Germany's flawed corporate governance

Boards behaving badly

Why the leading citizens of corporate Germany are so scandal-prone

Aug 6th 2009 | Berlin | From the print edition

THE streets of Germany's main cities still throng with shoppers; no shops are shuttered. Much credit for that is due to the country's famed industrial champions, which have been model corporate citizens throughout the recession, keeping employees on the payroll and investing for the long-term. Yet many of them are also remarkably scandal-prone. Big companies such as Deutsche Bank, Deutsche Telekom, Deutsche Bahn and Lidl have been caught spying on workers, journalists or board members. Siemens has confessed to bribing customers and MAN is being investigated for the same. At Volkswagen, a manager was caught paying off a member of its supervisory board. Schaeffler and Porsche are in trouble after launching murky, ill-conceived takeovers involving derivatives and mountains of debt. Yet these two seemingly contradictory aspects of German corporate behaviour may be opposite sides of the same coin.

One reason why Germany's biggest firms have not cut many jobs is its cherished model of stakeholder capitalism, which took root after the second world war and contributed to its rapid economic growth until the 1980s. Under this model, workers' representatives fill half the seats on firms' supervisory boards. A separate management board is responsible for running the business day to day. Companies are also required to act in the interest of all “stakeholders”, not just of shareholders.

That creates a tension between profits and jobs. A seminal, if dated, study is illustrative. It found that 83% of German managers surveyed in 1995 considered that the companies they worked for belonged to stakeholders rather than shareholders. Some 60% said that saving jobs was more...
important than paying dividends. In America and Britain, by contrast, almost 90% of managers said that paying dividends was more important than preserving jobs and 75% of managers felt that firms belonged to their shareholders.

Many Germans see this focus on stakeholders as a strength. Germany's Governance Commission, an official watchdog, decided earlier this year that German corporate governance had “proved its worth during the current crisis”. Involving employees in hard decisions about restructuring can help in a downturn. Firms such as Daimler have cut working hours and pay, with the support of their employees. And IG Metall, Germany's main industrial union, is in talks with several troubled firms about pay cuts for its members in exchange for shares.

German firms are renowned for taking “long-term” decisions. Even as revenues have plunged, Germany's big carmakers, for instance, have kept up spending on research and technology. “Workers' representatives tend to be very entrepreneurial,” says Walter Friederichs of Russell Reynolds Associates, a recruitment firm. “They want to preserve the company for the future.”

Yet Germany's system of corporate governance also lends itself to bad behaviour. One problem is the composition of Germany's supervisory boards: a study of Germany's biggest listed firms by Russell Reynolds found that on average their board members were older, had longer tenure, were less likely to have specific industry experience and were far less likely to be foreign than in Europe's other big economies. German supervisory boards are also often unwieldy, with up to 20 members. When the firm's management is included, meetings run to 30 people.

A second problem is the preponderance of family-controlled firms. That leads to a focus on the relationship between minority and controlling shareholders, rather than on the control that shareholders as a whole exercise over managers, says Matteo Tonello, a corporate-governance expert at the Conference Board, a think-tank.

Weak oversight of firms, private and public, may have contributed to the recent troubles of leading German firms that have allowed strong managers or controlling shareholders to take on too much risk, says Jörg Rocholl of the European School of Management and Technology in Berlin. One such example is Porsche, which for years resisted demands from the stock exchange to publish quarterly reports (it argued they would reflect badly on it during slow quarters). It is now being taken over by Volkswagen, its erstwhile target in a drawn-out takeover battle, after buckling under the weight of debt and derivatives it took on in a bid to wrest control of VW.

In many other countries, failings of corporate governance can often be addressed from the outside by shareholders pressing for change or taking over companies that are performing poorly. But in Germany this sort of activism is restrained by the absence of large, independent institutional investors and by the limited powers granted to activist investors.
Much has changed in Germany since the days of Deutschland AG, when banks and big firms had complex cross-holdings that prevented hostile takeovers. Even so, scepticism about shareholders' role in holding managers to account is still deep seated, says Hans Hirt, head of corporate governance at Hermes, a British fund manager with investments in Germany.

Hedge funds and private-equity firms are barely tolerated. After activist shareholders led by the Children's Investment Fund, a London hedge fund, forced Deutsche Börse to abandon its bid for the London Stock Exchange in 2005, the government passed laws making it harder for minority shareholders to push reforms. Christopher Hohn, who runs the fund, was labelled a "locust" for his aggressive tactics, and has since given up trying to change the company. Few Germans are likely to do battle in his stead.

From the print edition: Business