CORPORATE GOVERNANCE EVOLUTION IN BANKS

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VIRTUS INTERPRESS

Virtus Interpress
Kirova Str. 146/1, 20
Sumy, 40021
Ukraine
www.virtusinterpress.org

Published in Ukraine by Virtus Interpress

ISBN 978-966-96872-5-7

CHAPTER 2

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EVOLUTION OF CORPORATE GOVERNANCE IN THE GERMAN BANKING SECTOR

1. Corporate governance in banks

As for bigger companies in other industry sectors, also banks do have complex organization structures. Thus, general thoughts and approaches on/for corporate governance in other (bigger) companies and organizations normally are suitable for banks, too. Nevertheless, there do exist bank-specific aspects and requirements why corporate governance in banks has to be considered differently (Macey & O'Hara 2003).

A first point to be mentioned is the general legal and societal environment of banks which equals the one of other companies with the same legal form. Also banks have to recognize, to identify and to differentiate important stakeholders and define those stakeholders' influence and expectations on/towards the company and the impact which banks' business operations have on those stakeholders. A second point is that banks do have to consider different markets, too. In case where those markets influence the bank it has to mind this information within its decision making processes and strategy formulation as far as it limits or enlarges its scope of action and as far as it provides and changes incentives for action, e.g. on internal and external labor markets - including the market for managers - (Dufey et al. 1998; Fama 1980), equity and debt markets, including stock exchanges (market for corporate control) (Easterbrook & Fischel 1991) and markets for banking services. A third point to be mentioned is that banks do have to comply with the same standards and principles of corporate governance than all of the companies in other sectors. Nevertheless, there are further markets of special interest for banks, which are only in part relevant for other companies, e.g. the interbank market providing a disciplining function for banks' business operations (Schmidt & Noth 2010). Furthermore, especially for banks and other financial institutes there do exist specific regulations (e.g. the German Banking Act) and supervision authorities (e.g. the German Federal Financial Supervisory Authority – BaFin) which don't comparably exist in other industries but are an important part of banks' corporate governance system. This chapter is structured as follows: After a general introduction on general characteristics and requirements of corporate governance in banks in Section 1, Section 2 illustrates the structure and the business development of the German banking sector in the time period from 1970-2010. Section 3 explains the evolution of the predominant corporate governance structures within the three main pillars of the German banking sector. Section 4 summarizes our findings.

2. Structure and business development of the German banking sector

The German banking system is characterized by a great variety of different banking institutions. The predominating institutional banking type is the so-called universal bank (so-called Universalbank) offering a wide range of commercial and investment banking services, either incorporated under private or public law (Schneider et al. 1986). The second important institutional banking type is the specialist bank (so-called Spezialbank) (Klein 1998). Important criteria to differentiate German banking institutions are the legal form, balance sheet total, number of employees, direction of lending business and deposit business, business purpose and ownership structure.

Usually single banking institutions are divided via the criterion “legal form”. As a consequence, there is a three-pillar-structure of the German banking system, consisting of private commercial banks (e.g. Deutsche Bank AG, Commerzbank AG, Dresdner Bank AG, Deutsche Postbank AG; Unicredit Bank AG-HypoVereinsbank), public-law banks (so-called S-Finanzgruppe, e.g. BayernLB, WestLB, HSH Nordbank AG, Stadtsparkasse Hamburg) and mutual savings banks (e.g. DZ Bank, WGZ Bank) (Bofinger et al. 2008). A possible fourth pillar integrates further banks which are not already in one of the first three pillars (e.g. KfW Bankengruppe, Berlin-Hannoversche Hypothekenbank AG, Corealcredit Bank AG).

