



Germany's three-pillar banking system from a corporate governance perspective

Money, Macro and Finance Research conference

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Agenda



- ① **Corporate governance systems**
- ② **Corporate governance structure in the German banking system**
- ③ **Structure of the German banking system**
- ④ **Criteria of performance and competition**
- ⑤ **Summary**

1 Corporate governance systems



Anglo-Saxon literature on corporate governance mostly deals with relationship between top management and shareholders of a company

- Task of management
 - Increase equity's (market) value (**shareholder value**)
- **One-tier board** consisting of internal executives and non-executive outside directors
- Separation of management and supervisory boards is not necessary in the Anglo-Saxon corporate governance system since it is shareholder- and capital market-oriented

1 Corporate governance systems



Continental European corporate governance system:

- Balance different interests
- ➔ Separation of management and supervisory boards
- ➔ Supervisory board comprises of major shareholders, employee representatives, representatives of loan granting banks, etc.
- ➔ Main task of management board
 - Act **on behalf of the company**

1 Corporate governance systems



Hirschmann (1970): A stakeholder of a company can react on misguided developments with **objection** or **migration**

→ A stakeholder with short-term migration opportunities by means of, e.g., the labor or capital market is less dependent on objection opportunities than a stakeholder who faces less flexible markets.

Therefore the latter insists on having a voice in the company. Hence this stakeholder embarks on a long-term strategy

→ Design of corporate governance system depends on **time horizon** and opportunities to **reduce risk** in case of misguided developments **via markets**



1 Corporate governance systems

1.1 Shareholders

→ Shareholders as a whole or major shareholders can not sell their shares via the stock exchange at a price equal to the market value.

Without the opportunity of a buy-out, liquidation would be the only exit strategy, with the result that specific investments are only saleable if a sizeable discount is accepted (**sunk costs**)

→ As long as there is no market for buy-outs, control and codetermination rights are needed by shareholders since they have financed specific investments



1 Corporate governance systems

1.2 Loan granting banks

- Lenders, whose loans are short-term or fully collateralised, are hardly threatened in case of misguided developments
- If granted loans are long-term and not provided with full collateral (e.g. if the market for equity is not able to provide the capital needed to the full extent), lenders bear a part of the business risk in terms of default risk because their capital in turn is bounded in specific investments. Thus codetermination and monitoring rights are required
- **Financing structure** of a company and corporate governance system are interrelated



1 Corporate governance systems

1.3 Employees

- Employees, whose knowledge can easily be used in other companies, can quickly find a new employer in a flexible labour market and a company can immediately deploy these employees. No special protection is required for such employees
- Employees, whose human capital is characterised by specific know-how, are not easily transferable to other companies and from the company's perspective these employees are hardly replaceable. Sunk costs may arise for companies and employees
- Investments in **specific human capital** are only taken if they are protected by codetermination and control rights. Otherwise employees would rather acquire general and marketable know-how

1 Corporate governance systems



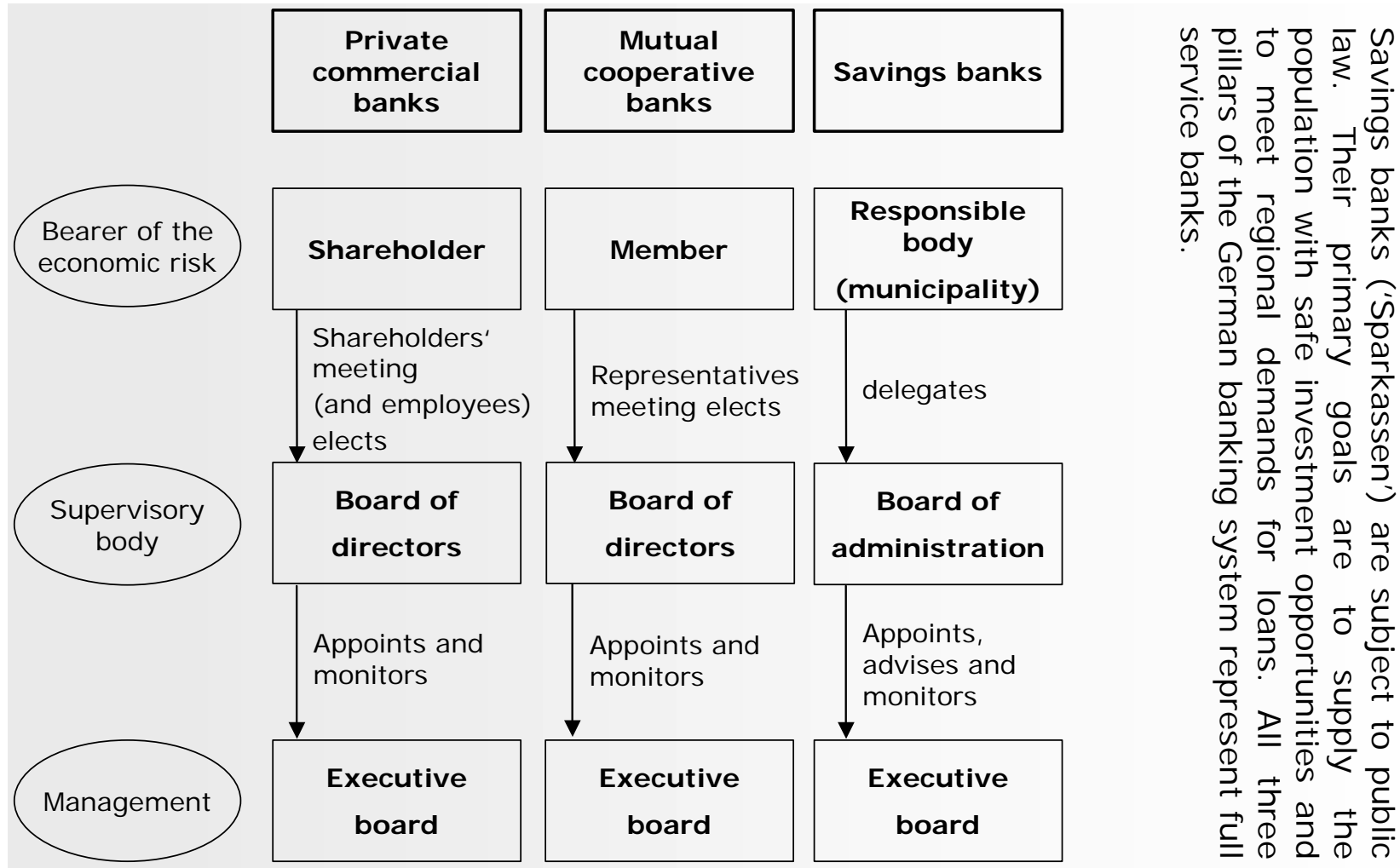
Corporate governance system	Anglo-Saxon system	Continental European system
Business objective	Shareholder value maximization	Corporate interests (stakeholder value approach)
Investment projects	Marketable	Company specific
Time horizon	Short-term	Long-term
Protection mechanism	Flexible capital and labour markets	Codetermination and control rights

