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Corporate Governance in Germany: Recent Developments and Challenges

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Abstract:
The traditional German corporate governance system has developed against the background of a pay-as-you-go pension system and the consensus-oriented German culture. The system that emerged was characterized by influential banks and bank loans being the main source of outside financing for the corporate sector. However, as the economic and regulatory environment changed over the last 25 years, the corporate sector shifted towards more equity financing, and more generally towards more market-oriented sources of finance. Simultaneously, the banking sector saw major transformations and Germany enacted a series of regulatory initiatives to modernize its corporate governance. As a result, the German corporate governance system developed notably with international and minority shareholder gaining influence at the expense of banks and other insiders. While this development – which is strongly influenced by the Anglo-American governance ideal, but does not simply adopt a market-oriented blueprint – is still ongoing, several open issues with room for improvement remain.

Keywords:
[Corporate governance, ownership structure, bank influence, board structure, codetermination, Germany]

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CORPORATE GOVERNANCE IN GERMANY: RECENT DEVELOPMENTS AND CHALLENGES[#]

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Keywords: *Corporate governance, ownership structure, bank influence, board structure, codetermination, Germany*

1. Introduction

Germany, like many other countries around the world, had its share of corporate governance scandals in the 1990s. Cases like those involving Metallgesellschaft in 1993 and Philipp Holzmann in 1999 exposed the need for a public debate of the *traditional* German corporate governance system with its influential banks.

From a governance perspective, banks have traditionally played (at least) a dual role in Germany.[1] As providers of bank loans they were the most important source of external financing, while

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[1] Some commentators argue that banks indeed played a triple role, with proxy voting – on behalf of retail shareholders – as a third role, e.g. Klaus J. Hopt, "Law and corporate governance: Germany within Europe," *Journal of Applied*

the German stock and bond markets long remained underdeveloped. At the same time, the banks were the focal points for the networks of cross-ownership and board linkages that were collectively referred to as *Deutschland AG,* or "Germany Inc."

But this system came under pressure as the economic and regulatory environment changed. More specifically, with the advent of globalization, German economists, policymakers, and business leaders began to sense the need for more market-oriented sources of finance. At the same time, the German banking sector changed, as bank regulation was tightened and the traditional business model of German banks shifted toward internationalization and fee-based services. Finally, in parallel the German regulatory bodies enacted several initiatives designed to encourage the development of market-oriented financing, especially markets for public equity. As a result, the financing of German companies has undergone significant changes during the past 25 years, and the German corporate governance system has changed along with it.[2]

Finance and legal scholars have provided a number of different perspectives on such developments and, more generally, on the relationship between a country's laws and regulations, its corporate financing practices, and its corporate governance system. The dominant view in the traditional law and finance literature suggests that a country's legal setting, which is considered to be influenced by the "origin of law," evolves in ways that end up encouraging competition and market pressure.[3] On the other hand, some legal scholars have reversed this logic by emphasizing the role of market competition in shaping legal and regulatory developments.[4] Drawing on both of these positions, a recent study has proposed a third possibility—that even small and often politically motivated legal changes can fuel market competition that, to the extent it succeeds in bringing about increases in productivity and economic growth, can end up generating pressure for further regulatory reform that is supportive of markets and competition.[5]

In this article, we focus on selected aspects of the development of corporate governance in Germany that we believe provide useful insights into what constitutes a workable, if not, an effective corporate governance system.[6] The first and most important of our insights is that economic competition and

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Corporate Finance, Vol. 27, No. 4 (2015), pp. 8-15. Indeed, Ekkehard Wenger and Christoph Kaserer, "The German system of corporate governance – A model which should not be imitated," in: Stanley W. Black and Mathias Moersch, Ed., Competition and Convergence in Financial Markets – The German and Anglo-American Models (Amsterdam: Elsevier, 1998) estimate that in 1992 banks exercised on average 84 % of voting rights on the shareholder meetings of the 24 largest German largest widely held corporations. We focus on the other two dimensions of bank influence here.

[2] See, for example, the discussion by Wolf-Georg Ringe, "Changing Law and Ownership Patterns in Germany: Corporate Governance and the Erosion of Deutschland AG," *American Journal of Comparative Law*, Vol. 63, No. 2 (2015), pp. 493-538.

[3] Rafael La Porta, Florencio Lopez de Silanes, Andrei Shleifer and Robert W. Vishny, "Law and Finance," *Journal of Political Economy*, Vol. 106, No. 6 (1998), pp. 1113-1155 and Bernard S. Black, "The Legal and Institutional Preconditions for Strong Securities Markets," *UCLA Law Review*, Vol. 48 (2001), pp. 781-855.

[4] Henry Hansmann and Reinier Krakman, "The End of History for Corporate Law," *Georgetown Law Journal*, Vol. 89, No. 2 (2001), pp. 439-468.

[5] See Ringe (2015), cited earlier.

[6] See Ringe (2015), cited earlier.

legal forces may work together to develop and improves a country's governance model.[7] Second, international investors, even institutional overseas investors, can be attracted by a governance system that retains significant "local" characteristics, such as the German system with its two-tier board system with codetermination. Third and last, tax policy can play an important role in the evolution of a corporate governance system.[8]

In the pages that follow, we discuss the growing importance of market-based financing in German corporate finance. We then look at the parallel evolution of the German corporate governance model during the last 25 years. We conclude with a discussion of some major challenges facing that the new German corporate governance model, including board structure and stock market participation.

2. Changes in Corporate Finance in Germany

Traditionally, Germany has been an economy in which companies rely heavily on bank financing, operating with relatively high leverage ratios and making little use of outside equity.[9] On the macroeconomic level, this firm-level behavior was reflected in the structure and size of the German financial market, as, for example, in its relatively thin equity market.[10] But as can be seen in Figure 1, this pattern changed considerably in recent years.

