“Choice and performance of corporate governance mechanisms in the German financial sector and the financial crisis”

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Choice and performance of corporate governance mechanisms in the German financial sector and the financial crisis*

Abstract

Corporate governance (CG) has been one of the most widely discussed topics over the last few years. Especially the role of the financial sector within the current financial and economic crisis has led to a massive loss of trust and put pressure not only on companies within the financial sector but also on policy makers to reform CG. Nevertheless, governance shortcomings contributing to the crisis of confidence are not uniquely American as one could expect taking a look at Lehman Brothers or Bear Stearns, however, with companies also in Germany adding their own governance shortcomings to the crisis. We try to find evidence on such shortcomings researching on a sample of the biggest companies within the German financial sector listed in the Prime Standard segment at the Frankfurt Stock Exchange. We identify shortcomings in compliance with the German Corporate Governance Code (GCGC) mainly in the cooperation between management board and supervisory board (one of the most remarkable characteristics of the German two-tier system) and also on transparency & disclosure on CG (e.g., on remuneration issues) and try to give answer on how to solve such problems in the future.

Keywords: corporate governance, performance, financial sector, financial crisis.
JEL Classification: G01, G21, G22, G23, G34.

Introduction

More than a decade of economic welfare, since the end of 2007, Germany, as well as many other countries in the modern world, have experienced a crisis which nobody had expected in its extent. The economic crisis that erupted in 2008 and deepened in 2009 is challenging a host of our conceptions and theories of effective CG. Again, after the well-known cases of Enron and WorldCom, the financial crisis has revealed severe shortcomings in CG arrangements. Especially the financial sector has been criticized. Only political bailout could abandon the financial crash of Hypo Real Estate and IKB Deutsche Industriebank AG and other companies in Germany depending on these companies. More than two years after that, scientists, politicians and regulators are still looking towards the future of the financial sector. The financial crisis represents a political as well as substantive challenge to policy makers. The impact of the crisis on judgements about CG practices is arguably summed up by the remarks of Alan Greenspan at a hearing by the US Congress: "I made the mistake in presuming that the self-interests of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and the equity of the firm" (Greenspan, 2008, p. 33).

The national and international response to the crisis has been characterized by widespread calls for further (re-)regulation of the financial services sector. Bank supervision, in particular, is being restructured and tightened. CG policy makers cannot stay aloof from the debate which raises questions about the relative role of legally binding, CG requirements and their enforcement as opposed to principles-based, flexible instruments. It is important to take a wider CG view since banks and others are not fundamentally different from other companies with respect to CG (OECD, 2009). Examining the future of CG within the financial sector in great depth is a difficult thing to do, especially when no one is sure whether the crisis is completely over, and whether banks and the financial system have already hit the bottom (Chambers, 2009). Recent cases like the one of Commerzbank AG with a further loss of € 4.5 billion in 2009 (and a need for fresh capital) and a strong financial linkage within the German financial sector, e.g. Allianz SE, Europe's biggest insurance company holds 10 percent of Commerzbank AG, should leave us rather sceptical.

Since the establishment and usefulness of these new regulations within companies are still open, this paper tries to examine whether CG failures could already have been detected before the financial crisis at the end of 2007. Firstly, taking a look at a German sample of the biggest companies within the financial sector, listed in the Prime Standard of the Frankfurt Stock Exchange, we try to analyze, if good CG, as specified by (soft) law, is really good by separating good from bad companies (in terms of financial performance). Secondly, based on our findings, we try to find new perspectives on how to reform the CG system nationally and take a look at remedial (legal) (re)actions against shortcomings on CG, and furthermore, try to give recommendations towards good CG internationally.

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1. Good corporate governance in Germany

