DEVELOPMENTS

Book Review – Krahnen/Schmidt, The German Financial System (2004)

*By David C. Donald**

Jan Pieter Krahnen and Reinhard H. Schmidt, editors, THE GERMAN FINANCIAL SYSTEM, Oxford University Press, Oxford, U.K. 2004, ISBN 0-19-925316-1, pp. 550, Price £79.00. Also available at Oxford Scholarship Online.

The German Financial System (Oxford: 2004) presents a detailed, economic analysis of the German banking and securities sectors as at mid-2003 and should be read by anyone who is serious about understanding German finance. The book is edited by Prof. Jan Pieter Krahnen, who is the director for Frankfurt's Center for Financial Studies,[1] and Prof. Reinhard H. Schmidt, who is a member of the Faculty of Economics and Business Administration of the Johann Wolfgang Goethe-Universität in Frankfurt.[2] Professors Krahnen and Schmidt also contribute individual chapters as well as introductory and concluding chapters that serve to frame the text. The remainder of the book is written by a team predominantly composed of German economists, with the support of a couple of legal scholars.

The German Financial System (hereinafter referred to as the "book" or the "text") is written in a very readable English for international consumption (including electronically over the internet). Although it is an anthology of articles authored by separate experts in various fields of research, each chapter was prepared with an eye on the book's overall design. It presents the German banking and securities sectors as they stood in early 2003, half way through an extensive program of legislative reform and beset by self-doubt after the collapse of the 90's bull market in which the reform movement had found support. The book focuses on the German

*Research Associate and doctoral candidate, Institute for Law and Finance, Johann Wolfgang Goethe-Universität, Frankfurt am Main. Email donald@ilf.uni-frankfurt.de.

[1] Information on the Center for Financial Studies and its activities is available at http://www.ifk-cfs.de/English/homepages/h-wiruberuns.htm.

[2] Information on the Faculty of Economics and Business Administration is available at http://www.wiwi.uni-frankfurt.de/1.0.html?&L=3.

https://doi.org/10.1017/S2071832200013961 Published online by Cambridge University Press

banking and securities sectors in their functions of financing the other sectors of the economy, asks whether the German economy is really "bank dominated" with "underdeveloped" capital markets, and – finding this to be the case – whether it is a good thing to push toward a more "market-oriented" system. The text carefully evaluates the leading economic studies of the German financial, securities and corporate sectors, and analyzes much studied topics like the "*Hausbank*" relationship and the application of the "path dependence" theory formulated by Professors Lucian Ayre Bebchuk and Mark Roe[3] to Germany's corporate and financial systems. My review will only touch some of the obvious highlights of this dense, 514 page work.

A carefully written text by German scholars in English is a welcome event. Twentieth century Germany is a fascinating object for scholarly study in numerous disciplines. For example, during a mere thirty years from 1919 to 1949, the German state abruptly jolted through five forms of government: from a monarchy to a democracy to a Nazi dictatorship,[4] and then into two separate governments, one democratic and the other communist.[5] In 2005, Germany presents the intriguing feature of a country with a culturally homogeneous history, but whose population was for an entire generation separated into two groups, isolated from one another, and educated in different political philosophies that were nearly diametrically opposed. If "irrational exuberance" caused serious whiplash among U.S. investors between 1996 and 2002, one can only attempt to imagine the psychological impact of a "newly liberated" German stepping out of communism to invest in Germany's late 1990's IPO boom only then to lose her entire savings by 2002. The authors wrote their contributions to the text shortly after this significant collapse of the equity markets.

Further, it is always difficult to understand the inner workings of any country from the outside. The English-speaking world has been fortunate to often receive the expert knowledge of ex-patriot Germans. The United States received a first large wave of Germany's best and brightest in the mid-nineteenth century when their attempts to form a German nation with a constitutional, democratic government

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[3] See Lucian Ayre Bebchuk & Mark Roe, *Path Dependence in Corporate Ownership and Governance*, in: CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE 69 (JEFFREY N. GORDON & MARK ROE, EDS. 2004). The essay was originally published in 52 STAN L. REV. 127 (1999). The 2004 version contains references to newer empirical research.