First, the percentage of equity in the capital structures of German industrial (that is, non-financial) companies has increased substantially during the last 25 years. Starting from a relatively low level, such companies have accumulated substantial shareholder funds over the last 25 years, allowing the median non-financial company to increase its equity-to-assets ratio by more than 50%, putting it on a par with companies in other European countries.[11] This significant shift toward equity financing is reflected in the significant increase in the size of the German stock market during this period. For example, by the middle of 2014, the shares of over 700 companies with an overall market capitalization of some 1.2 trillion EUR were being traded on the main German stock exchange, Deutsche Börse Frankfurt. Nevertheless, with only about 9 million individuals with direct or indirect shareholdings representing slightly more than

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[7] Note, that we are very careful with respect to cause-and-effect claims here. Issues of causation as well as corporate social responsibility are beyond the focus of this article.

[8] See Ringe (2015), cited earlier.

[9] Jeremy Edwards and Klaus Fischer, "Banks, finance and investment in Germany," (Cambridge: Cambridge University Press, 1994) and Raghuram G. Rajan and Luigi Zingales, "What do we know about capital structure? Some evidence from international data," *The Journal of Finance*, Vol. 50, No. 5 (1995), pp. 1421-1460.

[10] See the analysis in Asli Demirguç-Kunt and Ross Levine, "Bank-based and market-based financial systems: Cross-country comparisons," Working Paper, Policy Research, World Bank Development Research Group, Washington, D. C (1999) or in Christoph Kaserer and Marc Steffen Rapp, "Capital markets and economic growth: Long-term trends and policy challenges," Research Report, AIMA London (2014).

[11] We acknowledge that some caution is warranted with such a comparison over time and across countries (e.g., Rajan & Zingales (1995), cited earlier for a discussion of problems with the comparison of capital structure ratios). Still, the presented pattern remains robust, if we use standardized balance sheet data as provided by the BACH database maintained by the Banque de France (see www.bach.banque-france.fr and Kaserer & Rapp (2014), cited earlier, for an analysis). Using the BACH database also reveals that the pattern of increasing equity ratios is not limited to publicly listed firms but is also found among SMEs.

10% of the population—as compared to more than 20% in the U.S. and more than one third of the population in Canada—the German stock market is still quite small in relative terms.[12] In what is perhaps the most relevant comparison, the total market capitalization of the German equity markets as a percentage of German GDP was only 46% during the period 2001-2011 period, as compared to 123% in the U.S. and to 75% in the average EU15 country.[13] The economy-adjusted size of the German market lags behind even the average *bank-based* EU15 country of 58%—a group of countries that includes Belgium, Spain, Finland, France, Greece, Ireland, Italy, Luxembourg, Austria, and Portugal as well as Germany.[14]

Second, as can be seen in Panels B.1 and B.2, bank loans have become less important for the German corporate sector not only because companies increased their equity position significantly, but also because of notable increases in corporate bond volumes (which was virtually non-existent 25 years ago). In fact, for companies with listed securities, corporate bonds actually accounted for a larger portion of overall financing than bank loans in the aftermath of the recent financial crises.[15] In sum, the financing of German companies shifted toward equity and, more generally, toward market-oriented sources of finance.

A number of possible explanations for this shift in the financing pattern of German companies have been proposed. The European Commission, for instance, argues in a current commission staff working document that two recent tax reduction acts (the 2001 and the 2008 German TRA) have (1) reduced the historically high debt bias in Germany (e.g., due to a reduction of the historically high corporate tax rates) and (2) increased the relative attractiveness of retained earnings.[16] But even so, citing a recent study, the authors of the EC report acknowledge that the tax effect is only of moderate magnitude and other factors must play a role here as well.[17]

Probably more important in that respect are significant changes in, the business environment during the past two decades. For instance, during the wake of globalization and with the European

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[12] See DAI Factbook 2013 and Paul A. Grout, William L. Megginson and Anna Zalewska, "One Half-Billion Shareholders and Counting-Determinants of Individual Share Ownership Around the World," Working paper, SSRN Working Paper, (2009).

[13] See the analysis of Christoph Kaserer and Marc Steffen Rapp (2014), cited earlier. A similar pattern is observed, when we measure the number of listed firms per 1 mill. persons.

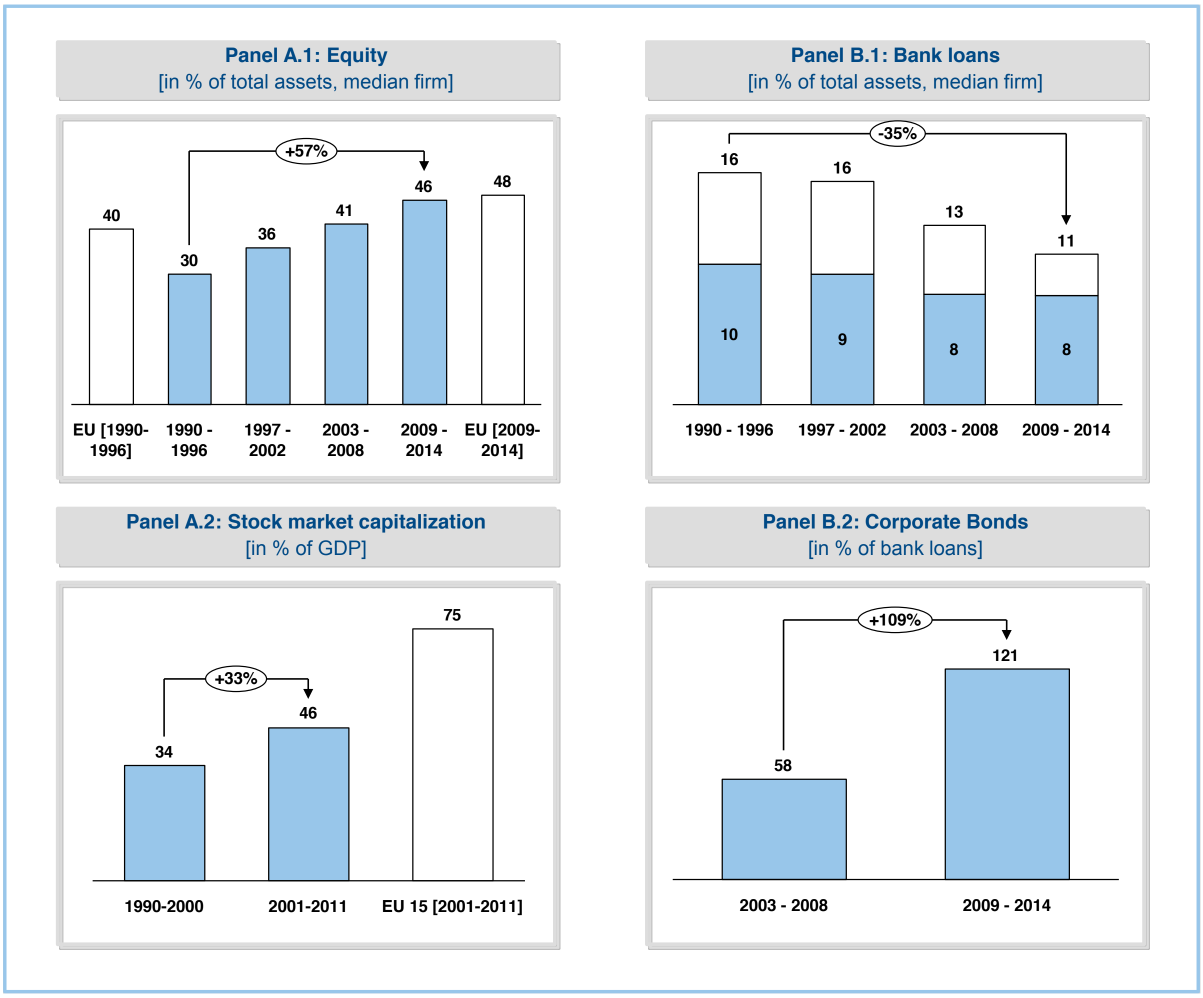
[14] See Demirguç-Kunt and Levine (1999), cited earlier and Christoph Kaserer and Marc Steffen Rapp (2014), cited earlier for this classification. Note, that including Germany in the control group gives a conservative estimate, as it underestimates the difference.