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2 Corporate governance structure in Germany



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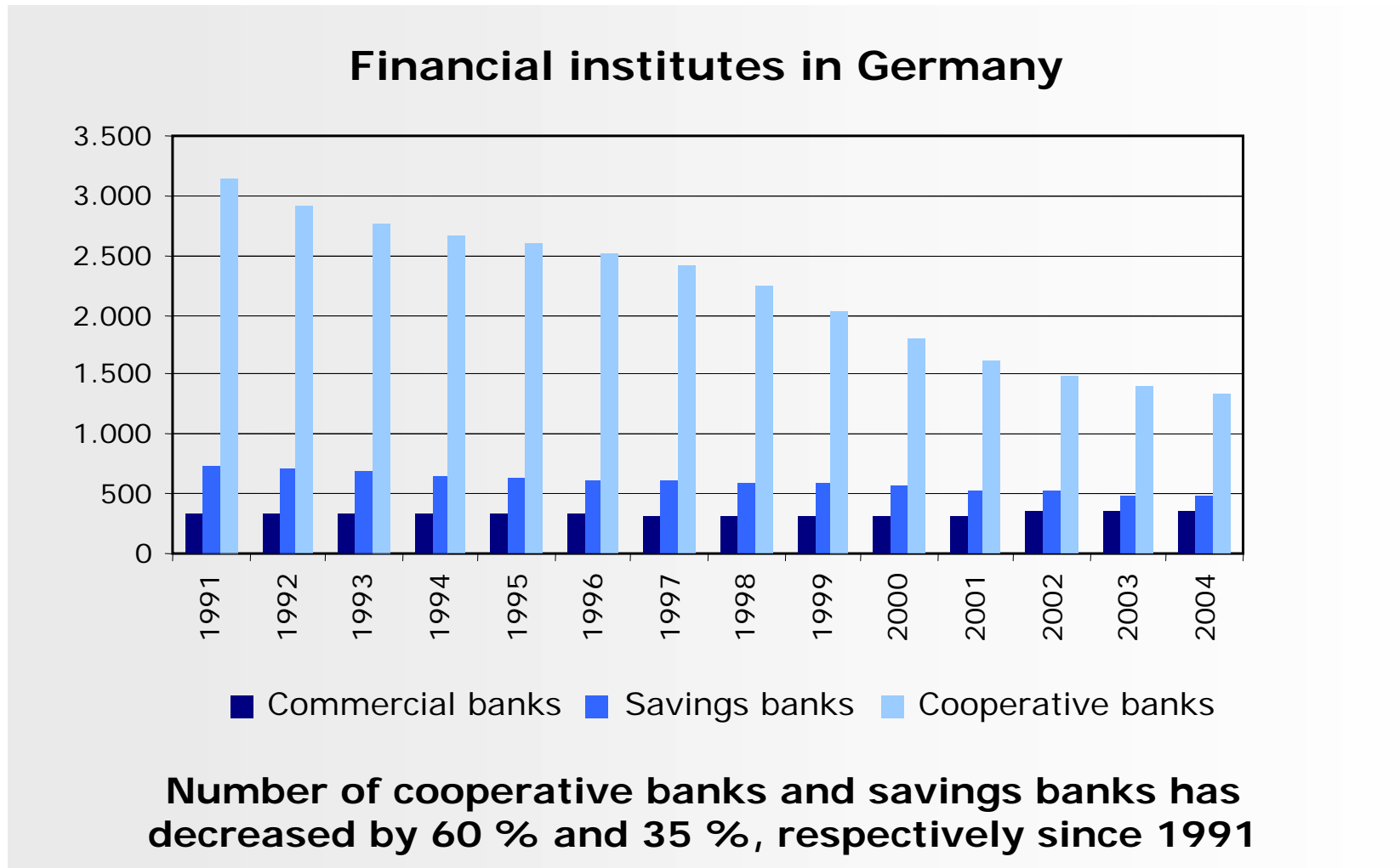


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3 Structure of the German banking system



