PARTICIPATORY INVESTMENTS BY BANKS: A STRUCTURAL PROBLEM OF THE UNIVERSAL BANKING SYSTEM IN GERMANY

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Discussions concerning the structure of the German banking system have been intense in recent years, principally at the political level but also among scholars. A major expression of this interest has been the nomination of a study commission on "Fundamental Questions of the Credit Industry", by the Federal Ministry of Finance in 1974. This commission's charge is to investigate the universal banking system that prevails in Germany. An especially important aspect of that system is the increasing practice of banks to invest in the shares of companies in the industrial and commercial sectors. A further problem arises from the practice in Germany whereby small shareholders give to banks their proxies for the general meeting; indeed, the majority of the shares of German companies are deposited in banks [1]. In addition, there is a close link between banks and industry through personnel interlocks; this is due to the membership on supervisory boards, since German law separates management and supervisory functions.

In Germany these matters that the commission will investigate are frequently the basis for slogans about the "power of the banks" [2]. In addition, consideration will probably be given to reforming the rules for the equity capitalization of the banks. The universal banking system as such will not be questioned. A separation system is not politically feasible, especially in the light of the trend to universalization in other countries [3]. Questions about proxy voting through banks (the so-called Depotstimmrecht or depository vote), as well as personnel interlocks, could more easily be answered by corporation law, but here, too, no decisive changes should be expected. The strength of the depository vote is the lack of a realistic alternative. The proxy system practiced in other countries can scarcely find support in Germany, since it affords no appreciable control over the organs of management [4]. According to press reports it is very likely that there will be a recommendation by the study commission restricting banks in their participation in the non-banking sector.

The banks' activities in share holdings will be discussed in this article as a structural problem of the German banking economy. Aside from the interest of the study commission in this question, there is an additional reason for considering it at

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this time. The Monopolies Commission, in its first report in 1976, proposed a
drastic restriction on participations to 5% of the capital of any one company [5].
The Monopolies Commission is charged by the antitrust law [6] to look into the
concentration of enterprises and to appraise the efficacy of regulations concerning
mergers and market abuse by dominant firms. The commission’s report contains an
abundance of material about banks and concentration [7] that will be referred to in
this article.

1. Bank participations in Germany: law and practice

A. The legal background

In Germany, bank participation is not regulated directly by law. Bank participa-
tory holdings, together with other long-term investments, are restricted only by
Section 12 of the Banking Act (Kreditvesengesetz). Under this section, a credit
institution may hold investments in real estate, buildings, ships, and shares, the total
book value of which does not exceed its capital and reserves. Participations are also
encompassed indirectly within the so-called “Principles of Equity Capital and
Liquidity” promulgated by the Federal Supervisory Agency for Banking [8]. How-
ever, these norms neither lead to a limitation on participations nor reveal their
extent. Participations through shareholdings are aggregated with the other invest-
ments mentioned above, in a single account. Furthermore, the concept of participa-
tion has not yet been adequately defined. In practice, the entries under the term
“participatory holdings” are generally limited to interests in other banks or in com-
panies in the near-banking sector (such as property management, leasing and invest-
ment advisory companies). In contrast, holdings in enterprises in non-banking sec-
tors exceeding 10% of the capital of a joint stock company are normally not
entered on the balance sheet as “participations” but as “securities” [9]. This
accounting practice has scarcely been changed by the directives for the preparation
of the annual accounts of banks [10]. According to these directives, in case of
doubt, shares in a stock company are presumed to be participations if they amount
to 25% of capital [11]. Thus, at least the larger holdings are supposed to be shown
as “participations”, but this presumption can be negated by an assertion that no
participation was “intended”. The banks usually disavow this intention by indicat-
ing that in the past their participations have not served to exert an entrepreneurial
influence, i.e., the banks have not pursued a policy of being directly active in the
business affairs of the companies whose shares they hold.

Recently the question of accounting for bank participations has been the subject
of intensive discussion between the Federal Supervisory Agency for Banking and
the Institute of Chartered Accountants [12]. The debate has dealt with the identifi-
cation of criteria for determining when the holding of shares amounts to participa-
tion. However, a definitive solution to this problem has not yet been found.
B. Participation in practice

The legal situation described above makes it virtually impossible to provide statistical data about bank participation in the non-banking sector. For this, reference can be made only to an early “Inquiry into Concentration” [13], covering a period up to the end of 1960. In its first report, the Monopolies Commission updated essential parts of the inquiry to the end of 1974, the year of the commission’s establishment. However, only limited conclusions can be drawn from the available data [14]. According to the report, banks held only about 3.2% of the share capital of all non-banking corporations. However, it should be noted that even with a wide distribution of participations in industry as a whole, concentrations of capital were found in certain sectors and, within these, in important enterprises. Thus there was potential for banking influence over a few, but important, branches of the economy.