Just as in all other central areas of the capital market also Germany found itself in international competition regarding regulatory framework. This competition can be seen above all in often-heard comparisons with the United States. Well aware of the strong controls placed on companies by the US exchange overseer, the SEC, and the strict laws that govern accounting and the capital markets, more and more market participants in Germany were also demanding a German CG code. In the meantime, the massive and spectacular insolvencies in the US, such as Enron, Xerox and MCI WorldCom, have brought about an increase in the regulations that apply to exchange-listed companies (e.g., the so-called Sarbanes Oxley Act, passed by Congress in July 2002). As a consequence of criticism on missing standardization and transparency of German CG, Germany (as one of the last industrial countries) established its GCGC in 2002. The GCGC provides recommendations and suggestions to listed companies for good and responsible CG. In case of the recommendations German listed companies have to declare yearly whether they hold them or not (§ 161 German Corporation Act, AktG). They do not have to explain why they do not hold single recommendations. This understated "comply or explain" principle is founded on the assumption that the market will monitor code compliance and efficiently adjust the allocation of capital according to its beliefs on governance quality. The capital market has two functions in this regard: (1) evaluation of possible deviations; and (2) enforcement. It is, after all, in their direct interest to assess the significance of deviations (Seidl et al., 2009). Accordingly, the opinion of policy makers is still, that those companies who dare not to comply with the code shall be punished by the capital market (Cromme, 2002). Generally, high levels of compliance with the GCGC are taken as a proxy for good CG. Meanwhile, some empirical studies have focused on compliance with the GCGC on firm performance, producing heterogeneous findings either reporting no impact (Bassen et al., 2006), a positive impact (Goncharov et al., 2006) or even a negative impact (Bassen et al., 2009) on firm performance, caused by different methodology, sample or time frame. The GCGC is being inspected and if necessary updated yearly by a code commission, to cover national and international best practices, legal rules and current state of the art. The goal of the GCGC is to increase the confidence investors have in the corporate leadership of German companies and to improve investor protection. It addresses all significant – and above all international – criticism of German corporate composition, including a lack of transparency in corporate management and not enough orientation to the interests of shareholders or limited independence of auditors and supervisory boards, often due to misinterpretation of German codetermination.

Besides code compliance, companies should focus on reporting on further CG issues not included specifically in the GCGC: above all, good CG has to be recognizable for capital markets to be an effective value driver. Unsurprising, missing transparency has also been identified as a core reason for the current financial crisis (Hellwig, 2009). Despite theoretical assumptions on CG reporting as a factor of companies' success which have recently been confirmed in several international studies (Haat et al., 2008), there has only been little effort in Germany to research on this topic empirically. Focusing on this gap, we try to find out, if transparency & disclosure on CG is as important within the German stock market as in Anglo-American stock markets (Netter et al., 2009). Increasing global convergence of governance systems could be a hint to expect transparency & disclosure being a key factor of success also for German corporations. This may induce a paradigm shift towards transparency & disclosure in the centre of the German CG system and a focus on external information expectation.

2. Method

2.1. Sample and data collection. Our sample covers the 25 biggest German companies listed in the selection indices DAX, MDAX and SDAX at the Frankfurt Stock Exchange in 2007. We only analyze companies accounting via IFRS to avoid regulatory bias (Table 1).

Table 1. Sample

DAX	MDAX	SDAX
Allianz SE	Aareal Bank AG	Colonia Real Estate AG
Commerzbank AG	AMB Generali Holding AG	Comdirect Bank AG
Deutsche Bank AG	AWD Holding AG	Deutsche Wohnen AG
Deutsche Börse AG	Deutsche EuroShop AG	DIC Asset AG
Deutsche Postbank AG	Hannover Rück AG	Grenkeleasing AG
Hypo Real Estate Holding AG	IVG Immobilien AG	HCI Capital AG
Münchener Rück AG	MLP AG	Indus Holding AG
		Interhyp AG
		MPC AG
		TAG Immobilien AG
		Vivacon AG

Companies within these indices underlie the highest standards of transparency & disclosure within the Prime Standard segment. Researching CG of companies within those indices could have a signalling effect for other (financial) corporations in Germany since these indices are covered most

intensely by investors. Thus, our sample is very valuable from a researcher's perspective. We compute a proxy for good CG by researching compliance with the GCGC in its 2006 version incorporated in a compliance scorecard covering 94 criteria. Furthermore, we research 38 criteria for transparency & disclosure on CG, incorporated in a transparency & disclosure scorecard (both valid and reliable) as published by Graf and Stiglbauer (2008a) in the journal *Corporate Ownership & Control* (Table 2); maximum scores of 94, respectively 38 can be achieved.

