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Corporate Governance of Banks – A German Alternative to the "Standard Model"

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Corporate Governance of Banks
– A German Alternative to the “Standard Model”[1][2]

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I. Introduction: Banks – special and opaque

Banks are special, it is typically held, and rightly so. They are also complex, and, as a consequence, to a significant degree opaque, even to those who are supposed to be in charge. It suffices to consider, at a micro-level, the web of interlinked activities as conducted in extending a rather standard, plain vanilla corporate loan – of course, only capturing a minor part of the portfolio of activities of banks, as they are accounted for on balance sheets. And, obviously, contingent claims, arising from the insurance-like products banks offer (for a fee), are off balance, but, ultimately, they count, of course, also.

The simple deposit-taking-loan-granting institution, as it populates textbooks (and macro models, if at all), is of course a useful pedagogical device – but also a myth, evidently much too simple. In this vein, basic banking laws and fundamental regulations (e.g. the EU’s Second Banking Directive or the German *Kreditwesengesetz*) regularly come up with long lists when defining banking in an enumerative fashion.

Thus, bank valuation is fiendishly difficult. Even what drives value is not definitely known, at least not ex ante. Consider the starkly contrasting valuations put on credit derivatives (structured credit products, in particular collateralized debt obligations) before and after the crisis.[3] Or think of the divergent views on the value of difficult to evaluate, so-called level-three assets. In fact, over time, banks have become ever more complex, especially so since the early 2000s.

As an immediate corollary, the corporate governance – as well as the supervision – of banks is as complex. Moreover, and importantly, banks sport still their national trappings. They come in varieties,

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[1] SAFE policy papers represent the authors’ personal opinions and do not necessarily reflect the views of the Research Center SAFE or its staff.

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[*] Contribution to a special issue of ZBB in honor of Prof. Dr. Hartmut Schmidt who, over a long and outstanding career, has contributed most fruitfully to our understanding of financial markets and financial institutions. His work always takes real problems as a starting point, is unabashedly practical and applied. Our profession owes him a great debt.

[3] In fact, in the profession (including academics), views on all those meanwhile maligned instruments were, *before* the crisis, not that divergent. By a substantial majority, they were generally seen as beneficial.

defined by the broader institutional context they are part of, and embedded in. Notwithstanding substantial regulatory (and recently supervisory) efforts at harmonization (think of the Euro Area's Single Supervisory Mechanism) this also holds true for European banking. And Germany is a (meanwhile) rather special case, defined by significant idiosyncrasies.

This is as well the case in corporate governance. By and large, Germany still follows a stakeholder – as opposed to a shareholder – orientation. In fact, Germany has often been rendered as Exhibit 1 of an insider-control-system, as defined by Franks and Mayer (1994). Before the Great Financial Crisis, convention had it that such an approach to mitigating agency conflicts within firms was basically outmoded. In balancing interests of different claimants to a firm's cash-flow, such a way of governance was deemed ineffective since it could easily lose its way between conflicting objectives. In a modern (banking) firm, given a well-defined set of contracts, ultimately the residual claimants should have the say, it was typically held. Only shareholders had the proper incentives to trade-off risks and returns.

In fact, the proposition of "the end of history in corporate law" (Hansmann and Kraakmann 2000), of only one model of corporate governance left, had to face up to substantial critique already in the wake of the crisis before, the one around the accounting scandals and large-scale corporate bankruptcies of 2001. Nonetheless, the "dominance of a shareholder-centered ideology" (Hansmann and Kraakman 2000) remained intact. The "standard model" was, for example, still the basic point of reference in a Communication of the EU Commission to the Council and the European Parliament on 'Modernising Company Law and Enhancing Corporate Governance in the European Union' in Oct 2003.[4]

There are several reasons – asset specificity, narrow definition of investors (and hence stakeholders), market efficiency assumption – why the "standard model" did not acclaim general consent for corporates in general, also at the time. But regarding banking, it was always difficult to disregard that "commercial banks pose unique governance problems for managers and regulators" (Macey/O'Hara 2003, p. 91). And, practically, banks have *of course* been treated differently in many national jurisdictions.[5] Nonetheless, neglecting specialness has largely prevailed in the academic literature. Only recently, banks' high leverage (i.e. the agency conflict between shareholders and creditors) as well as their reliance (dependence) on public sector insurance (that is, deposit guarantee schemes as well as, secondly, lender of last resort – that is the agency conflict between bank claimants and tax payers) have begun to be acknowledged more generally. This would call for a reassessment of the now standard view of corporate governance in banking.[6]

[4] For a critical assessment, see Kotz (2004).

[5] German law, for example, conceived banks as an "exceptional domain of competition" (*wettbewerlicher Ausnahmebereich*).

[6] This is also rightly criticized in Hagendorff (2014). See also de Haan and Vlahu (2016).

We hold this to be yet a too narrow perspective. For example, in the case of Germany's decentralized banking system, a substantial part of governance – 'supervision' – is implemented by the respective associations of the two banking groups (savings banks and cooperatives), to be precise: their auditor associations. To a degree, these auditors substitute for shareholders. But they conduct screening and monitoring on a much more granular basis than a supervisory board, as delegated monitor of (minority) shareholders, could possibly do. While this set-up is decisive to understand conduct – and probably also: performance – of these two sectors, it has generally been underappreciated, if acknowledged at all.

At the same time, as lessons drawn from the recent crisis, a broader governance perspective emerged also internationally (see for example Basel Committee 2010 and EU Commission 2010 and EU Commission 2011). Conflicting and nonetheless legitimate claims on corporate resources emanate from several groups: creditors, employees, suppliers, communities etc. For efficiency (and equity) reasons, they are also deemed worthy of inclusion (see Tirole 2000).

Evidently, views on corporate governance differ over time and across countries. Such views might even be subject to fads (Kotz 2004). In any case, it seems interesting to drill a bit deeper into the case of German banking since it shows, relative to the "standard model" (of the early 2000s), several idiosyncrasies or peculiarities. But the German banking landscape has, of course, changed over time. As has the corporate environment it is embedded in. To reiterate, corporate governance in Germany still today reflects a stakeholder orientation. But the degree of insider control (in the understanding of Franks and Mayer 1994) as concerns large, listed firms and banks has been substantially reduced (Bessler and Drobetz 2015). Ownership structure in those firms is meanwhile largely institutionalized as well as internationalized, which also shows up in their boards.

As concerns banking, Germany is typically described as a "three pillar system", composed of shareholder-owned commercial banks as well as public sector owned savings banks and cooperative sector credit institutions. The legal and institutional structures of public and cooperative banks differ in a substantial way from those of the large commercial banks as they are (meanwhile) characteristic of most financial systems. These differences are also reflected in their respective corporate governance regimes. These idiosyncrasies – or, from a certain angle, peculiarities – will be the topic of section 2.[7]

Evidently, institutional features and environmental background conditions tend to change over time. This warrants the historical (chronological) perspective we take in section 3. Covering more than half

[7] Somehow surprisingly, literature on the corporate governance of banks rarely (if at all) mentions the fact that apart from large shareholder-owned banks there are also public banks and cooperative banks in almost any country, even though, admittedly, they are typically less pertinent than in Germany.

a century, we distinguish in very much a broad-brush way between three phases.[8] The first one, mingling the reconstruction and the post-oil price crisis period, runs from the early 1950s up until about 1990. We do the mingling since banking structures had proven to be rather persistent over that time. The second phase, which one could label the phase of liberalization and modernization, covers the years 1990 to the start of the financial crisis. Finally, the third phase – from 2007 to the present - is shaped by the Great Financial Crisis and its still lingering aftermath. Section 4 concludes by briefly sketching current challenges and prospects.

II. Corporate governance of banks – German idiosyncrasies

1. Corporate governance of banks, in general

Corporate governance in banking has for a long time not been given much attention at all. Agency conflicts within banks were not seen as different from any other incorporated and listed firm. This applies to the international debate as well as to that in Germany.[9] However, as an upshot of the financial crisis, discussions about bank governance have come to the fore and changed in substance mainly for two reasons: First, there is a wide-spread suspicion that deficiencies in the corporate governance system of many banks, especially some of the larger ones, have been among the factors contributing decisively to the financial crisis and its severity.[10] Secondly, in the wake of the crisis, regulation and supervision, i.e. the *public* part of corporate governance, have also been found wanting. As an upshot, capital requirements have been significantly increased and liquidity ratios have been introduced. Moreover, supervisory regimes have been redesigned, in Europe (Banking Union) and elsewhere (Dodd-Frank etc.).