[4] See *e.g.*, MICHAEL STOLLEIS, GESCHICHTE DES ÖFFENTLICHEN RECHTS IN DEUTSCHLAND: WEIMARER REPUBLIK UND NATIONALSOZIALISMUS 74, 316 (2002).

[5] See GOLO MANN, DEUTSCHE GESCHICHTE DES 19. UND 20. JAHRHUNDERTS 981 (1992)

https://doi.org/10.1017/S2071832200013961 Published online by Cambridge University Press

came up against the Prussian military.[6] Toward the middle of the twentieth century, the United States then received a second wave of highly talented Germans who fled the horrors of Nazi Germany. Such ex-patriot Germans brought an intimate knowledge of Germany to U.S. universities and shared their insights with a generation of students. The reasons for such emigration have of course long disappeared, and the trickle of younger German scholars into North America – such as, for example, Peer Zumbansen in Toronto, Katharina Pistor at Columbia, and two of the authors of the book, Christian Leuz at Wharton and Frank Schmid at the Federal Reserve Bank – no longer completely fills the demand for information about Germany. U.S. legal scholarship has thus in recent years come to depend more and more on the studies and observations of talented Americans who do not necessarily bring a "native" understanding of Germany, its language and culture, to their work. One thinks in particular of Mark Roe's various analyses of German bank holdings and "social democracy" as determinants of German corporate governance.[7]

While this American-based scholarship on Germany is valuable, it tends to use Germany as one of a number of exterior controls to prove or disprove a theory formulated primarily for use in the United States. The scholarship asks: "Why isn't Germany like us?" and "What is the social cost or (even) benefit of this deformation?" Indeed, even if the analysis is not burdened with a specific agenda, the starting point of any comparison will already tend to stencil out a caricature: the second object compared usually looks quite different exactly because it is the second object. If you start with a chair and compare a table to it, the table will be characterized as extremely broad, high and missing a backrest. If you begin, say, with German corporate law and compare U.S. corporate law to it, the U.S. law will be characterized as lacking detailed appraisal procedures to guarantee accurate valuation of in-kind capital contributions and bereft of rules for the treatment of shareholder loans in the case of insolvency, not to mention totally lacking any provision for independent, supervisory directors. These are major topics in any text on German corporate law, while the first two are hardly addressed in a similar, U.S. text, and the third falls into the realm of securities regulation. In this way, even a completely neutral starting point for a comparison removes from view many of the subjects that a U.S. scholar would traditionally focus on and highlights absences as potential deformities.

In the field of law – in addition to the fine contribution of *The German Law Journal* – there is a growing supply of high-quality work in English on Germany by some of

[6] *Id.*, at 248.

[7] See MARK ROE, THE POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE (2003) and STRONG MANAGERS WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994).

https://doi.org/10.1017/S2071832200013961 Published online by Cambridge University Press

Germany's best legal scholars. These include works by Klaus Hopt (based in Hamburg)[8] and Theodor Baums (based in Frankfurt)[9] on corporate law, by Michael Gruson (based in New York and Frankfurt)[10] and Norbert Horn (based in Cologne)[11] on banking law, and by Michael Stolleis (based in Frankfurt)[12] on legal history. The *German Financial System* fits in this newer line of work and would be valuable – if for nothing else – exactly because it gives the foreign reader an understanding of the German financial system as it is currently understood by leading scholars within Germany.

The book is organized as a tightly knit anthology. Analyses of individual sub-sectors of the economy and related topics are sandwiched between introductory and concluding chapters that serve to guide the reader's focus and interpret the book's content, without forcing the reader to reach a specific conclusion. The first chapter, which is available on the internet,[13] is aptly entitled "The Purpose and Structure of the Book" and explains the book's main goal. Professors Krahnen and Schmidt explain that the book is a "country study" that aims to set forth the political determinants behind the evolution and shape of the German financial system: "The individual chapters of this book are, therefore, meant not only to provide information and analysis, but also to shed light on a number of myths surrounding the German financial system. Perhaps the most obvious myth about the German financial system is the contro-

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[8] See, for example, REINER R. KRAAKMAN, PAUL DAVIES, HENRY HANSMANN, GÉRARD HERTIG, KLAUS J. HOPT, HIDEKI KANDA, AND EDWARD B. ROCK, THE ANATOMY OF CORPORATE LAW A COMPARATIVE AND FUNCTIONAL APPROACH (2004), and KLAUS HOPT & EDDY WYMEERSCH, EDS. COMPARATIVE CORPORATE GOVERNANCE (1997).

