the Bundesbank shall pay heed to the guidelines (*Richtlinien*) issued by the BaFin, § 7 II 1 KWG / Banking Act.

d) Co-operation between Bundesbank and BaFin

The tasks of Bundesbank and BaFin mentioned above are laid down by parliament. Furthermore these two bodies have made an agreement, on the 30th October 2002, in which they detail their cooperation concerning the supervision of credit and financial services institutions. By this agreement the Bundesbank continues to fulfill most of the operational tasks, e.g. it evaluates the documents, reports, annual accounts and auditor`s reports submitted by the institutions. With the partecipation of the BaFin, the Bundesbank routinely holds prudential discussions with the institutions. Besides that, both Bundesbank and BaFin can hold prudential discussions with the institutions at any time. The Bundesbank also effects regular audits of banking operation. In these audits the banking supervisors assess capital adequacy and the suitability of risk management procedures. The BaFin may participate in the Bundesbank`s audits or carry out its own audits in individual cases[73].

[73] For details see agreement about the cooperation between BaFin and Bundesbank of 31st October 2002 and the supplementary *Aufsichtsrichtlinie* / supervision guideline of the Federal Minitery of Finance of 10th october 2003, both available under www.bafin.de

Furthermore, a plattform for the coordination of the co-operation between BaFin and Bundesbank has been created *(Forum für Finanzmarktaufsicht)*, consisting in members of both bodies and working under the chairmanship of the BaFin. The Ministry of Finance can partecipate in the proceedings, § 3 FinDAG.

3. The discussion before the creating of the BaFin: The role of the Bundesbank and the Länder

a) Controversial issues

Before the creation of the BaFin, the discussion contained most of all the question which role the Bundesbank shall have in banking supervision. This was also due to the fact that the creation of the BaFin was discussed in parliament together with the reform of the organisation and structure of the Bundesbank. Behind this question laid the real issue who should have the most supervisory powers: If all powers were given to the BaFin as a Federal Authority subject to directives from the Ministry of Finance that would have meant to have the supervisory power only at the side of the government. If the powers were divided between BaFin and Bundesbank this question would be dependend from the structure of the Bundesbank, which was under discussion at the same time. The Länder wanted to have more influence on banking supervision by giving the *Landeszentralbanken* (land central banks) the competence to take all kinds of sovereign administrative measures (general decrees and administrative acts) concerning regional credit institutions except from the dismissal of a manager or the withdrawal of a banking licence.

At the end of the legislative procedure, the Bundesbank continued to play an important role in the banking supervision. By the modification of the Banking Act on 22 April 2002, the role of the Bundesbank in banking supervision has been laid down by law for the first time.

Apart from the central question about the role of the Bundesbank, the fact that the supervision by the BaFin should be financed to 100% by the institutions supervised (before the institutions paid only for 90% of the costs) was criticised worrying that this could lead to inefficiency at the side of the BaFin.

In this context it was also said that banking supervision is a task of public interest so that the Bund (Federal State) should partecipate in the financing of supervision. The draft law was not changed concerning this point.

b) The bill of the government[74]

The draft law to merge the former three authorities, i.e. the Authorities for the Supervision of banks, insurance companies and securities trading, into one single body, the BaFin, was brought into parliament by the government (Social democrats/ Greens) and supported by the Liberal Democratic Party. It was seen as reasonable to merge the authorities because of the blurring of the differences in the services and products the financial intermediaries started to offer. Within this context, particularly the merger of the Allianz AG as an insurance company and the Dresdner Bank AG was regarded as the top of the iceberg and the beginning of a new age of the so-called *Allfinanz* (integrated financial services). The creation of a single regulator and supervisor should lead to a fairer and more neutral supervision concerning the cross-sector competition of banks, insurance companies and securities trading enterprises, to a higher grade of efficiency using cross-sector know-how and to synergy effects concerning staff and equipment of the authority. The single authority was also seen as a more efficient instrument in the face of the internationalisation of the financial markets. Furthermore, a single authority was considered to be more powerful in the fight against money laundering, because of the centralisation of information and know-how.

c) Critics

The opposition (Christian Democrats) criticised most of all a loss of power at the side of the *Länder* (German Federal States). This aspect was also the main argument of the *Bundesrat* (upper house of parliament representing the *Länder*).The *Bundesrat* claimed that the on-going supervision should be effected by the Bundesbank, i.e. by the *Landeszentralbanken* (Land Central Banks) according to the rules set up by the BaFin under the agreement of the Bundesbank (the draft law of the government contained that only the BaFin should make the rules and the Bundesbank should only have the right to be

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[74] BR-Drs. 400/01 (1st June 2001)

heard). According to the Bundesrat, the Landeszentralbanken should also be given the competence to take all kinds of sovereign administrative measures (general decrees and administrative acts) concerning regional credit institutions except from the dismissal of a manager or the withdrawal of a banking licence. This was seen as reasonable to avoid a duplication of work if one body is in charge of the supervision and another in charge of the necessary administrative action. The carrying out of the supervision and regulation by the Landeszentralbanken should also guarantee the institutions to be supervised by an authority that knows the regional situation and not by a central body far away from the institutions.

Most of all the Bundesrat wanted to make sure that the powers of the *Länder* (and by that also, at least in theory, the pluralism, i.e. the power of the opposition) in the banking supervision were maintained. The Act on the creation of the BaFin was discussed together with the reform of the structure of the Bundesbank. Before the reform, the *Landeszentralbanken* played an important role in the supervision.

d) Compromise found

Nowadays the *Landesbanken* continue to have this importance in supervision. The difference lays in the fact that before the nine presidents of the Landeszentralbanken were nominated by the *Bundesrat* and appointed by the Federal President. They were to a large extent independent in their decisions. As part of the former *Zentralbankrat* (central bank council) they were part of the decision-making organ of the Bundesbank. Fighting against the Act creating the BaFin the *Bundesrat* wanted to save these powers. Now the *Landeszentralbanken* are called *Hauptverwaltungen* (main offices) of the Bundesbank. Their presidents are subject to directives from the Executive Board and are no longer part of the decision-taking organ.

A compromise to save the influence of the Länder and by that the pluralism was found in the sense that the government nominates the president, the vicepresident and two more members of the board while the other four members of the board are nominated by the *Bundesrat* in accordance with the government (the draft law of the government planned that the government should nominate president and vicepresident while the remaining four members should have been elected by the president himself, by that, the government would de facto nominate the whole board).

D. Supervision on Insurance Companies

1. Supervision of the Federal State and of the Länder

According to the federal system in Germany, the supervision is divided between the *Bund* (Federal State) and the *Länder*. The *BaFin* as a Federal Authority monitores and supervises the private insurance companies with major economic importance as well as the public insurances (established by and subject to public law) that are active in more than one *Land*. In that field the BaFin is also enabled to set up regulations.

The *Länder* instead monitore and supervise the public insurances that are active only in one *Land* and the private insurance companies of less economic importance.

The BaFin and the supervision authorities of the Länder supervise all private and public insurance enterprises that are active in the field of private direct insurance and have their seat in Germany. Domestic companies running only re-insurance business are subject only to a limited supervision. Since 2002, also pension funds are subject to insurance supervision.

Enterprises with a domicile in another memberstate of the EEA are supervised by their home country, but the BaFin can take action (after consultations with the home country supervision authority) if the company offends against German legal principles.

The national insurance agencies (compulsory health and pension insurances) are not subject to the supervision of the BaFin but are controlled by other entities.

2. Authorisation

Insurance enterprises need a licence to start their business. They have to meet serveral requirements[75], e.g the insurance company has to have sufficient capital resources, the management has to be personally reliable, the business plan the company has to hand in must provide a sound business, only certain

[75] See §§ 5 ff. *Versicherungsaufsichtsgesetz* (VAG)/ Act on the Supervision on Insurance Companies.

legal constitutions are permitted *(Aktiengesellschaft, Versicherungsverein auf Gegenseitigkeit, öffentlich-rechtliche Anstalt),* insurance companies are allowed only to run the insurance and related businesses , within the company there has to be a separation of sections (for example, a life insurance company cannot offer health or damage insurance services) etc. If the requirements are met the BaFin has to give the authorisation, as the companies then have a legal claim to start the business.

3. Monitoring and administrative action

The BaFin supervises the authorised companies currently by gatherig and analysing informations and by general monitoring of the business[76]. The enterprise has to meet all legal requirements and regulations set up by the supervision authority.The companies are obliged to render accounts and to give all necessary informations to the BaFin to enable it to analyse the economic and financial situation of the enterprise. The BaFin can also effect audits. If the requirements are not met anymore, the BaFin can take admainistrative action, amongst other measures to substitute members of the organs of the enterprise or to withdraw the licence

E. Supervision on Securities Trading

In Germany there exist eight regional stock exchanges, most important is Frankfurt/ Main. The control of the stock exchange and the securities trading business is divided between the *Bund* (Federal State) that effects supervision by the BaFin and the *Länder* (States within the German Federation).

1. The *BaFin*

The BaFin is in charge of the supervision of the securities trading. According to the *Wertpapierhandelsgesetz* (*WpHG*) / Securities Trading Act, BaFin controls the securities trading and takes administrative action if necessary.

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[76] See §§ 81 ff. *Versicherungsaufsichtsgesetz* (VAG)/ Act on the Supervision on Insurance Companies.

That means its fields of competence are: the control if all securities transactions have been reported to the BaFin according to § 9 WpHG/ Securities Trading Act (this central rule[77] -in force since 1 January 1996- intends to create a "vitreous securities market" for the BaFin by establishing a disclosure duty for every securities transaction), prevention of insider-trading, control of ad-hoc-disclosure duties, control if alienators/ purchasers of stakes fulfil their obligation to announce the sale/ acquisition of important partecipations in listed companies, in order to inform the market about important changes in the structure of listed companies, control of deposited securities prospectus and the control if requirements concerning capital investment advice (investor protection), ongoing servicing and analysis are fulfilled. Last but not least, it is in the competence of the BaFin to co-operate with foreign authorities that are responsible for the supervision of securities trading.

The BaFin effects its supervision in the public interest, its aim is to protect the functioning of the capital markets. If the law that rules the activities of the BaFin -in addition to the public interest- pursuits also the protection of the individual investor and by that gives the individual a claim for the compensation of damages caused by insufficient supervision, is a controversial point[78].