[15] This observation is confirmed by looking at the bond market of Deutsche Börse: comparing the 2000-2006 period to the 2007-2014 period the average number of private sector issuers (bonds by private sector issuers) increased from 142 to 238 (from 6.260 to 11.065). Data as provided by the World Federation of Exchanges (WFE).

[16] European Commission (2015): "Country report Germany 2015," Commission staff working document SWD(2015) 25 final/2, http://ec.europa.eu/europe2020/pdf/csr2015/cr2015_germany_en., March 18,2015. Christoph Kaserer, Marc Steffen Rapp and Oliver Trinchera, "Payout policy, taxes, and corporate insiders: Evidence from the German tax reduction act 2001," *Zeitschrift für Betriebswirtschaft, Special Issue: Corporate Governance, Regulierung und Rechnungslegung*, Vol. 82, No. 5 (2012), pp. 85-114 document that the German TRA 2001 reduced both the propensity to pay dividends as well as the size of dividend payments.

[17] Salvador Barrios, Dimitrios Pontikakis and Sara Riscado, "The great swing in EU corporate savings: does tax policy matter," European Commission Joint Research Centre, forthcoming (2015).

Single Market introduced in 1993, corporate business models became much more international. Indeed, the percentage of international sales of the median German non-financial listed firm increased from one third to roughly one half. In a related development, international competition pushed German firms domiciled in a high labor-cost country towards more innovation. The OECD reports that business expenditures on R&D (as a percentage of GDP) increased by some 20 percent. At the same time, the business environment facing corporations became more unstable and operating uncertainty increased.[18] In sum, the business model of German firms developed in a way that risk-sharing considerations became more important and thus equity finance became more valuable and gained ground at the expense of debt financing.



Notes: The figure illustrates the development of corporate finance in Germany. Panel A.1 refers to of shareholder funds (equity) in the median non-financial capital market-oriented firm's balance sheet (as a percentage of total assets) for firms in Germany (blue bars) over the 1990-2014 period and compares it to their European counterparts (white bars). Panel B.1. refers to bank loans in the median German non-financial capital market-oriented firm's balance sheet (as a percentage of total assets). Thereby, blue (white) bars represent the total assets-weighted mean over all firms (all firms with bank loans larger zero). Panel A.2 reports the development of stock market depth (measured by aggregated market capitalization standardized by GDP) in Germany and compares it to the average EU15 country. Panel B. 2 refers to the average ratio of corporate bonds to bank loans in German non-financial capital market-oriented firm's balance sheet. The analysis in Panel A.1, B.1, and B.2 considers all non-overindebted firms (i.e. firms with positive equity) outside the financial sector for which a minimum of data is available (Revenues, Total Assets, and Shareholder Funds). The analysis for German (European) firms is based on a total of 13,379 (50,061) firm year observations from 1,232 (11,464) firms.
Source: The author's analysis of data as provided by Bureau van Dijk OSIRIS database (Panel A.1, B.1, and B.2) and the Financial Development and Structure Dataset (Version Nov. 2013) (Panel A.2)

Figure 1: Corporate finance in Germany

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[18] Andreas Killi and Marc Steffen Rapp, "Cash holdings and leverage of German listed firms – Evidence from 1992 to 2011," *Betriebswirtschaftliche Forschung und Praxis*, forthcoming.

These changes were accompanied by other noteworthy developments, which also contributed to the shift to market-based financing. One was the series of new regulations governing the banking sector, which effectively made bank loans more costly to corporate borrowers (as well as less profitable for banks). The most important of these regulatory changes were the increases in equity requirements for banks proposed by the Basel Committee on Banking Supervision in their capital frameworks, commonly known as the Basel Accords. Relatedly, with the increasing globalization of the financial service industry, German banks aimed to expand their business model toward internationalization and, in particular, fee-based services.[19][20] At the same time, the introduction of the Euro as a common currency in the Eurozone in 1998 provided the impetus for the development of European bond markets, which up until that point were very thin.[21][22]

Finally, there was another major—also regulatory-driven—contribution to the shift toward market-based financing: a series of initiatives by the German regulator to "modernize" the German corporate governance model, the subject to which we now turn.