Private commercial banks are mainly universal banks with the legal form of a corporation, obviously there are also private companies. Private banks are mostly major banks. Furthermore, there are regional banks, individual bankers, local branches of foreign banks and building-credit societies (Schneider et al. 1986). Public-law banks cover land banks, savings banks, land building associations and banks with special tasks. They are usually owned by the Federal Republic of Germany. Federal Lands or single communities and should act on common welfare. All together there are eleven land banks. After some fusions only seven of them are economically independent. Like credit banks, the land banks mainly operate as universal banks, but also as principal bank of Federal Lands and as central institutions for savings banks. Savings banks have also a license to operate as universal banks. Contrary to land banks, they are limited in doing business in specific regions (regional principle) but they cooperate with each other in specific fields like marketing, data storage and processing or product development to raise economies of scale. Generally, takeovers from abroad are strongly limited, whereas takeovers and fusions between land banks or savings banks are possible horizontally and between land banks and savings banks vertically (Bofinger et al. 2008; Schneider et al. 1986; Klein 1998). Mutual savings banks cover credit associations, their central institutes and corporate building associations. The legal form of a German association means that buying stakes of an association makes the stakeholder a member and co-owner and that voting rights’ power does not depend on the amount of the stake: every member has one voice. As a consequence takeovers from outside are hindered drastically. Similar to the savings banks, mutual savings banks underlie a historically grown regional principle (Bofinger et al. 2008; Klein 1998).

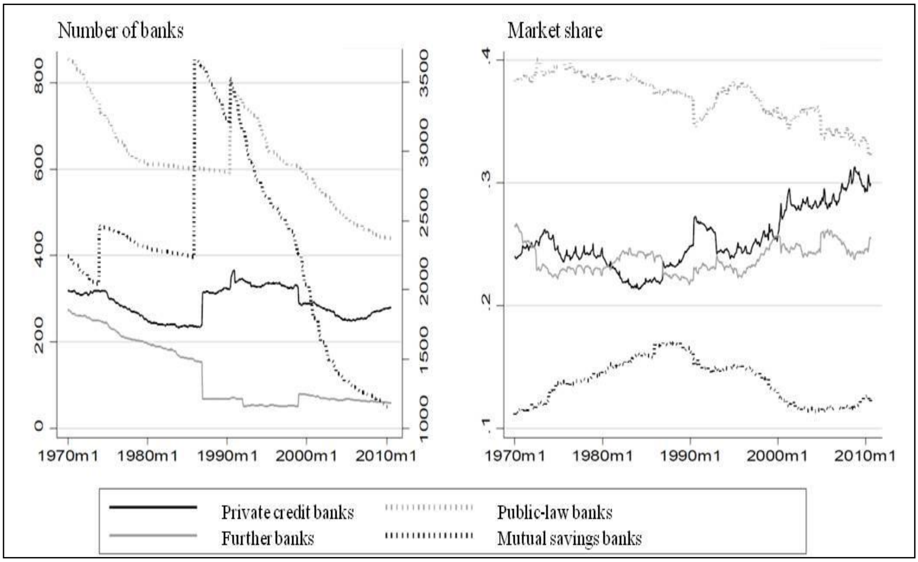

Figure 2.1 Four pillars of the German banking system: number of banks and market shares, 1970-2010

Within the left figure private credit banks, public-law banks and further banks are measured by the left axis; mutual savings banks by the right axis

Source: Deutsche Bundesbank, http://www.bundesbank.de; Schmidt & Noth 2010, 6

Figure 2.1 shows the number of banks within the four pillars and market shares measured by the aggregated balance sheet totals of the banks within the four pillars in the time period from 1970-2010. Public-law banks are leading by number and do have the biggest market share. Mutual savings banks have heavily lost in number over the last 40 years, whereas private credit banks are the only one which increased their market share. Figure 2.2 shows market shares of different types of banks within the four pillars a bit more in detail. As one can notice, only 2 percent of the market shares are held by foreign banks.

