Industry and Finance in Germany since Unification

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Abstract

Since German unification there have been dramatic and highly visible changes in the German financial system and relations between banks and firms in Germany. The traditional *Hausbank* system has weakened, as securities markets have become more important for both borrowers and savers. The demands of financial investors on how German firms manage themselves have–for better or worse–become increasingly influential in this time. In this article, I advance the thesis that bank-industry relations in Germany became increasingly differentiated, with one set of firms moving into an institutional environment readily characterized as market-based finance. Meanwhile, most German firms remain in a bank-based environment that, while not quite the same as the *Hausbank* model that prevailed at the time of unification, is still easily recognized as such. These changes in the financial system have had numerous consequences for the German economy, including increased pressure on firms to make greater profits and increased pressure on labor to limit wage gains and make concessions in the interest of corporate competitiveness.

Keywords

banks; corporate governance; bank-industry relations; Mittelstand; organized capitalism

German Politics and Society, Issue 95 Vol. 28, No. 2 Summer 2010
doi:10.3167/gps.2010.280208

Introduction

Since unification, there have been dramatic and highly visible changes in the German financial system and relations between banks and firms. While at the beginning of this era the transformation of the German financial system had already begun, it was still much closer to the traditional postwar *Hausbank* model characterized by close bank-firm ties. Today, however, the financial system is characterized by a stronger orientation to securities markets and bank-industry relations have become far more variable. The demands of financial investors and markets on how German firms manage themselves have–for better or worse–become increasingly influential in this time. This transformation has neither been smooth nor continuous. During the 1990s the federal government, along with the financial sector and key industrial firms, promoted the growth of securities markets and an "equity culture" (*Aktienkultur*) among German investors and firms alike. Politicians were hoping to support Germany as a global financial center and to provide German firms with diverse sources of finance, while financial institutions were looking for new sources of profit and to keep up with the transformation going on in the rest of Europe and especially the U.S. Many large industrial firms were happy to reduce dependence on the large banks and turn to new sources of capital. In many respects, the Social Democrats under Gerhard Schröder became even more ardent promoters of an equity culture than the Christian Democrats.[1] In its efforts to foster financial market integration in Europe, the European Union also promoted reforms intended to stimulate market-based finance.

The market crash of 2001 proved to be only a temporary setback in this transformation. Despite some growing misgivings within Germany about the rapid changes in finance, as exemplified most famously by the "locust debate" in 2005 (*Heuschreckendebatte*) over the desirability of private equity investment in firms, the transformation of the financial system marched on. The crisis of 2008/2009 will likely have more effects on German finance, but it is unlikely to reverse the direction of change witnessed over the last two decades. Given that the West German financial system was duplicated in the East after unification, the general contours of change just described apply there as well. Indeed, the process of rapidly privatizing firms in eastern Germany during the early 1990s gave a huge boost to the growth of private equity activity overall.

Since unification the German financial system broadly has moved to a significant degree away from a bank-based towards a market-based finan-

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cial system. In the former, banks provide the overwhelming portion of external capital to firms, often control securities markets that are relatively small, and practice "relationship banking" with firms based on a mutual expectation that the relationship will be long-term and persist through good times and bad. In market-based systems, by contrast, firms utilize securities markets to a much greater degree, banks and firms sustain arms-length relationships based on explicit contracts, and savers direct a greater portion of their assets into the various securities that firms use to finance themselves. While the changes in Germany have been profound, when compared to other leading economies, the country is still notably more bank-oriented. My interest in this article, however, is to analyze the transformation within Germany and its broader implications for the economy. Specifically I advance the thesis that bank-industry relations became increasingly differentiated, with one set of firms moving into an institutional environment readily characterized as market-based finance. Meanwhile, most German firms remain in a bank-based environment that, while not quite the same as the *Hausbank* model that prevailed at the time of unification, is still easily recognized as such.