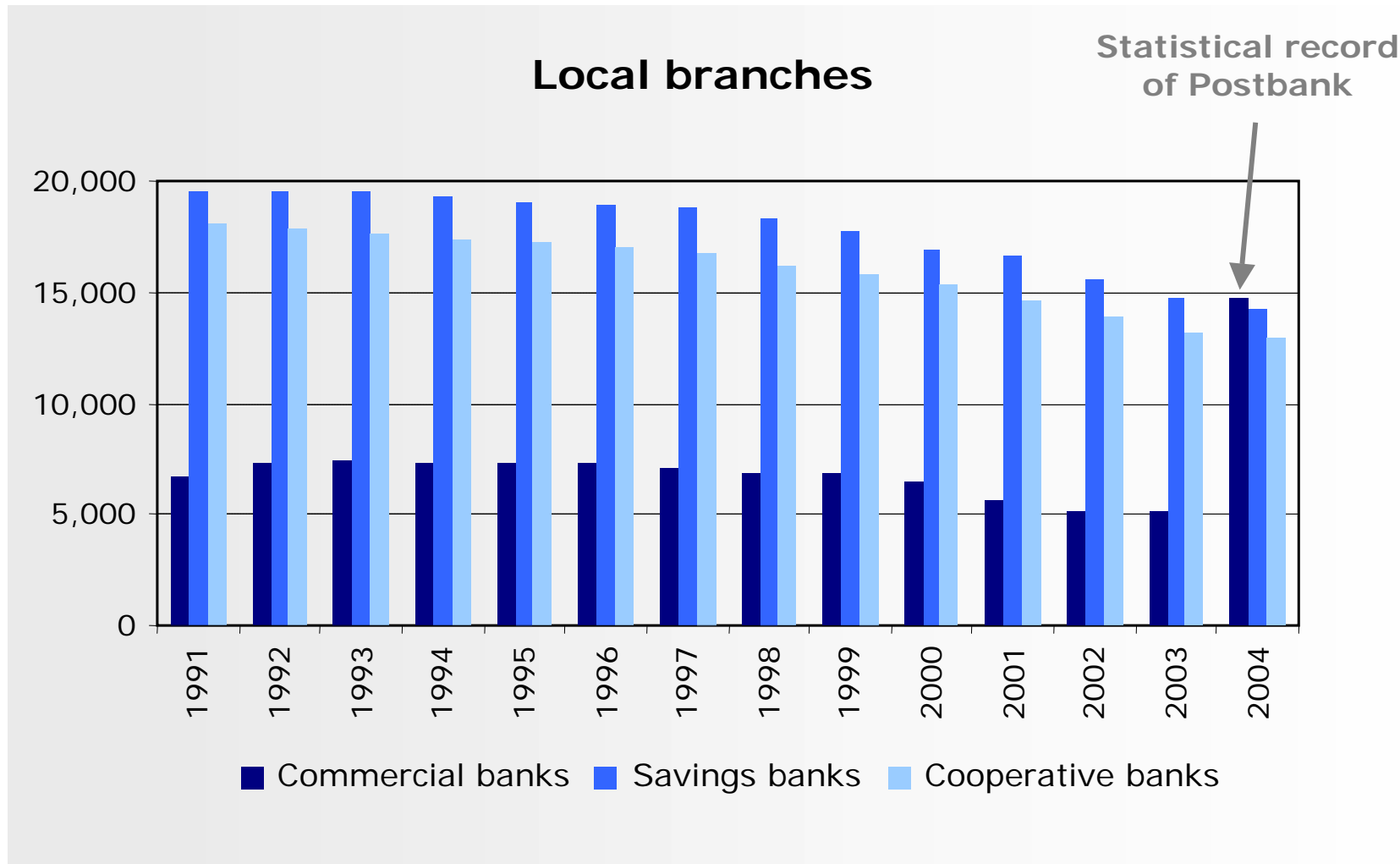
3.1 Consolidation in the German banking business