The position of the three leading banks (Deutsche Bank, Dresdner Bank and Commerzbank) is significant in this context. In 1960 they held two-thirds of the face value of all participations; 69% of their participations were in only ten enterprises. The concentrations inquiry revealed an increase in the volume of participations; this increase has not slackened. For the year 1970 the German Central Bank estimated that from 5 to 7% of the capital of German corporations was held by banks (as their own assets, as distinguished from shares held by them as depositaries) [15]. The potential for the exercise of influence over the economy by banks through participations cannot be adequately quantified, even in the light of the figures given here. That potential must be viewed in the context of the proxy voting right acquired by German banks with respect to shares deposited with them by their customers. To this should be added the links with investment companies which, in general, are dependent upon the banks. This relationship and its effects will be discussed later.

2. Motives for bank participation

The connection between current banking business and long-term participation in enterprises in other branches of the economy is not obvious. Normal banking business consists of facilitating investments, lending money and transferring funds. Acquiring participations has therefore been described as an “alien” activity [16]. What are the reasons behind this policy?

A. Unplanned participations

Participations are not always the result of a planned investment policy. But banks acquire participations frequently in the course of normal banking transactions. These latter participations should be viewed in the framework of general banking policy.

A bank’s taking part in the business of share flotation by other enterprises can
lead to its acquisition of a participatory interest. Usually when banks become involved in the flotation of a new issue they take a fixed allotment of shares through subscription and thereafter place them on the capital market at their own risk. In practice several banks share the risk of a single issue by forming a syndicate. The assumption of this market risk is an important aspect of the business of issuing shares of which account is taken in setting the banks' underwriting compensation. If there is insufficient demand in the capital market the members of the underwriting syndicate must take their allotment into their own portfolios. The total volume of participations that arise in this way is normally relatively small [17]. This is because, although the market risk is highest when shares are issued in connection with the founding of a company, the most frequent occasions for the issuing of shares in Germany involve the increase of capital by seasoned firms. In such cases, the standing of the issuer is already known, the amounts to be placed are frequently small and thus, with the sharing of the decreased risk by the members of the syndicate, the volume of unsold shares that each bank must take up is not large.

In addition to acquiring participations as a consequence of their involvement with the issuing of shares, banks also acquire participations in the operation of their credit business [18]. Especially in the field of industrial finance, banks are not always able to collect the loans they have made. The bank is usually neither willing nor able to extend the maturity date of such loans. If the enterprise cannot pay off the loan in cash, the bank may accept settlement in the borrower's bonds or shares. In such cases the bank may end up as the owner of these new securities, especially if they cannot be disposed of by the bank on the capital market. This typically is the case when the debtor company is in financial difficulties since the market is understandably unwilling to invest in such a company. Thus the bank's participation emanates from its normal business of advancing credit. Of course, share participations acquired in this fashion give the banks membership rights under company law and a consequent ability to exert influence in the making of business decisions in the reorganized company. This influence is frequently realized by the assumption of a position in the company's supervisory board. The bank then cooperates in finding solutions to personnel and financial problems in an effort to restore the solvency of the company. This influence can on occasion be used to reorganize the company by combining it with a stronger partner.

B. Planned investment policy

Unplanned participations are the outcome of the operation of normal banking business. They thus serve the bank's profit-making goals indirectly. But in the German universal banking system profits are also sought directly through purchase of shares. In such cases participations are acquired as the result of planned investment policy [19]. Banks will enter into this line of business if their credit potential is not exhausted. In such circumstances there exist incentives to diversify into securities. It should be stressed that banks are in an especially favorable
position in comparison with other institutional investors. The latter must pay "brokerage" commissions when investing in securities, whereas banks can make relatively costless use of their own brokerage networks in making their own investments. Furthermore, the value of the banks' proximity to the market should not be underestimated. Their activity in the securities business develops an expertise that leads to the acquisition of information about companies and about the securities markets, information that is useful not only for their customers but also for their own business dealings.