I start with a simple typology of two ideal-types of firm financing models. The first *Hausbank* model, which embodies the traditional unlisted firm, relies on domestic bank financing, has concentrated ownership, makes little effort to comply with shareholder value principles, and uses national financial reporting and accounting standards. I call the other the "international" firm model. The ideal-typical "international" firm is publicly listed, relies on market finance for its external financing, pursues a shareholder value orientation in management and corporate governance, has dispersed ownership, and utilizes international financial reporting and accounting standards. Between these two is a set of hybrid firms. This type may be a firm that is publicly listed but has concentrated ownership and complies with only some of the international standards and norms on corporate governance. My main empirical contention is that despite all of the changes in the last two decades, the large majority of German firms still falls into the traditional *Hausbank* model, while only a relatively small number closely approximate the international model and a slightly larger number fall into the hybrid category. The economic significance of firms in these last two categories, however, leverages the broader impact of these changes on the general German economic model.

There are two primary firm characteristics that appear to play a major role in determining a firm's categorization: size and ownership (private versus public listing). These characteristics have long distinguished firms

in their financing patterns, but changes in financial markets and other regulations have altogether amplified diversity within the German financial system since the early 1990s.

Some firms have embraced the international model, while others seek to limit financial market pressures by various means such as retaining concentrated ownership, especially by families. Diversity among smaller firms is rooted partly in divergent preferences among them and partly in barriers to their participation in the "international" model. For many modes of market finance they are simply too small (e.g., bonds or even private equity). Mediated financing, whether by banks or other financial institutions, remains the most cost-effective. German Mittelstand firms (SMEs) in some cases also have strongly resisted efforts to force elements of this international model on them. For example, in 2007 when the European Commission attempted to extend the requirement to use international accounting standards to non-listed firms, a groundswell of opposition began with German SMEs that feared it would undermine their traditional reliance on bank borrowing in which owner capital plays a crucial role as collateral. The revolt soon spilled over into the European Parliament and the Commission backed off.[2]

In the next two sections, I provide more empirical material on changing patterns of firm finance and bank-firm relations, first for large firms (the 'international') model and then for Mittelstand firms. The final section discusses briefly the impact on the German economy more generally.

The Changing Context of Large Firms in Germany

The "international" firm model can be characterized by four general features. First, there is a general shift in firm financing from bank to market finance, including international finance. Second, firms are increasingly subject to a common set of rules of financial transparency and sound financial practice. Third, firms are subject to increasingly common corporate governance rules and practices, such as shareholder value, minority shareholder protection, etc. Fourth, firm strategies and restructuring are increasingly subject to influence outside of firm management or corporate insiders, especially by financial market actors (notably institutional investors, hedge, and equity funds), which leads to a more active market for corporate control and restructuring via takeovers, mergers, and acquisitions.

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Changing Patterns of Firm Finance: Shift to Market Finance

For more than thirty years there has been a broad trend toward increasing self-finance and market finance by European corporations, a dynamic that has been most pronounced among larger firms. Federico Galizia[3] shows the percentage of total capital formation self-financed by German firms rising from about 72 percent in the 1970s to more than 86 percent in the 1990s. Across Europe, there is also a shift in corporate finance from loans to marketable securities (notably bonds), though this shift is largely confined to larger firms.[4] Evidence for this can be found in the data on corporate borrowing: from 1989 to 1998, outstanding domestic corporate debt rose from 40 percent to 63 percent of GDP, a reflection of the heavy restructuring by German firms due to reunification and new post Cold War economic conditions. From 1998 to 2005, however, corporate debt declined to 26 percent of GDP, reflecting not only the economic malaise of the early 2000s, but also the shift to market and private equity finance by many firms.[5] That said, banks are still the single most important source of external finance in most European countries, including Germany.[6] In Germany the there has been no clear long-term structural shift in the aggregate from bank loans to securities.[7] When broken down by firm size, however, the picture is different: large firms have always relied much less on bank and external debt than smaller firms, and this divergence has grown over time.[8] It is also the large firms that have turned to international securities markets for borrowing: from 1993 to 2005 international corporate debt rose steadily from 0.3 percent of GDP to 3 percent of GDP—a tenfold rise in little more than a decade.[9]

Changing Rules and Norms of Financial Management

Since unification, there have been numerous market and regulatory developments in Germany and Europe that have considerably increased the external transparency of the financial practices and condition of large firms. Altogether these changes have made many German firms more subject to the influence of external financial market actors, as well as opened the door to increased ownership and influence by non-traditional financial firms such as hedge and equity funds.