There are essentially five, interrelated factors which make the corporate governance of banks special:

(1) compared to typical firms, banks are highly leveraged, i.e. hold only a thin cushion of equity (relative to the risky assets they carry) to absorb losses;

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[8] In a more granular perspective, the years up until 1967, experiencing the convertibility of the Deutsche Mark (in 1958), the relaxation of various activity constraints, the liberalization of interest rates as well as the abolishment of the "competition agreement" (*Wettbewerbsabkommen*), both in 1967, would be another possible point of demarcation. Then, with the demise of the Bretton-Woods-System and the attempts at stabilizing intra-European exchange rates, new challenges arose for banks and their clients (f/x hedging, e.g.), also in comparatively stable West-Germany, deeply integrated into international markets. For our purposes, however, the cruder periodization suffices.

[9] Macey and O'Hara (2003, p. 91) highlight the same aspect, to continue with: "(t)his is particularly strange in light of the fact that a significant amount of attention has been paid to the role that the banks themselves play in the governance of other sorts of firms." In the German debate, this is the topic of "Power of banks" (*Macht der Banken*), as started with Rudolf Hilferding in 1910.

[10] This suspicion has been raised in almost any recent discussion of bank corporate governance, see, among many others, OECD (2009), Mülbert (2010) as well as de Haan and Vlami (2016) and sources quoted there.

(2) banks hold assets with a maturity substantially longer than their sources of funds, to a large degree available on demand (holds true for retail and insured deposits as well as wholesale, uninsured funding);
(3) banks, vulnerable to runs because of this maturity mismatch, enjoy a public-sector insurance, which (inevitably) comes with moral hazard, requiring public-sector supervision. (Retail depositors are not deemed being in a position to exert appropriate disciplining influence.);
(4) as a result of (1) to (3), banks are, are complex and opaque, very difficult to evaluate;
(5) banks and the banking system in general are a critical part of an economy's infrastructure: Stability and efficiency of a country's banking system are considered as quasi-public goods, or are at least a matter of general concern.

These factors (with the possible exception of (4)) have been typically mentioned in justifying regulation and supervision of banks.[11] The Great Financial Crisis (GFC), however, has lent increased power to their thrust. This is pertinent since the specialness of bank governance (as opposed to firm governance more generally) has now become acknowledged more broadly, implying that shareholder value maximization, meaning an exclusive focus on the interest of equity claimants, has become seen as indefensible. Taxpayers, quite literally, had (and have) an implicit interest in banks (providing insurance – writing a put option – of which they possibly had not been aware). The large-scale bail-out programs, as they were needed in most advanced economies to prevent financial sector implosion, testify to this. In the case of Europe, 13 out of its 30 largest banks needed a bail-out (Schoenmaker and Peek 2014). And, quite evidently, this indirectly also saved those who were second line through their intense inter-linkages, above all via the interbank market.[12]

To be sure, there are a number of additional factors which shape and impact on how the management of any large organization, and thus also of banks, can and should operate. All relevant laws (labor law, company law etc.) and regulations (standards, consumer protection etc.) obviously must be adhered to. In addition, and most importantly, pressures that originate from the markets in which their organizations are embedded act as determining constraints.[13] These laws and market pressures do not only affect the options the management of a bank has, but they also frame the incentives to which it is exposed. A market playing a particularly important role in the case of banks is the interbank money market, populated with particularly well-informed and keenly incentivized participants, exerting through their decisions (on rolling over funds – or not) a decisive influence. Alas, one would have been

[11] As standard sources see Greenbaum, Booth and Thakor (2015) or Dewatripont and Tirole (1994).

[12] Keeping the interbank market afloat, what central banks did, is functionally equivalent to bailing-out, see on the role of the interbank market in the GFC e.g. Kotz (2009) and Kotz, Nagel, Schaaf (2012).

[13] See Rieckers and Spindler (2004) and Schmidt (2004)

up for a bad surprise if one would have bet on this market's capacity to separate wheat from chaff – ex ante.

2. Corporate governance – two notions, two perspectives

Being embedded in specific jurisdictional contexts, corporate governance comes with national trappings. While this might seem remarkable from a pure economic perspective, it does not strike as noteworthy at all if one acknowledges the fact that aspirations firms are confronted with do mirror the varieties of economic systems they reflect (Hall/Soskice 2001, Roe 2003, Gourevitch/Shinn 2007).[14] In the international economic debate, largely shaped by authors with an Anglo-Saxon background,[15] the core issue for corporate governance is how providers of capital, in particular the shareholders in a public corporation, can make sure that the managers of their corporation act in their interest and, citing the famous survey article on corporate governance by Shleifer and Vishny (1997), "how they can assure themselves to get a fair return on the capital they have invested … and to prevent the managers from stealing or embezzling the shareholders' money".

Although the shareholder-manager conflict is also important for them, many European authors conceive corporate governance against a broader horizon. Corporations are generally seen as nexuses of *incomplete* contracts with all the attendant agency conflicts, including the one between equity holders and managers. However, in addition, there are e.g. conflicts of interest between shareholders and creditors, the former, given the shape of their pay-off functions, with a strong incentive to increase risk. This conflict is particularly pertinent in banking, given its capital structure.[16] The propensity to double down on risk exists since shareholders in banks hold put options, be it explicitly through deposit insurance or, implicitly, via potential bail-outs, both ultimately underwritten by taxpayers. As a result, residual claimants on bank cash flows have an (irresistible) incentive to increase leverage (e.g. Rochet 2008, Adnati and Hellwig 2012). In fact, this propensity could be amplified depending on the incentive structure of management, and it involves lower levels of the bank hierarchy as well.

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[14] Macey and O'Hara emphasize, however, "that it is strange that paradigms of corporate governance differ on the basis of national boundaries…" (2003, p. 92).

[15] This is a bit of a binary caricature, but a useful one. Hence, one finds it in a number of places: Allen and Gale, 2000 or Aglietta and Rebérioux (2005).

[16] A sufficient cushion of equity ("skin in the game") is generally seen as producing the right incentives for banks to appropriately screen and monitor their clients. This is the major reason for regulators calling for more capital of a better quality. More capital also provides for indirect benefits, that is a higher probability of survival, thus an increased franchise value. Short-term debt with a "sequential service constraint", making banks vulnerable to sudden withdrawals, might also serve as a monitoring device (see Jayaraman and Thakor 2014). Regulators emphasize the former incentive, whilst (partially) acknowledging the latter (with the liquidity coverage requirements).

Hence, a European understanding of corporate governance is broader in scope, accounting for the totality of institutional and organizational features bearing on decision making in (large) companies.[17] They include legal aspects and economic mechanisms protecting shareholders from potentially self-serving managers. And, acknowledging the incomplete contract nature of claims of other stakeholder groups, they go beyond encompassing creditors, employees (in particular those with firm-specific investments), suppliers as well as communities at large.[18] From this incomplete-contract perspective a broader (European) reading of corporate governance in banking derives the legitimacy and incentive-compatibility of non-residual claimants' interest in influencing corporate policy and conduct.

This juxtaposition of an Anglos-Saxon and a European view refers to the economic and financial literature concerning the foundations of corporate governance. In much of the more managerially and practice-oriented German literature one also finds numerous references to corporate governance in the sense of principles of "good" corporate management.[19] According to it, corporate governance concerns issues such as the role and composition of boards of supervisors and the required qualifications of its members, rules of compensation for the different levels of managers, as well as the proper organization of the risk management and compliance functions.

Interestingly, this more pragmatic notion of governance also prevails in the international literature which deals with the governance of banks.[20] Note, however, that in terms of substance, assessing the "quality" of governance under these aspects presuppose a specific view of what the overall role of corporate governance is. Thus, in the German context, "good governance" means governance geared towards the interest of a wider set of stakeholders, while in the Anglo-Saxon literature "good governance" in most cases means governance exclusively in the interest of shareholders.

3. Corporate governance – a *capitalisme rhenan* reading

With reference to work on transaction costs and agency conflicts, Peter Hall and David Soskice (2001) have proposed a binary perspective on capitalist economies, distinguishing between coordinated and liberal market economies.[21] This perspective can also be fruitfully applied to corporate governance.

[17] See e.g. Hommelhoff et al. (2010), especially the introductory article by von Werder (2010).

[18] See, in particular, Milgrom and Roberts (1992), Blair (1995) and Schmidt (2007).

[19] See for example most articles in the leading German language "Handbook Corporate Governance" (Hommelhoff et al., 2012), including the one by Wollmannstetter on the governance of banks. The German Corporate Governance Code, which was introduced in 2002 and lastly revised in 2015, is also largely shaped by this managerial view of the essence of a corporate's purpose.

[20] See the survey articles by Hagendorff (2014) and de Haan and Vladu (2016) and the empirical corporate governance research cited there.

[21] Hall and Soskice refer to Milgrom and Roberts (1992) as well as Williamson (1985).

Following a continental European or German perspective, the core problems of corporate governance can be summarized in a few questions:

1. Whose interests should be represented in the process of "governing" a company or any other large economically active organization?
2. What is the objective that the management of such an organization is expected to pursue and in whose interest is it expected to operate? That is: Do only owners' interests matter?
3. How can those whose interests are assumed to matter, deemed to be legitimate, exercise influence on important decisions of an organization?
4. How can those, who make strategic and operational decisions, that is, management, be monitored and made to work in the interest of the relevant and legitimate stakeholders?

