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Finance, control and profitability: the influence of German banks

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Abstract

Bank intermediated finance has been cited frequently as the preferred means for channeling funds from savers to firms. Germany is the prototypical economy where powerful universal banks allegedly exert substantial influence over firms. Despite frequent assertions about the advantages of a bank relation, empirical support is mixed. With a unique dataset and a focus on the fragility/sturdiness of inferences, this paper evaluates German bank influence in terms of three hypotheses: (1) do bank influenced firms enjoy lower finance costs? (No); (2) is bank influence a solution to control problems? (Yes); (3) do bank influenced firms have higher profitability? (No).
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1. Introduction

Channeling funds from savers to firms is one of the central problems facing an economy. In a frictionless world with widely dispersed and reliable information, finan-

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cial assets are perfect substitutes and are allocated independently of existing financial markets and intermediaries. In this case, the institutional structure of the financial system is merely a veil. Recent research casts serious doubt on this frictionless model because of implausible assumptions about the availability and reliability of information. In the presence of asymmetric information, financial structure has major impacts on the allocation of funds, the pace of capital formation, and the performance of the economy.

When lenders and firms face significant information asymmetries that create possibilities for opportunism by better-informed firms, banks may play an important role in financing and governing firms. Owing to economies of scale and scope, banks are arguably well positioned to finance and monitor firms. Germany is the prototypical economy where universal banks, which offer a wide-range of financial services, allegedly exert substantial influence over firms, and thus Germany is ideal for studying bank-firm relations and bank intermediated finance. The current study extracts testable implications from the German bank influence model (GBIM) and evaluates these hypotheses empirically.

The widely held view of German bank influence has three major components: finance, control, and profitability (cf. Edwards and Fischer, 1994, chapter 1). German banks allegedly supply finance relatively cheaply because of technical expertise and superior information. The latter follows from bank representation on firms' supervisory boards and long-term relations between banks and firms. The second component of German bank influence is that banks reduce managerial agency costs associated with corporate control. The superior information that lowers finance costs also permits banks to monitor management effectively. In addition to representation on supervisory boards, banks have substantial voting, power obtained either directly through ownership or indirectly through proxies, borrowings, or investment companies. Consolidated voting power, supervisory board representation, and long-term relations combine to provide banks with the potential to influence firms substantially. German banks thus would appear to have the power to reduce the agency problem at the core of the corporate control dilemma and, with large ownership stakes, the incentive to exercise control. In turn, lower finance costs for external funds and lower agency costs of corporate control have a favorable effect on firm profitability, the third component of the GBIM.

While these arguments are certainly reasonable, and perhaps even persuasive, alternative perspectives exist, and the GBIM needs to be evaluated empirically. Several studies have pointed to positive roles that banks play in the success of the German system of investment finance. This confidence has not gone unchallenged. Wenger (1992) and Wenger and Kaserer (1998) have written extensively on the deleterious effects of German banks. Perlitz and Seger (1994) and Seger (1997) find a negative influence of banks on firm performance. In an important book, Edwards and Fischer (p. 240) conclude that "the commonly-held view of the merits of the German system of finance for investment, in terms of the supply of external finance to firms and corporate control, receives no support from the analysis of available evidence."

However, most existing empirical work on Germany is based on relatively aggregate data or single cross-sections. In her review of Edwards and Fischer's book, Elston (1995) notes that much of the debate on the merits of the bank-based versus market-based finance has stagnated simply due to lack of detailed empirical evidence. Gorton (1995) expresses

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