In Germany, lawmakers and regulators advanced these developments in numerous steps. In addition to several financial market promotion laws promulgated since the early 1990s, in 1998 the Law on Control and Trans-

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parency in Enterprises (Gesetz zur Kontrolle und Transparenz im Unternehmensbereich, KonTraG) sought to support the growth of securities markets by limiting the influence of banks in firms and instead increasing corporate transparency, management accountability and protection for minority shareholders.[10] The KonTraG made German corporate law among the more shareholder-friendly ones in Europe. For example, it eliminated unequal voting rights and abolished voting caps in shareholders meetings–two features still common in other European Union member states.[11] Also in 1998, the Law to Facilitate Equity Issues (Kapitalaufnahmeerleichterungsgesetz, KapAEG) was promulgated which, among other things, allowed German firms to balance their books using the international (IAS) or American accounting standards.[12] This was a step sought by several large German firms eager to list their shares in New York.

As part of its broad program to modernize corporate Germany, in 2000 the Federal Government passed a corporate income tax taw that made the sale of long-term equity stakes held by large firms and banks in other firms tax free after 1 January 2002. This measure gave further impetus to the already ongoing sell-off of big industrial shareholdings–most notably by the large banks–and large-scale reshuffling of corporate assets.[13] Even before these tax changes, the 1990s had twice the level of mergers and acquisitions as during the 1980s–due in no small part to transactions in eastern Germany.[14] The number of capital ties among the 100 largest corporations declined from 169 in 1996 to 80 in 2000:[15] the percentage of corporate equity held by other German non-financial firms fell from 45.8 percent in 1995 to 32.5 percent by 2003.[16] Banks have also greatly reduced their direct involvement in corporate governance via board representation. In sum, the traditionally tight financial and personal linkages among German firms and banks have been greatly reduced. To be clear, though, many large German firms still have large, long-term shareholders–the difference is that now many also have a large number of institutional and retail investors who are interested in shareholder value.[17]

At the European level, there have also been many Directives passed that have fostered the growth of the international firm model in Germany. More recently, since 2005 the EU has required all listed firms in member states to begin publishing consolidated financial statements in accordance with International Financial Reporting Standards and International Accounting Standards, which were based on fair value or "mark to market" accounting principles. The shift added further pressure on German managers to give greater weight in their decisions to financial profitability.[18] Second, increased transparency and common financial disclosure rules

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were furthered by regulatory changes and listing rules in European stock exchanges during the 1990s. Third, and only recently receiving attention due to the 2008 crisis, is the growing influence of bond rating agencies on corporate financial practices. Any firm that issues bonds or other debt securities is likely rated by at least one of three major bond rating agencies that tend to spread Anglo-American norms about financial practices.[19]

Altogether, common accounting standards, stock listing regulations, and ratings agencies make corporate balance sheets more directly comparable across national settings. Among other things, this facilitates the ability of international investors to compare corporate performance across borders and to apply pressure on firm management. In short, then, German firms following the "international model" are part of an emerging, common global orthodoxy about financial practices and transparency (and the knock-on implications for general management practices).

Corporate Governance Norms and Rules

By the early 2000s, Germany and other European countries had by and large completed a wave of corporate governance reform. Shareholder value as a set of norms and practices has come to be the umbrella concept deployed both in public discourse and management practices to reflect the broad sweep of corporate governance changes. For shareholder value advocates, a central path to its achievement is through enhanced minority shareholder protection, such as rules that prevent or eliminate unequal voting and control rights and strengthened disclosure and transparency rules.[20] Germany, like other nations, has also made efforts to empower supervisory boards to oversee and control managers in the interests of shareholders. Finally, we can point to an increased use of performance-related pay for managers as a common corporate governance trend. The objective of these measures is to make the interests of shareholders and managers coincide by linking managers' remuneration with the performance of the firm through performance-related forms of compensation such as stock options.