3. The Development of the German Corporate Governance Model

The traditional German corporate governance model developed against the background of a "pay-as-you go" pension system[23] and within a consensus-oriented political culture.[24][25] As a result, German capital markets long remained relatively thin, and industrial companies relied heavily on bank loans as their main source of external financing. As a consequence, the banks themselves played a major role in corporate governance and decision-making, exercising (with other "insiders") effective control of such companies in what has often been described as an "insider system."

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[19] See Ringe (2015), cited earlier.

[20] Ramona Busch and Thomas Kick, "Income diversification in the German banking industry," *Deutsche Bundesbank, Discussion Paper Series 2: Banking and Financial Studies*, No. 9 (2009).

[21] Gabriele Galati and Kostas Tsatsaronis, "The impact of the euro on Europe's financial markets," BIS Working Papers, No. 100 (2001).

[22] Hélène Rey, "The impact of a five-year-old Euro on Financial Markets," in: Adam S. Posen, Ed., The Euro at Five: Ready for a Global Role?, (Washington: Institute for International Economics, 2005).

[23] Axel Boersch-Supan and Christina B. Wilke, "The German Public Pension System: How it Was, How it Will Be," Working Paper, NBER Working Paper No. 10525 (2004).

[24] Gerd Strohmeier, "Consensus Politics in Germany Versus Adversary Politics in the United Kingdom? An Evaluation of the German and the Westminster Model of Democracy on the Basis of the Veto Players Theory," *Journal of Contemporary Central and Eastern Europe*, Vol. 14, No. 3 (2006), pp. 229-245.

[25] Geert Hofstede, "Culture's consequences – International differences in work-related values," (Beverly Hills/London: Sage, 1980).

3.1. *Regulatory initiatives to modernize the German corporate governance model*

With the rise of global competition for capital in the early 1990s, the traditional German corporate governance model came under pressure. Authorities became sufficiently concerned about the effects of the traditional system on corporate productivity and competitiveness that they sought to modernize the traditional system. The outcome of such concern and efforts was a series of initiatives that had two main aims:[26] (1) developing (public) capital markets and (2) strengthening corporate governance. The result of such initiatives was a series of developments that have collectively been described by legal scholars as a "permanent corporate law reform."

But let's start by looking at what was troubling German policy makers enough to contemplate such changes. First, shortly after German reunification in 1990, German companies faced historically low sales margins,[27] and the German economy experienced negative GDP growth in 1993. Second, it was the beginning of a global era of privatization, and the German government had plans to privatize some of their largest SOEs entities, including Deutsche Telekom and Deutsche Post. In parallel, there came a series of corporate scandals—including those in Metallgesellschaft in Germany, and in WorldCom and, later, Enron in the U.S.—that fueled a worldwide public debate about corporate governance practices. Third, general concern about the sustainability of the German "pay as you go" pension system led to proposals by economists and policy makers to put the entire system on a sounder footing, including proposals for funded benefit plans. Fourth and finally, with the coming to power in 1998 of the Social Democrats (SPD), the political climate changed and German banks lost much of their political backing.

One major objective of the legal initiatives to reform German corporate governance was to strengthen (minority) shareholder rights. As part of this initiative, provisions were introduced that increased transparency, prohibited the use of multiple classes of voting shares, and regulated insider trading as well as related party transactions. Also, the Federal Supervisory Office for Securities Trading ("Bundesaufsichtsamt für den Wertpapierhandel") was established, which later became part of the Federal Financial Supervisory Authority ("BaFin – Bundesanstalt für Finanzdienstleistungsaufsicht") and is now widely viewed as the German equivalent of the U.S. Securities and Exchange Commission. As a result, shareholders enjoy much broader legal protection than in the early 1990s. Indeed, while in the early '90s shareholder protection was relatively weak in Germany, some researchers now view it on a par with that of other European countries. For example, as summarized in Figure 2, our analysis of data from recent studies suggests that protection of minority shareholders rights and the characteristics of German corporate directors both compare favorably with those of the U.K. as well as Scandinavian companies.[28]

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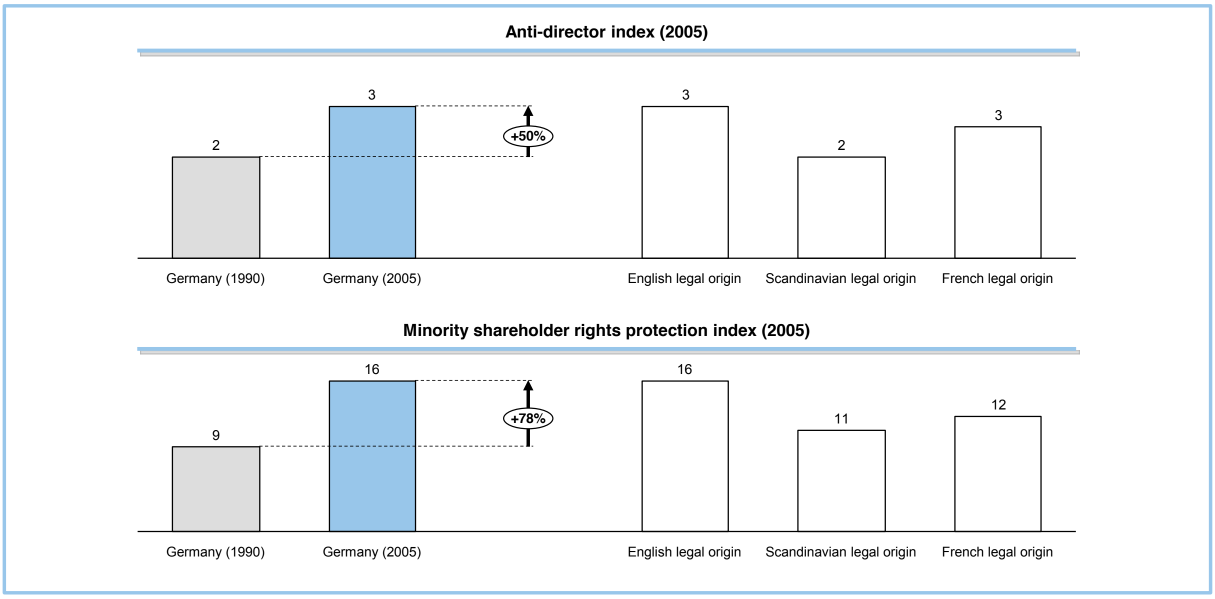
[26] Jürgen Odenius, "Germany's corporate governance reforms: Has the system become flexible enough?," Working Paper, IMF Working Paper, (2008).