2. The *Länder*

The stock exchanges are under the supervision of the *Börsenaufsichtsbehörde*[79] of the *Land* in which they are located. The *Länder* authorities do not control the securities trading business but the operating of the stock exchange in general. This supervision includes *Rechtsaufsicht* (control of the general legitimacy of all operations on the stock exchange, incl. the stock exchange self-administration) and *Marktaufsicht* (control of the trade) [80]. That means they control the

[77] The efficiency of the BaFin's supervisory function relies to a great extent on the compliance with this rule, Schlüter, p. 419.

[78] See Schlüter, p.420.

[79] The supervision is effected generally by the Minsiter of Economics of the Land, only in Nordrhine-Westphalia it is the Minister of Finance.

[80] Schlüter, p.411.

participants in the stock exchange business (admission to the exchange etc.), the electronic auxiliaries, the formation of the prices etc. The requirements are regulated in the *Börsengesetz*/ Stock Exchange Act and in the *Börsenzulassungsverordnung*/ Stock Exchange Admission Order.

The stock exchanges have to found and finance Trade Control Offices (*Handelsüberwachungsstellen*) following the guidelines of the *Länder* authorities which control these offices. The Trade Control Offices collect and analyse data about the stock exchange business and investigate in cases of doubt, § 4 *Börsengesetz*/ Stock Exchange Act.

3. Council for Securities

As a plattform to enable a better co-operation between the Federal State (BaFin) and *Länder* ,the Council for Securities (*Wertpapierrat*) was created, § 5 WpHG/ Act on Securities Trading. It consults the *BaFin*. All 16 Länder (i.e. also the *Länder* without a stock exchange) have a representative in the council. Regular meetings are held at least once a year.

4. Further centralisation within the BaFin?

The government is promoting a further centralisation of the supervision on the securities market within the BaFin. All former attempts to centralize the supervision have failed because the Länder put up resistance defending the dual system of supervision with the Federal State, i.e. the BaFin, on one side and the Länder Supervision on the other.[81]

[81] See Application of the Parliamentary Faction of Socialdemocrats and League 90/ the Greens, BTDrs. 15/930, p. 5.

III. THE SECURITIES MARKET

A. The Status Quo

In the comparision with the anglosaxon countries, the German securities market is of minor importance. On the equity markets the number of all – domestic and foreign- listed companies increased from 519 in 1991 to 989 in 2001[82]. But only 729 domestic companies were listed in 2002[83]. Whereas in the United Kingdom, to give an example for a market-based system, the number of listed domestic companies was 2251 (in 2004)[84]. The number of IPOs went from 15 in 1991 to 275 in 1999 with the boom of the New Market (*Neuer Markt*)[85] and then down to 24 in 2001 again[86]. Compared to other countries, in Germany the average age of the company when it is first admitted to the stock exchange is relatively high: whereas in the United Kingdom the average age was eight years, in 1995 at the German stock exchanges the companies were ca. 55 years old when they were first admitted[87].

On the other side the percentage of the population that invests in the stock market is in decline: The percentage of shareholders amongst the population[88] climbed from 6,8% in 1988 to 9,7% in 2000 to then fall down again to 7,8% in 2003[89]. The percentage of holders of investment funds shares is also in decline, as it went from 3.6% of the population in 1997 to increase to 15. 2% in 2001 to then fall to 12.7% in 2003[90].

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[82] Domanski,p.23.

[83] Hirte, p.22, fn.79.

[84] Turkington / Martin, p.11.

[85] In 1998 there were 71 IPOs in the Neuer Markt with a total volume of 6.9 Milliard DM, see Claussen, p.378.

[86] Figures: Domanski, p.23.

[87] Baums, Verbesserung der Risikokapitalvorsorge, p.3.

[88] In the Deutsche Aktiensinstitut Statistics only shareholders with an age of 14 years or more were taken into account

[89] Deutsches Aktieninstitut, factbook 2003.

[90] Deutsches Aktieninstitut, factbook 2003.

The bond market consits mainly in bonds issued by the public sector and the banks, whereas non-financial corporations account only for 1% of the bonds outstanding[91]. Looking at the German industries at the whole, debentures could not gain ground as a substitute for bank loans: In 1999 the debentures of the companies reached only the level of 3% of the GDP, wheras in the same year they reached 34% of the GDP in the USA[92]. But studying these figures one has to keep in mind, that the development is split between the larger stock coporations which developed the financing by bonds and the smaller and medium-sized enterprises which still rely on bank loans[93].

As a study of Mediobanca shows[94], the most important German industrial firms, i.e. those whose turn-overs added together represent at least 69% of the country`s GDP, increased the rate of financing by issuing industrial obligations from 12.7% of the total invested capital in 1997 to 28.7% in 2002. This is one of the highest percentages of all European countries, as the Mediobanca study demonstrates that for the same scope of firms in the United Kingdom, as a traditional market-based system, the percentage of financing by obligations went from 17.0% in 1997 to 24.6% in 2002. In Italy instead, the number climbed from 8.2% in 1997 to 16,8% in 2002.

B. Possibile Reasons for the Development

1. The Strong Position of the "Hausbank"

The stock market is one possibilty of financing resp. capital investment. Its weakness reflects the strength of the financial intermediaries, especially the banks within the financial system[95]. The strong position of the banks, the *Hausbank* principle gave no incentive to further develop a transparent capital market structure, including infrastructure for trading, clearing and settlement of securities, as well as the establishment of rating agencies and other entities

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91 Domanski, p.23.

92 Deutsche Deutsche Bundesbank, Monthly Report 01/2000, p.35.

93 For details see below.

94 Mediobanca, p.52.

95 Monopolkommission, p.20.

providing information for investors[96] ,because there was less need to be monitored by outside investors. The development to open the system for the financing by the capital markets started relatively late, so that it needs time to see the results.

Apart from their decisive influence in the governance and control of the Aktiengesellschaften, the banks play a central role in the financial system. The traditional model of financing is characterised by the so-called *Hausbank*. A company builds up a long and stable relationship with only one credit institution that effects the majority of all financial operations for this company. This Hausbank principle can be found within the larger Aktiengesellschaften[97] as well as within the smaller and medium-sized enterprises[98]. By that the Hausbank is permanently well informed about the situation the enterprise is in and consults the management of the company on a long-term basis.

The benefit of the bank-based system in general has been seen in the point that a long-term relationship between bank and borrower should make the bank far-sighted and allow the borrowing enterprise to focus on long-term projects. The banks as major shareholders with their representatives in the Supervisory Boards have the possibility to build up serveral formal and informal plattforms to cultivate personal contact to the management. By that they have access to a wide range of informations concerning also long-term strategies and projects, informations that would be difficult to obtain from outside[99]. The long-term nature of the financial relations provided stability against self-perpetuating economic downturns because the companies could rely on the banks to grant loans to them even in periods of slack economic activity[100]. The bank-industry relation in general is more stable, the banks do not withdraw their activity so easily and continue to finance the enterprises even in difficult periods modifying the looan conditions , allowing a delayed repayment etc.[101]

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[96] Domanski, p.19.

[97] See for example the relation between Deutsche Bank and Volkswagen.

[98] 40% of the smaller and medium-sized enterprises have only one Hausbank., Deutsche Bundesbank, Monatsbericht 01/2000, p.39.

[99] Rudolph, p.2056.

[100] Deutsche Bundesbank, Monthly Report 12/2003, p.27.

[101] Rudolph, p.2056.

Another benefit of the bank-based model has traditionally been seen in the idea that banks can supply finance realtively cheaply because they have superior information[102] resulting from their strong representation in the Supervisory Boards of the corporations, and that the superior information they have about the financial situation also helps them to control the management of the company effectively and that in turn lower finance costs for external funds and lower agency costs of corporate control have a favourable effect on firm profitably, an issue that has been doubted recently[103].

These stable relationships and the close links between banks and industry lead the company to a certain degree of dependence. But this bank-based system has guaranteed stability for many decades in Germany. This system seems to have been the appropriate one for the German economy in a period with less technological and structural changes, as from the reconstruction period after the war until the 1980s. Nowadays, technological progress is accelarated which considerably increases the need for the companies to finance innovations. Looking at the recent development during the last years, the slowdown of the German economy raises doubts if the bank-based system is still able to support the economic growth[104].

2. The Social Security System

The role the state plays in the financial system must be seen against the background of the economic order in Germany, i.e. the social market economy. The state generally abstains from interfering directly in the financial sector, it does not administer the lending[105], but sets up the rules in order to keep social peace. Public influence on the financial system is effected in two

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[102] Rudolph, p.2056.

[103] Chirinko/Elston, p.3 finding that bank influence is not associated with a reduction of finance costs nor a change in profitability.

[104] Domanski, p.36.

[105] As an exemption to the rule, the state can provide export guarantees (Hermes-Bürgschaften) and specific lending programs effected by specialised institutions.

ways: by the public banks[106] and by the pension system, which did not favour the investing in the securities markets as the state provided old-age provision.

The traditional public social security system (public pensions, health insurance and unemployment insurance schemes) has given no stimulus to the development of the securities markets as the state covers the need to provide for these risks. Especially the public pension system has been seen as one of the reasons for the historically limited scope of the German stock exchange[107]. The pension system is a pay-as-you-go system basing on contributions of the employees as well as of the employers. Its central idea is the one of a so-called *Generationenvertrag*, a social contract between the generations, this means that following the insurance principle, today`s employees finance today`s pensioners. This system created no incentive for long-term saving and by that it has reduced the demand for non-bank financial assets such as shares in pension funds or direct investments in securities[108].

As for the promotion of the investing in the securities market, a main step forward was made with the reform of the pension system which gave an incentive to invest in the stock market for private old-age provision and introduced for the first time pension funds in Germany[109]. As this new legislation changed the traditional German idea of "Father State" taking care of old age provision leaving no incentive for private measures, it was seen as a "peaceful pension revolution"[110].

But until 2004, the fiscal legislation favoured more the investing in life insurances -when held for more than 12 years- as in the stock market . Hence the private investors preferred the life insurance as an instrument of private old-age provision. As also the insurance companies restrain from investing their clients' saving capital in the acquisition of partecipations in smaller and medium-sized companies, this capital was lost for the promotion of smaller "new entries" on the stock market. The reason for this restraint can be seen in the restrictive requirements about the investment of the savings by the

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[106] For the role of the *Landesbanken* as an instrument of political influence, see above.