[9] See, for example, Theodor Baums & Kenneth Scott, "Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany," Johann Wolfgang Goethe-Universität, Institute for Banking Law, Working Paper No. 119 (2003), available at http://www.jura.uni-frankfurt.de/baums/; Baums, *Changing Patterns of Corporate Disclosure in Continental Europe: The Example of Germany*, in: GIURISPRUDENZA COMMERCIALE (2003); Baums, *Chapter on Germany*, in: SHAREHOLDER VOTING RIGHTS AND PRACTICES IN EUROPE AND THE UNITED STATES 109 (THEODOR BAUMS & EDDY WYMEERSCH, EDS. 1999); Baums, *The German Banking System and its Impact on Corporate Finance and Governance*, in: THE JAPANESE MAIN BANK SYSTEM 409 (MASAHIKO AOKI & HUGH PATRICK, EDS. 1995); and Baums, *Takeovers versus Institutions in Corporate Governance in Germany*, in: CONTEMPORARY ISSUES IN CORPORATE GOVERNANCE 151 (D. D. PRENTICE & P. R. J. HOLLAND, EDS. 1993).

[10] Michael Gruson, *Banking Regulation and Treatment of Foreign Banks in Germany*, in: REGULATION OF FOREIGN BANKS 339 (MICHAEL GRUSON & RALPH REISNER, EDS. 3RD ED. 2000).

[11] NORBERT HORN, ED. GERMAN BANKING LAW AND PRACTICE IN INTERNATIONAL PERSPECTIVE (1999).

[12] See, for example, MICHAEL STOLLEIS, A HISTORY OF PUBLIC LAW IN GERMANY 1914-1945 (THOMAS DUNLAP, TRANS., 2004). The German edition of this work is cited in footnote 4.

[13] The chapter is available free of charge in PDF form on the Oxford University Press website at http://www.oup.co.uk/pdf/0-19-925316-1.pdf.

https://doi.org/10.1017/S2071832200013961 Published online by Cambridge University Press

versy concerning relationship lending."[14] Various chapters of the book offer evidence from a number of angles to prove that the German financial system is indeed "bank-based" rather than "market-based." Yet this only tells half of the story about the book's purpose. Chapter 2, entitled, "What Constitutes a Financial System in General and the German Financial System in Particular?" sets forth the theoretical framework for the text. The chapter describes a number of increasingly sophisticated models through which a "system" can be understood, ascending from a mere descriptive enumeration of the institutions in an economy (the reader is certainly familiar with this approach, which is used in many overview texts), through an analysis of the roles that particular institutions play in an economy or sector (this functional approach is a standard practice in comparative studies), to an analysis of the complementary and consistent links between individual elements that cause such elements to constitute a system. The authors build on this last model, which they draw primarily from the work of Paul Milgrom and John Roberts, who in turn base their work on a branch of mathematics known as "lattice theory".[15] However, as Chapter 2 explains, the book applies the theory somewhat intuitively and analogically:

"Unfortunately, a formal proof of complementarity and consistency based on the mathematical theory which underlies the theory of complementarity cannot be performed in practice because it would require much more information than is available. However, one can attempt to describe a given financial system informally in such a way that complementarities which are *presumed* to exist become visible. If one can show that different key elements of the financial system in question fit together in a specific way, then this system is also likely to be consistent..."[16] "[Moreover,] we assume that the consistency of a financial system, or a good fit of its main elements, creates economic benefits."[17]

As a consequence, the text places its discussion of the "bank-based" nature of the German financial system within a framework of presumed (unproved) complementarities that are also not really proven to be consistent, and this assumed systematic network is then further assumed to be efficient. The overall structure looks like the arguments sometimes promoted in modern theory of science, in which a theory might be evaluated by internal consistency rather than external verifiability. As

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[14] JAN PIETER KRAHNEN & REINHARD H. SCHMIDT, EDS. THE GERMAN FINANCIAL SYSTEM 4 (2004).