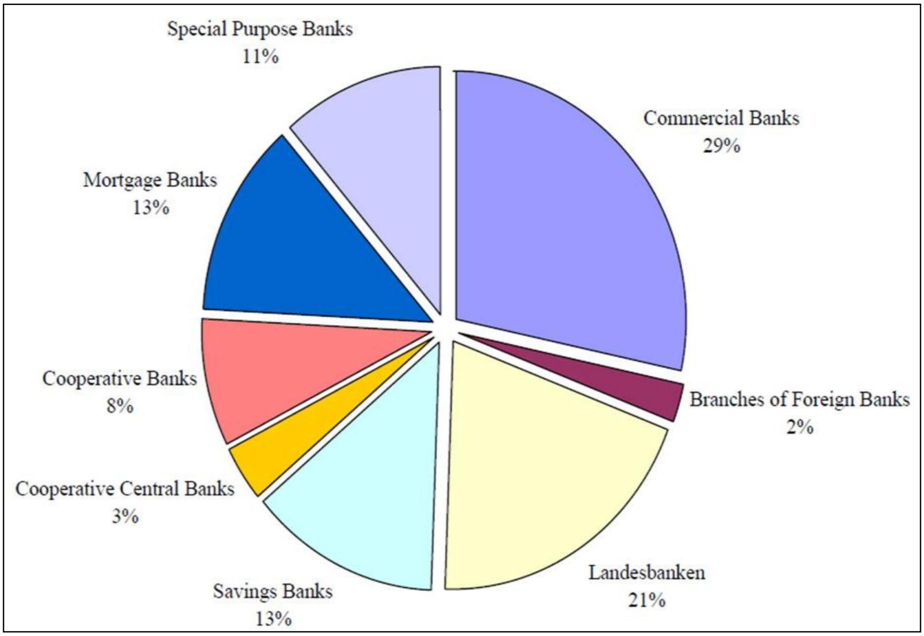

Figure 2.2 Market shares of different types of banks within the four pillars in 2008

Source: Deutsche Bundesbank, http://www.bundesbank.de; Köhler 2010, 4

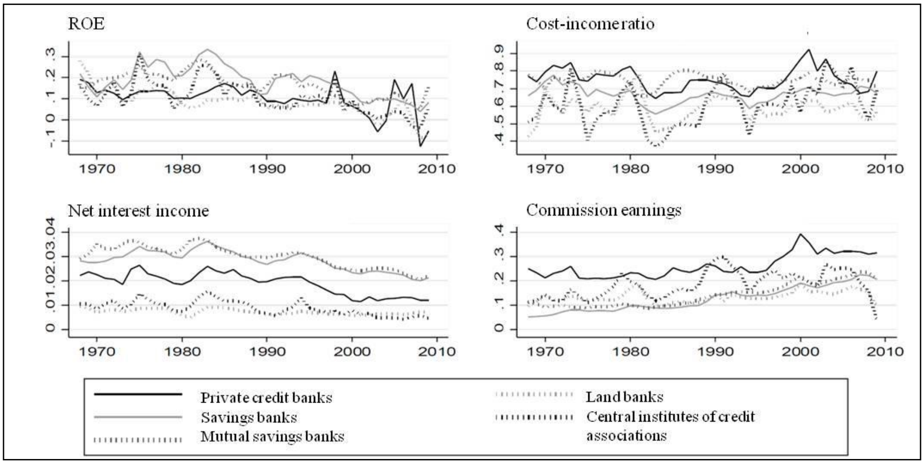

Figure 2.3 Business development within the German banking system

Source: Deutsche Bundesbank, http://www.bundesbank.de; Schmidt & Noth 2010, 8

Figure 2.3 shows the business development within the German banking market measured by return on equity (ROE), cost-income ratio, net interest income and the percentage of commission earnings on overall earnings in the time period from 1970-2010. All of the banking types do have a lower return on equity. Savings banks and mutual savings banks are less volatile on ROE and do have a higher ROE than private credit banks. The percentage of commission earnings on overall earnings has increased in all banking types but increased most heavily among private credit banks.

3. Evolution of corporate governance in German banks

3.1 Major private credit banks

As private credit banks are very heterogeneous in structure the following subsection has its focus on major private credit banks. Most of the German major banks do have the legal form of a corporation (so-called Aktiengesellschaft). Thus, the main structure of their corporate governance system is determined by the German Corporation Act (so-called Aktiengesetz – AktG). Despite listing at stock exchanges (e.g. the Frankfurt Stock Exchange) organization-control is the dominant corporate governance principle in Germany. This means, that German corporations are expected to have a two-tier board structure with no overlapping between the tiers. The first tier is the Board of Management (so-called Vorstand) the second tier is the Supervisory Board (so-called Aufsichtsrat) or a Board of Directors (so-called Verwaltungsrat). While the Board of Management has to manage the company – this means that the Board of Management is responsible for developing and implementing strategies and firm policy and control whether the company achieves its targets derived from strategy (daily business). The Supervisory Board has to monitor the business actions of the Board of Management and has to act as an advisor of the Management Board, too – this means that the Supervisory Board is an active discussant and business coach for the Board of Management.