[107] Reszat, p.99.

[108] Domanski, p.17.

[109] Altersvermögensgesetz (Act on Old Age Provision), 26 June 2001, Federal Law Gazette I 2001, 1310.

[110] Lenenbach, p.18.

insurance companies set up by the *Versicherungsaufsichtsgesetz* / Insurance Supervision Act. The Act provides that the insurance company has to chose low-risk forms of investment with the consequence that the insurance companies invest most of all in DAX companies and rarely in smaller and medium–sized enterprises[111].

After longer political discusion, the tax privilege for life insurances will be abolished with effect from January 2004. It can be exspected that more private households will invest in the stock market for old age provision. One more step to promote the stock market has been made.

3. Lack of transparency

a) The "Deutschland AG"

The transparency regulation developed rather late in Germany, as important disclosure standards and insider trading prohibition were introduced not before the 1990s. For instance, before 1994 the immediate publication of information relevant for equity prices was not mandatory for listed companies[112]. Even though this has been changed in the meantime, the intransparency of the whole system still is a problem.

The German economy is characterised by a complicated and intransparent net of interlinkings between the most important companies. Enterprises hold reciprocal partecipations in other companies. Normally this concerns not only two but serveral companies. We speak of a ring of interlinking when company A holds partecipations in B, B in C and C in A.. As the system covers all of Germany, i.e. as it includes most of the important companies, this net of interlinkings it has become popular to speak of the "Deutschland AG"[113]. Some say the idea behind these reciprocal partecipations would be that they allow the linked enterprises to exert influence on each other`s management circumventing disclosure duties according to anti-trust and stock corporation

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[111] Baums, Riskokapitalversorgung, p.21.

[112] See Domanski, p.20.

[113] Emmerich / Sonnenschein / Habersack, p.78.

law because the reciprocal partecipations do not reach the disclosure threshold[114].

Two major concerns arise from the reciprocal partecipations, on the one hand the problem of a watering of the capital requirements (*Kapitalverwässerung*), on the other hand the government voting rights (*Verwaltungsstimmrechte*).

The fact that the companies are linked means that each company holds indirect partecipations in itself. This structure contains the risk that the company`s capital as far as the partecipations are concerned consists in partecipations of the company in itself, i.e. in assets that are already part of the company`s assets[115]. As the issue of such a watering of the capital requirements is not seen as that dangerous anymore[116] the main problem nowadays is seen in the government voting rights, i.e. in the fact that the managment of the company is getting independent from the other shareholders. The management building up reciprocal partecipations aims at having the majority of the voting rights (via the interlinked companies) in its own Annual General Meeting[117]. Some say that if the mangement reaches this aim this leads to a status in which a club of managers assuring each other the majority in the Annual General Meetings is getting untouchable and uncontrolable for the other shareholders as this club will give the approval to each other`s actions[118].

In any case, one has to agree with *Baums* saying that there is a network of individuals who has the potential to dominate the Supervisory Boards and that we may exspect that their incentives to mutually monitor each other will not be pronounced[119]. Even if § 100 II No.1 AktG/ Stock Corporation Act does not allow a person to be member of more than ten Supervisory Boards, this does not help to deconcentrate the management structure as § 100 AktG applies only to the single person and does not hinder the enterprise to send other representatives to the Supervisory Boards. This structure of interlinkings –it has become common to call it a “jungle of interlinking”- is intransparent and raises fears on the side of the investors who do not know who de facto

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[114] Adams, p.149.

[115] Emmerich/ Sonnenschein/ Habersack, p.78., Wastl/ Wagner, p.244.

[116] Emmerich/ Sonnenschein/ Habersack, p.78., Wastl/ Wagner, p.244.

[117] Emmerich/ Sonnenschein/ Habersack, p.79.

[118] Adams, p.149.

[119] Baums, Corporate Governance, p.12.

controls the company they invested their capital in. Even if there are no reliable studies on the efficiency and the performance of the German Supervisory Board, the system of interlinkings raises fears that it could be almost impossible for private investors to exert influence on the corporation's governance, especially to dismiss the management. in case of mismanagement[120].

The AktG/ Act on Stock Corporations provides only smaller limitations for the reciprocal partecipations. According to § 19 I AktG a reciprocal partecipation exists only if two enterprises with domicile in Germany hold direct partecipations of more than 25% (each of them) in each other. If only one enterprise holds a partecipation of more than 25% and the other one a smaller partecipation the rules for the reciprocal partecipations do not apply. The consequence of this interlinking is that the enterprises have to communicate to each other the partecipations they hold, §§ 20 , 21 AktG. According to § 328 I, II AktG the enterprise that last reported its partecipations can exert its rights only for up to 25% of all shares of the enterprise it holds the partecipations in. The rights of the the enterprise that has reported its partecipations first remain untouched. Even though it was issue of hot debates to introduce limitations also for reciprocal partecipations that do not exceed the threshold of 25%[121], the KonTraG /Act on Control and Transparency for enterprises[122] did not establish further limitations for the reciprocal partecipations. Even if § 328 III AktG now provides that enterprises that know that they are interlinked in the sense of § 19 I AktG (i.e. with more than 25% in each other both of them) cannot exert their voting rights as it comes to the election of the members of the Supervisory Board, this rule de facto has no relevance as there are hardly any cases in which enterprises exceed the 25% threshold[123]. The bill for a *Gesetz zur Verbesserung von Transparenz und Beschränkung von Machtkonzentration in der deutschen Wirtschaft (Transparenz- und Wettbewerbsgesetz)* / Act on the improvement of transparency and the limitation of concentration of powers in the German economy (Transparency and

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120 Adams, p.149.

121 See below, Bill for the Transparency and Competition Act.

122 Gesetz zur Kontrolle und Transparenz im Unternehmensbereich / Act on control and Transparency for Enterprises from 27 April 1998, Federal Gazette I, p. 786.

123 Wastl/ Wagner, p.245.

Competition Act) of the Socialdemocratic Parliamentary Fraction [124] which did not pass the parliament, provided a reciprocal participation from a threshold of 3% on and forbid the exeting of the voting rights for those shares[125]. To avoid the conflicts of interests within the banks the Bill for the Transparency and Competition Act did not allow credit institutions and insurance companies to hold more than 5% of the company's capital in non-financial enterprises by direct or indirect participations. As the Bill did not find approval these modifications have not been realized.

Apart from the question of the concentration of powers within the "Deutschland AG" the legislation does not provide a clear picture of who is exerting the control of the corporations.

The WpHG/ Act on Securities Trading[126] does not provide full transparency of control, as serveral control rights do not have to be reported[127]. Hence it is not clear at the end who controls the enterprises.

§ 21 WpHG/ Act on Securities Trading deals with the notification of direct shareholdings (disclosure is obligatory when crossing the thresholds of 5%, 10%, 25%, 50% or 75% of the votes of a German company listed on an official EEC market either by reaching this threshold or losing it). Of bigger interest is § 22 WpHG/ Act on Securities Trading which provides disclosure duties for indirectly controlled votes that are attributed to a shareholder. As the WpHG leaves much room to interpretation[128] and as their are only a few court decisions, it is so far not an efficient instrument to combat intransparency. The legislation offers many possibilities for the owners of control to stay in the dark.

§ 22 WpHG/ Act on Securities Trading enumerates different forms of voting rights which has to be attributed to their owners. If the voting rights are attributted according to § 22 WpHG the shareholder has to disclosure his participation and report it to the company and the BaFin according to § 21

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[124] BT-Drs. 13/367 from 30 January 1995.

[125] Bill of a Transparency and Competition Act modifying § 19 AktG, BT-Drs. 13/367, Art..2 Nr.1.

[126] The EEC Transparency Directive was transposed into German law as part of the WpHG/ Act on Securities Trading, Federal Law Gazette I, 30.7.1994, p.1749 and following pages.

[127] Boehmer, Who controls Germany, p.5.

[128] Boehmer, Who controls Germany, p.3.

WpHG. But § 22 WpHG leaves room to interpretation as it rules are not absolutely clear. So are according to § 22 I No.1 WpHG votes of a subsidiary attributed to the parent company. § 22 III WpHG defines that a subsidiary is – among other possibilities- an enterprise which can be controlled by the company that has to report the votes. This rule allows the interpretation that shares held by non-listed companies only have to be attributed to their owners only if the owner has the majority of the control. This gives the possibility to hide the ownership of control to an extense degree. It seems possible that two individuals have the control of a whole listed company without being obliged to notify it. This could be possible if these two individuals establish two unlisted holding companies[129] in which each of them holds 50%. If these two holding companies then acquire each 50% of the listed corporation the two individuals do not have to notify as none of them has the major control of none of the holding companies[130].

b) The unclear dimension of the banks' control

(1) Delegated voting rights

The shareholders do not have to exert their voting rights. As many shareholders see their shares only as a form of capital investment, they are usually only interested in the maximising of the share value and not in issues concerning the governance of the company they hold the shares in. For that reason the presence of shareholders in the Annual General Meeting is low. In 1992 the percentage of shareholders present in the Annual General Meeting of the 24 biggest German corporations with mostly wide-spread shares was 58%[131]. It can be exspected that this number has not changed significantly in the meantime.

The banks' delegated voting rights do not have to be reported. By that, they are not attributed to the banks; § 22 WpHG does not apply . The idea behind that is that it would not be the bank that exerts control by delegated voting rights but the shareholder, as the bank before exercising the delegated voting rights

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[129] If the holding companies were listed, the owners of this holding would have disclose their participations when crossing the threshold of 5%, § 21 WpHG.

[130] Boehmer, Who controls Germany, p.5.

[131] Baums/ Randow, p.145.

has to make a proposal to the shareholder and then stick to that proposal, unless the shareholder has not instructed his bank otherwise, § 135 V, 128 II AktG. But it is at least questionable if this idea really justifies the lack of a disclosure duty as many shareholders are interested only in the increasement of the value of their shares and not in issues of corporate governance. Hence it is alleged that very few shareholders -some estimate the number might be about 2-3%[132]- instruct their bank when authorising it to exert delegated voting rights[133]. By that, the dimension of the control exerted by the banks via delegated voting rights remains relatively unclear.