From the banks' roles as lenders and underwriters, as well as through their representation on supervisory boards, they are in a special position to acquire inside information about businesses, information not known to the general public. This information can be valuable in connection with trading in shares. In Germany insider trading is not yet prohibited or otherwise regulated by law. A system of voluntary self-regulation does exist [20], but it is not considered very efficient [21]. Therefore, under the present legal situation, it should not be assumed that every opportunity to use inside information in their dealings on the securities market has been taken away from the banks.

Planned investment policy serves the purpose of stabilizing profits. Banks expect the continuous receipt of dividends and, even more, increases in the value of the corporate shares acquired. The latter can also be viewed as a shield against inflation. Furthermore, like the various segments of the diversified universal banking system generally, securities participations are an important factor in risk distribution [22].

C. Trading in participatory blocks

Frequently participations are created or acquired not so much to serve as long-term financial investments but rather to meet the transitory needs of a flexible capital market. In such situations, blocks of shares are themselves the subject of trade. When new groups of companies are formed, when joint ventures are created or split up, when property passes by inheritance, or when other changes in business relationships are contemplated, it frequently becomes necessary for a strong financial institution to step in and help develop a constructive solution to a business problem of this type, such as to put together participations, hold them temporarily and then sell out [23]. Banks are sometimes instrumental in special situations of this type designed to ward off the influence of foreign capital [24]. A bank may enter into such a transaction as a half-way house in connection with its activities in corporate finance or as a corporate consultant. In countries where banking is organized under the separation system, these same functions are undertaken by investment banks.

D. Participations as devices to cement business relationships

Although the banks do not make a point of it, there are weighty arguments that banks' participation policy is aimed at extending the market for their services and cementing the resulting business relationships [25]. This has been confirmed by the
investigations of the Monopolies Commission [26]. As previously mentioned, the banks have tended to participate rather heavily in just a few branches of the economy. This phenomenon can hardly be explained except by the reason just stated, unless these participations are unplanned. The participations acquired in these few areas of business cannot be attributed to any superior profitability and quality of the companies invested in, since no such superiority exists [27]. It is therefore probable that such planned participations are predominantly related to the banks' interest in intensifying their business relationships with the companies whose securities are acquired. This perception of the banks' interest is also consistent with their thesis that they have not used their participations to pursue a policy of controlling the underlying companies. Thus these acquisitions reflect normal banking business policy.

The voting power that a bank can exercise as a shareholder under company law may influence business decisions concerning relations of the bank with the company. This is even more likely if the bank can buttress its own voting power by the exercise of proxies to vote shares deposited with it by customers or by its strong position as a creditor of the company.

As a shareholder with such influence the bank can solidify its relation to a company with respect to credit and other banking needs; it can draw lucrative foreign business into its sphere. In connection with a company's issuing shares, the participating shareholder-bank can expect to serve as a member of the underwriting syndicate and can secure for itself a favorable allotment of the shares being issued. In short, the spectrum of services offered by the universal bank can be brought into play; the company within the bank's sphere of influence is put into the service of the bank's general business policy [28].

E. Conclusions

This sketch has shown that bank participation in other branches of the economy can always be viewed in connection with the entrepreneurial goals of the banking industry. To the extent that participations are not directly profit-oriented investments, they are the outgrowth of the performance of normal banking tasks: underwriting the flotation of shares, collection of loans, corporate consulting and corporate finance. They serve also to increase and cement business relationships. When dealing in shares or blocks of shares, banks claim to be exercising a public welfare function, i.e., the maintenance of a flexible capital market. Although the performance of this function cannot be denied, it is somewhat a background factor and must be viewed as accessory to more general business activities. In any event, market transactions in share participations as such justify the holding of only temporary participations [29].

The question remains whether the participatory investments should be considered an essential element in the ability of a bank (and indeed of the banking system as a whole) to perform as an efficient economic unit, i.e., to maintain profitability and stabilize risk as well as to provide security from inflation for its invest-
ments [30]. A conclusive statement seems to be impossible. The Monopolies Commission has legitimately indicated that similar questions might be asked with respect to enterprises in other branches of the economy besides banking. The banks' economic objectives could be accomplished more readily with a large number of smaller participations; the efficiency of the capital market would also be increased [31]. Moreover, if one looks at the low dividend yield from participations and notes that non-German banking systems maintain their efficiency despite a comparatively small holding of participations, it cannot be said that participations are of primary importance in the banking business as a whole.