3 Structure of the German banking system



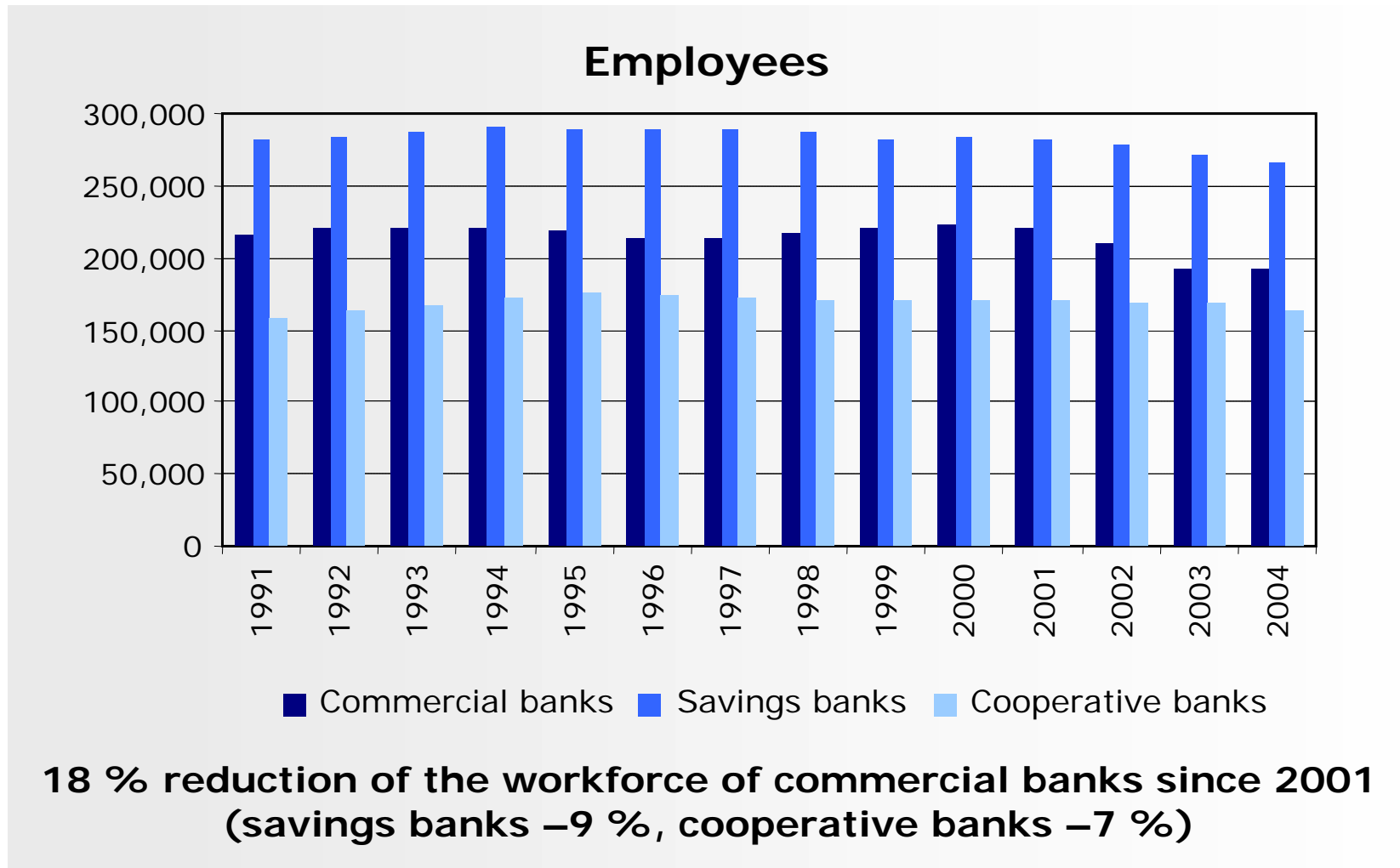
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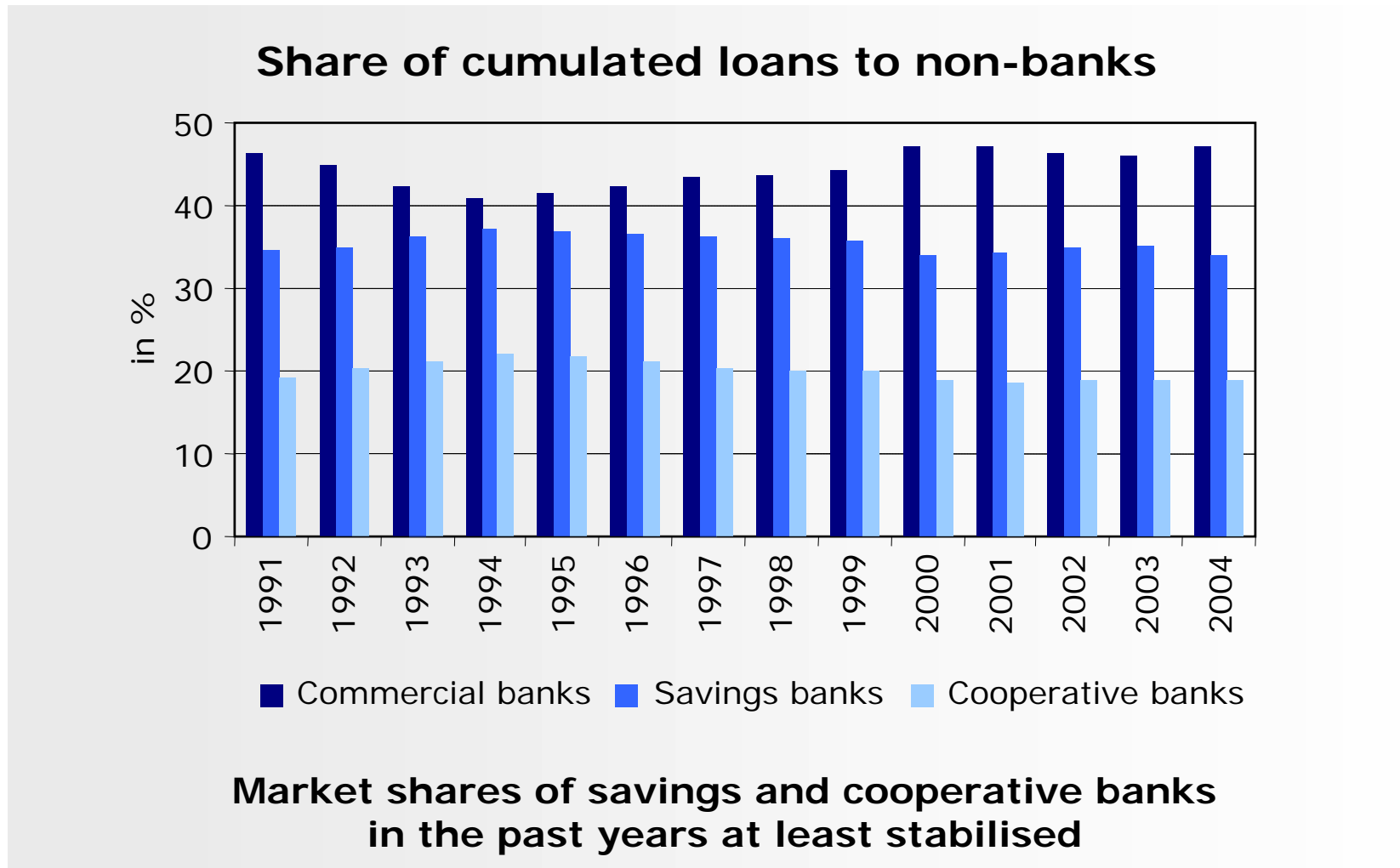
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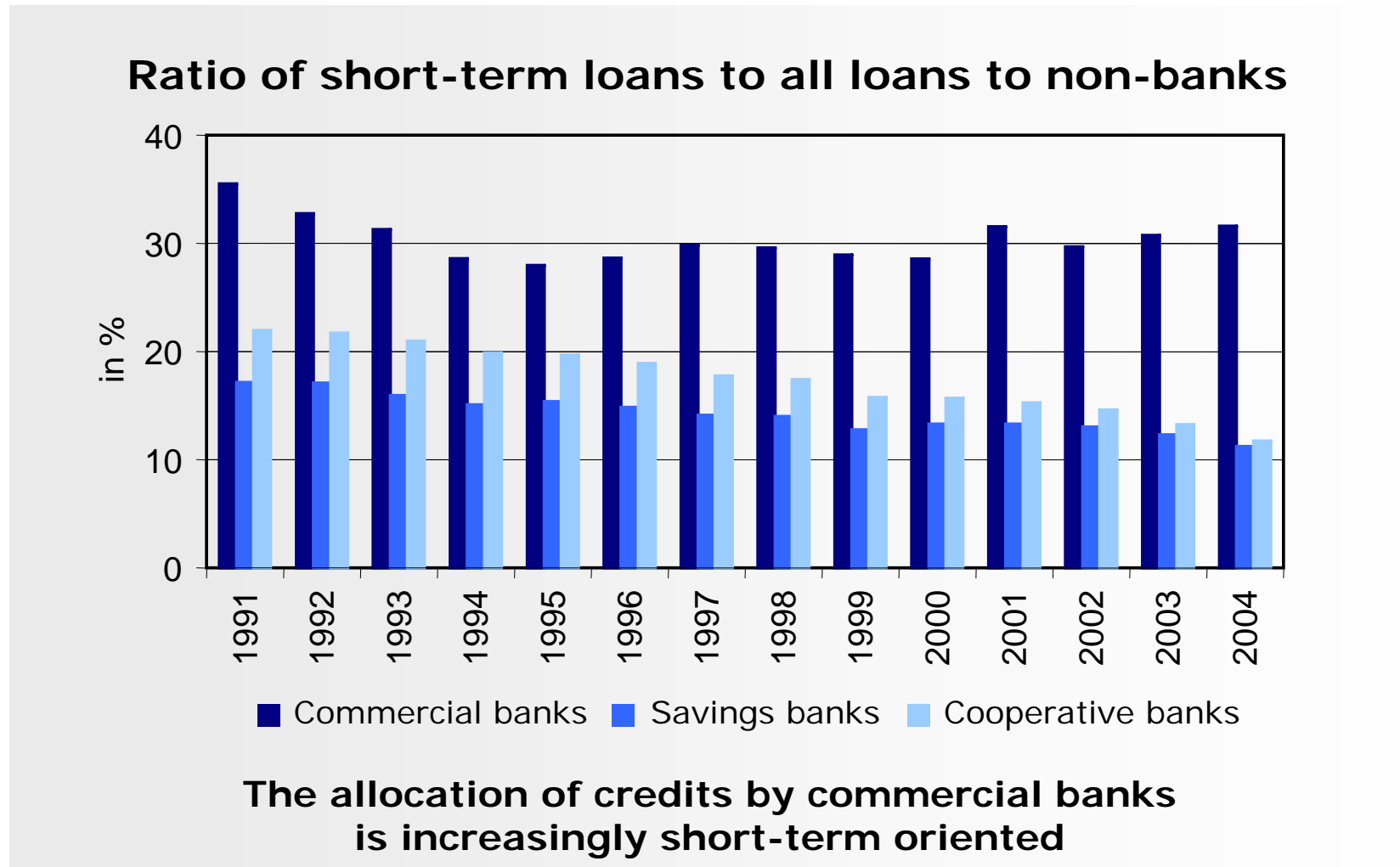
3.2 Loans to non-banks