Even though the bank as a shareholder and its clients as shareholders who the bank represents via the delegated voting rights have in theory the same interest in maximising the value of their shares[134], one has to keep in mind that the bank is not only shareholder but as a stakeholder pursuits also other aims that are not always in the interest of its clients. As providers of loans the banks can e.g. have an interest in having a conservative management in the company that prefers financing by loans and does not follow risky business strategies. With the help of the delgated voting power the banks can pursuit this interest. As *Baums and Randow* stress the banks de facto become loan providers with voting rights and by that can enjoy the advantages of a less risky business strategy without taking the disadvantages possibly resulting from such a strategy for shareholders, i.e. a reduced share value[135].

The system of the delegated voting rights that gives the credit institution a considerable influence on the governance and control of the company has been subject to a lively discussion. *Baums* suggested that credit institutions should only be allowed to exert delegated voting rights if given a special instruction by its clients how to vote for each single item of the agenda of the Annual General Meeting[136]. The votes of shareholders that are not present or not represented in the Annual General Meeting should be exerted by a professional, i.e.paid, *Stimmrechtsverwalter*/ Voting rights administrator, who would be elected by the Annual General Meeting, only auditors could be elected and only if they have not been working for the company within the last

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[132] Adams, p.152.

[133] Boehmer, Who controls Germany, p.4.

[134] Peltzer, p. 26.

[135] Baums/ Randow, p. 150.

[136] Baums/ Randow, proposal for a new legislation, p. 156, § 128 a I AktG.

three years[137]. This voting rights administrator should advise the shareholders before the Annual General Meeting that in the case they are not present or represented by others in the Annual General Meeting he would exert their voting rights, he further would have to explain in which way he intends to vote[138]. The bill for the Transparency and Competition Act provided the same[139]. As this system would have been helpful to represent the shareholders better or if it just led to an artificial activation of votes of those shareholders that are not interested in voting had been questioned.In addition, it seems doubtful that shareholders who are not interested in exerting their voting rights should pay for the services of their representative if they do not give special instructions to their credit institutions that offers this service for free. Neither of the proposals (*Baums*' and the bill fo the Act on Transparency and Competion) have been realized.

But with the NaStraG/ Act on Registered shares and Voting Rights Exersion[140] a new § 134 III 3 AktG now allows a representation of the shareholders by a *Stimmrechtsvertreter*/ Voting Rights Representative nominated by the company, i.e. by the administration. Further details are not regulated, neither on the requirements for the representative, the organisation of the proxy vote nor on the supervision. A further regulation would be necessary to avoid that the company controls itself via the Voting Rights Representatives[141] as within the current legislation also a proxy voting by employees of the company is possible[142]. To avoid conflicts of interests the Regierungskommission Corporate Governance suggested that a proxy vote by

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[137] Baums/ Randow, proposal for a new legislation, p. 157, §§ 135, 135a AktG.

[138] Baums/ Randow, proposal for a new legislation, p. 157, § 135 b III AktG

[139] Bill of a Transparency and Competition Act modifying §128 II, III, 135 I, II AktG, BT-Drs. 13/367, Art.2 Nr.6a, b, 8a. *Baums*' "voting rights administrator" was called "Shareholder representative" in the bill.

[140] Gesetz zur Namensaktie und zur Erleichterung er Stimmrechtsausübung (Act on Registered Shares and Voting Rights Exersion), 18 January 2001, Federal Law Gazette I, 123.

[141] Hirte, p.151, critical: Bachmann, p. 636, who does not see the necessity to regulate the exersion of minority shareholders' voting rights as long as the control is still exerted by the banks and/or major shareholders.

[142] Report of the Regierungskommission Corporate Governance, sign 122.

representatives nominated by the administration should only be allowed if special instructions are given by the represented shareholders[143].

To avoid conflicts of interests between the banks as representatives of the shareholders via delegated voting rights and the same banks as shareholders of the company themselves the KonTraG/ Act on Control and Transparency in Enterprises introduced in § 135 I 3 AktG the limitation that a bank holding a direct or indirect partecipation of more than 5% in the company cannot exert the delegated voting rights unless it has special instructions from its client for every single item of the agenda, but this special instruction is not necessary as long as the credit institution does not exceed its own voting rights. As the percentage of voting rights the banks exert by the delegated voting rights (and indirectly by the investment funds they own) is in general much higher as the one resulting from their own shares, it can be exspected that the banks will chose to exert the delegated voting rights of their clients rather than their own voting rights. It seems doubtful if this restriction will help to mitigate potential conflicts of interests for the banks raising from the various roles they play as representatives of the shareholders, as shareholders themselves, as granters of loans and investment bank because the restriction does not touch the crucial issues themselves, i.e. the potential confict of interest remains as the banks still play the same roles.

(2) Investment fund managing companies

The *Kapitalanlagegesellschaften*/ investment fund managing companies make it even more difficult to disclosure the system of control, as the the law provides exemptions for them. § 10 Ia KAGG/ Act on the investment fund managing companies provides that the voting stock of the investment fund managing company is not attributed to anyone, as § 10 I a KAGG/ Act on investment fund managing companies exempts these companies from the requirements of § 22 WpHG/ Act on Securities Trading. That means that neither the clients of the investment fund managing company nor the banks as owners of the investment fund managing company have to report their stakes.

[143] Report of the Regierungskommission Corporate Governance, sign 122..

It is because of that instance, that *Boehmer* comes to the conclusion that the *Kapitalanlagegesellschaften* / investment fund management companies play the role of making controlling ownership anonymous[144].Most of the time the Kapitalanlagegesellschaften are owned by credit institutions - even though the Social Democratic Party when in parliamentary opposition tried to forbid a participation of credit institutions or insurance companies in investment fund managing companies[145]. The credit institutions do not have to notify because it is alleged that the managers of the investment fund act in the interest of their clients and the clients do not have to notify as they cannot exert control themselves[146]. Questions arise whether this view is justified as the fact that the *Kapitalanlagegesellschaften* are owned by the banks bears the high risk of a conflict of interests within these companies. The *Kapitalanlagegesellschaften* should act in the interest of their clients but it does not seem impossible that they act in the interest also of their parent company, i.e. the bank, for example by buying stocks of a company that is a loan debitor of the bank and has got into troubles to repay the credit[147]. Another example is the possibility of the banks to prevent hostile take-overs by using their Kapitalanlagegesellschaften to make a short-term investment in a large stake of the company. Distribuiting this stake over several *Kapitalanlagegesellschaften* all owned by the same bank, this action has not to be notified as it stays below the disclosure threshold[148].

4. Lack of minority investor protection

a) Major Shareholders Structure within the AG

In the anglosaxon market-based model there is a strong separation between ownership and management. The problem arises that the management

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144 Boehmer, Who controls Germany, p.4.

173 The Bill for a Transparency and Competition Act from 30 January 1995, BT-Drs. 13/367, was brought into parliament by the Socialdemocratic Parliamentary Fraction. It failed.

146 Boehmer, Who controls Germany, p.4.

147 Adams, p. 157.

148 Boehmer, Who controls Germany, p.4.

normally does not only pursue the interests of the shareholders, i.e. the increasing of the shareholder value, but also other own interests. As the market-based model is characterised by a widespread ownership, the single investor sees his shares as a capital investment and is rather not interested in following the business of the mangement as he -holding only a smaller partecipation- has only a limited influence on the government[149]. If the single shareholder is not satisfied with the performance of the management he sells his shares and by that exerts his control. Also the possibility of a hostile takeover helps to discipline the management as the mangement, fearing to be substituted in such a case, will try to keep the shareholder value high to prevent the hostile takeover.

The German bank-based model instead is charecterised by a concentration of major shareholders. The top shareholders are banks that are also stakeholders as they provide bank services to the enterprises. Also other industrial firms and families are involved as major shareholders. Because of that structure it is not so much the problem of the single smaller shareholder who does not have enough influence to control the management, that arises in Germany. As the major shareholders are represented in the Supervisory Boards and as there generally is a smaller number of major shareholders they –at least in theory- can monitore and control each other and by that the management[150]. Still, speaking of this reciprocal control one has to keep in mind the problem of the Deutschland AG, as seen above one should at least question if this system of checks and balances really works.

The main issue in the German model in that field is the problem of the minority shareholder protection. The major shareholders are represented in or at least interlinked with the management and by that have an advantage in information and power over the smaller investors which they could use to the disadvantage of the smaller investors[151]. The problem increases as the smaller private investors normally invest via the investment fund managing companies which are usually bank-owned so it is at least possible that these investment companies do not always act only in the best interest of their clients. In addition, the private investors delegate their voting rights to their depositing

[149] Rudolph, p.2055.

[150] Rudolph, p. 2057.

[151] Rudolph, p.2057.

credit institutions which as shareholder and stakeholder in the enterprise also have own interests in the company.

The predominant position of the banks in the German model led to the consequence that in the German legislation the stress is more on the creditor protection than on the investor protection looking for example at the capital requirements or the accounting standards[152].

b) Personal liability of managers

The personal liabilty of the members of the Executive Board is an instrument to balance the distinction between the interests of the owners and the independence of the Executive Board. The possibilty to make the management liable helps to protect the investors as it has a preventative function even though court decisions in that field are rare. Apart from tort liability (§ 117 AktG / Stock Corporation Act), according to § 93 I AktG the members of the Executive Board are liable to the company (not to the shareholders directly) for intentional or negligently caused breaches of a legal, statutory or contractual[153] duty which has caused a damage to the company. According to § 93 I 1 AktG the members of the Executive Board have to perform the governance as reasonable and careful managers, i.e. not only as well as they personally can but as well as it can be exspected from a good manager. But the court is limited in the ex post examination whether a decision of the management has been taken with the necessary , because the managers have a leeway to take decisions (the so-called business judgement rule)[154]. The members of the Supervisory Board are responsible to the same extent according to §§ 116 I 1, 93 I AktG. As regards the responsability of the members of the Supervisory Boards one has to keep in mind that they do not have to monitore every single measure of the Executive Board but have to intensify the supervision when there is a suspicion for irregularities[155]

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[152] Merkt. p.127.

[153] The members of the Executive Board have duties arising most of all from the Stock Corporation Act, the statutes of tke stock corporatio and the contract they have with the corporation.

[154] Hirte, p.97.

[155] Witte / Hrubesch, p. 726.