[27] Norbert Walter, "Die problematische Scheu vor der Aktie - Der Kapitalbedarf der deutschen Wirtschaft oder wie läßt sich die Finanzierung unserer Wirtschaft besser sichern?," *Der Bürger im Staat*, Vol. 47, No. 1 (1997), pp. 42-47.

[28] See Marina Martynova and Luc Renneboog, "Evidence on the international evolution and convergence of corporate governance regulations," *Journal of Corporate Finance*, Vol. 17, No. 5 (2011), pp. 1531–1557.



Notes: The figure illustrates the development of legal investor protection in Germany over the 1990-2005 period and compares the 2005 state to other European countries, which are clustered according to their legal origin.

Source: The authors's analysis of data reported by Martynova& Renneboog (2011).

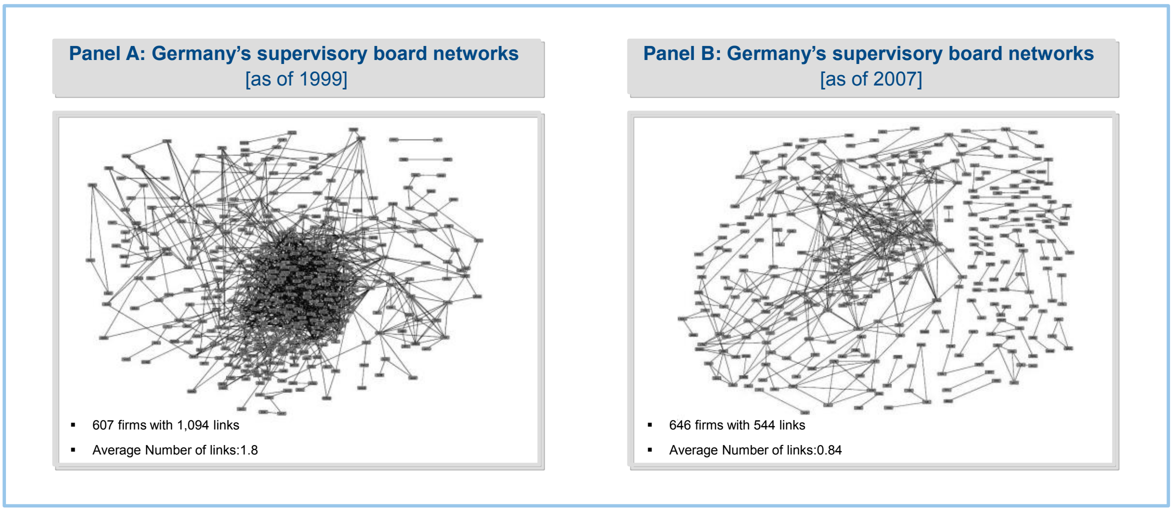
Figure 2: Legal shareholder protection in Germany

A second major objective was to improve internal governance, particularly the functioning and accountability of the supervisory board. With this end in mind, the Corporate Sector Supervision and Transparency Act (KonTraG), the Transparency and Disclosure Act (TransPuG), and other initiatives not only expanded the responsibilities, but also increased the potential liability, of non-executive directors.[29] As a result, the general perception of what it means to serve as a supervisory board member has changed dramatically. Indeed, while in the past it was generally considered merely an honorary post, today membership on a supervisory board is an important post with significant liabilities. To cite just one example, in 1999 Henning Schulte-Noelle, the CEO of Allianz, also sat on nine supervisory boards of other large German companies, including those of Siemens, Dresdner Bank, Thyssen-Krupp, Munich Re, MAN and BASF. But by 2012, when Paul Achleitner took over his post as a chairman of Deutsche Bank, he had to resign from the management board of Allianz, whose statutes no longer allowed executives to simultaneously act as a chairman of another listed company. By this time, the German "old boy" director network made up of executives from financial institution and the companies embedded in their dense web of cross-holdings had been largely dismantled. [30][31]

[29] E.g., Markus Roth, "Corporate boards in Germany," in: Paul Davies, Klaus Hopt, Richard Nowak, and Gerard van Solinge, Ed., Corporate boards in law and practice. A comparative analysis in Europe (Oxford: Oxford University Press, 2013).

[30] Christian Andres, André Betzer and Inga van den Bongard, "Das Ende der Deutschland AG," *Kredit und Kapital*, Vol. 44, No. 2 (2011), pp. 185-216.

[31] Christian Andres, Inga van den Bongard and Michael Lehmann, "Is busy really busy? Board governance revisited," *Journal of Business Finance & Accounting*, Vol. 40, No. 9-10, pp. 1221–1246 document that embeddedness into the network is associated with poor monitoring.



Notes: The figures illustrate the network of directors in German listed firms. Each node represents one firm within the network (i.e. which has at least one director that is simultaneously a director in another listed firm). The sample are all German CDAX-firms, i.e. all firms listed at the German regulated market

Source: Dominik Böhler, Marc Steffen Rapp and Michael Wolff, "Director networks, firm performance, and shareholder base," Working Paper, SSRN Working Paper (2010).

Figure 3: Disappearing director network

3.2. Expanding the investor base

In addition to improving internal governance and strengthening protection for minority shareholders, another major aim of the legal governance initiatives was to broaden the base of shareholders in German companies. But this proved to be challenging for two main reasons.

First of all, German households were then, and continue to be, rather conservative and did not invest heavily in the stock market.[32] Accordingly, in the 1990s the ownership structures of German listed companies were both highly concentrated and interlinked.[33] For example, one study that looked at the ownership structure of 171 large German listed industrial companies in a single year—1990—reported that 85% of those companies had a single shareholder with at least 25% of the voting shares, and that 57% of the companies had shareholders who owned more than half of the voting shares.[34] And for this same sample of companies, the majority of the blockholders that owned more than 25% of the voting shares

[32] One reasons for that may be seen in the traditional German pension system, which is a pay-as-you go system (e.g. Boersch-Supan and Wilke (2004), cited earlier). As a response, the German government enacted a pension reform promoting voluntary private pension supplements that invest partly in capital market-oriented products in 2001.

