Introduction to Mini-Forum on German Banks

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The claim that German banks are different has typically been made with reference to the large German commercial banks. These banks control equity voting rights in German public companies (AGs), either through owning shares themselves or through exercising proxy votes for shareholders who have deposited shares with them. Furthermore, these banks are represented on the supervisory boards of AGs. It has been argued that these distinctive institutional features give the large German commercial banks significant information about, and control over, the managers of AGs, which enables them both to play an important role in corporate governance, and to supply more external finance to public companies than do banks in economies without such a significant bank role in corporate governance.

I have questioned this view, both for pre-1914 and post-1945 Germany. Edwards and Ogilvie (1996) argued that AGs did not raise large amounts of external funds from the German Great Banks in the period 1870–1914, and that the evidence available was not generally consistent with the claim that the Great Banks exerted substantial control over industrial companies. Indeed, the high profitability of industrial companies in the period 1895–1914 resulted in such competition between commercial banks for their business that the power in the relationship between banks and industrial companies lay far more with the latter than the former. Edwards and Fischer (1994) studied the more recent period, and concluded that the available evidence did not support the claims that bank supervisory board representation and control of equity voting rights resulted in a greater supply of external finance to AGs or a more effective system of corporate control.

In both Edwards and Ogilvie (1996) and Edwards and Fischer (1994), one component of the argument that the distinctive institutional features of large German commercial banks have received too much emphasis derives from the observation that only a relatively small proportion of economic activity in Germany is carried out by AGs. AGs are the only German firms which are permitted to issue shares and are required to have supervisory boards. By comparison with the U.K., a larger proportion of economic activity is carried out in Germany by private companies (GmbHs), partnerships and sole proprietors. These types of firms do not have supervisory boards and are not permitted to issue shares, and hence the distinctive characteristics of large commercial banks are irrelevant for such firms.

The observation that a relatively large part of economic activity in Germany is carried out by firms other than AGs means that it is misleading to emphasise institutional features of German banks which are relevant only for AGs. But this observation also raises the question of how it is possible for such a large fraction of economic activity to be conducted by GmbHs, partnerships and sole proprietors, none of which are able to raise external finance in the form of tradeable shares for public subscription. Given the large size of many of these non-AG firms in Germany, this is a very important question. A possible answer to this question is that the German banking system is able to provide forms of loan finance which are a close substitute for the equity shares which these firms cannot issue. Since the market for bank lending to German non-bank enterprises is certainly not dominated by the large commercial

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banks, and appears to be competitive, there are a number of other types of German bank than the large commercial ones which are candidates for consideration as providers of such loan finance.

In my view, the most important theme in the following papers by Deeg and Vitols is their argument that the distinctive characteristics of the German banking system reside more with other types of bank than the large commercial ones. Deeg and Vitols focus in particular on the banks contained in the savings bank and credit cooperative sectors. Both of these sectors have a three-tier structure which in principle allows the benefits of decentralised banking based on good local information to be combined with the achievement of economies of scale in the provision of more specialised banking services. The importance of these two banking sectors in the market for bank loans in Germany, and their three-tier structure, are both distinctive features of the German banking system which Deeg and Vitols highlight, correctly in my view. Indeed, while Deeg and Vitols seem to imply that the importance of these banks for the provision of external finance to firms is a relatively recent development, I would suggest that these banks also played an important role in this respect in the pre-1914 period.

The economically important consequence of the competitive market for bank loans in Germany, and in particular the contribution of the savings banks and credit cooperative sectors, might thus be argued to be the ability to provide loan finance that acts as a good substitute for equity finance to firms which cannot issue shares. I am sympathetic to this argument, but it is one which needs to be analysed carefully, since there are some reasons to question it.