The German law makes the enforcement of this instrument difficult, as according to § 112 AktG it is the Supervisory Board that has to sue the Executive Board[156]. Two problems arise from that: First, if the Executive Board has commited faults this very often means that the Supervisory Board has failed to fulfill its monitoring tasks. That might make the Supervisory Board restrain from taking action against members of the Executive Board[157]. The second aspect is, that the two Boards are frequently personally interwoven in the sense that former members of the Executive Board can later on be found in the Supervisory Board[158].

Except from the Supervisory Board itself, the shareholders can decide with the majority of the votes to sue the members of the Executive Board, § 147 I and II AktG / Stock Corporation Act. To protect the minority shareholders, also a minority of shareholders that represents at least 10% of the company's nominal authorized capital has the same right (§ 147 I AktG).

Once the Annual General Meeting has agreed (with the majority of votes or with shares that represent 10% of the share capital) to take legal action against the managers, a minority representing 10% of the share capital or 1 Mio Euro of the share capital can claim that the court shall decide whether to mandate special representatives (others than members of the Supervisory Board) to take legal action, § 147 II 2 AktG. The 10% threshold that is necessary for an agreement of the Annual General Meeting is seen as an obstacle, as it is too high to guarantee minority shareholders' protection, who in addition could restrain from taking action against the management as they fear the high costs and expenses they have to bear if the action was dismissed[159]. The KonTraG / Act on Control and Transparency of Enterprises, in force since May 1998, has strenghened the minority shareholder position insofar as now 5% of the share capital or shares of 0.5 Mio Euro are sufficient to demand to take action against members of the Executive Board, but only if there is a strong suspicion

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[156] Normally, it is the Executive Bloard that represents the company, vis-à-vis the Executive Board the company is represented by the Supervisory Board.

[157] Baums, Corporate Governance, p.7.

[158] As a recent example for the personal relations between the Boards see Juergen Weber, former chairman of the Executive Board of the Lufthansa AG, since 2003 chairman of the Supervisory Board, Der Spiegel 13 / 2004, pp.88-90.

[159] Baums, Corporate Governance, p.9.

that the company has been damaged by dishonesty or considerable infringement of the law or the statute, § 147 III AktG.

The system and the requirements to render members of the Executive and the Supervisory Board personally liabel are about to change. To regain investors' confidence after a series of scandals about manipulated balance sheets and enterprise failures[160], the government presented a bill for a *Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts* (UMAG)/Act on Enterprise Integrity and the Update of the Right of Opposition on the 28th January 2004, which shall be enforced by 2005[161]. With the UMAG the transformation of the proposals of the Government Commission Corporate Governance[162] that has begun with the *Transparenz- und Publizitätsgesetz* (TransPuG)/ Act on Transparency and Disclosure of 19th July 2002[163], was continued[164].The main issues of the UMAG concern a modification of the legislation on the personal responsability of managers towards the company, an alteration of the regulation on the shareholders' rescission rights as well as a modernisation of the requirements for the calling of the Annual General Meeting. As for the personal liability of managers three main alterations are provided by the UMAG: First, the reduction of the threshold for the minority shareholders to render the managers personally liable, second, the modification of the procedures of an action for damages and third, the codification of the

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160 See the Federal Minister of Justice, Brigitte Zypries, who mentions the scandals about Enron and WorldCom in the USA, but also Comroad and Flowtex in Germany, Zypries, p.1.

161 For details about the UMAG see: Martin/ Carrara, Il Sole 24 Ore, 1 August 2004.

162 The *Regierungskommission* (Government Commission) *Corporate Governance*, also called *Baums*-Commission, mandated by the government in May 2000 to analyse deficits of German corporate governance and control and to make proposals for new legislation.

163 TransPuG, 19th July 2002,, Federal Gazette I, 2681.

164 The *Regierungskommission* (Government Commission) *Corporate Governance* made two main prposals: A) Recommendations for a Commission to develop a German Corporate Governance Code, B) Recommendations for the legislator, see Final Report of the *Regierungskommission* (Government Commission) Corporate Governance, BT-Drs. 14/7515 of 14th August 2001. Point A was realised by the mandation of the Commission German Corporate Governance Code, also called Cromme-Commission. Dr. Gerhard Cromme, President of the Supervisory Board of the ThyssenKrupp AG, is the President of the Commision German Corporate Governance Code.

Business Judgement Rule (which until now was recognised in court decisions but not laid down by law).

§ 147a I AktG-UMAG[165] provides that shares representing 1% of the nominal authorized capital (until now 10%) or shares that have a stock market value of 100 000 Euro (until now shares that represent 1 Mio Euro of the nominal authorised capital) are necessary to take legal action against the managers. To facilate the reaching of the necessary quorum, § 127 a I AktG-UMAG provides a platform of communication for shareholders: every shareholder who wants to take legal action can put an advertisement in the electronic *Bundesanzeiger* Federal Announcement Gazette and by that look for other shareholders with the same intention[166].

The procedures of the legal action are changed by the UMAG. The shareholders shall be able to claim damages in their own name for the company (actio pro socio), the representation by special representatives (§ 147 II AktG) is not provided anymore. The legal action is divided in two parts: First, the shareholders have to apply for the admission of the action for damages. According to § 147a AktG-UMAG the action is admitted only if the shareholders were holding their shares before they got to know the break of duties, they demanded in vain that the company itself shall take legal action against the managers fixing a final date until which the company should take the action, there are facts that justify the suspicion that the managers have committed a breach of duties which has caused damages to the company and if such action would not conflict with the best interests of the company. The company has to pay for the cost of the admission procedure only if it was successful, § 147a VI 1 AktG-UMAG. By that the legislator wants to avoid that shareholders take action if there are no adequate reasons for such action.

Apart from the 10% threshold that due to current legislation is necessary for minority shareholders to take legal action, it has been argued that shareholders could restrain from taking action against the management as they fear the high costs and expenses they have to bear if the action was dismissed[167]. To give the shareholders an incentive to try to prosecute their rights if there are

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[165] By "AktG-UMAG" I refer to the alterations of the AktG provided by the UMAG.

[166] The company has to be informed about the advertisement three days before the publication.

[167] Baums, Corporate Governance, p.9.

adequate reasons, the new legislation provides that once the action was admitted, the company has to cover all costs of the procedure even if the action later on is dismissed, § 147 a I VI 3 AktG-UMAG.

When the action has been admitted in the prior proceeding, the intervention of other shareholders in the main proceeding is not possible, as the main action is admitted only for the initial plaintiffs who demanded the admission of the action. The idea behind this legislation is to avoid free riders who want to become a party of the main action only because they see that due to the admission the action promises to be successful and due to § 147a VI3 AktG-UMAG they do not have to fear to be burdened with the costs as even if the main action was dismissed the company would have to cover the costs[168]. Hence, others than the initial plaintiffs cannot be party of the main action, if they want to persecute their rights they have to demand another admission of a damage claim. In this second admission procedure the court will examine again all the requirements of §147a I AktG-UMAG. Especially, the court will have to decide if such new action will not conflict with the best interests of the company, § 147a I Nr. 4 AktG-UMAG. As a rule, there will be a conflict with the best interests of the company as regards the costs the company has to cover for this new main action, unless the new plaintiffs are able to present new important material or new facts, in other words: if it can be seen that the new plaintiffs are only free-riders[169]. The strengthening of the minority shareholders' rights by the planned legislation is deserving. With the rules about the covering of the costs of the procedure a good compromise has been found. On the one hand the shareholders are encouraged to persecute their rights if they really see an adequate reason for an action as than they only bear the risk to pay the costs of the admission procedure, in addition, as the new legislation provides an actio pro socio and abolished the special representatives, the shareholder have a better control on how their rights are persuited as they persecute them in their own name. On the other hand the bill avoids an abuse of this instrument of minority shareholder protectionas the court has to admit the action[170].

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[168] Reasons for the bill of the UMAG, p.37 of the bill, available under www.bmj.bund.de.

[169] Reasons for the bill for an UMAG, UMAG bill, p.37.

[170] Kuthe, p.451, Lenzen/ Kleinert, p. R102.

To mitigate the responsability of the managers and by that to avoid a brain-drain of qualified managers who could chose to work abroad rather than to fear a vast personal responsability § 93 I 2 AktG-UMAG implements the Business Judgement Rule to give the managers the possibility of exculpation. The new § 93 I 2 AktG-UMAG is a codifiction of the jurisdiction of the decisions of the Supreme Court. In the ARAG-case the *Bundesgerichtshof* / Supreme Court decided that the Executive Board has a vast leeway to decide which entrepreneural decision shall be taken[171]. This rule applies to members of the Executive and of the Supervisory Board, §§ 116 s.1, 93 AktG . It is up to the managers to set forth and prove that due to the business judgment rule they are not liable[172].

According to § 93 I 2 AktG-UMAG a manager is not responsable for a break of duty if taking an entrepreneural decision he could assume without gross neglicence to act in the best interests of the company basing his decision on adequate information. This exculpation possibility has five requirements: The measure has to be an entrepreneural decision, the manager has to have acted in good faith, without external influences, in the best interests of the company and on the base of adequate information[173].

A measure is an entrepreneural decision if it is not based on duties according to law, the articles of the company or the contract between the manager and the company but charecterised by prognosises and assessments.

The decision whether the manager acted in the best interest of the company is taken from an ex ante point of view, the manager must have been allowed under the existing cicumstances to assume that he acts in the best interests of the company. The best interests of a company are to increase its returns and competitiveness on a long-term base. The manager shall not persuit others than the company's interests, he is allowed to pursuit his own interests only if he can deduct them from the company's best interests[174]. The government stresses that the bill shall leave a considerable leeway for the manager as he shall still take into consideration "instinct, experience, phantasy and the feeling for future developments, markets and the reactions of consumers and

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[171] Bundesgerichtshof, 21st April 1997, BGHZ 135, 244.

[172] Reasons for the bill for an UMAG, UMAG bill, p.19.

[173] Reasons for the bill for an UMAG, UMAG bill, p.17.