The impact of such corporate governance reforms on German firms is quite variable. First, corporate governance reforms have so far had relatively little consequence for the vast majority of small and medium-sized firms, since such firms are not typically listed and the EU has made little effort to change corporate governance rules for SMEs. Even among large German firms, many are relatively unaffected because they have some

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degree of choice in the extent to which they change their corporate governance practices. Like many other nations, Germany regulates corporate governance in part through a voluntary code rather than a full regime of mandatory corporate governance rules. In practice, it is enterprises that are more globally oriented or whose shares are widely held which have generally made the most changes, i.e., have come closest to the "international model."[21] Second, firms have chosen diverse ways to satisfy the corporate governance demands of institutional investors. German firms commonly appease investors through increased transparency of management and company finances, rather than by selling off weakly performing divisions as is common in France.[22] In Germany, corporate reforms also left intact key elements of its traditional corporate governance model such as codetermination and works councils, which are typically viewed as antithetical to shareholder value.[23]

Enterprise Ownership, Control and Restructuring

For much of the postwar period, large firms in Germany were controlled by large blockholders (bank, families, other firms). The control of such "insiders" was also frequently strengthened through a variety of control enhancing mechanisms (CEMs) such as dual voting shares, cross-shareholdings, pyramids, etc. As result of efforts to foster financial market growth and securities markets in particular, various pressures have emerged to reduce blockholding ownership Europe-wide.

Indeed, across Europe there is a notable trend toward the unwinding of cross-shareholdings, most strikingly in the cases of France and Germany.[24] A decline in the role of banks as industrial shareholders is readily apparent in Germany, and non-financial enterprises also have displayed a reduced interest in holding large shares in other companies.[25] Gregory Jackson shows that during the 1990s the proportion of shares held by "stable investors" (banks, insurance firms, corporations, and the state) declined from 60.2 percent to 52.8 percent, while shares held by individuals, institutions and foreigners–who are much more likely to actively trade shares–rose from 39.8 percent to 47.1 percent.[26] The change is greatest among large firms. Of the twenty largest publicly traded firms in Germany, only a quarter have a shareholder with more than a 20 percent stake.[27]

The dispersion of ownership is generally viewed as leading to more pressure on firms to maximize shareholder value–i.e., manage their share prices for maximum gain–and greater influence of outside investors over

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firms. The rapid recent growth of hedge and private equity funds that are taking large stakes in, or buying outright, firms in Germany and then restructuring them, pushes this process even further.

SME Finance in Germany

Germany has long been seen as the paragon of a bank-based financial system and the picture for SMEs generally bears this out. First, Germany historically has had the highest level of bank loans as a percentage of company liabilities. Aggregate corporate borrowing declined dramatically beginning in the 1990s (as elsewhere), but still remains comparatively high.[28] As noted earlier, this decline is accounted for largely by declines in bank borrowing by large firms. Thus, German SMEs are now substantially more indebted than large firms,[29] though bank debt as a percentage of balance sheet totals has remained steady for SMEs since the mid-1990s.[30] Compared to other European cases, bank borrowing by German SMEs has also been composed to a much greater degree of long-term debt, reflecting the long-term *Hausbank* relationship.[31] Trade credits and especially leasing have become important alternative sources of external funds, but bank borrowing is still dominant.[32] Thus, the historic *Hausbank* relationship appears largely intact for SMEs. This stability in bank borrowing and relationship is attributable to a number of factors, including the tax system, the unique character and stability of the banking system marked by the role of strong savings and cooperative banks focused on SME finance, strong public support programs for SME lending, and the strong aversion of SME owners to outside interference and equity.[33]

The low equity ratios of German SMEs compared to large firms and SMEs in other countries suggests that they are relatively undercapitalized.[34] This ratio has been declining for a long time,[35] often precipitating worries over an “equity gap” and reformers’ demands for more private equity investment. In the 1980s and 1990s, public authorities established numerous publicly financed equity funds to address this concern, and also efforts to stimulate the growth of private equity. In the 1990s, equity funds played a small but significant role, especially in the restructuring of eastern Germany. Nonetheless, equity ratios remained comparatively low and thus the potential market for private equity and venture capital in Germany is quite large. Following the general European pattern, private equity did grow dramatically in the late 1990s, declined equally dramatically after the stock market peak in 2001, then rebounded in recent years, making Germany