3 Structure of the German banking system



3.2 Loans to non-banks



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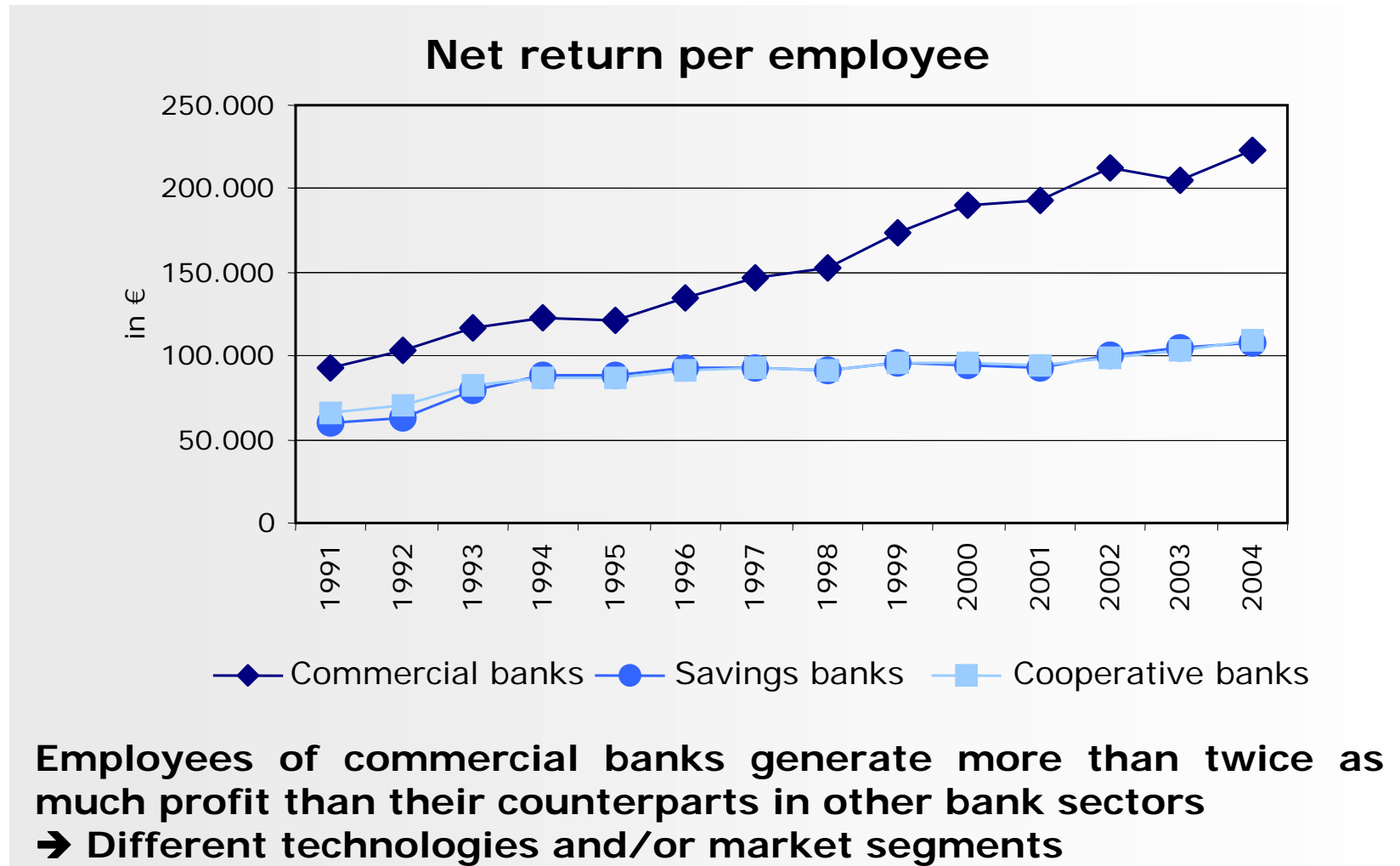


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4 Criteria of performance and competition