If one of the distinctive features of the German banking system is that it provides loan finance as a substitute for share finance to those firms which are not public companies, then it would be expected, given the greater importance of such firms in Germany, that overall use of bank loan finance by non-financial enterprises in Germany should be larger than elsewhere. However, the comparison of the sources of finance for investment by the aggregate non-financial enterprise sectors in Germany and the U.K. in the 1970s and 1980s by Edwards and Fischer (1994) did not provide any evidence that bank loans financed a larger proportion of investment by non-financial enterprises in Germany than in the U.K. The absence of evidence of a greater use of bank loan finance in Germany is particularly striking given the fact that, because of their relative unimportance in the U.K., unincorporated enterprises, which would be expected to be particularly dependent on bank loans for external finance, are excluded from the U.K. aggregate non-financial enterprise sector, but are included in the corresponding German sector. Of course, it is not possible to establish definite conclusions about the importance of bank loan finance for particular types of firms from data on the aggregate non-financial enterprise sector. The aggregate findings do, however, raise some questions about the importance of bank loans for non-AG firms in Germany which can only be satisfactorily answered by comparisons of the sources of finance for investment by similar types of firm in Germany and elsewhere.

Even if it is the case that non-AG firms in Germany do not use more bank loan finance than do similar firms elsewhere, it can be argued that German banks provide loan finance in forms which are more appropriate for financing long-term investment. Both Deeg and Vitols emphasise the high proportion of bank lending to firms in Germany which is long-term (defined as having an original maturity of greater than one year). Such long-term loans form a particularly large proportion of lending to firms undertaken by the savings bank and credit cooperative sectors. This observation certainly suggests that much German bank lending to firms is of a form which appears to be a substitute for the share finance which is unavailable to non-AGs. However, before concluding that this is definitive evidence that the German banking system is different, and provides loan finance in a form which substitutes for shares, it is necessary to go beyond the broad classification of bank loans into different maturities, and analyse the nature of the loan contracts in greater detail.

To begin with, it must be noted that the general business conditions of German banks give them the right to withdraw loans at any time if, in their view, the borrower's position has worsened enough to cause concern, and there is evidence that German banks do use this right when firms are in financial distress. Furthermore, most long-term bank lending is made at an interest rate which is fixed for five years from the start of the loan, but is then renegotiated. Long-term bank lending in Germany does not, therefore, involve banks in unbreakable long-term commitments of finance to firms. Even if it did, however, it is not obvious that this form of lending is superior to alternatives, such as, for example, the financing of long-term investment by a sequence of short-term loans which are rolled over during the lifetime of the investment. Diamond (1991) analyses the trade-off between short- and long-term loans in a two-period model of asymmetric information and incomplete contracting. Firms with profitable investments choose to finance them with short-term loans, planning to refinance on more favourable terms at the end of the first period when new information arrives, while firms with unprofitable projects choose to finance with long-term loans since they do not expect the new information that will arrive during the lifetime of the investment to be favourable. This theoretical analysis suggests that a given total of loan finance may be allocated to better borrowers if it comprises a high proportion of short-term loans rather than a high proportion of long-term loans. More generally, it points to the need for a careful examination of the terms of different types of loan, including the interest rate and collateral requirements, together with the information available to banks, before it can be concluded that loans of long maturities are superior to sequences of short-term loans as a means of providing investment finance to firms. In this context, it is worth noting that in Japan, where bank loans constitute a far larger proportion of the finance of investment by the aggregate non-financial enterprise sector than in Germany (Corbett and Jenkinson (1996)), most of such lending is formally short-term, but is typically rolled-over, so that it is effectively long-term. The general point here is that the economic significance of different forms of lending cannot be assessed solely on the basis of the maturity classification in banks' balance sheets.

The questions I have raised in the preceding paragraphs do not mean that I disagree with Deeg and Vitols in their view that the economically significant ways in which German banks are different are more likely to be found in the relatively competitive nature of the German banking system, and in particular in the importance of the savings bank and credit cooperative sectors, than in the distinctive institutional features of the large commercial banks. I find this view quite persuasive, but I also think that more detailed comparative analysis is required before it can be established definitively.

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