The reasons that have been given for the present volume of participations do not render moot a discussion of their legitimacy [32]. The matter finally comes down to an analysis of the consequences that flow from their existence.

By bringing influence to bear on companies, participations serve to intensify business relationships. Beyond holding participations, banks have other ways of exercising influence, as indicated in the next part of this article. In Part 4, the question will be asked: what are the effects of participations on the companies concerned, on inter-banking competition and on other markets? Finally, in Part 5, the effects of participation will be looked at from the standpoint of the protection of depositors.

3. Participations and other possibilities for banks' influence on enterprises in the non-banking area

In Germany banks and business enterprises are connected not just through deposit and credit transactions or the bank ownership of participations; three other phenomena creating such relationships are discussed hereafter: influence through proxy voting, connections between banks and investment companies, and personnel interlocks.

A. Influence through ownership of shares

Direct influence on business decisions can be exerted through shareholder voting only if the shareholders can command the majorities required by company law. Banks hold these majorities through participations only in exceptional cases [33]. But there are occasions when a holder of a block of shares can veto a company's decision that, under the law, requires a qualified majority. In these cases, the bank's assent to a certain decision (e.g., a capital increase) may be bargained for by the company with concessions to the bank in other areas.

B. Bank-connected investment companies

To the extent that, as is usual in Germany, a bank controls an investment company, the bank's voting influence on an enterprise whose shares are owned by the investment company can be strengthened [34]. But the bank will not always have
the controlling influence on the investment company [35]. Furthermore, under
German law not more than 5% of the capital of an investment company (open-end
fund) may be invested in the shares of any one enterprise and not more than 5% of
the capital of any one enterprise may be acquired by an investment company [36].
Voting influence through a bank’s connection with investment companies is there-fore relatively slight, although it should not be totally disregarded.

C. Proxy voting (the depository vote)

In Germany the banks’ proxy vote is common practice. It is the banks that cast
the votes of the many small individual shareholders in the general meetings of
public corporations, votes that otherwise would not be exercised. This constitutes
an important difference from the general practice in other countries (Italy excepted)
of allowing otherwise neglected votes to be cast by the management itself or by
groups opposed to management [37].
The right of proxy voting by German banks is related to their custodial business.
Certificates for shares, especially of small shareholders, are typically not delivered
to the purchasers but are deposited in the custody of banks. Therefore the resulting
voting right acquired by the banks is described as a depository voting right (Depot-
stimmenrecht). The ability to exercise the vote of the depositing customer is provided
by the corporation law (§135 Aktiengesetz). To exercise this right the bank makes
its own proposals known to the shareholder and asks for instruction. As far as no
instructions are given, the bank can vote in accordance with its own proposals. If
new points of view arise in the general meeting, the bank can deviate from its pro-
posals if it can conclude that the shareholder, with knowledge of the situation,
would have concurred in the deviation.
This regulation is supposed to guarantee that the proxy will be used in general
meetings for the benefit of the bank’s deposit customers rather than for the bank
itself. The shareholder’s right to give instructions should preserve a genuine repre-
sentation of his interests [38]. Nevertheless, it must be admitted that this proxy
right can, at least in part, add to the banks’ influence. The opportunity to give
instructions will be used by only a small percentage of the shareholders to whom
the bank writes at any time. A recent survey disclosed that instructions were
given in only 350 instances out of 300,000 communications to customers [39].
Whether one views this response as silent acquiescence in the banks’ proposals or as
evidence of the passivity of the small shareholder — which appears more likely —
the exercise of the proxy certainly does not foreclose bank influence [40]. In any
case, it can safely be asserted that the interests of the bank and the shareholders are
frequently parallel and that conflicts arise only under certain circumstances [41].
It is not possible to qualify the real influence exercised through the proxy right.
However, the quantitative importance of the representation of the small share-
holder by proxy can be discerned to a certain degree. No exact figures are on hand
[42] but it appears that approximately 50% of the shares in German companies
(other than insurance companies) are in bank custody [43]. If bank ownership of shares of about 7.5% is added to that, there exists a potential voting power of almost 60% in the hands of the banks. The significance of this percentage is further underlined by the fact that in Germany the average attendance at general meetings ranges from only 70% to 80% [44]. Of course, at any one general meeting the proxy right will usually be exercised by several banks, which has the effect of dispersing the potential for influence.