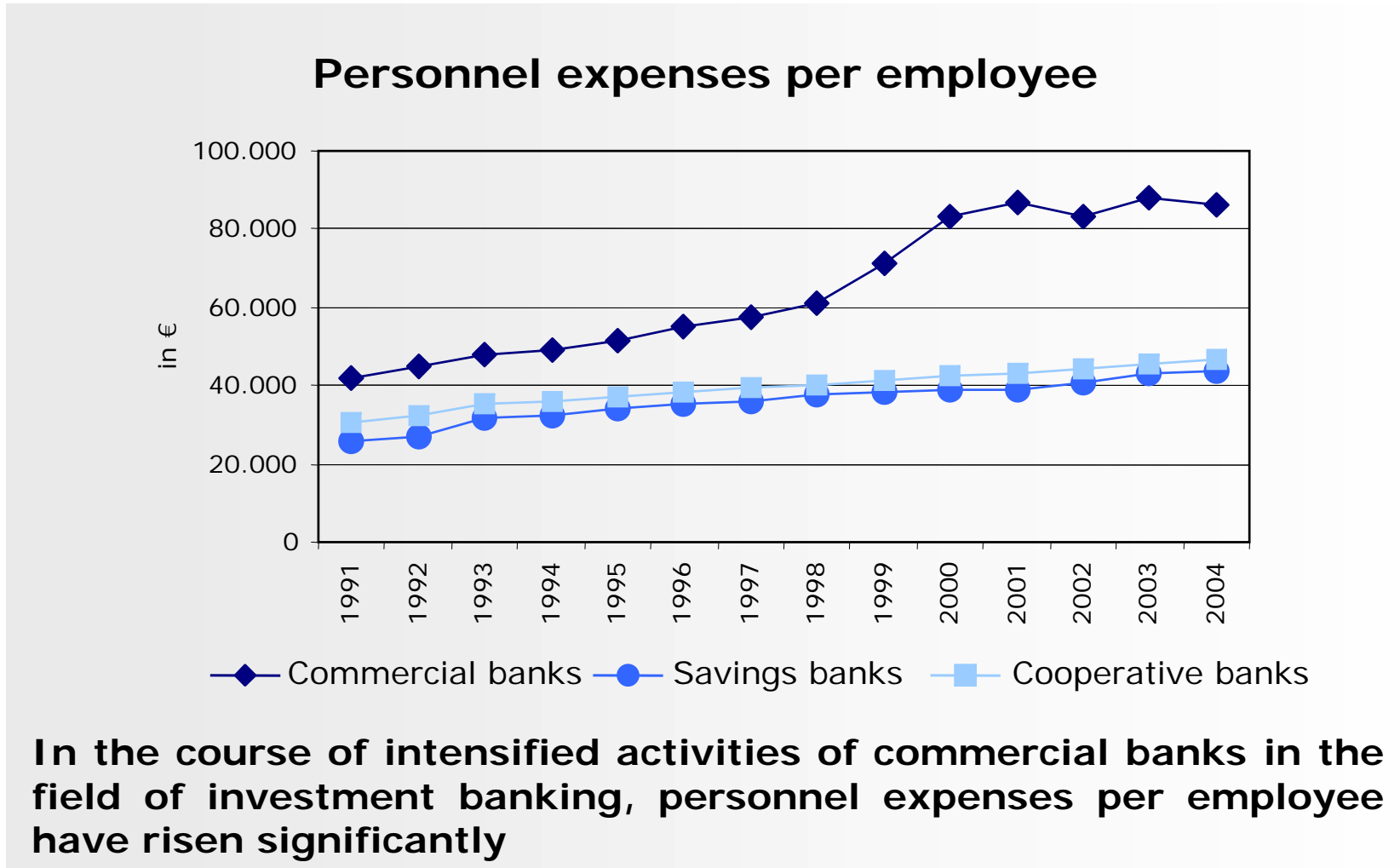
4.1 Workforce-oriented ratios



4 Criteria of performance and competition



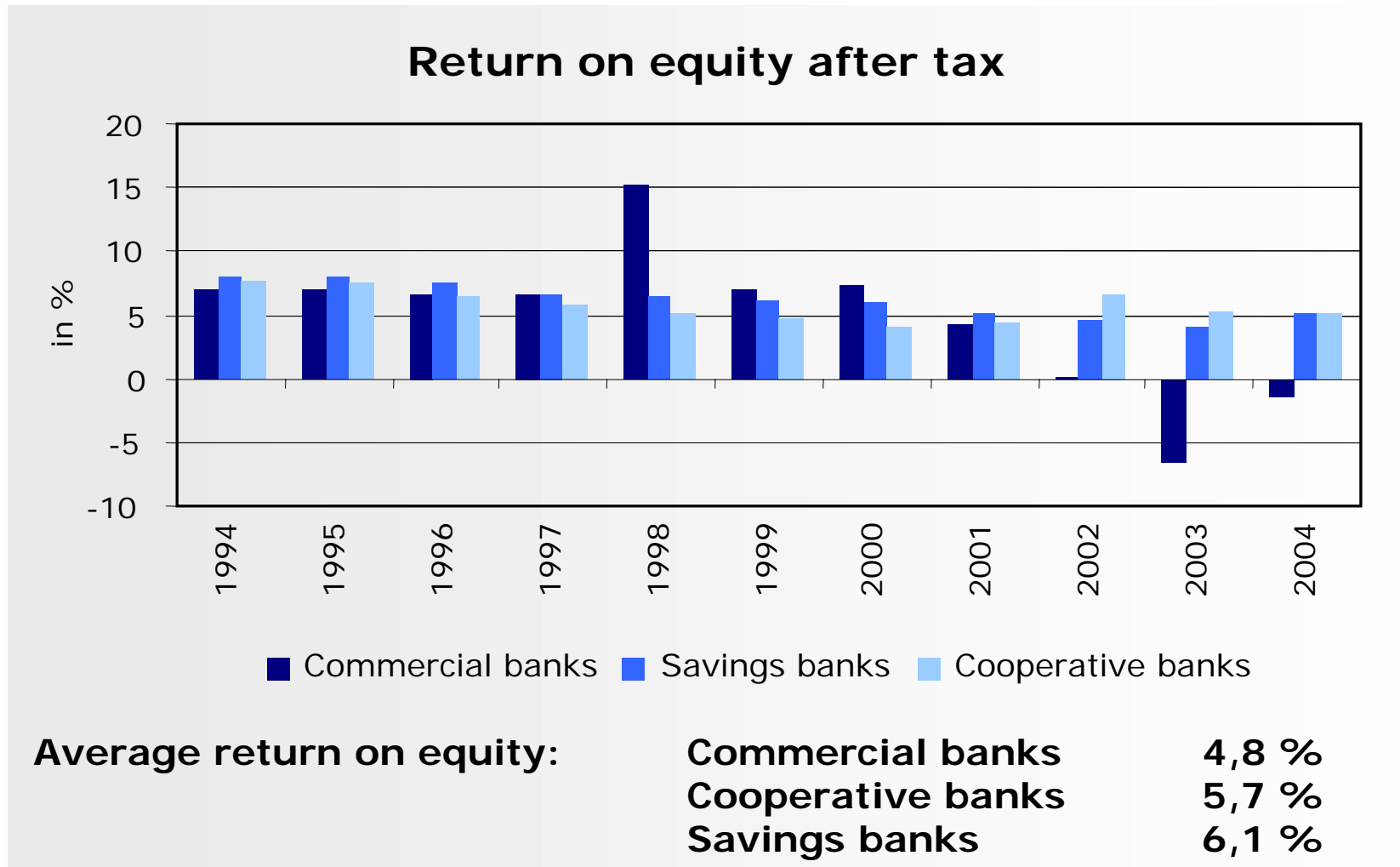
4.1 Workforce-oriented ratios



4 Criteria of performance and competition



4.2 Cost of capital

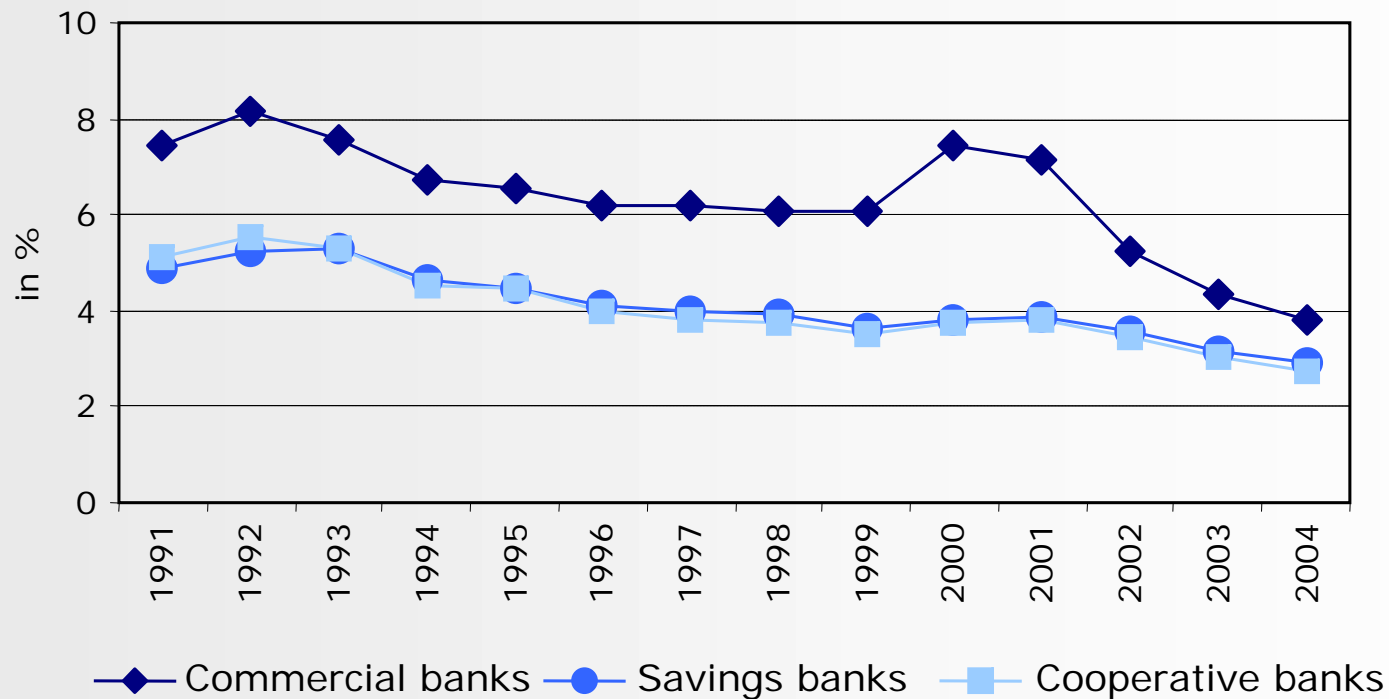


4 Criteria of performance and competition



4.2 Cost of capital

Interest rate on deposits and borrowed funds

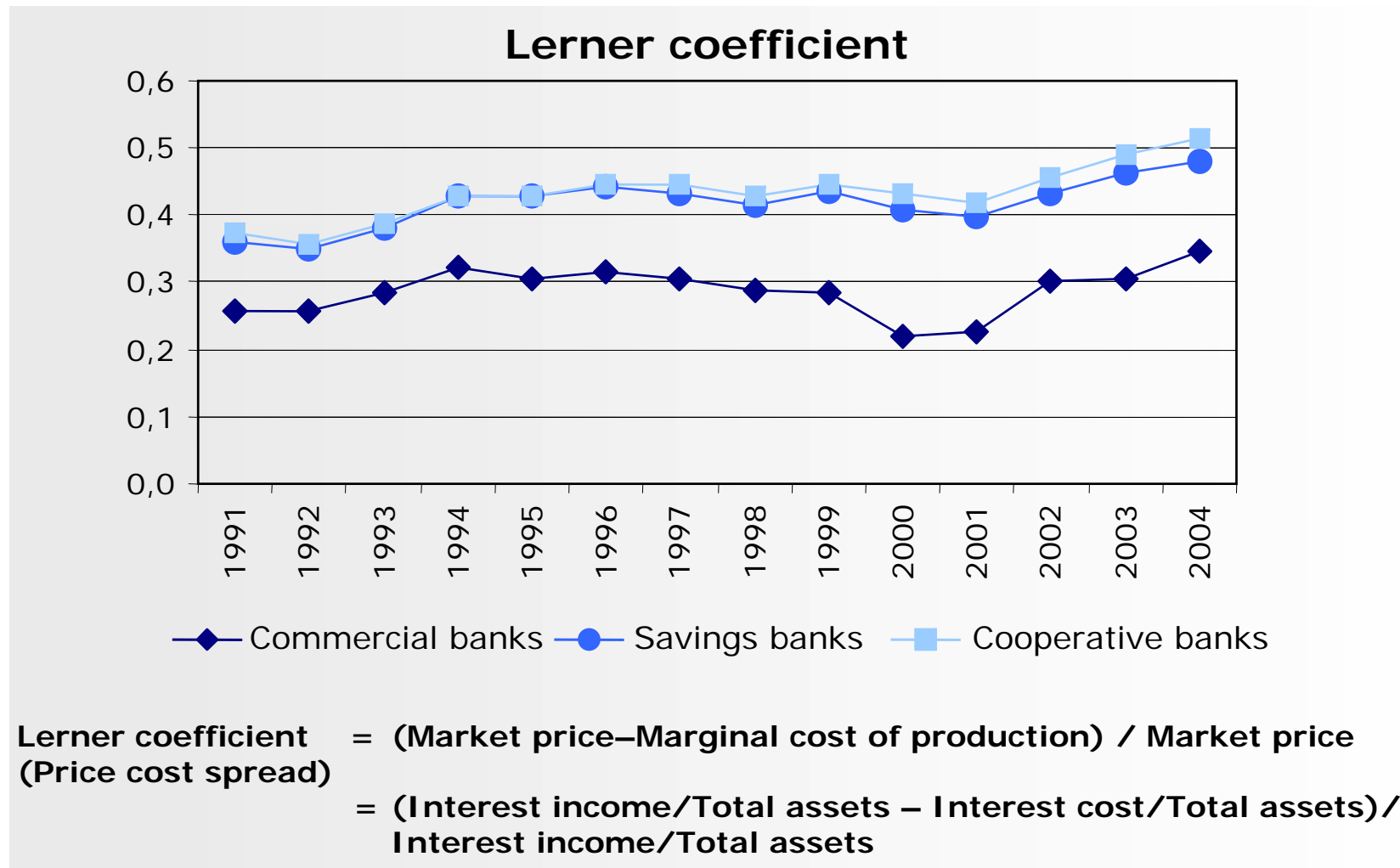