Table 2. Main categories of code compliance and transparency & disclosure

CODE COMPLIANCE (GCGC 2006)			TRANSPARENCY & DISCLOSURE		
No.	Category	Criteria	No.	Category	Criteria
1	Shareholders and the general meeting	8	1	Declaration of conformity to GCGC	7
2	Cooperation between Management Board and Supervisory Board	8	2	CG report	5
3	Management Board	17	3	CG Internet reporting	8
4	Supervisory Board	38	4	Compensation system	8
5	Transparency	10	5	Board quality, independence and integrity	6
6	Reporting and audit of the Annual financial statements	13	6	CG commitment and firm-specific CG code	4
Σ		94	Σ		38

Using content analysis, we analyze all data available from an informed investor's perspective, e.g., compliance statements, annual reports, CG reports, compensation reports, agenda of shareholders' meetings, codes of conduct, bylaws and companies' website. We also collect data on performance measures and further CG mechanisms which we describe in the upcoming section. Sources for collecting data were Thomson Financial Datastream, Worldscope, Deutsche Börse Group and the German Federal Financial Supervisory Authority (BaFin), companies' annual reports, balance sheets and income statements.

2.2. Modelling. Whilst there does not exist a unitary model integrating CG mechanisms and performance variables, "even in advanced market economies (like Germany), there is (still) great deal of disagreement on how good or bad the existing governance mechanisms are" (Shleifer and Vishny, 1997, p. 737). Thus, governance models have to be specified separately out from theoretical assumptions and empirical findings, whereas each equation should ceteris paribus have a causal interpretation. First of all, we define, which variables shall be endogenous: we calculate a set of five variables on firm performance (Table 3), including two accounting-based measures (ROA, ROE), two hybrid performance measures (MTB and Q) and one market-based measure (TSR)[1]. We additionally calculate control variables as a set of governance mechanisms. Those mechanisms are considered regularly in comparable German CG performance studies (e.g., Bassen et al., 2006).

Table 3. List of variables

Abbr.	ENDOGENOUS
ROE	Return on equity
ROA	Return on assets
Q	Tobin's Q
MTB	Market to book ratio of equity
TSR	Total shareholder return
	EXOGENOUS
C	Compliance with the GCGC (2006 version)
TD	Transparency & disclosure on CG
SIZE	Market cap (mio. €)
VOLA	Volatility (252 trading days)
FREEFLOAT	Freefloat
CLOSEHELD	Closely-held shares
GROWTH	Growth in sales (2007/2006)
DEBT	Debt
RD	R&D intensity (tsd. €)
BDSIZE	Board size (German management board)
BANKS	Company in banking industry: 1; 0 otherwise
FINANCIAL SERVICES	Company in financial services industry: 1; 0 otherwise

First of all, models (1) to (5) cover SIZE. Brailsford and O'Brien (2008) show that small-cap companies within a portfolio have higher average margins, than predicted by CAPM. Also, Diaz und Sanchez (2008) report smaller companies as being more efficient and less bureaucratic in adopting resources. Thus, size could also have an impact on operating performance. On the contrary, bigger companies are quite often brought together with economies of scale and market power and, therefore, higher financial performance (Grant et al., 1988). Ownership structure has an undefined impact both on fundamental and capital market performance. Blockholding is connected with higher firm performance, due to greater continuity of interests which is assumed to have a stabilizing function through hindering investors to exit companies

[1] Empirical CG studies often calculate one single performance measure, which induces problems in generalizing findings for other performance measures.

fastly, since this may decrease firm value enormously and cause substantial financial losses (Baysinger and Butler, 1985). On the contrary, ownership concentration also represents power, which may either be used supporting or opposing towards management. Thus, a low extent of FREEFLOAT could also lower firm performance in case of ongoing conflicts between large shareholders and management. This argument is often being brought into discussion with institutional investors, which are assumed to operate rather on a short-term than a long-term basis, and thus, often come into conflict with companies' long-term targets (Ingley and Walt, 2004).

Also, DEBT, RD and BDSIZE[1] are integrated in models (1) and (2). General statements on an optimal debt level with a conclusion on financial stability of companies cannot be predicted definitely. Moreover, aspired profitability and induced risk are influencing factors on the debt level. Debt generally increases profitability, but also increases risk, with two possible consequences: either profitability of investments decreases or the interest level increases extraordinary. Following this assumption, ROE could be lower than ROA: these losses could induce a loss of equity value. RD is generally reported to increase firm performance (O'Mahony and Vecchi, 2009). Companies spend on R&D to increase competitiveness and their ability to increase return on investment (Heshmati and Lööf, 2008). However, also decisions on R&D intensity may be affected by opportunistic behavior (horizon problem). Managers, in fact being employed in companies less time in comparison to the optimum horizon of an investment may favor projects, which increase short-term outcome to increase their personal income (Kalyta, 2009). Concerning BDSIZE, small boards may lack precision in decision-making due to single board members' limited managerial capacity but also smaller boards may lack critical mass for efficient decision-making (Thomsen, 2008). Contrariwise, larger boards may suffer lacking consensus among lots of different opinions or lacking coordination of decision-making and monitoring may be hindered due to difficulties in observing processes and actions of single board members (Eisenberg et al., 1998).