[15] See Paul Milgrom and John Roberts, *Complimentarities and fit: Strategy, structure and organizational change in manufacturing*, 19 JOURNAL OF ACCOUNTING AND ECONOMICS 180, 181 (1995).

[16] Krahnen & Schmidt, *supra* note 14, at 29.

[17] *Id.*, at 62.

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said, this theory is introduced in the first and last chapters as a framework within which the text may be interpreted, and does not really affect the content of the other chapters with the exception of Prof. Schmidt's economic analysis of German corporate governance in Chapter 12.

The book offers information and insights on most aspects of German finance. The text contains three excellent chapters detailing the types of German banks, how they are regulated and the costs and benefits of their typical relationships, in particular the *Hausbank* relationship, with client firms. In another chapter, Dr. Andreas Worms, Deputy Head of Money and Capital Markets at the Deutsche Bundesbank, explains in detail the roles played by banks in channeling monetary policy from the European Central Bank to the non-financial sectors of the German economy. An otherwise very useful chapter – authored by Prof. Raimon Maurer - describes the types of institutional investors that are active in the German market, the economics of their growth, and their regulation. It must, however, have gone to press just before Germany's Investment Modernisation Act went into final form in 2003, which makes the chapter in part somewhat out-of-date.[18] Two chapters present a competent outline of the German equity markets and existing measures for investor protection, although the authors' good work has, again, partly been out-paced by the rapid change that the German markets have experienced in recent years.[19] A related chapter presents valuable insight into the trends in initial public offerings and venture capital over the years and investigates why the volumes of such activity differ from that found in the United States and the United Kingdom. In another chapter, two professors of accounting (Jens Wüstermann at Mannheim and Christian Leuz at Wharton) view German accounting rules in light of the accusation that they provide less information than their U.S. and U.K. counterparts, and conclude that German accounting principles were indeed designed for a system of insiders. Three other chapters address corporate governance and the market for corporate control in Germany.[20]

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[18] On the Investment Modernisation Act, *see* Edgar Wallach, *Hedge Funds Regulation in Germany,* in: HEDGE FUNDS: RISKS AND REGULATION 119 (THEODOR BAUMS & ANDREAS CAHN, EDS. 2004).

[19] Since the book was published, Germany has adopted the Investor Protection Improvement Act of 28 October 2004 (*Das Gesetz zur Verbesserung des Anlegerschutzes vom 28.10.2004*), which significantly amended the Securities Trading Act (*Wertpapierhandelsgesetz*) to bring German rules on insider dealing and market manipulation into conformance with EU rules, a Business Integrity and Modernization of Shareholder Actions Act (*Gesetzes zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts*, or "UMAG"), which facilitates shareholder suits against management, and the Securities Suit Joinder Act (*Gesetzes zur Einführung von Kapitalanleger-Musterverfahren*), which allows a number of related securities complaints to be joined together for streamlined proceedings.

[20] For a summary of the German government's program to reform corporate governance and the measures taken up through 2002, see Theodor Baums, *Company Law Reform in Germany*, JOURNAL OF CORPORATE STUDIES 181 (2003). Professor Baums chaired the government's special Commission that studied

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The reader comes away from the book with an excellent overview of the German banking system, a good idea of the types and position of institutional investors active in Germany and an understanding of how the German equity markets are structured. However, the book's particular focus on the relationship between banking and industry, and on the effects of this relationship on the development of the equity markets and corporate governance has led to the exclusion of two of the more significant elements of German finance. First, the active German debt market, and its peculiar institution of the *Pfandbrief* are hardly discussed.[21] Nowhere in its discussion of organized equity markets does the book give more than a passing reference to Eurex, which is the world's largest futures and options exchange, and is jointly operated by Deutsche Börse AG and SWX Swiss Exchange.[22] Eurex eclipsed the London futures market not long after its creation and has quickly grown into one of the world's premier markets.[23]

The book's strength is its analysis of the role of banks in Germany. Chapters 2 and 3 present convincing evidence that Germany indeed has a bank-based financial sector and that intermediation through banks is still strong in the German economy, and Chapter 7 provides a careful analysis of the *Hausbank* relationship and its potential advantages.