Maintaining a widespread network of local branches is considerably more cost-effective than refinancing at the interbank market

4 Criteria of performance and competition



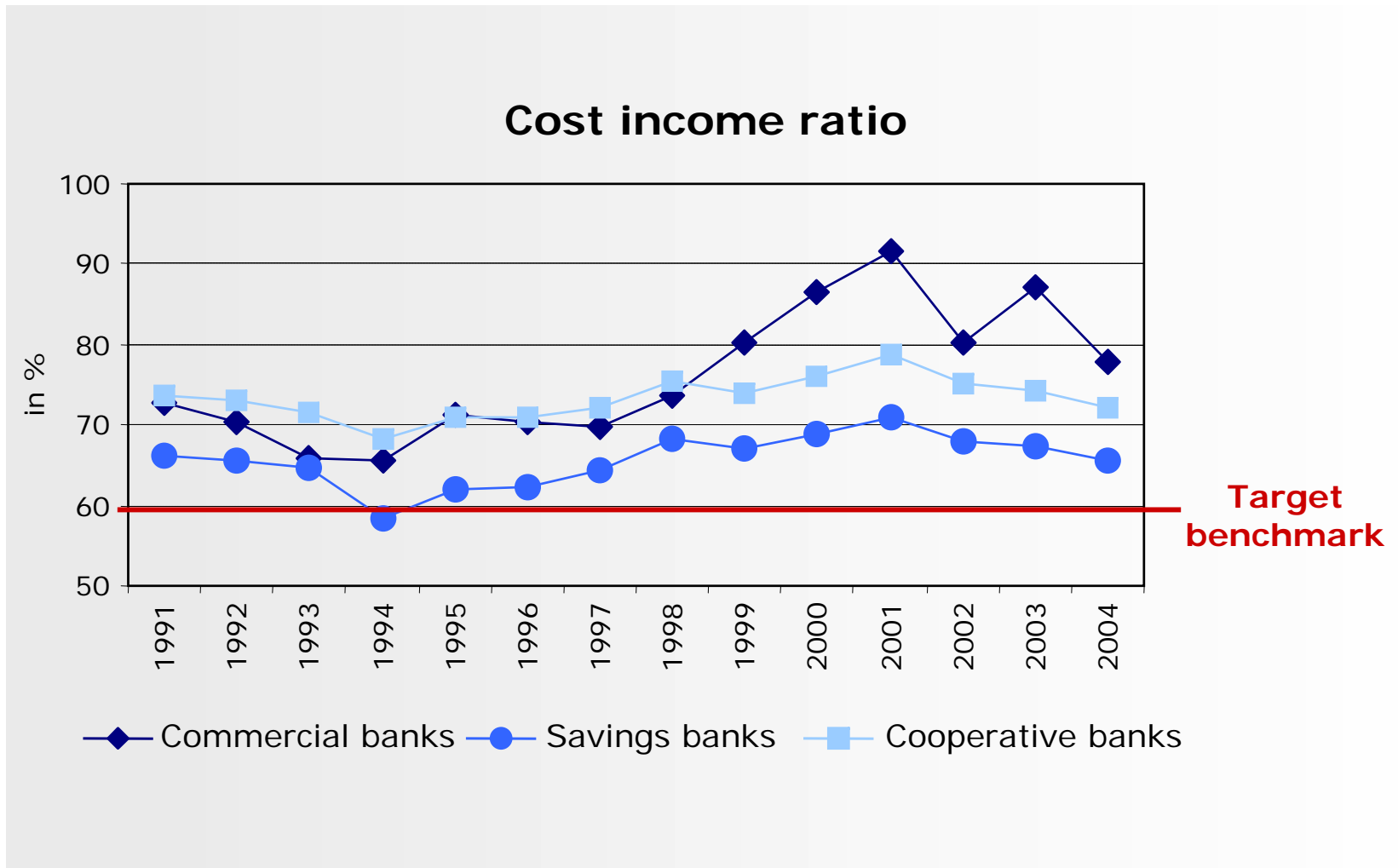
4.3 Competition-oriented ratios



4 Criteria of performance and competition



4.3 Competition-oriented ratios



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5 Summary



- A recommendation for a shift to the Anglo-Saxon system not only requires that all elements of this system have to be adjusted to again achieve a **coherent** system of corporate governance and labour and capital markets. Additionally a system transfer requires the proof that the desired corporate governance system is overall **economically beneficial**
- The dimension of **market access** has to be emphasized in our initially formulated list of distinguishing features for types of corporate governance systems. Here we do not focus on the access to publicly traded capital but instead on the access to **regional**, private and cost-effective capital