During the three periods into which we will look in section 3, different answers have been given to these questions. But the general thrust of these answers is still today that in Germany not only shareholders' interests are regarded as important and legitimate.[22] (This goes beyond the trivial assertion that managing a company in the interests of its owners would always require considering the interests of others to a certain extent if it wants to be successful as a business.) Thus, the German corporate governance system is until today stakeholder oriented, and it is also organized accordingly. The most obvious manifestation of this more encompassing orientation is the legally mandated representation of employees on supervisory boards of large companies (*Mitbestimmung* or codetermination).[23]

Just to mention in passing, mechanisms for dispute settlement between the different stakeholders as well as how management can be held accountable for complying with its fiduciary obligations are other issues of corporate governance.

4. Germany's financial system, continuously behind times?

Germany's financial system has been bank-dominated since the mid-19th Century – and this continues to be the case. Ever since that time, in terms of legal structure, three types of institutions prevail – privately owned banks, publicly (municipally) owned savings banks and mutually held cooperatives.[24] Whilst apparently backward, this has also been judged as a major advantage (Gerschenkron 1962).

[22] See also Hartmut Schmidt et al. (1997), the first English language study of German corporate governance by German authors.

[23] Banks, more specifically, the larger ones were until the early 2000s strongly represented on boards of non-financial firms. In addition, their influence was buttressed by their capacity to represent shareholders in General Assemblies whose stocks they held in custody (*Depotstimmrecht*).

[24] In fact, initially this was not so much different in other jurisdictions. And in continental Europe a three-pillar structure was to be found in most countries until the early 1990s.

Banks are the most important institutions at which households save and accumulate wealth, and they are at the same time the most important source of external finance for non-financial firms and households, until today.

Concurrently, at least in its role as a source of funding and as an element of corporate governance, the capital market has been comparatively unimportant. This is, inter alia, a consequence of the pay-as-you-go pension system, promising defined benefits with lower variance (and largely delivering). German banks also have had close relationships with their corporate clients (the famous *Hausbank* relation), and most non-bank financial institutions have been closely associated with banks.

Admittedly, these features have been more pronounced only fifteen years ago but, by and large, the general characterization of the German financial system as a bank-based system still applies. This also implies a stark difference to the financial systems of countries from the Anglo-Saxon world (Allen and Gale 2000; Hackethal et al. 2005).

German banking is segmented into three groups or pillars defined in line with legal status and, aligned with this, the purpose or guiding motive(s).[25]

The first "pillar" consists of private commercial banks. These banks pursue a strategy of maximizing profits, which is also supposed to translate (at least strongly correlate with) an enhanced value for their owners. As a group (see Table 1), they have a share of around 40% of total bank assets, though somehow lower shares in loans to domestic non-financial clients as well as in retail clients' deposits.[26] Among the private commercial banks are the four so-called big banks, which are large internationalized universal banks that (still) make use of an extended branch network. Their share in total assets, loans and deposits makes up more than half of those of all private commercial banks. Other private banks are typically more focused than the big banks, be it regionally or in their business lines.

The second "pillar" consists of the savings bank group. At its core are some 400 local, municipally-owned savings banks. Almost all of them are governed by a public law regime and operating in a narrowly defined region, that is the area covered by the respective public body which owns and underwrites the operation of a savings bank. Savings banks have a large and dense network of branches, covering all parts of Germany. They are supported by their regional and federal associations, which provide services with high-fixed costs and commensurate economies of scale (payments infrastructure, IT, risk management tools, advertising etc.).

[25] For a recent account of the structural changes in German financial system, see Bessler and Drobetz (2015) as well as Behr and Schmidt (2016).

[26] This reflects mainly the four big banks' wholesale-orientation, which also implies a substantially larger share of interbank loans and deposits on their balance sheets.

Municipal savings banks traditionally relied in managing liquidity balances (or activities on a larger scale) on central institutions, organized along provincial and later along states (Länder) lines, this is where their name (*Landesbanken, LBs*) derives from. After some restructuring, largely in the wake of the GFC, the regional institutions are owned by one or several federal states as well as, in varying proportions, the local savings banks through their regional savings banks associations. Since the mid-1970s, the share of savings-banks-related activities at LBs decreased. They developed into wholesale banks, focusing on the larger Mittelstand's firms, big corporations and public sector (municipalities, states, sovereigns) funding. Today, notwithstanding the significant deleveraging at LBs[27], in terms of total assets and loans to non-bank customers the entire savings bank group is about as large as that of the private commercial banks, and the two parts of this banking group are about equally large in terms of assets and business loans. Given differences in business orientation, savings banks, of course, have substantially more branches and a completely different funding structure, mainly based on retail deposits.

Table 1: Structure of German Banking

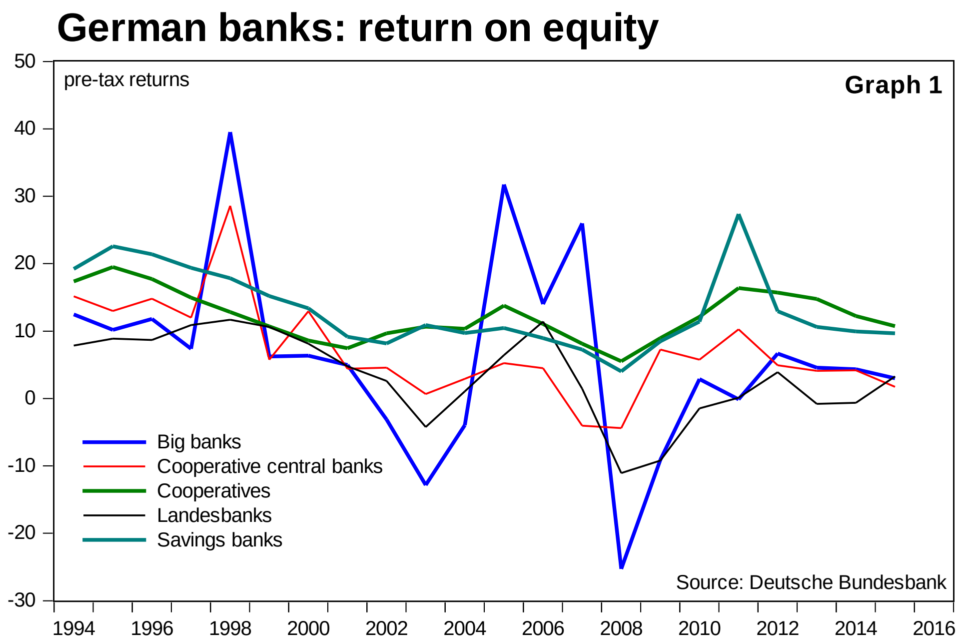
	Total assets in bn Euro		% of total		No. of institutions	
	2000	2016	2000	2016	2000	2016
Private banks	1,704,413	3,186,938	28%	41%	294	266
Big banks	969,783	1,885,492	16%	25%	4	4
Regional banks	613,223	931,300	10%	12%	200	159
Foreign banks	502,854	2,107,212	13%	26%	292	276
Savings banks group						
Landesbanken	1,222,704	938,638	20%	12%	13	9
Savings banks	953,920	1,156,997	16%	15%	562	408
Cooperative group						
Regional centers	227,383	299,837	4%	4%	4	2
Credit cooperatives	533,621	838,809	9%	11%	1,792	1,010
Mortgage banks	891,816	286,349	15%	4%	31	15
Building societies	153,632	214,746	2%	3%	31	20
Special purpose	460,829	1,269,079	7%	16%	13	21
Total	6,148,318	7,951,822			2,740	1,749

Source: Deutsche Bundesbank, *Bankenstatistik*, various issues; foreign banks comprise banks majority-owned by foreign banks as well as branches of foreign banks (already in-cluded in other groups).

The third "pillar" is that of the cooperative banking group. Like the savings bank group, this group comprises about 1000 local cooperative banks, some of them rather small, two large central banks,

[27] Several LBs, heavily exposed to structured credit products in the U.S., were forced to call for state aid. (As were private sector institutions and, of course, not only in Germany.) Which they received with strings attached by the EU's DG Competition. Some were merged (SachsenLB), one unwound (WestLB) others substantially downsized (HSH, BayernLB etc.).

important commercial banks in their own right[28], as well as a number of other specialized financial institutions. Roughly speaking, the cooperative banking group is about half as large as the group of the private commercial banks and the savings bank group. Like savings banks, *Genossenschaftsbanken* are defined by a distinctive ownership structure, a local focus as well as a supporting network organization, in their case a *FinanzVerbund*.[29]



Graph 1: illustrates pre-tax RoE of German banks, broken down by banking groups, over the period between 1994 and 2015, including, what the data especially for the big (internationally exposed) banks show (bold blue), two crisis periods (2002-03 and 2008 following). Over the sample period, mean returns for the big banks have been 6.25 with a standard deviation of 14.6%. Mean returns for local banks (savings banks plus cooperatives) came in at 12.7% with a standard deviation of 4.75. The simple correlation coefficient between the two regionally focused credit institutions is 0.8 whereas the linear association between savings banks/cooperative credit institutions and big bangs is only about 0.33. Source: Deutsche Bundesbank, *Bankenstatistik*, various issues.