[1] There are two separate boards in the German dual board system. The first one is the executive board, named the "Management Board" (in German "Vorstand") which is comparatively equal to the Anglo-American management team. The second one is the "Supervisory Board" (in German "Aufsichtsrat") with in part an advising role but with its main task to appoint and dismiss the members of the Management Board and to monitor them. The dual board structure of the German dual board system intrinsically would imply to test also on possible size effects of the Supervisory Board as a separate governance mechanism. We do not consider this as a good decision, since the size of the Supervisory Board in our German sample is mainly determined by legal rules such as the codetermination act and less a conscious/independent decision of firms, to gain competitive advantage (Grant, 1998).

Models (3) to (5) cover GROWTH, which may influence future expectations of investors positively and normally being priced in (Yermack, 1996). We integrate BANKS and FINANCIAL SERVICES into models (1) to (5): economic literature often discusses, if firm performance can be explained via unitary, cross-industrial benchmarks (Ohlson and Juettner-Nauroth, 2005). Accordingly, investors operating on a long-term basis would not take industry into account. Nevertheless, structural differences between industries and their impact on firm performance can be neglected neither theoretically (Porter, 1979) nor empirically (Pedersen and Thomsen, 1998). Again, it has recently been discussed if industry-specific performance analysis is better than a cross-industrial one (Fairfield et al., 2009). We follow the assumption that knowledge on the proportion between equity and DEBT (and its shift) is important for capital markets and may influence stock evaluation (Hull, 1999). On the other hand, debt may put pressure on management to increase performance, since serving creditors primarily reduces free cash flow, which management cannot use for future projects (control hypothesis) (Jensen, 1986). Higher degrees of debt may also induce higher agency costs, since the interests of shareholders and creditors may differ to a greater extent (Myers, 1977): serving creditors primarily lowers the proportion that can be used for paying dividends on shareholders. Additionally, lower present cash flow decreases possibilities for future projects and higher future cash flow. RD is integrated in models (3) to (5) due to the steadily high investment-cash flow sensitivity towards R&D investments (Brown and Petersen, 2009). Models (3) to (5) cover ROA and ROE exogenously, since operating performance has been demonstrated to be an influencing factor on firm value (Reschreiter, 2009). Capital markets demand a compensation for risk factors (Bae et al., 2006); following volatility-feedback hypothesis both good and bad news signal an increase of volatility, inducing a higher risk premium (Pindyck, 1984). To avoid a bias on firm performance due to expected strong asymmetric distributions of SIZE as well as DEBT, we calculate them as their natural logarithm.

3. Analysis and results

Table 4 reports the descriptive statistics for variables in the study. Compliance with the GCGC and transparency & disclosure show rather small variance. This could possibly result in a non-detection of significant impacts of both variables on firm performance. One should also notice the above average debt ratios in the German financial sector (Graf and Stiglbauer, 2009) and the wide range in firm size. The models proposed were tested using the predictive analytics software SPSS 17.0 to generate least squares parameter estimates. An OLS estimation was conducted, which yielded models that fitted the data

very well, despite not having as many variables as expected to be significant at a minimum of 10%. However, we take this as a hint for further research on CG models, to explain even more variance of firm performance through CG mechanisms and thus handle better the complexity of the CG issue (Table 5). Some authors have suggested a formal detection-tolerance of the variance inflation factor (VIF) for multicollinearity (O'Brien, 2007). To examine the issue of multicollinearity, we calculated variance inflation factors (VIFs) for all variables. All of the VIFs were below the rule of thumb cut-off of 10 (Hair et al., 1995), with a minimum of 2.213 for the dummy BANKS and a maximum of 8.103 for FREEFLOAT. Thus, none of the remedial actions against multicollinearity (Cohen, 2003) is needed.