[174] Reasons for the bill for an UMAG, UMAG bill, p.18.

competitors" when taking his decisions[175]. Wheras *Kuthe* sees in the implementation of the business judgement rule only a codification of the status quo in the jurisdiction[176], *Kinzl* is against the implementation[177]. *Kinzl* argues that the new § 93 I 2 AktG-UMAG does not change the existing duties arising for the managers from § 93 I 1 AktG, that demands that the managers have to act with the prudence of a proper and careful manager, therefore the implementation of the business judgement rule should be obsolete[178]. It cannot be denied that the contents of § 93 I 2 AktG-UMAG can be deducted already from § 93 I 1 AktG. But this should not be an obstacle to implement the rule for reasons of clarification. In addition, *Kinzl* stresses the point that the decision which information has to be provided before the entrepreneural decision is also an entrepreneural decision which can be examined in the retrospective only with difficulties, as judges "in general are bad managers", they should not replace the manager's decision by their own[179]. Even though one has to admit that the retrospective examination of the question if the information taken into consideration was adequate will be difficult, there is a need for a juridical examination of the decisions taken, and as the business judgment rule only codifies the existing standard, i.e. as the business rule is already applied by the courts, it is deserving that it found entrance in the act.

c) Hostile takeovers

Hostile takeovers can not only increase the value of the shares and by that are in the interest of the investors. They are also an instrument of control of the management, as the management fears to be substituted in such a case, hence it will try to maximise the value of the shares.

Before the KonTraG / Act on Control and Transparency of Enterprises came into force in May 1998, the statutes of many German stock corporations provided multiple voting stocks or caps on voting rights, most of all to prevent hostile take-overs. By that voting rights and ownership fell apart. For the

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[175] Reasons for the bill for an UMAG, UMAG bill, p.19.

[176] Kuthe, p.451.

[177] Kinzl, p. R003.

[178] Kinzl, p. R004.

[179] Kinzl, p.R 004.

period between 1988 and 1996 there were only 17 hostile take-overs in Germany whereas between January 1985 and June 1996 in the United Kingdom there were 320[180]. One famous example was the case of Pirelli trying to take over Continental in 1990-1993. Eventhough 95% of the shares were widespread and only 5% held by the Deutsche Bank, the take over did not take place, most of all because of voting caps and the building up of a defensive block with a blocking minority (organised by the Deutsche Bank)[181].

The KonTraG abolished the possibilities of multiple voting rights for all and for voting caps for the listed companies, by that it abolished obstacles to the possibilty of hostile takeovers.

In the cases the companies are characterised by a concentration of ownership the possibility of a hostile takeover does not protect the minority shareholders as the decision is not up to them. The use of this instrument in a broader range makes a deconcentration of the ownership structure necessary.

5. Stress on the stakeholder value

a) The nature of the stock corporation

The stock corporation system is characterised also by a separation between the owners of the company, i.e. the shareholders, and the management, i.e. the Executive and the Supervisory Board. § 76 I AktG/ Stock Corporation Act determines that the Executive Board "directs the company under its own responsibility", i.e. it is not subject to instructions of the owners.

It is subject to debate in Germany, if the company is an entity consisting in all groups that hold an interest in it, such as employees, shareholders, creditors and others with the result that the management has to pursuit the interest of all these stakeholders or not[182]. Even following the opinion that does not see the

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[180] Chirinko/ Elston, p.22.

[181] Höpner, p.4.

[182] For more information about this debate see *Hopt*, Directors' duties to shareholders, employees and other creditors: a view from the continent, in: McKendrick (ed.), commercial aspects of trusts and fiduciary obligations, Oxford 1992, 115 ff.

company as an entity of stakeholders, § 76 AktG/ Stock Corporation Act causes a conflict of interests as the owners, i.e. the shareholders are interested to maximise the value of their shares whereas the management is not obliged to pursuit this aim as it is independent. The old AktG/ Stock Corporation Act of 1937 provided in its § 70 I that the Executive Board has to consider the interests of the enterprise, the shareholders, the employees and the public wealth. Even though this explicit list has been abolished , some seem to keep it in mind when interpreting the actual § 76 I AktG. In *Henze* `s point of view the different interests have to be balanced for each single case, normally the interests of the shareholder shall prevail but there are cases in which the management has to give priority to the stakeholders`, especially the employees` interests to save social peace[183]. Others stress the point that the Stock Corporation Act provides a stock corporation that is orientated at the interests of the shareholders with the consequence that in cases of doubt the management has to pursuit the shareholders` and not other stakeholders`interests.

Apart from this debate, in certain aspects the German system puts a stronger stress on the stakeholder than on the shareholder value[184]. This can be seen e.g. by the following circumstances:

b) Bank-company-interlinking

The German system allows a high grade of accumulation of powers in the banks. The credit institutions grant loans to the companies in which they hold (directly or indirectly) big shares of partecipations, it allows the accumulation of the voting rights in the Annual General Meeting (especially via the delegated voting rights by the deposited securities), it provides only moderate restrictions for the membership in the Supervisory Boards[185], the investment fund managing companies are subsidiaries of the credit instituions and the banks run the investment banking business.

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[183] Henze, p.212.

[184] Domanski, p.20.

[185] To prevent a conflict of interests, § 100 II No.1 Aktiengesetz/ Stock Corporation Act provides that a person is only allowed to be a member of up to ten Supervisory Boards.

This predominant position of the banks causes concerns that the decisions taken in the management of the company could often be in favour more of the bank as a stakeholder than of the shareholder value. This fear of the investors that decisions are not taken in their own interest (i.e. to increase the invested capital) but in the interest of others, arises also concerning the investment fund managing companies which are subsidiaries of the banks. To give an example for the fears that the system does not provide the necessary measures to avoid a possible conflict of interests: It seems possible that a bank granting a loan to an enterprise and later facing the difficulties of the borrower to repay the credit, could advise its subsidiary investment fund managing company to buy stocks from the issuing borrower, even if possibly the investment fund managing company would have restrained from acquiring these stocks for its clients. Another scenario that causes concerns is that a bank because of its insider informations wants to sell the partecipations it holds in an enterprise and finds an acquirer in its own investment fund managing company, i.e. in the clients of this funds[186].

c) Co-determination

The corporate law in Germany puts a stress more on the stakeholder than on the shareholder value[187]. One of the most powerful instrument in that aspect is the strong co-determination strengthening the position of employees and trade unions: According to § 1 Co-Determination Act of 1976, in enterprises[188] with more than 2,000 employees 50% of the members of the Supervisory Board are elected by the employees (the other 50% according to common corporate law by the Annual General Meeting), these members of the Supervisory Board have to be representatives of the employees or members of a trade union. This system is called the quasi-parity model because in the rare case of a stalemate in the vote of the Supervisory Board the chairman –who is elected by the shareholders rather than by the employees- has the casting vote, an instrument which in practice is rarely used as it could considerably damage the relation between shareholders , management and workforce[189].

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[186] Adams, AG 1994, p.157.

[187] Domanski, p.20.

[188] Both, AG and GmbH.

[189] Baums, Corporate Governance, p.11.

In enterprises with more than 500 but less than 2,000 employees a third of the members of the Supervisory Board have to be representatives of the employees[190][191].

The Co-determination has been seen as a sign for the intention to keep social peace and to build a middle way between harsh capitalism and strong socialism[192]. But it can be suspected also to have a deterrent effect for investors, as the investors are only interested in an increase of the capital they invested. The representatives of the employees instead could lead the company to pursue other aims. As managers have a propensity to expand firms in ways that do not benefit shareholders but rather favour themselves and the employees[193], a Supervisory Board with a strong representation of employees will support this tendency (at least as the management pursuits the aims of the employees) and will put less stress on the control of the Executive Board concerning shareholder value. It is assumed that co-determination has a second aspect that weakens the attractiveness of investing in stocks: in reaction to the co-determination, i.e. to avoid the influence of the employees, managers and shareholders seem to have kept the Supervisory Board weaker for longer - despite global business changes that led to its strengheneing elsewhere- by infrequent board meetings and poor information flow to the boards[194]. In many German firms the members of the Supervisory Board who are elected by the shareholders meet with the Supervisory Board without the partecipation of the employees`representatives before the formal Supervisory Board meeting. In these informal meetings they tend to discuss the main issues without the evaluation of the employees`reprensentatives to later on build a shareholder/ Executive Board coalition against the employees`reprensentatives in the formal Supervisory Board Meeting. By that the idea of co-determination loses its meaning[195].

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[190] For the coal and steel companies there is a third model of co-determination providing full-parity for workers' representation.

[191] For further details see: Hirte, pp.122-125.

[192] Roe, p.71.

[193] Roe, p.72.

[194] Roe, pp.72, 73, Schiessl, p.596.

[195] Schiessl, p. 596.

The creation of the new legal form of the Small Stock Corporation (*Kleine Aktiengesellschaft*) in 1994 has the intention to simplify the establishment of a stock corporation, amongst other aspects the prescriptions about the co-determination were equalised with those of the limited company / *GmbH*. Still, the fear of the owners of the company to lose control because of the representation of the employees in the Supervisory Board, remains as there are serveral exemptions for the listed stock corporation.

For those who want to invest in the larger listed stock corporations the influence of the employees via the co-determination will reamain to be a an issue of concern, as the co-determination and its economics effects have been extensively discussed and have frequently been seen as detrimental for corporate performance, but due to political reasons the co-determination at present is not questioned by any party in Germany[196].

(1) Excursus: Social Market Economy

The role the state plays in the financial system has to be seen before the background of the economic order. In addition, the idea of the social market economy has an impact also on the corporate law[197].

To understand better the idea that stands behind the co-determination, we have to take into consideration that the economic order in Germany is characterised by the so-called *soziale Marktwirtschaft*. This economic model was developed by Ludwig Erhard[198] and Alfred Müller-Armack and realised from 1948 forth in the Western zones of occupation and later on in the *Bundesrepublik* . It is a synthesis between elements of liberalism, christian social ethics and socialdemocratic ideas. The *soziale Marktwirtschaft* is based on the theory of ordoliberalism developed by the so-called Freiburg school in the years 1930 which main idea is that a functioning and fair competitive order cannot be developed by the powers of the market only, but that the state has to guarantee the functioning of the competition by creating and supervising the

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[196] Baums, Corporate Governance, p.11 with further references.

[197] Gros-Pietro / Reviglio / Torrisi, p.296.

[198] Ludwig Erhardt was Minister of Economics in the Christiand Democratic government of Konrad Adenauer (1949-1963), later chancellor (1963-1966). He is called the "Father of the German economic miracle", i.e. the reconstruction of the economy after the second world war.

rules of the game"[199]. In addition to that, the state has to perform sociopoltical tasks. The state provides the legal framework to establish and maintain a liberal but fair competitive order and intervenes only when necessary. In brief words: as much liberty as possible, as much state as necessary. But the idea of the social market economy goes further, it is not limited to a definition of the role of the state. The idea that stands behind it is that the whole society should work together to reach the optimal balance between free competition and social justice[200].