German corporate and securities law and produced a report containing recommendations in 2001. For an inside account of the Commission's work, see Baums, *Reforming German Corporate Governance, Interview*, 2 GERMAN L.J. No. 12 (16 July 2001), available at: http://www.germanlawjournal.com/article.php?id=43. Most of the Government Commission's recommendations have been enacted. *See* preceding note for a partial list of laws enacted. An English translation of the Commission's recommendations is available as an annex to Theodor Baums, *Company Law Reform in Germany*, INSTITUT FÜR BANKRECHT ARBEITSPAPIER NO. 100 (2003), available at http://www.jura.uni-frankfurt.de/ifawz1/baums/Bilder_und_Daten/Arbeitspapiere/.

[21] For an in-depth analysis (in German) of the German regulation of debt issues and reforms that are being contemplated, see THEODOR BAUMS & ANDREAS CAHN, EDS. DIE REFORM DES SCHULDVERSCHREIBUNGSRECHTS (2004).

[22] For information on the establishment of Eurex, see Siegfried Kümpel, BANK- UND KAPITALMARKTRECHT 2085 *ET. SEQ*. (2ND ED. 2000). Current information on Eurex, including a link to information on its Chicago-based subsidiary, eurex US, is available at http://www.eurexchange.com/index.html.

[23] As Pagano and von Thadden note, "The volume of trade on EUREX has increased almost tenfold between 1996 and mid-2001, from € 172.4 billion to € 1,639.1 billion . . . . In the process it killed off Bund futures trading on London's LIFFE. Also futures trading in French, Italian, and Spanish bonds dwindled into disappearance by 2001." Marco Pagano & Ernst-Ludwig von Thadden, *The European Bond Markets under EMU* 16 (Working Paper, November 2004), Forthcoming in the OXFORD REVIEW OF ECONOMIC POLICY.

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In Chapter 2, Schmidt & Tyrell explain that influential studies published during the 1990's appeared to prove that the German economy was no more bank based than, say, the United Kingdom.[24] Yet this chapter cites work by Hackethal (one of the co-authors of the text) & Schmidt[25] that demonstrates these studies rested on the following erroneous assumption: "all financing that flows from one type of source, such as the funds flowing from the banking sector to the non-financial sector, are first used to fund the reverse flow of the same type, such as debt repayment from corporations to banks. By implication, it is assumed that only what remains after this netting is used for investment purposes."[26] Since loans must be paid back, this assumption resulted in a net flow of zero funds from the banking sector to the non-financial sectors, leaving internal financing as the dominant source of funds for the non-financial sectors. Instead of netting out fund flows, Hackethal & Schmidt look at "gross financial flows, without specifying ex ante how any of the inflowing funds are used."[27] The results show that "German banks provide a far larger share of external corporate financing than American banks, whereas securities financing . . . is virtually insignificant."[28]

In Chapter 3, after outlining the types, sizes, numbers and market shares of the various types of banks in Germany, Professor Andreas Hackethal uses intermediation ratios[29] and securitization ratios[30] to analyze the role of banks in Germany as compared to the economies of the United States, the United Kingdom, France and Japan. His results show that in the United States and the United Kingdom, "[b]ank loans, commercial paper, corporate bonds, and corporate equity held by banks constituted only about 10 per cent of enterprises' total inter-sector liabilities at the end of the observation period [1998]. . . . In sharp contrast . . . . [in Germany] [t]he ratio

[24] See Krahnen & Schmidt, *supra* note 14, at 44.

[25] Andreas Hackethal & Reinhard H. Schmidt, *Financing Patterns : Measurement Concepts and Empirical Results*, WORKING PAPER NO. 33, FINANCE AND ACCOUNTING SERIES, UNIVERSITY OF FRANKFURT (2003), a revised version (WP 125) is available at http://www.wiwi.uni-frankfurt.de/schwerpunkte/accounting/index.php?men=4&lg=0&case=wp.

[26] Krahnen & Schmidt, *supra* note 14, at 46, also see p. 94.

[27] *Id*., at 46.

[28] *Id.*

[29] "Intermediation ratios measure the proportion of sectors' total financial assets and liabilities, respectively, that constitute claims on financial institutions (asset intermediation ratios) or liabilities vis-à-vis financial institutions (liability intermediation ratios)", *id.* at 90-91.