Another special characteristic of German corporate governance is codetermination. Foreign observers are often a bit confused how German codetermination works and what the consequences of the participation of employees within Supervisory Boards are (Joshi 2004). There are different types of codetermination on the basis of different legal rules. The ones presented here are the most common for major banks. Companies being subject to the German Codetermination Act (so-called Mitbestimmungsgesetz) are expected to have a Supervisory Board of more than 12 members, when they have a number of employees between 2.000 and 10.000; they are expected to have more than 16 members in their Supervisory Board, when they have a number of employees between 10.001 and 20.000. If a company has more than 20.000 employees the Supervisory Board should consist of more than 20 members (following § 7 No. I Mitbestimmungsgesetz). The head of the Supervisory Board has two votes. There's another codetermination act for companies with a minimum of 500 and a maximum of 2000 members (so-called Drittelbeteiligungsgesetz): Those companies are expected to have two-thirds of its members within the Supervisory Board representing shareholders and one-third representing the employees. Summing up, according to those characteristics the German corporate governance system is called an insider system.

The power of the market for corporate control (outsider system) to discipline managers is normally lower in the banking sector than in other sectors. Takeovers in the banking sector require approval by the supervisor which causes considerably delays the acquisition process and makes hostile takeovers difficult (Prowse 1995). Restrictions that limit ownership in certain types of banks also limits possibility for takeovers, e.g. savings banks in Germany are not allowed to be taken over by private credit banks. Thus, the four-pillar structure of the German banking sector considerably restricts the power of the market for corporate control in the German the banking sector. Moreover, German Boards of Management and Supervisory Boards do not only have to consider the interests of (a bank's) employees but also the interests of multiple stakeholders (§ 171 AktG) and shareholders represent only one group within this stakeholder map. This is why the German corporate governance system is often called stakeholder system, too (Tricker 2009). As a consequence of the strong role of banks within the German corporate governance system, it is also called a bank-based (financial) system (Vitols 2001). This classification for Germany derives from several aspects (Nassauer 2000):

- Banks are the most important creditors for non-financials
- Banks are important shareholders of non-financials
- Banks may be shareholders and creditors in one legal person
- Banks do often have members inside Supervisory boards of non-financials

- As a consequence of proxy votes banks may operate on their customers' as well as on their own interests

Nevertheless, relations between banks and non-financials in Germany are normally based on stability. On the long run, this is advantageous for both sides, especially in economic trouble when reliability and trust are important. These close ties were criticized in particular by foreign observers and suppose influence of banks on the management of non-financials, e.g. through (Nassauer 2000):

- Influencing competition or causing cartels between different non-financial companies in branches when banks are invested in companies of the same branch
- Banks may generate cheaper credits for companies they are invested in or influence companies' financial structure in general
- Banks may limit companies scope of action, when their interests are affected

Statistics until 1996/2000 show banks to have great stakes and a dominating/central role within the German financial system. Things changed a lot in the last ten years with banks losing influence considering their stakes which makes the so-called Deutschland AG disappear (Figure 2.4). Nonetheless, banks might have indirect voting power by using proxy votes as German atomistic shareholders still are rather inactive and often assign their right to raise their voice onto banks (Edwards & Nibler 1999).

This is a shift of banking power from direct to indirect control, but with still letting banks have an important role within the German economy. Coming back to the targets and the stakeholder approach German private credit banks were formerly known for. Taking a look at lower margins in general (Figure 2.3), there was also a shift towards investment banking with the beginning of the 1990s (and the fall of the iron curtain). While an important function of the private credit banks was to stabilize the German economy and to give the German economy good growth perspectives, private credit banks now emphasize the importance of the capital market, the pressure by the capital market with major banks listed on the stock market and try/have to maximize annual yields or the pressure by foreign major banks. Nonetheless, the commitment towards a greater circle of stakeholders and the traditional two-tier corporate governance structure didn't change. Considering the points of regulation and supervision of banks the general tendency in this time was towards deregulation and liberalization – the loss in importance of Deutsche Bundesbank within the European Monetary Union with the European Central Bank at its top reinforced the shift towards shareholder-value orientation, too (Schmidt & Noth 2010).