Table 4. Sample characteristics

	N	Range	Minimum	Maximum	Mean	Std. deviation	Variance
ROE	25	0.450	0,040	0.490	0.204	0.106	0,011
ROA	25	0,250	0.000	0.250	0.060	0.063	0.004
Q	25	3.550	0.890	4.440	1.472	0.919	0.845
MTB	25	9.400	0.690	10.090	2.604	2.550	6.503
TSR	25	0.680	-0.540	0.140	-0.154	0.183	0.033
C	25	0.319	0.681	1.000	0.832	0.100	0.010
TD	25	0.447	0.421	0.868	0.661	0.106	0.011
SIZE	25	66386.710	212.980	66599.690	9062.004	1.672E4	2.796E8
VOLA	25	0.452	0.095	0.547	0.287	0.105	0.011
GROWTH	25	1.290	-0.160	1.130	0.207	0.318	0.101
CLOSEHELD	25	0.851	0.000	0.851	0.271	0.251	0.063
FREEFLOAT	25	0.850	0.150	1.000	0.711	0.230	0.053
DEBT	25	51.350	0.170	51.520	13.175	16.094	259.029
BDSIZE	25	9.000	2.000	11.000	4.640	2.498	6.240
RD	25	86200.000	0.000	86200.000	4060.920	17281.871	2.987E8
BANKS	05						
FINANCIAL SERVICES	16						
Valid N (listwise)	25						

Models (1) and (2) confirm a significantly positive impact of C on ROE and ROA. Also, in models (3) and (4), C has a weakly significant positive impact on Q and on MTB. Taking a look on the impact of TD on firm performance, we detect a weakly significant negative impact of TD on ROE and a significantly positive impact of TD on TSR. Furthermore, ROA and VOLA have a highly significant positive impact on Tobin's Q in model (3). Examining the impact of ownership structure, we identify a significantly positive impact of CLOSEHELD on TSR in model (5). FREEFLOAT does not hold as a clear predictor for companies' success. GROWTH significantly reduces ROE, whereas R&D significantly boosts ROE. LnDEBT has a highly significant negative impact on ROA. We do not detect a significant moderating role of BANKS and FINANCIAL SERVICES.

Table 5. OLS regression results

	ENDOGENOUS				
Model	ROE 1	ROA 2	Q 3	MTB 4	TSR 5
(Constant)	0.166 (0.569)	-0.048 (0.706)	-0.470 (0.823)	-9.079 (0.063)	-1.211 (0.006)
C	0.825** (0.011)	0.275** (0.044)	4.465* (0.100)	9.772* (0.098)	-0.340 (0.467))
TD	-0.426 (0.159)	-0.163 (0.151)	0.081 (0.966)	1.880 (0.645)	0.798** (0.033)
ROE			-2.322 (0.373)	7.252 (0.205)	0.444 (0.342)
ROA			16.295*** (0.006)	13.552 (0.226)	0.558 (0.538)
lnSIZE	-0.018 (0.533)	-0.003 (0.789)	0.016 (0.936)	0.289 (0.493)	0.052 (0.151)
VOLA			4.274*** (0.001)	-6.629 (0.163)	-0.630 (0.114)
FREEFLOAT	0.280 (0.159)	0.043 (0.613)	-1.251 (0.557)	-2.846 (0.400)	0.356 (0.214)

Table 5 (cont.). OLS regression results

	ENDOGENOUS				
CLOSEHELD	-0.083 (0.619)	0.112 (0.143)	-1.190 (0.367)	-0.276 (0.921)	0.645** (0.015)
GROWTH	-0,145** (0.050)	-0.047 (0.134)	-0.462 (0.454)	-0.482 (0.715)	-0.069 (0.530)
lnDEBT	-0.024 (0.370)	-0,038*** (0.005)			
RD	3.457E-6** (0.047)	3.050E-7 (0.666)	1.003E-5 (0.473)	4,819E-5 (0.124)	-1.787E-6 (0.475)
BDSIZE	0.009 (0.451)	0.000 (0.983)			
BANKS	0.012 (0.865)	0.050 (0.132)	0.188 (0.680)	0.315 (0.749)	0.060 (0.466)
FINANCIAL SERVICES	0.004 (0.968)	0.019 (0.664)	0.171 (0.810)	2.596 (0.108)	0.087 (0.498)
R-Sq	0.642	0.805	0.787	0.872	0.828
Adj. R-Sq	0.340	0.640	0.574	0.743	0.656
Sig. F change	0.099	0.004	0.016	0.001	0.005
SEE	0.086	0.038	0.599	1.292	0.107

Note: *, **, *** denote significance at the 10%, 5% and 1% levels, respectively.