The peculiarity compared to the "standard model" resides in the allocation of property and control rights. Savings banks are publicly owed.[30] Cooperative banks, established as institutions of self-help,

[28] At the time of writing, the two remaining central institutions, DZ-Bank AG and WGZ-Bank AG, have agreed to merge. DZ-Bank itself has been a merger between DG Bank (formerly at the apex of German cooperatives) and the southern German SZ Bank.

[29] See Kotz and Nagel 2002 or Hackethal, Kotz and Tyrell 2007.

[30] Nuances of public ownership get generally lost when summarized under the heading state-owned. But these nuances are important. Whereas state-owned regularly implies a direct influence of the respective government public sector institutions can enjoy a significant degree of autonomy, stretching towards complete independence. There are, for sure, differences in the degree of independence. (Incidentally, a similar issue arises with the independence of central banks. Here, to capture the variance, indexes have been constructed.) Those nuances are, as a rule, not accounted for in the literature. In the case of German savings banks, for example, autonomy or independence is buttressed by the rules and regulations they must follow, identical to the legal framework of "normal" banks. And then there is the peer-group assessment or control (laid down in state laws) which comes with the auditing of the supervisory associations (*Prüfungsverbände*) as well as the performance evaluations of the respective associations.

self-responsibility and solidarity, follow the principle of *one member, one vote*. Their mission is to foster members' and clients' interest. To be brief, more than two-thirds of the German banking sector does not pursue a profit maximization objective. And following standard priors, this should show in significant performance differences across sectors. And it does, but in unexpected ways. There is no clear leader according to various measures of performance, *au contraire* (see Graph 1 and Table 2)[31].

Table 2: German banks: Pre-tax Return on Equity (1994-2016)

	All banks	Big banks	Landesbnks	Coop bnks	Save banks
Mean	7.59	6.25	3.39	12.23	13.09
Maximum	19.34	39.51	11.69	19.48	27.35
Minimum	-7.70	-25.30	-11.07	5.53	4.00
Std. Dev.	5.83	14.06	6.39	3.67	5.83
Obs.	22	22	22	22	22

Source: Deutsche Bundesbank, *Bankenstatistik*

That is, standard performance indicators show that the local banks performed about at least as well (or even better) than the private big banks. This has also been shown for the years before the financial crisis.[32] Most interestingly (and counterintuitively), these higher returns of local banks came with a significantly lower variance.

To add a footnote: The three-pillar structure of banking, prevailing in Germany, has formerly been the rule in almost all European banking systems. Since the 2000s, however, banking systems have been fundamentally restructured in most other countries (Schmidt et al., 2014). Hence, Germany's peculiarity in this domain is of a recent vintage.

III. The trajectory of German banks' Corporate Governance over the years

In this section, we observe how the corporate governance of German banks has developed over the past fifty years. In doing so, we distinguish, as mentioned above, rather coarsely three phases. For each phase, we summarily assess the corporate governance of four groups of banks: (1) the big commercial banks in the legal form of a public corporation, (2) local savings banks, (3) large regional public banks (because their governance differs substantially from that of the local savings banks), and (4) local cooperative banks. In the context of the first phase, we also describe general and lasting features of the governance regimes of these four groups of banks.[33]

[31] For the comparison based on standard performance measures see Behr and Schmidt (2016) for the German case and, with a cross country-comparative perspective, Ayadi et al. (2009, 2010).

[32] See for example, Altunbas et al. (2001) and Ayadi et al. (2009, 2010). Probably less surprising, but equally relevant, is the empirical evidence that savings banks and cooperative banks are on average less risky than privately-owned commercial banks (Beck et al. 2009).

[33] See also Schmidt and Noth (2011).

1. Corporate governance in Germany between 1950 and 1990

a) The economic and ideological environment

The time after the end of the Second World War up until 1990, the year of Germany's re-unification, can be separated into two periods. The immediate post-war and reconstruction phase (lasting until the mid-1960s and including the *Wirtschaftswunder* years). This was followed by a period characterized by two deep crises (1975 and 1980/81), requiring structural adjustments, as well as recoveries until 1990. A defining characteristic, from early on, was cooperative, some call it corporatist, mode of economic regulation in Germany. Since the early 1950s, this also included largely cooperative labor unions, understanding themselves as stakeholders with a long-term interest in their firms. Over time, this developed into *Modell Deutschland* (a campaign slogan of Chancellor Schmidt in the mid-1970s) or *Deutschland AG*. Large banks and insurance companies were at the center of a dense network of financial and personal ties, connecting essentially the entire German corporate world (Beyer 2003).

For most of this period, the banking market was basically segmented along client lines. Talk was of *Gruppenwettbewerb* – a competition between sectors. The relationships between the different large banks as well as those between the banking groups were not characterized by intense rivalry but rather by a system of complementarity and even collegiality. (Banking relationships were long-term oriented and encompassing in scope. The elasticity of substitution for individual bank products was low. They were often seen as joint products.) For the non-financial corporate sector this symbiotically went with manager dominance, as it has been described for the U.S. many years ago by Berle and Means (1932) or Galbraith (1967). Most bank managers of that time shared the view that the power (or influence) of banks, which clearly existed, should be used to the benefit of what these managers regarded as the common (corporatist) economic and political interest of the German economy. This perspective is very well represented in a quote from an interview which Alfred Herrhausen, then the *speaker* of Deutsche Bank, gave a few days before he was killed by terrorists: "We as bankers must ask ourselves every day whether the decisions we make reflect a keen sense of responsibility, that is, whether they serve the interest of the *res publica*, the community at large, as much as the interests of our clients, our staff and our shareholders"[34] The idea that managers should maximize shareholder value was largely unknown among bank managers, and even those who were aware of the concept regarded it as simply inappropriate: corporate governance in its (meanwhile) "standard model" understanding would have been clearly unconventional.[35]

[34] Radio interview in Süddeutscher Rundfunk, Oct 17, 1989; our translation.

[35] Of course, the notion of shareholder value (as well as the concept of economic value added), while in terms of economic substance old wine, only gained relevance, also internationally, in the academic literature and as a *performative* concept in the late 1980s (Rappaport 1986, Aglietta and Rebérioux 2005).

b) The corporate governance of large private commercial banks

Private banks, as a group, show significant heterogeneity. Therefore, we restrict ourselves to discussing the corporate governance of the large commercial banks in the legal form of a corporation with widely distributed shares and a large branch network. Of course, the law on public corporations applies to them. In a stark contrast to most large German non-financial firms, the big banks of that time were really independent: they did not have influential block-holders from outside the financial sector, retail shareholders had barely any say (if at all) and institutional investors had also not yet made their appearance on the scene. The capital market had basically no role in funding capital expenditures or allocating risk. At the same time, given that it was dominated by the big banks, it was also barely relevant as an instrument of corporate governance.

The power in the big banks resided almost exclusively with the top managers. The role of the supervisory board was commensurately limited. As a rule, the chairman of the supervisory board was a former CEO, who typically shared the management board's positions rather than representing the views of dispersed (minority) shareholders or other stakeholders.

An important and unique feature of the governance of all big banks during that period was an informal rule: the consensus principle. Important decisions of the management board were only taken when all board members supported them. In line with this, banks did not have a chairman of the management board but rather a "speaker" – or even at times two "speakers" – elected by the members of the management board.[36] Finally, the appointment of new management board members was, even from a 'standard model' angle, somewhat unusual: Formally, they were appointed by the supervisory board, but this board always followed the recommendations of the management board. Thus, top management was self-recruiting, and its entrenchment was almost perfect.

We have already pointed out that in general German corporate governance is stakeholder oriented. Until 1990, bank top managers fully embraced this orientation, not least because a stronger and more focused orientation on shareholder interests would have amounted to an impediment to do what they regarded as their overarching mandate: to assure the proper functioning of the German economy.[37]

In retrospect, this may strike as peculiar, even strange, but in a time when bank margins were still ample, competition well-contained and banks' profits abundant, this satisficing view of corporate goals was deemed to be consistent. Moreover, it does not imply that the corporate governance of the big banks was ineffective; in fact, it was a rather well conceived and working system of peer control. The

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[36] According to corporate law, a chairman would have to be appointed by the supervisory board.