The proxy voting right of the banks is a matter of continual discussion, most of which is critical [45]. The bank’s influence resulting from its exercise cannot be denied. This is a structural problem for all corporations with a large body of shareholders. As long as votes are not exercised by the owners themselves, but through third parties, there exists a potential danger to the interests of the small shareholder. Consequently it has been proposed by some German legal writers that the voting right should be abolished and that there be a contemporaneous increase in management’s fiduciary duty [46]. This proposal, however, has next to no prospect of being realized. The proxy voting right as such is not seriously in question.

D. Personnel interlocks

Banks are represented on the supervisory organs of corporations to a very great extent. According to the investigations of the Monopolies Commission, this is true for at least one-third of the companies, 28% of whose supervisory board members are bank representatives [47]. Of course there is a question whether this is a factor of influence additional to those already existing, since such representation is chiefly evidence of the influence that can be exercised through voting or as an outgrowth of credit connections. Nor should this representation necessarily be viewed as an unwelcome intrusion by banks into the affairs of enterprises, since the enterprises themselves are interested in bank representation: bank representatives provide expert advice and help to strengthen credit relationships. However, it should be appreciated that in this way banks enlarge their opportunities for acquiring information about the financial affairs and business policies of the companies concerned.

4. Effects of the banks’ influence

The factors mentioned above indicate that there is a potential for bank influence that cannot be considered negligible. The various means for influencing the decision-making process cannot be measured quantitatively; the possibility of combining the several factors would preclude this. But participation by banks can at least be described as playing a considerable role.

What are the effects that emanate from this potential for influence? The answer to this question is important in assessing the legitimacy of bank participation. There
may be effects on the enterprises in which participations are held as well as on competitive conditions in several markets.

A. Effects on the enterprise itself

The interests of an enterprise may be adversely affected in some measure when security is given for bank loans. If the bank is in a strong position it may insist on excessive security for an extension of credit; this may interfere unduly with subsequent business activities.

More serious problems are caused by the potential conflict of interests between bank and enterprise in the field of long-term financing. As legal writers have pointed out, even though an increase in the capital of an enterprise might be warranted, a bank might be inclined to press the enterprise to meet its financial needs by short-term credits, in view of better prospects for bank profits from its loan business [48]. Such action by a bank can endanger the soundness of a corporation's financial structure and lead to undercapitalization. This has led to the macro-economic criticism that the securities market has been neglected because of the influence of universal banks [49]. However, one can view this situation in general only as a potential danger, since it is doubtful that a bank can force an inappropriate means of financing upon a corporation with growth potential and the capability of issuing long-term securities.

In addition, it is possible that the voting power of banks being represented on corporate governing bodies may impede efficient control of these bodies. This could have an adverse effect on company interests when, for example, the bank promotes the adoption of a resolution discharging its representatives from liability or urges the payment of unreasonably high compensation.

B. Market effects

Stock participations by banks may restrain competition between banks as well as between the corporations that are the subject of participation. These effects are the Monopolies Commission's concern and led to proposal for new regulations [50].

The significance of participations with respect to inter-bank competition is particularly apparent and has been recognized for a long time [51]. As mentioned above, as a shareholder the bank can establish and secure a position for itself as a house bank. The investigations of the Monopolies Commission revealed easier access to lucrative membership in syndicates and to foreign business [52]. In sum, competitive advantages are derived from share participations to a certain extent.

This tendency toward impeding inter-bank competition through participations requires a harmonization throughout the European Community, since otherwise an integrated market for banking services cannot be established. This means that cemented bank-customer relationships will prevent effective competition from foreign banks [53].

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But this picture may be overdrawn. Existing inter-bank competition has already set limits to the ability of banks to freeze business relations even with enterprises in which they hold participations. No company will have to fully succumb to a bank even if it is its most important shareholder. A significant factor leading to this conclusion is the increasing competition in Germany between private commercial banks, on one hand, and the savings and state banks established under public law, on the other [54]. Another limit to the banks' influence can be found in the financial emancipation of companies that results from their use of internal financing through earned surplus or from establishing their own banks.

Finally, there is the question of the somewhat less visible effect of bank participations on competition among the enterprises that are subject to such participations. It has been commonly accepted that banks do not use their shareholdings to set the business policies of those enterprises [55]. However, there is no institutional guarantee of this self-restraint. Deviations from this policy might occur if a bank tries to improve its position as a shareholder by means of restricting competitive market forces.