As compliance with the GCGC and transparency & disclosure on CG have been detected as significantly important for a set of different performance measures within our sample, we take a closer look at the single categories determining the extent of both governance mechanisms (Table 2). A first point that is very important to notice is category 2 (cooperation between management board and supervisory board) with a mean performance of 60.8 percent (Figure 1). Taking a look at the figures on transparency & disclosure we identify a degree of performance of 68.5 percent on remuneration issues, an even smaller degree of performance of 40.7 percent on category 5 (information on board quality, independence and integrity) and only 33.0 percent on category 6 (CG commitment and information on a firm-specific CG code based on the GCGC). Splitting these figures by industries we identify banks as performing best in nearly all categories of compliance and transparency & disclosure, closely followed by financial services companies (Figure 2).

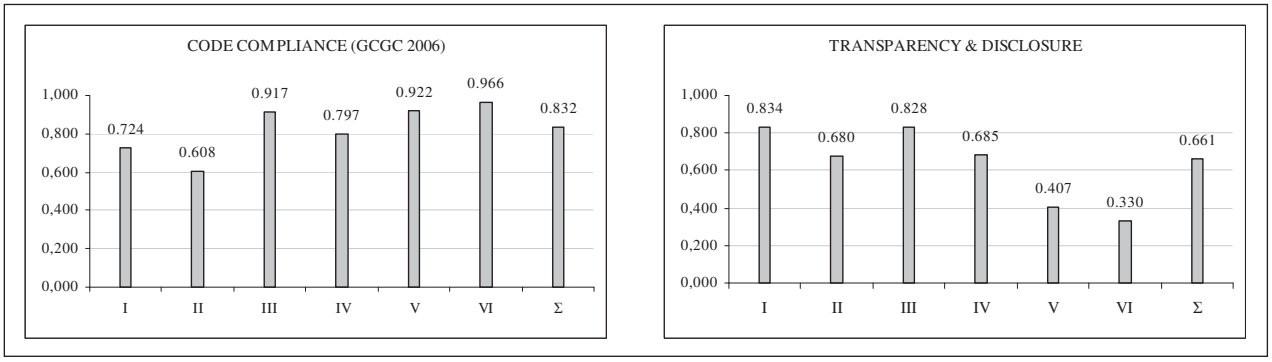


Fig. 1. Code compliance and transparency & disclosure by main categories

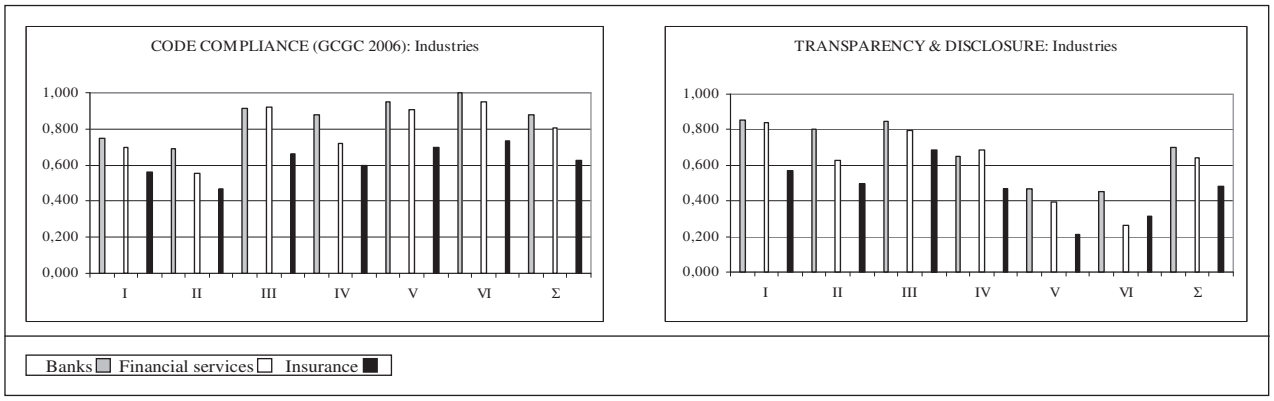


Fig. 2. Code compliance and transparency & disclosure by main categories and industries

Nevertheless, one should not overestimate these findings because banks in our sample are mainly listed in DAX, which traditionally shows higher rates of compliance and transpareny & disclosure (Stiglbauer, 2010). However, financial services companies which are mainly listed in SDAX (Small Cap Index) do perform well apart from index effects. Nevertheless, the sub-samples of the three industries differ in size, which could influence the findings for single industries.