[30] "Securitization ratios take an instrumental perspective and measure the proportion of total claims and liabilities, respectively, that take the form of securities", *id.* at 91.

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has remained roughly constant at 60 per cent".[31] Hackethal concludes that "the immense stability in intermediation ratios and financing patterns of firms between 1970 and 2000 . . . [is] strong evidence for our view that the way in which and the extent to which German banks fulfil the central functions for the financial system are still consistent with the overall logic of the financial system".[32]

Chapter 7 is perhaps the most interesting in the book. In it, Elas & Krahnen provide a very insightful analysis of the *Hausbank* relationship. The results of a 1997 study questioning banks about their relationships with clients showed that a *Hausbank* typically has:

- a high share of the client's debt financing,
- a high share of the client's payment transactions,
- a high share of the client's long-term or short-term financing,
- a special, intense or exclusive business relationship with the client,
- a long-term relationship with the client firm, and
- influence over the client firm's management.[33]

The chapter then performs a careful evaluation of the empirical studies testing the potential benefits of the *Hausbank* relationship. The chapter concludes that *Hausbanks* typically have access to non-public information from their borrowers, especially in the case of mid-sized firms, that the relationship tends to facilitate financing after rating downgrades, and that *Hausbanks* are more likely to take part in workouts of distressed client firms.[34] The authors do not examine the relationship between the possession of non-public information and the rules on insider dealing, market manipulation, and required current reports.

The only disappointment in Chapter 7 is a discussion of custodian banks' exercise of the voting rights from their customers' shares. Surprisingly, the chapter fails to acknowledge the significant reforms of proxy voting that the German government found necessary to enact in 1998[35] and 2000,[36] and also appears to equate collective

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[31] Krahnen & Schmidt, *supra* note 14, at 93-94.

[32] *Id.*, at 100-101.

[33] *Id.*, at 211-212.

[34] *Id.*, at 227.

[35] See Law for Monitoring and Transparency in Business Undertakings (*Gesetz zur Kontrolle und Transparenz im Unternehmensbereich*).

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action problems that may stand in the way of coordinated action by custodian banks with the outright exclusion of such action.[37] Oddly enough, the authors ignore the findings of the German government when preparing the 1998 and 2000 legislation, fail to consider newer figures on bank equity and proxy votes,[38] apparently fail to grasp the problem of custody account votes being used to "rubber-stamp" management positions, and then without offering anything more, assert in summing up the chapter that "contrary to the common presumption in the literature, the available evidence does not suggest that banks use proxy-voting rights in a systematic way to influence management decisions."[39] Regretfully, this does not match the rigor found in the rest of the chapter.

A theory of the German financial system's complementary "inner logic". As said above, the text not only describes the institutions of the German banking and securities sectors and attempts to pin down the true functions of individual institutions and relationships, but also seeks to present (at least intuitively) the inner complementariness and consistency of the system's components, as well as relate such systemic feature to the process of evolution and reform taking place at the time the book went to print. The theoretical framework is to be understood in the context of the "path dependence" theory of Bebchuk and Roe, as a related publication by Schmidt & Spindler makes clear,[40] and it seeks to find confirmation in the various conclusions presented in the book. The theory is discussed at varying levels of abstraction and with somewhat varying conclusions in Chapters 2, 12 and 15. The text posits an insider system of "three groups of powerful and 'influential' stakeholders – blockholders, employee and/or union representatives, and banks."[41] and finds that the monitoring activity they perform is "made relatively easy by the fact that the groups which form what we have called the governing coalition have a largely similar long-term goal. It does not consist in the maximization of shareholder

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[36] See Law Concerning Registered Shares and to Facilitate the Exercise of Voting Rights (*Gesetz zur Namensaktie und zur Erleichterung der Stimmrechtsausübung*).

[37] See Krahnen & Schmidt, *supra* note 14, at 200-202.

[38] See FABRIZIO BARCA & MARCO BECHT, THE CONTROL OF CORPORATE EUROPE (2001).

[39] See Krahnen & Schmidt, *supra* note 14, at 227.

[40] See Reinhard H. Schmidt & Gerald Spindler, *Path dependence and complementarity in corporate governance*, in: CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE, *supra* note 3, at 114.