[37] See e.g. the account in Gall (1995) concerning the market leader Deutsche Bank and several articles in Herrhausen (1990).

same inner logic may also have been behind the system of big banks being the "house banks" of large non-financial corporations in whose governance big banks used to play an important role.[38]

In this respect, the big German banks and their top managers were not at all unique in continental Europe. The managers of most large banks in neighboring countries held largely similar views of their roles until around 1990 and acted in the spirit of what has been called "cooperative capitalism" or "coordinated market economies" in the "Varieties of Capitalism"-literature to which we already alluded (see Hall and Soskice 2001, as well as Amable 2005).

c) The corporate governance of local savings banks

With very few exceptions, all German savings banks are organized and governed under a public law regime laid out in the savings bank law of the respective federal state in which they operate. As public law institutions, they do not have owners in a conventional sense, even though this is often erroneously claimed. However, instead of owners they have what one might call a supporting public entity[39], in most cases a municipality or a county. Some of the property rights of these entities are similar to those of the owners in a private law institutions, but overall their legal position is weaker than that of the owners of a private bank.

Savings banks are run by a management board, obliged to follow the same banking laws and rules (secondary legislation) as the other banking groups (*Kreditwesengesetz* etc.). Members of the management board are appointed – and let go – by the administrative council, whose chairperson is regularly the mayor of the city or the top administrator of the county. In most cases, the supporting entity is also represented in the savings bank's credit committee, which has to confirm important credit decisions. Apart from these roles, the supporting entity and its representatives are not allowed to interfere in the operational decisions of the management as this would violate the "established sound business principles" and would raise concerns of the supervisory authorities charged with examining savings banks.

However, it would be somehow far-fetched to assume that there is *no* political influence at all. Savings banks pursue a public purpose (*öffentlicher Auftrag*) and are by law also expected to support the local

[38] The standard modern sources on German "house banks" are Harhoff and Körting (1985) and Elsas and Krahnen (1998).

[39] The German term for "supporting entity" is "Träger", implying that the responsible public sector entity had to underwrite the capacity of a public institution to discharge its obligations (*Anstaltslast*) as well a step in in case of default (*Gewährträgerhaftung*). Since 2002, however, after an agreement reached between the EU Commission and Germany, neither Landesbanken nor Sparkassen enjoy *Gewährträgerhaftung* or *Anstaltslast* for liabilities they issued. Instead, they rely on a within-group organized insurance mechanism, funded by risk-based fees, and in line with the German Deposit Guarantee Act, implementing the pertinent EU Directive.

economy. And, in fact, there are indications that there might be some political influence.[40] However, no conclusive evidence has been produced validating systematic abuse of political power over local savings banks. There are a number of reasons why this might be the case: Robust auditing procedures, conducted by the respective associations, continuous peer-group based monitoring, and rankings which determine the risk premiums for the deposit guarantee scheme.

Given these constraints (statutory obligation to pursue a public purpose) and incentives, it seems natural to assume that savings banks are less profitable than private banks. However, this is not borne out in empirical studies which show that the return on equity of savings banks is slightly higher, cost income ratio are substantially lower and variance of return is significantly lower than these performance indicators are for comparable private banks.[41] In other words, the legal form (public-law regime, public-purpose orientation, i.e. the mandate to support the local economy), does not seem to come at the cost of lower profitability or cost-effectiveness. As important, while individual savings banks face at times challenges, they have not generated systemic financial stability problems.

d) The corporate governance of public regional banks

Landesbanken, also belonging to the savings banks sector, are public sector institutions as well, though some of them are incorporated as stock companies. But they are of course not listed and they are also supposed to serve a (not very well-defined) public purpose.[42] Liabilities of *Landesbanken*, issued until 2005 (with a grandfathering until 2015), were ultimately underwritten by the federal state which had established (or guaranteed) the LB. For investors, these state guarantees meant, of course, that they were in fact buying the debt of federal states. In other words, these obligations had triple-A status. Therefore, LBs were able to compete with the big private banks for the business with large German and international corporate clients on attractive terms.[43] In search for yield, they were, rather unfortunately from an *ex post* perspective, also able to venture into structured credit products which ultimately have proven highly problematic, or into markets for U.S. subprime issues. But that is, in fact, what many banks, independent of their legal status, did.

Owners or, as the case may be, supporting entities of a (public) regional bank are typically the savings banks of the respective region and the federal state in which it is domiciled.[44] The management is

[40] See Hackethal et al. (2012) with empirical findings on political influence on German savings banks and a comparison to the situation in other countries.

[41] See the sources in note 28 *supra*.

[42] The former, by now dissolved, West LB (since 2002), to Landesbank Berlin (since 1994) and HSH Nordbank AG (since 2003) have adopted the legal for of a joint stock corporation.

[43] See section 2c below on the phasing out of these guarantees.

[44] The share of the equity held directly by the savings banks of the region or indirectly via their associations and by the respective home state differs significantly from case to case.

independent, but it is controlled by a supervisory or administrative council staffed with representatives of the owners or, as the case may be, of the supporting entities.

The legal basis for all regional banks are special laws issued by the respective federal state. By and large, and in contrast to the savings bank laws, these rules appear to leave more leeway for political influence[45]

Originally, the LBs were limited in their operations to serving as clearing banks – liquidity centers or *Girozentralen* – for the savings banks in their region and as the house bank of the respective state and to providing those services to savings-bank clients for which the local savings banks were too small. Already in the 1950s, this started to change, LBs began to act as genuine commercial banks; they gained a substantial market share in the corporate loan market and also entered the field of investment banking. This so-called meta-business – 'meta' from the perspective of the saving banks was justified or legitimized since it supported savings banks in their primary functions. And LBs delivered scale and scope economies. Over time, however, it became ever more difficult to align this with the primary mandate of serving a public purpose. Moreover, demands on the capacity of supervisory boards rose commensurately. However, as we will see later, this was obviously also the case for international wholesale banks, independent of their legal form. And many of them were found wanting.

Another aspect had been criticized: A number of LBs were used as instruments of industrial policy; they became development or promotional banks. In fact, this might have been closer to the public service mandate (or *öffentlicher Auftrag*). Nonetheless, it was seen as a task better performed in specialized institutions. In the wake of the crisis, the major charge addressed at LBs has however been that those responsible for monitoring the management, namely the administrative councils, were incapable of curbing excessive expansionist activities of the management (Hau and Thun, 2009).

2. The corporate governance of cooperative banks

The German cooperative law of 1899 defines a cooperative as an enterprise being owned by its clients (called members) and whose purpose is to support the economic endeavors of its members by running a "cooperative business". This is the so-called principle of identity: owners are clients *et vice versa*. It implies that it is not the purpose of a cooperative to maximize profits even though assuring the existence of the cooperative and enabling it to grow is a prerequisite of its economic survival. Therefore, evidently, also cooperative banks must operate in an economically efficient way, that is, generate surpluses on a continuous and lasting basis.

[45] See the highly critical account of such interventions in Sinn (1997) and Hau and Thun (2009), who argue (rather summarily) that politicians on these boards generally tend to lack financial competence.

In some respects the property rights of the clients-owners-members resemble those of the shareholders in a corporation while in others they are more like those of the members of a club. In order to become a member, a person must buy at least one share, and on this basis gets a share of annual profits, distributed as dividend. Members also have a vote in the annual meetings. However, voting rights do not depend on the number of shares: one person has only one vote. This is the so-called democratic principle.

Another important feature is that members, given that they want to exit, are not permitted to sell their shares at a price, as determined in an arm's-length transaction. Instead, they can only give their shares back to the cooperative and in return receive the amount that they had once invested plus, in some cases, their part of retained earnings.

From a standard economist's perspective, the governance regime of a cooperative bank seems almost weird. That every member has only one vote and cannot sell his shares and that the liability of the members is also limited, almost annihilates his or her incentives to play any active role in governance, provided the cooperative bank is not on the brink of collapse. Given this incentive structure, free-rider and coordination issues should prevail. It does not pay to monitor management or put pressure on it. Managerial autonomy can be fully exploited, apparently.

Cooperative members are rationally disinterested in holding managers up to task. This is obvious to managers themselves. Hence, they apparently have no reason to run a cooperative bank in a value-increasing way. This seems to be simply a defining feature of cooperative governance.

The long-term performance of cooperatives, however, flies in the face of such a conclusion. To be sure, managers have no strong incentive to maximize returns. Hence, they are not prone to embark on particularly risky activities. This implies that they also do not have a strong incentive to increase the value of their bank by treating socially and economically weaker members of the cooperative badly – and this is exactly one reason why cooperatives have once been created some 150 years ago. Secondly, it prevents them from pursuing excessive risks via leverage. On average, cooperatives hence have a preference for a comparatively safer business profile. Given this reputation of being typically 'boring' makes them – like *Sparkassen* – attractive for depositors. Such deposits, of course, are a much less vulnerable source of funds than money or capital markets. This also rhymes with them being seen as stable and reliable lenders, again, not unlike *Sparkassen*.