Discussion and conclusion

General implications, shortcomings on corporate governance and some remedial (re)actions. Firstly, compliance with the GCGC has been identified as a value-driver for the German financial sector. This means, actors within the German capital market already put pressure on German listed companies to adopt the GCGC rules. Even more remarkable is the fact to be noticed that compliance also improves operating performance (ROE and ROA). Secondly, companies, which already solved their agency problems better than others (through adopting the GCGC rules to a higher extent) are also able to be more transparent towards CG (Aksu and Kosedag, 2006). We illustrate only those formerly theoretical mechanisms for Germany (Graf and Stiglbauer, 2008b), which we now confirm empirically for the German financial sector (Figure 3)[1].

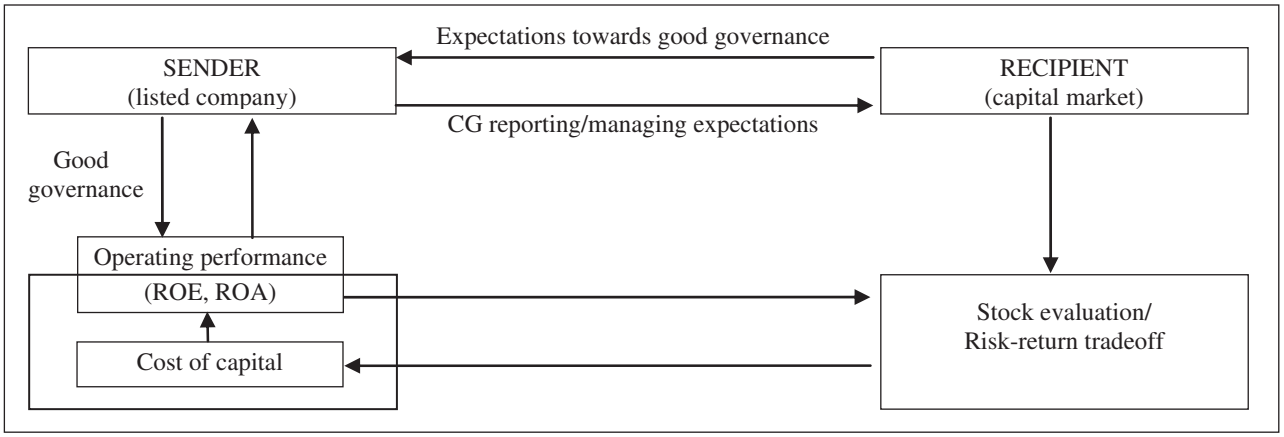


Fig. 3. Mechanisms of good governance and governance reporting on capital markets

Nevertheless, we detect some shortcomings on compliance with the GCGC and transparency & disclosure on CG. Low degrees of performance concerning cooperation between the Management Board and the Supervisory Board are problematic since this relationship is at the heart of the German CG system (two-tier board structure). It is almost widely discussed internationally if German Supervisory Boards hold expectations towards monitoring and advising management boards effectively. This could be a further, bad signal for international investors towards German corporations and may confirm them in their reservations towards the German CG system (e.g., German codetermination). This could also be problematic, regarding the issue of transparency & disclosure on CG, especially on remuneration issues (category 4), since company boards were directly responsible for the sharp rise in executive compensation before and after the financial crisis, often little related to company performance that many public figures came to criticize as improper ("pay without performance", Bebchuk and Fried, 2006). Accordingly, German government has passed two laws concerning remuneration. The first one from 2006 is called the Act Regarding the Disclosure of Management Board's Remuneration (VorstOG), with its main purpose to give companies an incentive towards proper, performance-based executive compensation. Against all expectations, executive salaries have been levelled and (unfortunately) boosted, with a common argument of companies that one cannot evaluate separately the performance of individual board members, said Klaus-Peter Müller, Head of the German Code Commission, criticizing the financial sector heavily (Müller, 2009). Consequently, German government has passed the Act Regarding the Appropriateness of Management Board's Remuneration (VorstAG) in 2009, with its main purpose to link the variable remuneration of the Management Board to the company's development based on several years' assessment data. As a first reaction, by example Allianz SE assesses the short-, middle- and long-term elements of managers' variable remuneration equally in the future and enforces its malus system in case of bad performance, as well as Deutsche Bank AG does.