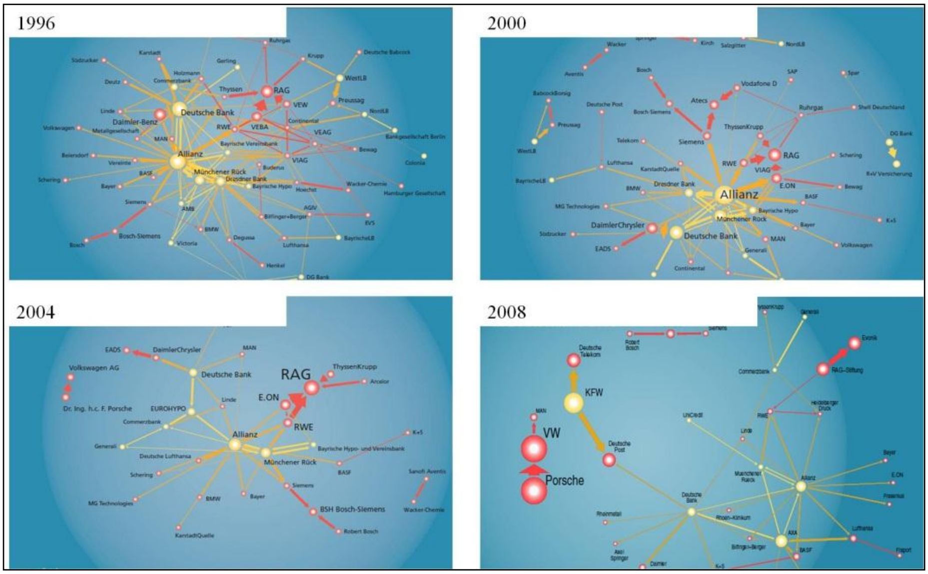

Figure 2.4 Decreasing stakes of major German private credit banks within the Deutschland-AG

Source: Max-Planck-Institut für Gesellschaftsforschung, http://www.mpifg.de; yellow: finance – finance relation; red: industry – industry relation; orange: finance – industry relation

If private credit banks managed this (self) increased market pressure well, is highly disputable taking a look at the consequences of weak risk management and risky investments of German banks which become obvious in the current financial crisis. Accepting lower margins instead of depending on help from the German state to manage high debt ratios might have been a better policy for some as private credit banks well as for land banks and special interest banks.

Following Myers (1977), high debt ratios may lead managers to act too much on the interest of shareholders and let pass by projects with positive cashflow.

High debt ratios force management to take cashflow for paying companies' dues which additionally leads to a loss of equity and induces higher risk of illiquidity. Subprime crisis has shown drastically, how the whole German economy can suffer from such overly risk-taking firm politics, e.g. from Hypo Real Estate Holding AG (which also didn't withstand the recent European stress-tests; Deutsche Bundesbank & Bundesanstalt für Finanzdienstleistungsaufsicht 2010), IKB Deutsche Industriebank AG or Commerzbank AG. As a result German banks (mainly private credit banks, land banks and the special banks Hypo Real Estate Holding AG) had to write off totalling \$55.9 billion until October 2008 (Hardie & Howarth 2009). German government has reacted immediately and gave fresh money or guarantees for these institutions with its protective shield of ˆ 360 billion (total commitment guarantees: ˆ300 billion; total commitment recapitalisation: ˆ 60 billion from the stabilization shield Financial Market Stabilisation Fund – SoFFin; Figure 2.5). Further action towards higher equity ratios shall clearly be taken by companies within the financial sector themselves (Sanio 2009). There are also examples like Hypo Real Estate Holding AG or Commerzbank AG, where the German state participates now not only as regulator but also as shareholder by giving guarantees to those institutions but not as an active shareholder within the supervisory board.