Moreover, despite of the weak governance rights of the member-owners, there are potentially powerful sources, more than partial substitutes, which align incentives in a welfare-enhancing way: The job of a cooperative-bank manager is attractive, typically well paid and it also comes with a high respect in local communities. This fact alone makes managers care about a good performance, though not necessarily one which increases the value of the bank for the owner-members. After all, their main mission is to help the members to achieve success in their own economic endeavors. If they do not perform well, clients might withdraw their deposits and good staff members might leave – and, for obvious reasons, managers will want to avoid this because it undermines their position.

Then there is another source of pressure on management and thus an important element of cooperative banks' governance: already many decades ago, the regional associations of cooperative banks created auditing divisions. The role of the auditors not only include assuring the propriety of the accounting and disclosure system but also closely monitoring that the banks are well managed in line with the cooperative law and statutes. If the audits reveal deficiencies it can indeed seriously endanger the positions of managers.

But what are the incentives for the auditing organizations and the individual auditors? Or: who audits the auditors? Firstly, the audit departments are mandated to act in the interest of the cooperative mutual guarantee system that protects the individual cooperative banks and their clients by making sure that no cooperative bank gets into trouble and thereby becomes a burden for the guarantee system (i.e. for the other banks). And, secondly, it has become a frequent practice that auditors who have been really good – and this means: really tough – in their job for many years will later be rewarded by being elected to the position of a top manager in a cooperative bank. In addition, there are peer-group reviewing and ranking via the association on many dimensions (in particular in risk management). Thus, the overall incentive system is more complex than a system with a simple maximand: profits. But, practice bears witness to the fact that the governance system of cooperative banks works. The overall good performance of the banks that belong to this group testifies to this.[46]

3. The corporate governance of German banks between 1990 and 2007

a) The changing economic and ideological environment

The year 1990 marked the end of the West-East divide, saw Germany's unification, and ushered in a period of almost completely unquestioned economic and intellectual U.S. dominance. It led to more than a decade of strong economic growth in the Western world and, after some delay, also in the former socialist countries of central and Eastern Europe. This had far reaching consequences for the role of the financial sector and for economic policy in general. For many, the United States became the uncontested model of what constitutes a "true" market economy. With the disappearance of the ideological competition of the "socialist model", there was no longer a need to demonstrate that capitalism can be kind and soft and the ideal complement to a democratic political regime.

[46] This argument was first presented in Ayadi et al. (2000).

These changes also had far-reaching consequences for the political debate about corporate governance in most Western countries, for relevant public policy and also, to a certain extent, for the practice of corporate governance, including that of banks. In Germany, the federal government installed a Government Commission which after long deliberations produced a comprehensive "Report" (Regierungskommission 2001) highlighting aspects in which the corporate governance regime of public corporations should be strengthened. This report led to substantial changes in German corporate law including the creation of a German "Corporate Governance Code". Interestingly, however, this report did not address the two most controversial topics of German corporate governance: the dual board system with its strict separation between the management board and the supervisory board, as well as mandatory codetermination. Thus, it also did not question the fundamental stakeholder orientation of the German corporate governance system and its character of an "insider control" system.[47]

The Corporate Governance Commission, which was, following suggestions in the Report of the Government Commission, created with the mandate to regularly update the Corporate Governance Code followed suit, also leaving this traditional orientation untouched and even endorsing it explicitly in its pronouncements. Moreover, most of the numerous new laws issued in Germany during this phase strengthened the instruments of *internal* governance rather than those of capital market-based governance. Thus in spite of a great deal of political activism during this time the reforms did not lead to the adoption of an "outsider control" system as it prevails in the United States or in Great Britain.

b) Changes in the corporate governance of the "big banks"

There were good reasons to expect that the corporate governance of the big banks, organized as corporations, should change more than those of other banking groups. This was indeed the case, because the shares of these banks were held by the general investing public – more precisely: by institutional and often international investors – and most of the relevant legal changes were particularly addressed to large widely held corporations. However, if one tried to pinpoint the aspects in which the formal governance regimes of these banks really changed, one would hardly find any direct evidence. The distribution of roles between management board and supervisory board remained largely unchanged, and even in the public proclamations of most top bankers and in the annual reports of the large banks the old rhetoric was retained: they presented themselves as still being committed to the interest of shareholders as well as those of other stakeholders.

[47] The chairman of the Government Commission, law professor Theodor Baums, wrote in the introduction to the Report (p. VII.) that these two topics were not addressed because they had proven their worth. At the time, this also reflected the consensual modus operandi between the (Social-democratic-Green) Government as well as the representatives of "big labor" and "big management" in the Government Commission.

However, reality did change. The relative weight attached to the interests of different groups were no longer the same as fifteen years earlier and bank managers started to care more about how investors assessed what they did. In internal deliberations and in the policies pursued by management shareholder interests were now given more weight than those of other stakeholder groups: "shareholder value" started to catch ground. This was of course not only a consequence of the political debate and the legal changes. Economic background conditions probably made big banks more amenable to adjustment: interest margins shrank; foreign banks entered the German market, making it more contested; many large firms started to prefer capital market financing over traditional bank loans; and regulatory restrictions became tighter. Thus, especially for the big banks, the economic situation became more challenging, pushing them towards gradually giving up the old management centered governance system and policies.

c) Changes in the corporate governance of the savings bank group

Following an agreement between the EU Commission and the German Government reached in 2001, the former public guarantees for the public banks (as going concern) and their liabilities were abolished on July 18, 2005. For the local savings banks, the end of public guarantees did not have much of an effect because public guarantees had never been invoked in the past decades and savings banks used almost exclusively customer deposits as a funding source and not capital market funds, which might have benefitted from the guarantees. Therefore, the end of the public guarantees did neither affect their legal status of being public law institutions nor their business model nor their governance system. They remained public law institutions and served their clientele as well and as much as before.

For several of the public regional banks, the *Landesbanken*, the situation was completely different. Already for a long time they had relied heavily on capital market funding. Thus, they had greatly benefitted from the access to funding with safest status, the upshot of the state guarantees. In fact, the long-time span between 2001, when the agreement with the EU was reached, and 2005, when it took ultimately effect, had offered them the opportunity to soak up considerable sums from the capital market. In retrospect, it is evident that those funds were not deployed to best possible uses. A considerable part was allocated to securitized loans, causing subsequently substantial – for some: existential – losses. Other effective ways of wasting resources was acquiring foreign banks, which later turned out to be of equally questionable value. Consequently, the business model of several LBs banks was up for a fundamental reappraisal in the wake of the Great Financial Crisis. This also put major question marks behind their corporate governance system. At present, it is an open question where this will lead, since the reform of the system of public regional banks is work in progress.

d) Changes in the corporate governance of cooperative banks

For the time between 1990 and 2006, the situation for the local cooperative banks is almost exactly like that of the local savings banks. There was no change in their corporate governance regime. This lack of change is somewhat surprising in view of the fact that during exactly this period the cooperative banking systems in many other European country have experienced far-reaching reforms. If one tries to find out what may explain this difference a possible answer is that in contrast to most other countries the German cooperative banks have for 80 years, the time when the first German banking law was enacted, been subject to the same regulatory and supervisory regime as all other banks. This has early on forced them to adapt to economic and regulatory pressures. In this process, they had to develop and nurture their specific strengths.

In summing up this section, one can say that the rules and the practice of corporate governance have hardly changed at all for the locally rooted relatively small financial institutions in the public as well as the cooperative sectors during the years between 1990 and 2006.

For the larger public LBs fundamental changes of the way in which they are governed are to be expected. However, so far, it is only evident that their governance needs to change; how it will materialize is not yet clear.

Only for the big banks in the legal form of a private law corporation with widely dispersed shareholders, corporate governance has changed substantially. But even in this case, change is not one of the relevant laws and other formal rules but rather of the underlying philosophy and the spirit in which these banks are managed and controlled: The orientation towards shareholder interests and the awareness of the importance of capital market developments has greatly increased and made German share-based banks more like their counterparts from other countries and more different from the other types of German banks.

4. Crisis' impact on corporate governance of German banks

a) How German banks were affected by the financial crisis

German banking, to be more precise, German wholesale banks, with a substantial international footprint and significantly exposed to structured credit products, were hard hit by the financial crisis – regardless of ownership structure and not unlike their peers in other countries. Germany, in fact, committed in 2010 – aggregated over capital injections, liquidity guarantees and asset support – 25 percent of its GDP to backing up the banking system. This was a bit less than the Euro Area average (of 28 percent).[48] Small economies with high concentration ratios and internationalized wholesale banks

[48] This comes with a slight statistical caveat, favoring a bit our comparison: This Euro Area average includes Germany.

had to accept substantially higher contingent liabilities. However, the Netherlands (committing 52% of its GDP) as well as Germany have run *structural* current account surpluses. Such net asset accumulation, obviously, comes with substantially larger gross flows. And somebody has to do the intermediation or hold the ultimate claims.