6. Structure of the Stock Exchange

It seems possible that the structure of the stock exchange has had an influence on the so far –compared with Anglosaxon countries- relatively less developed structure of the capital market in Germany. The German credit institutions, most of all the private banks, have had –at least in the past- considerable influence on the stock exchange favoured by the fact that the stock exchange is run in form of a private stock corporation while the stock exchange itself is a public authority. So is the Frankfurt stock, the most important German stock exchange, run by the Deutsche Börse AG. When established in January 1993 the major banks together hold 81% of all shares, other shareholders were the other seven regional stock exchanges and brokers[201]. It could be exspected that by that the structure and the development of the stock exchange will be influenced by the interests of the credit institutions[202]. Because of that, proposals were made to follow foreign examples and gain more independence at the side of the stock exchange from the banks by running the stock exchange as, for instance, non-profit organisations, or at least to take measures to guarantee a widespread distribution of the shares of the Deutsche Börse AG[203]. Realised was the last idea. The Deutsche Börse AG went public. This changed the structure of ownership. The banks sold their partecipations to a

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[199] Gros-Pietro/ Reviglio/Torrisi, p.296.

[200] Gros-Pietro/ Reviglio/Torrisi, p.296.

[201] Hansen, AG 2003, p.R 198.

[202] Baums, Verbesserung der Riskokapitalversorgung, p.5.

[203] Baums, Verbesserung der Riskokapitalversorgung, p.5.

high degree or -as the Deusche Bank AG- completly[204]. In 2003, 53% of the capital was held by foreigners. The shares of the Deutsche Börse AG are distributed as follows: 80% institutional investors, 18% initial shareholders and 2% others[205]. The Deutsche Börse AG now is one of the blue chips of the DAX 30, in 2002 it performed a return rate of 38,5%[206].

IV. IS THE GERMAN FINANCIAL SYSTEM REALLY CHANGING?

To answer the question if Germany is really on its way from a bank-based to a market-based financial system, one has to keep in mind the characteristics of the bank-based system and look at each aspect seperately.

A. Concentration of ownership ("Deutschland AG")

There seems to be a trend that the major shareholders of the so-called Deutschland AG, i.e. the top shareholders of the most important industrial firms, tend to sell many of the partecipations they hold. The study of *Wojcik* about the ownership structure in German companies comes to the conclusion that especially the financial intermediaries tend to sell their partecipations in the industry, as they are the major shareholders this could be a sign of a deconcentration of ownership. If these are single cases or if it is a permanent trend time will show. It also will be seen if this will lead to a deconcentration of ownership or just to an exchange of partecipations. As shown above it is quite likely that the banks transferred the shares they held in the industry to their own investment fund managing companies. The fact that due to current legislation the net of interlinkings between the major shareholders is relatively intransparent, makes it even more difficult to answer this question.

B. Dependence on bank loans

Within the last years, the structure of financing is changing.

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[204] Schmidt, p. R 53.

[205] Hansen, AG 2003, p.R 198.

[206] Hansen, AG 2003, p.R 198.

1. Changes in the financing strategies of the companies

As an effect of globalization, i.e. of a worldwide liberalisation and deregulation during the last years, the larger Aktiengesellschaften have become less bank dependent by gathering capital from the international financial markets[207], as well as by improving their corporate and intercorporate banking[208]. As a study of the Deutsche Bundesbank shows the dependence on bank loans is declining with the increasing of the size of the annual turnover, i.e. enterprises (all legal forms) with a higher turnover are less dependent on bank-loans than enterprises with a smaller turnover, for example within enterprises with an annual turnover of 50 million Euro or more the share of bank lending of the balance sheet total declined from 9% to 7% in the period between 1990 until 1996, whereas within enterprises with an annual turnover of less than 2.5 mio Euro the share of bank lending increased from less than 32% to more than 39% [209]. Whereas the smaller companies rely on bank loans, for the larger companies the most important instrument of raising external capital are pension provisions, they account for ca. 15% of all liabilities within enterprises with an annual turnover of at least 50 Mio. Euro[210]. But this modell is getting less attractive recently as the life exspectancy of the employees is increasing[211].

An explanation for this distinction in the dependence on bank loans can be found in the theory of the information asymmetries. Between the debitors, i.e. the companies, and the creditors, i.e. the providers of capital, exists an information asymmetry. The capital providers are in need of reliable information about the company. Raising capital from the capital markets demands that the companies provide the informations the creditors need to estimate the risks. This causes high costs. Hence, for the listed Aktiengesellschaften it is easier to raise capital from the capital markets as they are already subject to serveral disclosure duties according to the Act on Stock Corporations and due to the requirements of the securities trading supervision. As the costs of risk assessment is independent from the size of the enterprise the smaller companies are burdened to a higher degree with the costs of this

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[207] Monopolkommission, p.35.

[208] Gros-Pietro/ Reviglio/Torrisi, p.304.

[209] Deutsche Deutsche Bundesbank, Monthly Report 01/2000, p.39.

[210] Deutsche Bundesbank, Monatsbericht 1/2000, p.40.

[211] Monopolkommission, p.36.

assessment[212]. Therefore the companies with a higher turnover are less bank-dependend. Smaller companies finance investments by bank loans as the Hausbank with which they have a long and stable relationship already has the necessary information over the status of the company. The Hausbank can provide bridge loans or allow a deferred repayment if the enterprise gets into a tight liquidity position as it covers the additional costs that arise from that by a surplus in future businesses with the same client[213].

As concerning corporations, i.e. most of all GmbH and AG, another study of the Deutsche Bundesbank conferms that financing by bank loans is dependent on the size of the annual turnover. This study shows that in the year 2000 the share of bank lending of the balance sheet total within corporations with an annual turnover of less than 5 mio Euro was ca. 28% , whereas it was ca. 7% within companies with an annual turnover of 100 mio Euro or more[214].

As both studies of the Deutsche Bundesbank do not relate only to the stock corporations but also to other legal forms, these figures give only a limited answer to the question to what dimension stock corporations substitute bank loans with capital market instruments.

Mediabanca published a study[215] that compares the capital structure of the most important firms in serveral European countries, analyzing those firms whose turn-overs added together represented at least 69% of the country`s GDP in 2002. This study shows that within the most important German industrial firms the quote of financing by bank debts went from 22.9% of the total invested capital in the year 1997 down to 15.5% in 2002. Compared to a market-based model like in the United Kingdom where the quote went from 10.2% in 1997 down to 7.8% in 2002, the dependence of the German firms on the banks is still quite strong, but there is a visible decline. In Italy instead the firms still rely much more on the banks even though also here the percentage of financing by bank debts declined from 37.0% in 1997 to 30% in 2002. Even though the *Mediabanca* study does not explicitly relate to stock corporations it can be assumed that the object of the examination were most of all stock

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[212] Deutsche Bundesbank, Monatsbericht 1/2000, p.40.

[213] Deutsche Bundesbank, Monatsreport 1/2000, p.39.

[214] Deutsche Bundesbank, Monatsbericht 10/2002, p.43.

[215] Mediabanca, p.52.

corporations as the most important industrial firms are organised in the legal form of stock corporations: in 2000, 77% of the 100 biggest German enterprises were organised in the form of an Aktiengesellschaft[216].

Therefore it can be assumed that the German stock corporations tend to be less bank-dependent.

2. Changes in the business strategies of the banks

a) Slowdown of the real economy

As an effect of the recent global economic slowdown the German banks have seen losses on loan and equity portfolios.

The German stock market partecipated until the middle of 2000 in the global cycle of exaggerated price movements. When the equity price bubble bursted, it led to a severe decline in the value of bank and insurance company investment portfolios as well as reductions in turnover in and earnings from products and services associated with the capital market. Some of these reductions were dramatic and occurred primarily in the field of investment banking, on which a number of big banks had previously been concentrating[217].

The profitability of the banks deteriorated further because of the shrinking interest rate margins and the fact that the macroeconomic stagnation in Germany made large value adjustments necessary. As a result the profitability of some large German banks was questioned by the international financial markets and rating agencies.[218]

b) New banking strategies

This development has forced the banks to review their business strategies:

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[216] Hirte, p.21.

[217] Deutsche Bundesbank, Monthly Report 12/2003, p.5.

[218] Deutsche Bundesbank, Monthly Report 12/2003, p.6.

(1) Tightening loan conditions

Borrowing loans the banks have a worse position because of the capital they lost and the worse rating they obtained, they can get capital only under tightened conditions. The consequence is, that the conditions under which the banks lend money to the companies also become much more severe. On the one hand, because the banks want to avoid further losses, taking into consideration also the recently high rate of insolvencies. As a consequences of the continuing recession[219], in 2002 about 37,500 companies became insolvent, i.e.the number is 2.5 times higher than in 1993.[220]. On the other hand, because risky loans lead to a worse rating for the banks. Most of all it is the *Mittelstand*, the smaller and medium-sized enterprises, that suffers from the difficulties to get loans and by that to finance necessary investments. The Basel II Accord that connects the ammount of the own capital with which the bank has to back a loan to the risk profile of the borrower, is seen as another thread to the *Mittelstand*: Basel II feared to make it even more difficult for the *Mittelstand* to get a loan[221], especially for enterprises from risky industries as for example the construction industry. Taking into consideration this problem, the Basel Committee has agreed on facilitations for loans for smaller and medium-sized companies, allowing for example less severe conditions for loans that do not exceed the ammount of 1 mio. Euro (classifying them as retail portfolio)[222]. Still, Basel II is seen as a thread for the German *Mittelstand* .

(2) Selling partecipations

In addition to a reduction of costs by streamlining the branch network, a reduction of the staff and a reorganisation of instruments and structures, the credit institutions tend to sell the partecipating interests they hold in the larger

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[219] Another aspect that led to this considerable increase in the number of insolvencies is that the legislator from dicember 2001 on. has created the possibility to defer the costs of the insolvency proceedings in the case the debtor is not able to procure the necessary means. As many companies used this new legal possibility it has distorted the statistic to a certain degree, see Deutsche Bundesbank, Monthly Report 10/ 2003, p.33.

[220] Deutsche Bundesbank, Monthly Report, 10/2003, p.33.