GUARANTEES		RECAPITALISATION	
Company	billion €	Company	billion €
Aareal Bank AG	1.2	Aareal Bank AG	0.3
BayernLB	2.8	Commerzbank AG	6.7
Commerzbank AG	5.0	Hypo Real Estate Holding AG: - Former shareholders - Hypo Real Estate Group - FMS Wertmanagement	9.8 *0.3* *6.5* *3.0*
Düsseldorfer Hypothekenbank AG	1.5	WestLB AG	3.0
HSH Nordbank AG	6.0		
IKB Deutsche Industriebank AG	7.3		
Sicherungseinrichtungsgesellschaft deutscher Banken mbH	4.4		
Σ	28.2	Σ	19.8

Figure 2.5 SoFFin outlays by category

Source: http://www.fmsa.de, (Last update: 2011-11-30)

3.2 Public law banks: Savings banks and land banks

Savings banks are public banks. They have a public law status and underly a special law for savings banks (so-called Sparkassengesetz) adopted by every single federal state within the Federal Republic of Germany. They do not have specific owners or shareholders, but instead municipalities or administrative districts grant the savings banks. Municipalities and administrative districts have specific rights like owners but those rights are not much weaker compared to those of owners of private credit bank. Savings banks are managed by a head who manages the company according to business principles. The head is supervised by a Board of Directors (so-called Verwaltungsrat) which is headed by the mayor or the district administrator. Moreover, the municipality or the administrative district is a member of the savings bank’s Credit Management Committee which decides on major credits. Nevertheless, municipalities and administrative districts are not allowed to influence the head’s management and the head’s management and the supervision by the Board of Directors are free from direct political influence. Savings banks’ role is to support the local economy (regional principle and regional limitation of economic action, so-called Regionalprinzip). Thus, one must assume an indirect political influence connecting political targets and economic targets of savings banks (Vins 2008). Nevertheless, there are no signs, that savings banks operate ineffective taking a look at Figure 2.3 and further empirical studies, illustrating the important role of savings banks for the stability of the German financial system and the supply of money (Ayadi et al. 2009). Summarizing, the corporate governance structure of savings banks tends to be advantageous and in contrast to private credit banks rather save against crisis like the current one. This is a consequence of lower risk-taking and a different (public) function which is not to maximize profits or to increase shareholder value. The Regionalprinzip also secures to savings banks against risky operations outside the community or the administrative district and also limits competition between savings banks. As savings banks aren’t listed or do have specific shares to sell or buy there’s no market for corporate control, too (Schmidt & Noth 2010). Moreover, with the beginning of the 21st century savings banks intensified the installation of professional risk management systems within the S-Finanzgruppe (Bülbel et al. 2010).

Land banks are a bit more complex in governance structure than savings banks. Whereas formerly all land banks had a public law status like the savings banks, some of them nowadays do have the legal form of a corporation (e.g. WestLB, Landesbank Berlin, HSH Nordbank AG) creating no greater financial risk for those single land banks as debt was guaranteed by the federal states. As a consequence, and a general trend of the internationalization also land banks increased national as well as international operations, with the safeguard of the federal states being able to get cheap money, cheaper than their (major) competitors from the private credit bank sector. Savings banks, savings banks associations and the federal states within the land banks operate, grant the land banks. According to the savings banks the head of a land bank operates independently, too. He is also supervised by a Board of Directors on the basis of specific legal rules. In contrast to the savings banks these legal rules enable greater political influence. The traditional function of land banks is to be the main bank of a federal state, to be the central giro office of the savings banks and to support operations which cannot be handled by savings banks due to limited size. This function changed with the beginning of the 1950s when land banks started to operate like commercial/private credit banks, especially as creditors for major companies. This should have led land banks to install professional management and supervisory boards, but they didn't. Additionally, some land banks (like WestLB) did not only raise the finance for the local economy but also started to promote the local economy or specific projects with close ties to political targets and industry policy (Schmidt & Noth 2010). It is not hard to understand that the existing governance structures didn't fit to the new strategy of land banks, namely to operate internationally like a major commercial/private credit bank as well as locally as financier and promoter of the local economy (Sinn 1997). A tremendous change for the second pillar of the German banking system was the end of the already mentioned joint liability agreement, statutory ultimate guarantee obligation for claims against regional banks and savings banks that arose prior to 18 July 2005. Excessive risk-taking within the US subprime market or mergers of Hypo Alpe Adria by BayernLB (International Monetary Fund 2006) showed drastically that the corporate governance structures and the abilities within Management Boards and Boards of Directors of land banks did/do not fit to their (new) business operations and international as well as regional ambitions (Hau & Thum 2009). As a consequence of high losses, similar to some private credit banks, the Federal Republic of Germany started help with its Financial Market

Stabilisation Fund (Figure 2.5, notice guarantees for BayernLB and HSH Nordbank AG and recapitalisation for WestLB AG; further financial help has been given to SachsenLB and LBBW) and uptil now intensified supervision by the Deutsche Bundesbank and the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin).