However, the extent of losses, in terms of *accounting* profits, differed substantially between institutions. In line with this, markets also differentiated across individual banks which showed in rapidly falling stock prices as well as strongly increasing CDS premia.[49]

Amongst the remaining private banks, only Deutsche Bank had not to rely on *direct* public sector support. But, of course, banks are special, i.e. interconnected, meaning tiding over a bank's competitor ultimately amounts to supporting bespoken creditors also. Bailing out is always, by necessity, about bailing out creditors. (Moreover, Deutsche was also on the receiving end when creditors with counterparty risk in AIG were made whole by the U.S. Administration.) Commerzbank, having taken over the very troubled Dresdner Bank (with problems in particular in its Dresdner Kleinwort Benson entity) from Allianz, could only survive on the back of substantial injections of public sector resources in the form of equity (preferred shares) and debt guarantees. HRE, another important private bank, was delisted in October 2008 and went into receivership: Its assets are to be unwound, backed by SoFFin, the government financial market stabilization fund. IKB, partially owned by KfW and thus no pure play private bank - running on exclusively private sector principles though - was bailed out by a consortium of banks in the fall of 2007, no public money involved.

A majority of *Landesbanken* was also severely affected by the crisis, in need of government support. Some *Landesbanken* were saved through mergers (Sachsen LB, RLB). West-LB, formerly the largest one in this group of banks, was ultimately liquidated. Its assets are unwound through an asset management company or bad bank – *Erste Abwicklungsanstalt*, conceptually identical to *FMS Wertmanagement*, the HRE bad bank.

In a sharp contrast to that, the regionally focused banks – be they savings or cooperative sector institutions – were virtually unaffected in the first round or on impact. Of course, later on they suffered from the repercussions of the ensuing crisis in the real economy or, to a lesser extent, in their role of co-owners of regional public banks. In relative terms, however, they have proven to be winners, gaining market share from the large private and public banks which were forced to deleverage.

This bears witness to the point we stress in this article: Performance differences of German banks during the financial crisis are largely *unrelated* to differences in their respective corporate governance

[49] See for a concise overview Stolz/Wedow 2010; see also Hüfner (2010) for the German case. Schoenmaker and Peek (2014) offer a comprehensive account of European banking.

regimes. Instead, they testify to the pertinence of the *differences* in business models between these two groups. As concerns *Landesbanken*, unfortunately a majority of these institutions used the window of opportunity offered by the extension of the *Gewährträgerhaftung* (backing-up their creditor status) to take up funds which were deployed very unwisely.

b) Regulatory lessons drawn from the crisis

Immediate reactions were about crisis containment, including, most importantly, the ECB's liquidity provisions way beyond benchmark requirements or the lowering of eligibility criteria for collateral in its market operations as well as – automatically – the shock-absorbing effects of Target2, the Eurosystems clearing and settlement system. In addition, intervention schemes were developed, basically from scratch, for example the already mentioned temporary SoFFin (which morphed into the now permanent FMSA), a special financial market stability facility.
What is more pertinent for our case – the bearing of regulatory changes on banks' corporate governance –, are of course the changing rules and institutions as they arose in response to the crisis. Given that regulation creates incentives and restrictions for what banks can do or may want to do, it is clearly an essential part of the governance regime of banks. It is the external, public sector dimension of monitoring a bank's alignment with being safe and sound. And banks, most obviously, respond to their background conditions.

Initially, this redesign of rules was very much an international effort. It began in early 2009, in preparation of the London G20 Summit under the auspices of the Financial Stability Board. Objectives pursued were concisely listed in a Report to the G20 Leaders (FSB 2009): more and better capital, robust market liquidity, dealing with too-big-to fail, strengthening accounting standards, improving compensation practices, expanding oversight of the financial system, strengthening robustness of OTC markets, improving securitization and adhering to international standards.[50]

Evidently, there are too many regulatory and institutional changes to be discussed (or even enumerated) here in any detail.[51] However, from a European perspective, two strike us as particularly important, also directly affecting the corporate governance of German banks (as well as those of other jurisdictions). One, the Banking Union, is institutional, concerns the implementation, the other, Basel III (currently about to evolve into Basel IV), regards the setting of tougher prudential rules.

Basel III was about adapting, that is tightening, capital requirements in light of the crisis; put simply, more and better capital, that is, loss-absorbing capacity. It also included for the first time liquidity

[50] For a comparison of the political, financial, monetary and regulatory reactions to the financial crisis in different parts of the world, see the proceedings of the 2010 international meeting of the Shadow Financial Regulatory Committees edited by Robert Litan (2011). One chapter in this volume (pp. 155-221) covers the case of the EU.

[51] For a useful list, see Köhler (2010).

requirements in the form of a liquidity coverage ratio as well as a net stable funding ratio. The former requires a bank to hold high-quality liquid assets so that it could survive 30 days of dysfunctional markets (BCBS 2013). The latter obliges banks to have access to stable funding, covering funding requirements for a year (BCBS 2014).

In Europe, these rules have been implemented through a directive and a regulation on capital adequacy (CAD/R IV).[52] The strengthened capital standards imply more self-insurance on the side of banks.[53] Hence, via their incentives effect, these rules attempt to mitigate the conflict between equity and debt holders. They should also protect deposit guarantee institutions, which have also written a put, against risk shifting. More particularly, the objective of Basel III is to reduce the frequency as well as the severity of crises, as captured by the welfare losses from crises (BCBS, 2010b).[54] Systemically important banks, deemed to enjoy a too-big-to-fail funding advantage, have to face a surcharge of 2.5% of tangible common equity. In addition, a total loss absorbing capital (in the form of subordinated and contingent convertible debt) should be issued. These requirements are to be met in 2019, the TLAC target in 2022.[55]

How much of a burden this poses on banks, being obliged to substitute cheaper debt with more expensive equity – and, ultimately, via banks passing on higher weighted costs of funding – on output and growth, is an ongoing debate. Insofar as banks are special, i.e. the Modigliani-Miller's irrelevance proposition only holds to a degree, there will be costs in terms of lost output. And, to state the obvious, banks, per definition, have a higher leverage than typical non-financial firms since they provide their clients with deposits (checking accounts etc. or inside money). These liabilities "are really a product supplied by the bank rather than simply a means of funding the bank" (Herring 2011, p. 9). Clearly, the

[52] Regulations are directly applicable, must be implemented as such. They leave no room for national derogations. In this case, the regulation concerns the prudential requirements (capital, liquidity, leverage, disclosure requirement etc.) to be heeded by credit institutions. The objective is to establish a single rule book for the European Union.

[53] In Europe, using a harmonized and more stringent definition of capital, banks have to hold capital amounting to at least 8% of risk-weighted assets: this includes common equity of 4.5% (instead of 2% under Basel II), topped up with additional Tier 1 and Tier 2 requirements. Additional buffers (for capital conservation, cyclical shocks as well as systemic risks of large banks) are added.

[54] These effects are substantial. Based on work by Laeven and Valencia (2008) as well as Reinhart and Rogoff (2009), the Basel Committee on Banking Supervision (BCBS) assesses the median loss to be 63 percent of a base year's income with an annual probability of such a loss occurring between 3.6% and 5.2 %. Increasing capital (and liquidity) requirements reduces crisis probabilities, though with diminishing effect (BCBS 2010, p. 16).

[55] In addition to the reinforced prudential requirements (capital, liquidity), building on a report by a High-Level Experts Group (Liikanen et al. 2012), the EU adopted in 2014 a directive on the recovery and resolution of banks as well as common approach to bank restructuring (or unwinding, if need be). To ensure the applicability of the newly established requirements for bail-inable debt, a minimum volume of eligible (junior) instruments should be issued. This relies – ex ante – on the monitoring role of subordinated debt. If applicable, it would also – ex post – facilitate bank-insolvency procedures.

societal costs of higher capital requirements should be balanced against the benefits of a less crisis-prone system.

Over and above Basel III, the CRD IV also enhances governance with its stipulations on remuneration, the risk management function (risk oversight by boards) as well as additional transparency requirements (profits, taxes etc.).

As regards the second innovation, Banking Union - the new institutional set-up of supervision and bank resolution in the Euro Area - is, from a corporate governance perspective, arguably more pertinent than the changed rules. [56] Here, we touch on three aspects only. The first is the Europeanization of supervision. The Single Supervisory Mechanism, comprising the ECB as well as the competent national authorities), located in the ECB, but carefully separated from the institution's monetary wing, is supposed to implement the single rule book in a consistent way across member states. In essence, it denationalizes banking politics, severs the link between national supervisors and the supervisees (Kotz 2014). This approach is crystallized in the bank-individual Joint Supervisory Teams, in charge of monitoring the about 120 largest European banks (more than 4/5 of the EA banking market). On a more operational level, monitoring devices like the comprehensive balance sheet assessment or the ensuing stress-testing have had very practical consequences. For example, within banks, they strengthened the role of the Chief Risk Officer. This also holds true with regard to the *Banking Recovery and Resolution Directive*, which established the Single Resolution Mechanism and, inter alia, calls for the development of a recovery plan – not unlike the living wills to be submitted in the U.S. – to be updated at least annually. One positive effect of this exercise is to increase transparency about critical functions *within* banks.