[33] See Jeremy Edwards, Marcus Nibler, Erik Berglöf and Julian Franks, "Corporate governance in Germany: The role of banks and ownership concentration," *Economic Policy*, Vol. 15, No. 31 (2000), pp. 237-267, Mara Faccio and Larry H.P. Lang, "The ultimate ownership of Western European corporations," *Journal of Financial Economics*, Vol. 65, No. 3 (2002), pp. 365–395, and Andres et al. (2011), cited earlier.

[34] Julian Franks and Colin Mayer, "The ownership and control of German corporations," *Review of Financial Studies*, Vol. 14, No. 4 (2001), pp. 943–977.

were either influential families (in 21% of the cases) or other German companies (in 28% of the cases).[35] The latter resulted in substantial cross-ownership within the German private sector,[36] a situation that not only represented the basis of the so-called Germany Inc., but was considered an obstacle to the efficiency of the private sector by many commentators[37] and, in particular, the Social Democratic Party of Germany.[38]

But to dismantle these networks of cross-holdings, two problems had to be solved. First, the prevailing tax regime created substantial "lock-in" effects, since many of the ownership stakes were acquired many years ago and had increased substantially in value, which then would be exposed to capital gains taxation. To address this problem, the German Social Democrats under Chancellor Schröder enacted a Tax Reduction Act in 2001 that allowed corporations to sell ownership stakes without being taxed on capital gains.[39] The 2001 TRA came at a time when globalization, regulation, and technological innovation were all providing momentum for the idea of economies of scale in the financial industry. And, indeed, financial institutions reduced their cross-shareholdings substantially over the next few years and when they sold their stakes, the networks of cross-ownership largely dissolved.[40] At the same time, the number of board seats held by bankers fell sharply and thus banks gave up the two most important channels through which they had previously maintained their influence over the corporate sector.[41]

The second major problem was to find "new" shareholders not only to replace the banks, but to provide fresh equity capital to the corporate sector. One solution was to attract foreign investors. But here there were other major obstacles—most notably, the limited transparency and non-standard governance features, especially the two-tier board system with codetermination. To address these issues, the

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35 See Caroline Fohlin, "The history of corporate ownership and control in Germany," in: Randall K. Morck, Ed., A History of Corporate Governance around the World: Family Business Groups to Professional Managers (Chicago: University of Chicago Press, 2005) and Julian Franks, Colin Mayer and Hannes F. Wagner, "The origins of the German corporation – Finance, ownership and control," *Review of Finance*, Vol. 10, No.4 (2005), pp. 1-49 for the history of listed firms and their corporate ownership in Germany.

36 While such ownership patterns have been observed in many countries, the German setting was characterized by the fact that financial institutions have been focal. Ekkehard Wenger and Christoph Kaserer (1998), cited earlier, estimate that in 1994 shareholdings of Allianz and Deutsche Bank accounted for at least 8 percent of the gross market capitalization. Similarly, Andres et al. 2011, cited earlier, report that in 1998 Allianz owned (direct or indirect) shareholdings in 35 of the 150 largest German listed firms.

37 Wenger and Kaserer (1998), cited earlier.

38 See the discussion by Karl-Heinz Naßmacher, "Unkontrollierte Macht? Banken als Thema öffentlicher Politik Stellung und Tätigkeit der Kreditinstitute in Deutschland und ihre Kontrolle," *Der Bürger im Staat*, Vol. 47, No. 1 (1997), pp. 3-10.

39 See Courtney H. Edwards, Mark H. Lang., Edward L. Maydew and Douglas A. Shackelford, "Germany's repeal of the corporate capital gains tax: The equity market response," *The Journal of the American Taxation Association, Supplement 2004*, Vol. 26, No. 1 (2004), pp. 73-97, Anke Weber, "An empirical analysis of the 2000 corporate tax reform in Germany: Effects on ownership and control in listed companies," *International Review of Law and Economics*, Vol. 29, No. 1 (2009), pp. 57–66 and Markus Brendel, Bernhard Schwetzler and Christian Strenger," A paradoxon of policy intervention: the case of the German Tax Reduction Act," Working Paper, HHL Working Paper (2015) for examinations of the German TRA 2001, which is often also named GTRA 2000 (e.g. Weber (2009)).

40 See Andres et al. (2011), cited earlier.

41 See, for instance, Ingolf Dittmann, Ernst G. Maug and Christoph Schneider, "Bankers on the boards of German firms: What they do, what they are worth, and why they are (still) there," *Review of Finance*, Vol. 14, No.1 (2009), pp. 35–71.

German Corporate Governance Code (GCGC) was established in 2002. Adopting the "comply-or-explain" design of the Cadbury Report that was published ten years earlier, the GCGC is a "soft-law" initiative with two main goals: (1) to increase disclosure of important governance policies and practices of German companies for international investors; and (2) to provide a framework of internationally recognized best practice rules of corporate governance for the boards of German companies.

Thanks to all these initiatives, corporate ownership of German companies became much more international, and the overall concentration of ownership in German companies was reduced significantly during the last two to three decades.[42]

3.3. *Increasing managerial incentives*

Another important change in German corporate governance has been a significant strengthening of managerial incentives in German companies during the last 20 years. Stock option plans, for example, became feasible for German companies only as recently as 1998 with the passage of the Corporate Sector Supervision and Transparency Act (KonTraG). Since then, the number of firms using stock-based incentives has increased substantially, to the point where almost half of Prime Standard companies now have stock-based incentive systems for their top executives in place.[43] But perhaps providing even stronger incentives for performance, studies have also report a very sharp drop in average CEO tenures, from over nine years in the early 1990s[44] to 5.4 years for the largest 90 listed German companies during the period 2002-2011.[45] At the same time, executives' exposure to liability has been significantly increased.[46] Cum grano salis, incentives for German executives changed considerably towards a more market-oriented situation.