[221] H.-A. Bauckhage, Wirtschaftspolitische Perspektive eines Bundeslandes, in: Integrierte Finanzdienstleistungsaufsicht, pp. 113, 115.

[222] Monatsbericht 12/03, BMF, p.42.

companies[223], encouraged by the fiscal reform that abolished tax on these capital gains. For example, the Deutsche Bank sold its 34% partecipation in Gerling and its 9.1% share in MG Technologies as well as bigger parts of its shares in Münchner Rück, Allianz and Continental[224]. In addition, the banks become global players[225]. In a recent study *Wojcik* found out that the banks gave up a lot of the direct shares they held in the industry. But he stresses that it is "very likely that ...(the banks) transferred some of their holdings to investment funds and then started managing them as parts of diversified asset portfolios"[226]. This is not proved by studies but the idea is convincing as a selling of the shares on the capital market would not be favourable in a period of low economic performance.

c) Consequences for the real economy

Problems arise for the smaller and medium-sized enterprises, the so-called *Mittelstand*. They still dipend most of all of loans. So far the withdrawal of the private credit institutions could be to a certain degree compensated by a higher grade of engagement from the side of the Sparkassen and co-operative banks[227]. Still, also the Sparkassen become more and more restrictive granting loans. This restraint of the banks hampers the beginning economic rebound, as especially the *Mittelstand* still possesses only relatively small equity resources[228]. This increases the need to be provided with money to be able to prefinance and to invest. The *Mittelstand* has to face more difficulties to borrow money because the costly risk assessment requirements the banks demand in order to grant loans are not worth the smaller enterprises` while[229]. As a survey of the

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223 Deutsche Bundesbank, Monthly Report 12/2003,

224 Handelsblatt, 11 June 2003.

225 See e.g. the acquisition of the British Kleinwort Benson by Dresdner Bank (1995), of the British Morgan Grenfell (1989) and Bankers Trust New York (1999) by Deutsche Bank as well as the acquisition of the British Standard Charter by Westdeutsche Landesbank (1990).

226 Woycik, p.19.

227 Bundesfinanzministerium, Monatsbericht 12/2003, p.41.

228 Deutsche Bundesbank, Monatsbericht 10/2002, p.42.

229 Norbert Irsch of the state owned KFW Bank Group stresses that without taking the necessary risk assessment measures the smaller enterprises de facto are suspended from the granting of loans, FAZ 11 March 2004.

state-owned KFW Bank Group shows, 43% of the enterprises complain about growing difficulties to borrow a loan[230].

A study of he Federal Ministry of Finance shows that it can be exspected that also smaller and medium-sized enterprises could change to finance investments via the capital market, most of all in the off-exchange field as well as via bonds and Asset Backed Securities[231]. Still, the cost factor has to be considered.

For the biggest part of the Mittelstand going public is out of the question: between 72% and 90% of the companies -depending on the survey- cannot imagine going public[232]. The reason for this restraint can be seen in the fear of losing control of the company`s governance, the reservation against disclosure duties as well as tax disadvantages. Many enterprises restrain from converting to the legal form of an AG because they fear to lose control over the governance. Whereas the rules concerning the governance of a limited company, a GmbH, are relatively flexible, i.e. the members of the company can deviate from the prescriptions, the regulation on the AG is strict, according to § 23 V AktG/ Stock Corporation Act, for the sake of investors` protection[233] it is not possible to deviate from the rules. Regarding the governance of the company, the main concerns of losing control when transforming into a stock corporation are caused by the fact that according to § 76 I AktG/ Stock Corporation Act the Executive Board is independend from the owners in its decisions. In addition, if the company exceeds a certain size, the representation of employees in the Supervisory Board within the regulation on the co-determination can weaken the position of the owners. Also capital requirements for going public build an obstacle. According to the Federal Ministry of Finance a going public could be possible for larger and well-established medium-sized companies as well as for companies from innovative sectors, for the biggest part of the Mittelstand the loans will continue to be the most important instrument of financing[234].

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[230] The KFW-Bank survey included 4600 enterprises from 24 different sectors, the survey is available online:
http://www.kfw.de/DE/Research/Sonderthem68/Unternehme.jsp

[231] Bundesfinanzministerium, Monatsbericht 12/2003, p.43.

[232] Bundesfinanzministerium, Monatsbericht 12/2003, p.43.

[233] Hirte, p.42.

[234] Bundesfinanzministerium, Monatsbericht 12/2003, p.43, p.45.

As shown above the bank loan dependence of the enterprises reduces with the size of the enterprise, i.e. with the size of the annual turnover. Therefore it is more the Mittelstand that suffers from the tightened loan requirements. But also smaller Aktiengesellschaft get into financing difficulties.

Therefore it can be assumed that the tightening of the loan conditions will not lead to a considerably increase of IPOs. But it could effect the financing habits of the already listed companies.

As shown above the dependence on bank loans seems to be in decline. Still, German corporations rely more on bank loans than firms in traditionally market-based countries.

C. Control by the banks

Even if the banks tend to sell partecipations they still have control via the delegated voting rights. As shown above the delegated voting rights give the banks great influence on the control of the corporation`s government. The recent introduction of a proxy vote possibility could lead to changes. If this will really be the case time will show, as this instrument is relatively new. The fact that the voting rights representative will be mandated by the corporations' administration and that due to current legislation there is no regulation neither on the requirements nor on the supervision of such a representative, causes concerns. This could lead to the consequence that –as long as the banks' influence on the administration remains as strong as it has traditionally been- the administration either restrains from mandating a voting rights representative or choses a person who acts more in the interest of the (bank-influenced) administration.

D. Reforming the Law on Stock Corporations

Market-based financial systems help to promote innovations more than bank-based systems can do. The technological development and the expansion of the markets favour the security paper form because it is tradable. Germany as a traditionally bank-based system started compared to other nations with a more market-based system relatively late to react to this development. The financial intermediaries are subject to a considerably stress of competition. The aim of

the state is to help the financial enterprises to face the more demanding conditions of competition on the one hand, on the other hand to promote the further development of the whole financial system. This second aspect has a higher priority as it is not in the interest of the the state that deregulation helps the financial intermediaries to delay a structural change. The regulatory set-up is aiming at the following aspects: to guarantee a stability of the financial system as a basic requirement for the trust of the investors, in this light the protection of the private investors is of central importance, to balance the different interests of investors and enterprises, to keep the system flexible to structural changes that should be the consequence of market competition and not of political influence[235].

The aim of legislation should be to provide a framework for governance and control of the companies that makes them strong enough to resist in the growing international competition. Good corporate governance makes the raising of funds on the capital markets easier as it attracts investors. It is for that reason that the Stock Corporation Act is in a permanent state of development. In the beginning of the 1990s the legislator started to change the Stock Corporation Act step by step via serveral new acts. Some do not see this development as a real planned reform but more as a patchwork of legal proposals without a conception of a real change, more as different legal steps realised at the same time only by coincidence[236]. The permanent alteration of the legal framework concerning the Aktiengesellschaft has even been seen as an obstacle to the development of the stock market[237]. Others stress the point that the external economic conditions change slowly and that the reaction of the legislator therefore should be to smoothly change the direction and not to abruptly alter course as the change would include a permanent learning process for all parties concerned[238]. In any case, the improvements reached so far concerning the legal framework have brought the German capital market a big step forward[239]. Especially the abolition of the voting right caps can be seen as

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[235] Monopolkommission, p.15.

[236] Claussen, Aktienrechtsreform 1997, AG 1996, 481.

[237] Claussen, AG 1995, p.163.

[238] Seibert, AG 2002, p.420.

[239] Schiessl, p. 593.

a major improvement as it facilitates the possibilities of take-overs which are also an instrument of control. The pension reform gave an incentive to private old age provision via the capital market. The tax reform stimulated the major shareholders to sell big parts of their shares. The introduction of a proxy vote possibilty could possibly help to mitigate the control powers the banks exert via the delegated voting rights.

New legislative projects have been begun. On 25 February 2003, the Federal government has issued a 10-points-program for the further promotion of the investor protection[240]. This program shall be transformed into law step by step until the end of 2005. Within this framework, the Federal Ministery of Justice has presented on 28 January 2004 a bill for a *Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts (UMAG)/* Act on Enterprise Integrity and the Update of the Right of Opposition[241]. The intention of this bill is, on the one hand, to strengthen the rights of the minority shareholders by extenting the personal liability of managers[242] , on the other hand, to stopp the abuse of the instrument of the action of opposition against the decisions of the general assembly.

Up to now, the traditional instrument of the investor protection has been the action of opposition against decisions of the general assembly. With that instrument, even one shareholder with only one share has been able to block important measures, upon which the general assembly had aggreed. The problem of the so-called "*räuberische Aktionäre*"/ predatory shareholders, who file the suit only to abandon the action when offered a compensation by the company, has increased during the years and has been seen as a local disadvantage of the German market. On the other hand, the instrument of the action for damages against the managers was less developed, due to the high quorum necessary to file the suit. With the UMAG, the focus of investor protection will move from the action of opposition to the action for damages.

Up to now, shareholders can enforce a claim of the company against their managers only if their shares together represent 10% of the company's share capital or 1 million Euro. According to the UMAG , it shall be sufficient

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[240] See: http://www.bundesfinanzministerium.de/dokumente/ix-..17030/Artikel.htm

[241] Available under http://www.bmj.de/media/archive/701.pdf.

[242] For details see above.

to hold 1% of the share capital or shares with a market value of 100.000 Euro. Shareholders who meet these requirements shall be able to file a suit in their own name for the company. This radical reduction of the quorum can be exspected to enable all institutional investors to use this instrument of investor protection and by that to make the German market more attractive.

Also the intention of the UMAG to restrict the possibilities to abuse the action of opposition against decisions of the general assembly, is deserving. In the case of incorrect information by the management of the company, an action of opposition shall only be admissibile, if a reasonable average shareholder would have built his decision on that information. In addition, the UMAG intends to introduce a special urgency procedure to allow the company to record certain important measures in the trade register, even though an action of opposition is pending with a court. This shall be possibile under the condition that either the action obviously has no prospect of success or the interest of the company to set in force the decision of the general assembly prevails.

The UMAG can be seen as a good compromise which strengthens the investor protection and at the same time helps to keep the company capable of acting.

Important steps are taken, others must follow.

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