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the third largest market in Europe.[36] Nevertheless, on a GDP basis Germany remains well behind the UK, France, the Netherlands, and Sweden. In short, despite an apparently higher "need" for external equity, German SMEs are not rushing to it. During the 1990s, there was also a marked trend toward initial public offerings (IPOs) among German firms—a welcome development by government and financial market actors. The number of listed firms in Germany rose from 436 in 1983 to 933 in 1999.[37] The IPO trend was fostered by dynamics in eastern Germany but also the Neuer Markt, created in 1997 to encourage more small firms to go public. But, after peaking in 2000, the number of listed firms began to decline and the number of IPOs dropped back to levels of the early 1990s.[38]

The Meaning of Changing Bank-Industry Relations

How do these changes in bank-industry relations affect the broader German model of organized capitalism? In the comparative capitalisms literature, it is posited that essential complementarities exist between the financial system and other key institutional domains of the economy.[39] In coordinated market economies like Germany, long-term finance ("patient capital")—notably *Hausbank* practices and concentrated ownership—is hypothesized to support production strategies based on long-term relations and investment, as well as incremental innovation.[40] The leading German firms, for example, have long emphasized technical criteria as much as financial ones as a basis for investment decisions.[41] Similarly, traditional German accounting rules enabled firms to amass large hidden reserves that helped managers smooth out fluctuations in reported earnings and thus facilitate long-term investment. The required use of International Accounting and Financial Reporting Standards, along with strengthened financial disclosure rules, greatly reduces the capacity of German firms to engage in such "smoothing," thus forcing them to focus more on shorter-term financial performance measures.[42] The varieties of capitalism school predicts that national capitalisms that mix institutions with different logics—such as short-term market finance with inflexible labor markets—will underperform relative to economies whose institutions uniformly follow either a liberal market or a coordinated logic. In short, to the extent that capital has become less "patient" in Germany, we would predict two outcomes: increased pressure on unions and labor markets for greater flexibility and a reduction in the ability of German firms to engage in long-term cooperation with other firms, whether for research or production purposes.[43] There is ample evidence for the first

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outcome, as attested by the recent literature on German industrial relations. Though to be clear, pressures on the labor market are likely due more to increased product market competition than changes in the financial system.[44] For the second outcome, evidence is still anecdotal.

On one side of this issue stand those who argue that financial system changes are not fundamentally altering the coordinated or organized character of the German economy. In this view, the institutional changes observed in Germany since the early 1990s represent a normal process of adjustment to altered market environments that preserve basic patterns of strategic coordination among firms.[45] Thus, the increased shareholder value orientation of large German firms, for instance, has not undermined codetermination (labor-management coordination) because new complementarities have been generated.[46] The return of booming exports by German firms in the mid 2000s and the comparative resilience of the German economy during the current recession support such a conclusion.

On the other side of this issue are those who argue that the consequences of increased financial market influence are still working their way through the country.[47] While codetermination remains formally intact, its character has shifted to "comanagement" in which labor's goals take second place to those of the corporation.[48] Viewed this way, the rise of private equity and hedge fund investors may also be seen as mechanisms forcing the erosion of the traditional *Hausbank* system for Mittelstand firms as well. If such investors apply strict cost-cutting and profit maximization standards while loading the firm with debt in order to fund the acquisition, then firms may be more likely to disengage from the strategic coordination regimes that have been essential to Germany's advantage in incremental innovation. While there is anecdotal evidence to support this erosion hypothesis, there is also evidence that the German institutional context often modifies the behavior of such investors.[49] At this point in time, resolving this debate requires much more empirical research.

The financial crisis of the late 2000s had major and obvious consequences for Germany in the short term. Over the long-term, however, it is less clear whether the developments of the past twenty years will resume their forward march. A number of the large German banks have been chastened by the huge losses sustained in the crisis and the pitfalls of fancy financial products. Although Commerzbank never went as far down the road toward Anglo-American banking as Deutsche Bank, after the crisis, it strengthened its commitment to more conventional German banking with industry. As elsewhere, the crisis also laid low private equity and activist hedge funds that had relied heavily on bank borrowing to fund their

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acquisitions. Thus the "locusts" are not swarming Germany, at least for a while. Moreover, the effort to create an "equity culture" among German investors has had moderate success at best. That said, there is no way back to the financial industry and bank-industry relations present at the time of unification. Many of the new financial products and opportunities that emerged for banks, firms, and investors since then are still useful, desired, and now embedded in German and European laws and regulations. The persistence of diverse financial models in Germany seems to be the likely future for some time to come.

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