3.4. *No blueprint, but a local solution*

Although many of the above ideas to modernize German corporate governance have been borrowed from the Anglo-American model, the German regulator did not simply adopt a market-oriented blueprint. A number of important *local* features have survived. For instance, as compared to the Anglo-

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[42] For a more detailed analysis see Julian Franks, Colin Mayer and Hannes F. Wagner, "The Survival of the Weakest: Flourishing Family Firms in Germany," *Journal of Applied Corporate Finance*, Vol. 27, No. 4 (2015), pp. 27-35. Deutsche Bundesbank, "Ownership structure in the German equity market: general trends and changes in the financial crisis," *Deutsche Bundesbank, Monthly Report* (September 2014) provides a recent and detailed overview on the aggregate shareholder structure of the German equity market.

[43] Marc Steffen Rapp and Michael Wolff, "Vergütung deutscher Vorstandsorgane 2014," *Fachverlag Düsseldorf*, (2014).

[44] Steven N. Kaplan, "Top executives, turnover, and firm performance in Germany," *Journal of Law, Economics, & Organization*, Vol. 10, No. 1 (1994), pp. 142-159.

[45] At the same time, executives' exposure to liability has been increased, see Klaus J. Hopt (2015), cited earlier.

[46] Klaus J. Hopt (2015), cited earlier.

American tradition, the German law assigns relatively strong rights to shareholder meetings, where important corporate decisions such as equity issuance and distributions of capital get made. Germany also has a distinctive "law of groups" (*Konzernrecht*) that is designed to deal with conflicts between majority and minority shareholders.[47] What's more, although there has been and continues to be considerable debate about the structure of German boards, it remains unique in at least three aspects. First, Germany still has the two-tier board structure with codetermination, which means that labor and trade unions represent 50 percent of the seats on the supervisory board of large companies, and 33% of the boards of medium-sized companies. Second, there is an ongoing debate about the definition of independent directors in Germany. This is mainly due to the fact that not only unions but also founders (and their families) are uncomfortable with their treatment under commonly accepted definitions. Third, any member of a supervisory board, whether elected by shareholders or by employees, is required by law to be committed to the interest of the "corporate enterprise" (only). The GCGC goes even one step further and declares that it "*clarifies the obligation of the Management Board and the Supervisory Board to ensure the continued existence of the enterprise and its sustainable creation of value in conformity with the principles of the social market economy (interest of the enterprise).*"[48] This formulation is notably different from the primary responsibility of U.S. corporate boards to shareholders.

In sum, the German regulatory bodies did not simply copy a market-oriented legal setting, but instead augmented the existing model (with its local features) by introducing shareholder-oriented elements designed to enable market forces to work.[49]

4. Challenges Ahead

Some of the challenges that come along with the changing governance environment outlined above are:

4.1. Diversity of ownership structures and shareholder engagement issues

One major issue faced by regulatory authorities is the considerable variety of firm-level governance structures in German companies. As recently as 2012, two out of five non-financial Prime Standard companies continued to be classified as family firms.[50]

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[47] One key rational for the law of groups is found in the fact, that the German regulator regularly emphasizes the "interest of the enterprise". If a firm is now part of a group of firms and dominated by another firm, the regulator considers the free development of the "interest of the enterprise" to be limited and thus has enacted regulations to deal with these kind of situations. See Hopt (2015), cited earlier.

[48] Indeed, the idea of an "interest of the enterprise" gained again in momentum in the aftermath of the recent financial crises. For instance, while the initial version of the GCGC argued that it "*clarifies the rights of shareholders, who provide the company with the required equity capital and who carry the entrepreneurial risk*", since 2009 the code declares that it "*clarifies the obligation of the Management Board and the Supervisory Board to ensure the continued existence of the enterprise and its sustainable creation of value in conformity with the principles of the social market economy (interest of the enterprise).*"

[49] Ulrich Noack and Dirk A. Zetzsche, "Corporate Governance Reform in Germany: The Second Decade," *European Business Law Review*, Vol. 16, No. 5 (2004), pp. 1033-1064.

[50] Christian G.R. Kohl and Marc Steffen. Rapp, "Family firms and best-practice rules of corporate governance: Evidence from the German corporate governance code," Working paper, Universität Marburg, (2014).

German authorities have adopted two different approaches to deal with this issue: Soft law initiatives and opt-out clauses. On the one hand, the regulator supports the German Corporate Governance Code by a mandatory *comply-or-explain* provision.[51] On the other hand, several regulatory initiatives provide opt-out clauses that allow shareholders to vote (albeit with a minimum of 25 percent of the share capital) on whether or not the firm should comply with a legal regulation. This applies for instance to the disclosure of executive remuneration[52] as well as the cooling-off period for former management board members before joining the supervisory board.

Another issue identified by regulators is the quest for shareholder engagement. On the one hand, there is increasing attention to intensive engagement by hedge and private equity funds that gather stakes that enable them to influence decision making and possibly even gain board seats and some measure of control.[53] This raises questions of minority protection. On the other hand, while the most recent Volkswagen case has triggered intensely negative reactions by large institutions that have announced legal redress actions for corporate wrongdoing and delayed information,[54] some commentators are concerned that investor governance could suffer with the increasing share of international investors and passive (index-oriented) institutional investors engaged in the German stock market. Several approaches have been put forward to mitigate this issue. For instance, the German regulator enacted a voluntary but non-binding say-on-pay regime.[55] Also, the BaFin (the Federal Financial Supervisory Authority) is seen to put emphasis on institutional investors fulfilling their fiduciary duties in terms of voting and engagement. Finally, the Shareholder Rights Directive of the EU, and the increased importance of investor governance included in the 2015 update of the OECD Governance Principles, should also see stronger engagement activity by shareholders.

4.2. *Proxy voting issues*

Another issue that warrants attention with the increasing importance of (international) institutional investors is the growing influence of Proxy Voting agencies, particularly ISS and IVOX/Glass Lewis. Specifically, it makes it mandatory for companies to respond to engagement requests of their shareholders. To facilitate dealing with proxy advisors, the German IR Association (DIRK) has published a guide for IR-managers to illustrate efficient ways of working with them.[56]

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[51] See Hopt (2015), cited earlier.