[41] See Krahnen & Schmidt, *supra* note 14, at 395. For a similar finding of complementary between at least two of these elements, see also ROE, DETERMINANTS *supra* note 7, at 81 ("Codetermination and block ownership are complementary, and it is hard for one to exit without the other also existing, irrespective of which one came first.")

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value, but rather in ensuring stability and growth."[42] The goal of the business corporation is thus complementary and consistent with the interests of its governing coalition. Moreover, the nature of the coalition and the goal of the corporation are consistent with other characteristics of the German financial system: "Its functioning rests on internal, non-public information as opposed to public information,"[43] and corporate finance comes largely from relationships with a small number of banks.[44]

One result of constructing a constellation in mutually dependent balance is, however, that change is made very difficult. If a policy maker sets the goal of constructing a harmonious model reflecting an accepted paradigm, individual elements like protecting the rights of a given group or achieving a certain economic result will become less relevant than the overall design. This systemic perspective can be seen in the text's discussion of Germany's efforts to reform its corporate governance system. The text admits that the German system of insider control may benefit by extracting rents from disenfranchised outsiders:

"Where does this compensation [for active participants in monitoring] come from? In part . . . . it may also come from the 'exploitation' of those shareholders who are not insiders, that is, the small shareholders and possibly also some institutional investors. There is no doubt that shareholder protection has been weak in Germany for a long time. . . . However, in functional terms, it may have been necessary since with a very high level of investor protection in place it might not have been possible to compensate the active stakeholders for their monitoring effort, and thereby to provide them with incentives to monitor management."[45]

The fact that "shareholder protection has been weak in Germany for a long time" led the German Government Commission on Corporate Governance in 2001 to recommend certain actions to strengthen shareholders' rights.[46] Some of the Government Commission's recommendations on investor protection were enacted be-

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[42] Krahnen & Schmidt, *supra* note 14, at 396.

[43] *Id.*, at 397.

[44] *Id.*

[45] *Id.*, at 403. The economic consideration that controlling shareholders may have to be compensated for monitoring activities has also been raised by thoughtful commentators with regard to U.S. corporate law. See Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785 (2003).

[46] See BERICHT DER REGIERUNGSKOMMISSION "CORPORATE GOVERNANCE" (THEODOR BAUMS, ED. 2001).

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fore the book was published and others have been enacted since.[47] Following the theory emphasizing complementariness and consistency, the book does not take issue with the Government Commission's efforts to empower the disenfranchised or increase the attractiveness of the German market for international investors, but rather with its failure to choose "*the best model* of corporate governance for Germany."[48] In the delicate world of complementary and consistent systems, a policy maker cannot simply help one group exercise its rights or discipline the abuse of another, but must *choose an entire model* and replace the old one all at once. In order to avoid imbalance, changes may well be "abrupt and far-reaching."[49] In this way, the theory of complementary constellations runs into a dead end: change might be reasonable, but it creates inconsistency, and yet it is politically impossible to replace an entire financial system simultaneously.

As said, however, the book does not press this theory to the end, but swerves away from its ramifications with a pragmatic wisdom that may be *inconsistent*, but is welcome. In the book's last chapter, Professors Krahnen and Schmidt take a position that no longer posits complementariness and consistency as the measure of German finance, but offers an agnostic assortment of three stylized views: i) a market-based system is better, and evolution towards it increases welfare, ii) consistency is the key, and use of either a pure bank-based or a pure market-based model increases welfare, or iii) a system combining the advantages of bank-based and market-based systems increases welfare.[50] As the "best of both worlds" solution, the authors seem to prefer the last view without first subjecting it to a complementary litmus test. Indeed, the book then offers a refreshingly lawyer-like mechanism that could allow the value of corporate loans containing a valuable element of private, "relationship specificity" to be given an accurate value even under fair value accounting rules by permitting firms to "carry the difference between the nominal value of a claim [i.e., considering the benefits of private relationship] and its fair market value as an asset (i.e., to activate the wedge as a special goodwill asset)."[51] Thus, the book ends as it begins, with plenty of creative energy and valuable insights.

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[47] See *supra* note 19.

[48] Krahnen & Schmidt, *supra* note 14, at 406, emphasis added.

[49] See *id.*, at 389.

[50] See *id.*, at 498-513.

[51] *Id.*, at 512.

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