Moreover, except for shortcomings concerning cooperation between the management board and the supervisory board and the qualification of supervisory boards in general (category 5, trans-

[1] The negative but not significant impact of TD on ROE and ROA could be explained via a loss of competitive advantage when reporting on governance practices that work in companies. Companies, therefore, may have to make a trade-off between the interests of the capital market, demanding for full disclosure and being a governance benchmark for competitors (Maingot and Zeghal, 2008).

parency & disclosure scorecard), the Code Commission has put the issue of improving the professionalism of supervisory boards (§ 100 AktG) of listed companies as one of the main issues on its agenda in 2010. This may expand the group of suitable candidates that could in future exercise supervisory mandates and achieve greater diversity within management teams with a focus on more women or foreigners in corporate boards. Furthermore, the Commission addresses the fundamental need to increase the qualifications of Supervisory Boards in general by expanding additional training that is available to both future candidates for Supervisory Boards and existing members. This may provide in-depth theoretical and practical information, in particular in the areas of legal principles, group financial accounting and risk controlling or provide in-depth information on the rights, obligations and responsibilities of supervisory boards on the basis of the German Corporation Act (§ 107 AktG) and the GCGC. Further aspects of training may include examining how committees work, reporting and controlling mechanisms as well as providing practical information on the work of supervisory boards with codetermination and addressing conflicts of interests (German Code Commission, 2010). Additionally, Germany has passed the Accounting Law Modernization Act (BilMoG) in 2009 with several changes in CG. Besides the qualifications and duties of supervisory boards BilMoG discusses the establishment of an audit committee (§ 324 and 264d German Commercial Code, HGB) and its duties of supervising audit processes, effectiveness of internal control processes and audit (§ 289, 315 HGB); also, it puts pressure on listed companies to inform its stakeholders about CG specific issues via a Declaration on Corporate Governance (§ 289a HGB), which could include a firm-specific CG code and a commitment towards the GCGC and planned action of CG, which has also been detected to come rather short within transparency & disclosure on CG (category 6). This declaration could be a standardized instrument for companies to present own CG practices on a recipient-specific basis and be a further source for investors to compare companies by CG specific issues.

Finally, the impact of ownership structure and debt will be discussed. A negative (non-significant) impact of freefloat on Q and MTB confirms the assumption of Shleifer and Vishny (1986); freefloat increases monitoring costs which lower company evaluation. This negative monitoring-effect may discourage blockholders to invest in those companies. On the other hand, we may confirm the assumption of Goncharov et al. (2006) that the German CG system is moving into the direction of a market-based system away from the traditional bank-based system. Regarding the positive impact of freefloat on ROE and ROA we also can refute Hackethal et al. (2005) that the German capital market does not have a disciplining role. Concerning the positive impact of closely-held shares on ROA we are able to detect decreasing agency costs through a disciplining role of this ownership structure (Diamond and Verrecchia, 1982); the higher the share proportion of management, the stronger are the incentives to work efficiently, since decision-making is connected directly with managers' own financial situation. Obviously and despite weaker ties of control through limited share proportions of outside shareholders, also outside shareholders seem to benefit from bigger share proportions of management within the German financial sector (TSR), confirming recent findings of Fahlenbrach and Stulz (2009) for the US companies. 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. This phenomenon may explain the negative impact of debt on ROE and ROA: high debt ratios force management to take cashflow for paying companies' dues which additionally leads to a loss of equity in our sample 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, IKB or Commerzbank. German government has reacted immediately and gave fresh money or guarantees for these institutions with its protective shield of more than € 400 billion. Further action towards higher equity ratios shall clearly be taken by companies within the financial sector themselves (Sanio, 2009).

Limitations

Several limitations must be reported in this study, starting with our sample. Increasing our sample on further corporations of the financial sector within the German stock market would make our study even more representative. Moreover, the data derive from one year, caused by the special focus of this study to research on the year before the subprime crisis. Maybe panel analysis over several years could change our findings. Nevertheless, supporting our approach, Black et al. (2006) promote one-year studies in governance research, since governance does not change heavily over time (sticky governance). This study also suffers from the fact that declared compliance cannot be considered as being equal with real compliance. There's only little possibility and pressure, in contrast to the US, to proof

whether companies' reporting on compliance with the GCGC is correct; the possibility that managers will be punished due to (conscious) false reporting is also being considered as rather low in the German legal system. Another limitation derives from the aspects analyzed with our transparency & disclosure scorecard. Maybe different researchers, analysts or investors use other or further aspects.

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