[52] Christian Andres and Erik Theisen, "Setting a fox to keep the geese – Does the comply-or-complain principle work?," *Journal of Corporate Finance*, Vol. 14, No. 3 (2008), pp. 289-301, study the issue of executive remuneration disclosure in Germany.

[53] Wolfgang Bessler, Wolfgang Drobetz and Julian Holler, "The returns to hedge fund activism in Germany," *European Financial Management*, Vol. 21, No. 1 (2015), pp. 106-147.

[54] For more details about the Volkswagen case see Charles M. Elson, "The Bug At Volkswagen: Lessons in Co-Determination, Ownership, and Board Structure," Journal of Applied Corporate Finance, Vol. 27, No. 4 (2015) pp. 36-42.

[55] Daniel Powell and Marc Steffen Rapp, "Non-mandatory Say on pay votes and AGM participation: Evidence from Germany," Working Paper, SAFE Working Paper No. 107 (2015), study the voluntary say-on-pay regime in Germany.

[56] See Deutsche Investor Relations Verband, "Stimmrechte auf der Hauptversammlung – Empfehlung zur Zusammenarbeit mit Proxy Advisors," https://www.dirk.org/dirk_webseite/static/uploads/IR%20Guide%20Proxy%20Advisor_FINAL.pdf , December 2, 2014.

4.3. *Board quality and corporate culture*

Two issues that received much public attention are the development of proper board structures and how to improve corporate culture.

The question of sufficient board independence is seen as increasingly important by international investors. There is also concern about sufficient business and overboarding. The German Law from 1965 restricts the number of non executive directorships to ten; the German Corporate Governance Code recommends that members of the management board of a listed firm not have more than three outside non-executive directorships (with chairmanships counted double). Still, there are noteworthy exceptions, such as the chairman of ThyssenKrupp and Deutsche Telekom also serving on the supervisory boards of four other quoted companies. Given the increasing number of board and committee meetings due to increasing regulatory pressure and the complexity of the business development, it is hard to imagine that each mandate can get the necessary attention.

The equally important matter of sufficient board diversity has been mainly restricted to the gender issue: in March 2015 a law was passed requiring listed firms (and firms covered by the codetermination law) to establish firm-specific gender quotas for supervisory boards, the management board and the next management levels from 2016 onwards. There are no prescribed quotas but the established percentages must be achieved no later than 2017. However, the top 108 listed firms with at least 2000 German employees and subject to full co-determination must have at least 30 percent females (or males) on their supervisory boards, with these quotas to be achieved by board elections from 2016 onwards. While this is an important step forward toward gender equality, it has been argued that there is at least a temporary lack of qualified females with sufficient business expertise.[57] The gender issue appears to preempt the necessary progress for a comprehensive diversity concept that covers business skills, age, and internationality.

The recent serious governance failures have given rise to a vigorous debate of corporate culture issues. It has become increasingly evident that despite a full set of company specific rules, codes, and other self-regulatory instruments, major governance lapses have occurred that have been attributed to failures of leadership by executives and their failure to instill a thorough grounding in and acceptance of appropriate business ethics by employees.

5. Summary and Outlook

In the wake of globalization, limited economic growth in Germany after unification, a change of power in the German political arena and several EU-initiatives aiming to foster market-based financing, the traditional German corporate governance model came under pressure. In this article, we discuss three parallel developments that have gone hand in hand during the past 25 years: (1) a pro-

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[57] See Christian Strenger and Julia Redenius-Hövermann, "Der Referentenentwurf zur Frauenquote : Kritik und Verbesserungsvorschlag," *Zeitschrift für Corporate Governance*, No. 6 (2014), pp. 266-270 for a critical debate.

nounced shift in the financing of German companies toward more market-based financing sources, in particular public equity financing; (2) the enactment by the German regulator of a series of initiatives (including changes in the corporate tax system) to facilitate market-based financing and to improve corporate governance; and (3) reductions in the concentration of ownership along with a general strengthening of managerial incentives to increase shareholder value.

As a consequence of these changes, German capital markets have developed, and the German stock market has succeeded in attracting international investors and expanded in breadth and depth (as reflected by the increase of total market capitalization as a percentage of GDP by one third when comparing the '90s to the first decade of the current century). To the extent that such markets enable companies to raise public equity and share risks with a broader public, economists tend to view the growth of stock markets as helping to bring about increases in corporate investment and productivity.[58] More specifically, a larger public equity market is expected to provide the corporate sector with both the funding and the incentives to engage in greater risk-taking, leading eventually to more growth in jobs and GDP.

But having recognized the potential role of public equity markets in funding corporate investment, (very) recent developments in the German capital markets have proved somewhat disappointing. For instance, the German equity market has seen a substantial drop in the number of IPOs. For example, during the period 2010-2014, there have only about a dozen IPOs per year.[59] Part of the explanation may be a demand-side issue: The scarcity of German entrepreneurs willing to give up control—a reluctance that is reflected in governance structures of U.S. companies like Google and Facebook, as well as the growing number of "unicorns" —private companies with valuations in excess of $1 billion that have chosen to stay private—in the U.S. But the supply-side may clearly also play a role here. In particular, German households seem to be rather reluctant to engage in equity investment, with only 8.4 million direct and indirect (via funds) shareholders, which actually represents a decline of 4 million from 2001 to 2015.[60] And both reflecting and perhaps contributing further to that status quo is the lack of depth and liquidity in German public markets. The latter - certainly not improved by recent regulatory restrictions for banks holiday trading positions - may well stem from a governance system that is still not sufficiently protective of minority shareholders to attract even more international investors and thus increasing liquidity. To this extent, more attention to strengthening German capital markets and governance is warranted for the future.

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[58] Also, it may allow banks and financial institutions to raise equity that can then be translated into loans to the corporate sector.

[59] See Wolfgang Bessler and Wolfgang Drobetz, "Corporate Finance in Germany: Structural Adjustments and Current Developments," *Journal of Applied Corporate Finance,* Vol. 27, No. 4 (2015), pp. 44-55.

[60] See Deutsches Aktieninstitut, "Studie zu Aktionärszahlen 2014," Deutsches Aktieninstitut, (2014).

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