It is more than evident that these requirements have far reaching consequences for the structures and strategies of banks. And equally evident, these new rules of the game have far-reaching implications for which interests, and by way of implication also whose interests, banks' top managers must consider when they make decisions. In this sense, they are a part of the set of incentives and restrictions of bank managers and (supervisory) board members and thus of banks' corporate governance regimes in the broad sense of the term laid out above.

Imposing restrictions for the structures, strategies and policies that banks and their leaders have to observe is one way of shaping the governance of banks.[57] Especially in countries where depositors and other creditors do not have a direct involvement of any kind in decision making and the monitoring of

[56] Similar developments took place in the US, where the Dodd-Franks Act of 2010 substantially strengthened the supervisory role of the FED, and the UK, where the Bank of England has again been made the main bank supervisor.

[57] Hopt (2017), Laeven (2011) and Laeven and Levine (2009) also emphasize that regulation-imposed restrictions can be interpreted as substitutes for a direct involvement of stakeholders, especially depositors and other creditors, in the governance of banks.

top management and in which the sole responsibility of top management is towards shareholders, it may be a useful alternative to protect the interests of other stakeholders at least to a certain extent. But even in countries like Germany, where bank top managers have, for different reasons, a certain responsibility to several stakeholder groups, imposing restrictions of the kind described here is a useful complement, likely to strengthen the stakeholder orientation of the governance regime in practice.

c) The post-crisis academic research on banks' corporate governance

The crisis experience has ushered in a flood of relevant papers. Some are genuine research papers, some are of a more descriptive nature, and some are primarily policy oriented. It is beyond the scope of this article to provide a full account of the relevant literature; several useful surveys have already been mentioned. Instead, we only highlight a few aspects that have a direct bearing on policy implications.

As far as the general orientation is concerned, it is evident that a number of contributions concur in emphasizing that (1) deficiencies of bank corporate governance, (2) inadequate regulation and supervision and (3) strong risk-inducing incentives for bank managers due to performance-based compensation – and even more so the combination of all three – may have substantially contributed to the emergence and the severity of the financial crisis (e.g. Laeven 2011). However, how much importance the individual elements of this "toxic mixture" of deficiencies have is a controversial point. For instance, Hopt (2017) expresses doubts concerning the extent to which governance failures alone bear a large part of the responsibility for the crisis. On the basis of a thorough empirical analysis, Berger et al. (2016) question the strong negative risk-inducing effects that performance-based compensation for top managers of banks is often assumed to have and instead show that remuneration schemes for managers lower in the hierarchy may have been a more important contributor to the crisis.

Equally on a general level, almost all recent post-crisis academic contributions now acknowledge that bank governance is indeed special and that in particular the lack of concern for depositors in the existing governance regimes of the Anglo-Saxon countries and others that strive to mimic these regimes should be reconsidered. This aspect had already been pointed out in the already mentioned contribution of Macey and O'Hara (2003). As Hopt puts it, shareholder governance needs to be complemented by what he calls depositor or creditor governance.

When it comes to discussing details, most Anglo-Saxon academic contributions follow the same internal logic (e.g. Mehran et al. 2011): After stressing that bank governance is different, they address, one by one, four areas of governance: executive compensation, board composition and board members' required qualification, the appropriate role of risk management as a part of governance and finally the potential role of market discipline.

Most remarkably, however, important empirical studies of Beltratti and Stulz (2010) and Fahlenbrach und Stulz (2011) find that banks with strong shareholder value orientation, performed better before the crisis, but worse in the crisis. These results have been corroborated by Brealey, Cooper and Kaplanis (2012).

However, there is one surprising feature of the current academic debate, even if it is explicitly policy-oriented: Hardly any contribution questions the assumption that the general governance and ownership regime of the large shareholder-owned corporation is the only suitable legal form of a bank. Or, to be more explicit, one looks in vain for any reference to other types of banks such as public (savings) banks and cooperative banks. They simply do not seem to exist in the academic debate. We regard this as a serious lacuna. Considering the German experience might have suggested pondering an alternative option.

d) A reassessment of policy options in the wake of the crisis?

As concerns non-standard legal forms of banks (public savings banks or cooperatively owned credit institutions), the policy debate seems to have become somewhat more open-minded. The relative crisis resistance of the two groups of banks in Germany, the public local savings banks and the cooperative banks, sheds a new light on the relative advantages of their business models as well as on their governance and ownership regimes. The skepticism concerning "non-conventional" forms of banking, prevailing since the turn of the century (Schmidt 2009), has lost much of its appeal.

Political calls to privatize all public banks or opening them up for acquisitions by private banks, as it had often been requested before the crisis hit, are heard much less frequently in Germany. Also, at the EU level, a change of mood is discernible. The argument that diversity of bank types and ownership models in banking may have its positive sides (Ayadi et al. 2009 and 2010) is gaining ground. Explicitly referring to the consequences of the financial crisis, the former EU Commissioner Michel Barnier said that he now appreciated the importance of also having this type of banks, as well as cooperatives, as an integral part of a sound and crisis-resistant European banking landscape. He added, that he would take care that their "specialness" will not be endangered by the EU-level regulations (Handelsblatt 2011).

And even at the IMF, formerly the most fervent critic of the German public banks, some changes of views is noticeable. A recent article in the IMF's "Finance and Development" (Ostry et al. 2016) with the provocative title "Neoliberalism: Oversold?" points in this direction. Even though this article does not explicitly refer to banking, its plea for "Finding a right balance" between state and private sector indicates a certain reorientation in a direction apparently gaining ground at the IMF more generally. This might even have repercussions for the financial sector policy of the IMF, some time.

Thus, the doors to a fundamental political debate about the important issues of banks' corporate governance may be more open now than they have been for a very long time.

IV. By way of concluding

The standard model of corporate governance did not hold up well – during the last two crises, i.e., neither in the Enron et al. crisis of the earlier 2000s nor in the Great Financial Crisis which broke in 2007 – and it still lingers.

In fact, as an upshot of the GFC it became clear that the corporate governance of banks is different. Banks are excruciatingly difficult to read, not only from the outside. The BIS, for example, has established working groups with the mandate to understand the substantial differences in risk-weighted assets. (In a similar vein, quantitative impact studies to reality-check capital requirements, as they arose from bank-internal models, were regularly run numerous times before assessments of riskiness converged.).

It is even more complicated: Those who interpret the GFC as largely a failure of corporate governance systems, and mainly in public sector banks, are faced with (at least) five problems.

- First, and most embarrassingly, banks with the strongest shareholder-oriented governance performed worse during the crisis. As Colin Mayer writes: "Improving corporate governance [as conventionally understood] would have led to worse performance in the financial crisis" (Mayer 2013, 61).
- Second, most vulnerable have been those institutions which had most of their funding in interbank markets, or through other types of non-deposit funding (repos etc.) as well as a high leverage, all the three making them particularly vulnerable to *wholesale* runs. On an international scale, this includes, of course, mainly private sector, shareholder-focused institutions.
- Third, the opacity of banks is so high, that supervisory boards would be challenged if they were supposed to drill deep into financial engineering products and their portfolio consequences, which ultimately count. The Report which UBS had to write in 2008, upon request from its supervisor, to its shareholders is particularly telling.
- Fourth, boring banks, attempting to generate satisficing returns only, performed on average and over the long haul better. They have less ambitious performance goals and they account for a broader base of interest.
- Fifth, and finally, in as much as the crisis was systemic – exposing problems across institutions, their common exposure to correlated risks – appropriate corporate governance would of course not have been an answer.

It was apparently not the legal (or ownership) structure but business models that fragilized banks – had they been public or private. And, of course, there were very substantial accidents in the private sector in Germany as well. In wholesale banks, it were – ex post – well-defined activities (or business lines) which had been, not long before, hailed as wells of lasting profits.

Experience bears witness to the fact, that banking systems including boring banks, i.e. those with a broader stakeholder orientation and less of a focus on short-term profits, appear to be more resilient. In the case of Germany's local banks, with geographically constrained reach, some of the agency conflicts between creditors and debtors are attenuated by rather granular monitoring procedures (auditing associations). They complement public supervisors. Their examinations are supposed to protect the group-wide insurance schemes; hence they are rather intrusive. Peer-group control, being external and independent, adds a further layer of protection.

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List of abbreviations

AIG	American International Group
BCBS	Basel Committee on Banking Supervision
CDS	Credit Default Swap
CRD	Capital Requirements Directives
FMSA	Bundesanstalt für Finanzmarktstabilisierung
HRE	Hypo Real Estate
IKB	Deutsche Industriebank
KfW	Kreditanstalt für Wiederaufbau
OTC	Over-the-Counter
RLB	Raiffeisenlandesbank
SoFFin	Sonderfonds Finanzmarktstabilisierung
TLAC	Total Loss-Absorbing Capacity