3.3. Mutual savings banks

Mutual savings banks have the legal form of cooperatives. Most of them do have “Raiffeisen” or “Volksbank” in their firm name and are organized in two central institutes, the Deutsche Zentral-Genossenschaftsbank (DZ Bank) and the Westdeutsche Genossenschafts-Zentralbank (WGZ Bank). Cooperatives are owned by their customers. Thus, the main target of cooperatives is to manage a joint business and not to maximize profits. In order to participate on a cooperative’s dividends a customer has to buy at minimum of one cooperative share which also guarantees a vote for the Members’ Meeting. Every holder of a cooperative share has one vote, independent from the number of shares he holds (one person – one vote principle). This prevents big shareholders to use power to dominate atomistic shareholders but leads also to the situation that cooperative shareholders are pretty inactive. Shares cannot be sold, they can only be given back to the cooperative and the member of the cooperative gets back the amount paid and some additional reserves. Thus, there doesn’t exist a market for corporate control in the cooperative sector. In case of liquidity problems every shareholder is normally obliged to inject a defined additional amount of capital into the cooperative. The Members’ Meeting is the top executive for decisions inside the cooperative. It elects the members of the Supervisory Board which names the members of the Management Board to manage the cooperative. Management Boards are also monitored by the central organization of the cooperative banking group (Bundesverband der Deutschen Volksbanken und Raiffeisenbanken – BVR), which acts like a statutory auditor to check cooperatives’ accounting and auditing as well as management quality and management practice. The one person – one vote principle definitely causes a problem already known from cooperations where atomistic shareholders do have problems to raise their voice and to find coalitions with one another. Therefore, it is difficult for them to fire members of the Management Board unscheduled. As the main target of cooperatives is not to maximize profits shareholders do also have little incentives to raise their voice. This is the same with the Management Board members who are not primarily measured by their economic success. One cannot merge cooperatives. Thus, traditional takeover mechanisms known from private credit banks do not work for cooperatives and cannot trigger performance effects against management. Apart from incentives towards profit maximization there are specific advantages of cooperatives' corporate governance structure. With the major goal of managing a joint business, managers do not raise firm value against the interests of weak cooperative shareholders. This leads to a situation of low-risk taking by cooperatives (Schmidt & Noth 2010) and a sound and stable financial situation of cooperatives within the current financial crisis.

4. Conclusion

The German banking sector consists of three main pillars, namely private credit/commercial banks, public-law banks and mutual savings banks. All of them show very different corporate governance structures and very different evolutions and developments. Considering (major) private credit/commercial banks the corporate governance structure comes very far to the well-known German two-tier system (also called stakeholder or bank-based system) with differences in supervision and regulation and different impact of single markets on banks compared to non-financial firms. The major evolution in the three main pillars of the German banking system has taken place in the private credit banks sector. With the beginning of the 1990s major private credit banks in Germany were driven by deregulation, globalization of capital markets and decreasing economic success in the traditional fields. Thus, German private credit banks started excessive risk-taking in investment banking and a shift towards shareholder orientation, taking US and UK banks as an example. This led to massive problems when the recent financial crisis arose as the traditional corporate governance structures didn't fit to the new business models and the new challenges. Nevertheless, it is not only the private credit banks but also the land banks within the second pillar (public-law banks) of the German banking system. With the end of the joint liability agreement, statutory ultimate guarantee obligation for claims against regional banks and savings banks in 2005 also land banks came into pressure by the recent financial crisis. Excessive risk-taking within the US subprime market or mergers showed drastically that the corporate governance structures and the abilities within the boards of land banks did/do not fit to their (new) business operations and international as well as regional ambitions. Minor changes and minor impact of the financial crisis could have been detected considering the savings banks within the public-law banks and the mutual savings banks. Their corporate governance model is based on stability, risk-reduction and self limitation in business operations connected with different main goals than profit or shareholder value maximization. Summarizing, corporate governance characteristics of savings banks and mutual savings banks might be an example for future evolution of corporate governance in the whole German banking sector.

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