The Monopolies Commission pointed out that banks just being shareholders cannot do otherwise than participate in making significant entrepreneurial decisions in the companies they hold, particularly those concerning investments and finance; in these cases information concerning the competitive conditions of the enterprises in which they hold shares becomes part of the decision-making process [56].

Beyond these effects on competition, in some instances in Germany it has become apparent that participation by banks impedes the making of rational decisions in the market for corporate control [57]. The functioning of this market depends on an undisturbed balancing of supply and demand, particularly in mergers, sales of blocks of controlling shares and the formation of company groups. This process requires that independent decisions be made by the opposing parties to a negotiation and that they be focused on the economic success of the acquisition. This pre-condition is no longer fulfilled once a single bank or several cooperating banks, using their influence over several companies, force a combination. In such a case, it is no longer the economic rationality of a market composed of competing interests that governs these mergers.

C. Conclusions

As this sketch has indicated, bank participation in non-banking enterprises creates distinct risks for these enterprises, for the existence of undistorted inter-bank competition and for the functioning of the market for enterprises themselves. General provisions of law directed against corporate and market control cannot prevent these effects. The German law on company systems (Konzerneinricht), codified in the Federal Corporation Law (Aktiengesetz) since 1965, contains some provisions to check de facto influence over a corporation [58]. However, it is not easy to prove "control" [59], since the banks' potential to compel the making of decisions
rests on different factors. Also, their influence can become effective even below the threshold set by the statute. Finally, it must be noted that the statutory limits are designed to be drawn against entrepreneurial influence and are therefore hardly fitted to rule banking relations.

Using the antitrust laws to govern the effects of bank participations is beset with extraordinary problems. Only in exceptional cases will there exist either unlawful conscious parallel action or the ability to prove it [60]. Control of excessive concentration begins only where dominating positions are either created or strengthened [61]; participatory investments will generally not be qualified under this standard.

Since general antitrust law forms only limited barriers, it seems an obvious step to deal with the risks arising from bank participations by regulating them directly. The Monopolies Commission argues that this step should be taken, but solely because of the effects of participations on competition. The commission stresses the fact that the positive effects of concentration that are present in other cases (e.g., rationalization and economies of scale) simply do not exist where banks engage in participations that are not focused on the near-banking sector. The majority of the commission asserts that there should be a limit of 5% on the acquisition of the capital stock of any one corporation [62]. Before a position on this limitation is taken in this article, there are problems with respect to the protection of depositors that must be examined. It is precisely because of these considerations that other countries have put limits on bank participations [63].

5. Bank participations and the protection of depositors

Deposits are entrusted to banks for only limited periods; in order to safeguard them against losses a bank has to try to reduce the risks connected with its business activities. Furthermore, repayment of deposits on the date they are due must be guaranteed. These risks, concerning security and liquidity as principal goals of banking policy, are incurred by participatory investments.

A. The security risk

Whenever banks invest clients' funds in shares or stock, a substantial risk of loss arises. Losses may be realized as a result of incompetent management, an economic crisis in the particular sector or a general fall in share prices. It is practically impossible to spread this risk; banks can take steps through their representation on supervisory boards only against mismanagement.

The security risk is increased when a bank ties itself too closely to the success or failure of any one enterprise by way of a substantial participation. If business goes bad and the value of the participation falls, it seems a natural step for the bank to help the enterprise by generously extending credit. In this case losses from partici-
pation will be increased by losses in the credit sector. As a preventive measure diversification to the greatest possible extent can reduce the security risk, even if it cannot do away with it completely. For this reason it seems appropriate to set limits to the acquisition of the shares of any one company.

B. The liquidity risk

The importance of the banks' continual readiness to pay depositors on demand leads to the question of the relationship between participations and the banks' equity. Participations cannot be considered liquid assets; the latter are characterized by the fact that they can be transformed into cash at any time, without discount. That is not the case with shares, for several reasons. Although participations are not "due" at any time, so that they can be used at the banks' entrepreneurial discretion, this discretion is subject to the influence of outside factors. Frequently there is no market for the shares. This can be true for closely-held corporations or for those whose shares have never been listed on an exchange. Even if the shares can be sold on an exchange, it should be noted that sale of a substantial block may lead to a fall in share prices. In addition, the time at which a sale is necessary might be quite unfavorable in view of the then current price of the particular shares.

From the German point of view, because of the time lags that interfere with ready sale of participations and their potential lack of marketability, participations are considered fairly non-liquid [64]. Therefore the only funds that qualify for participations are those that are not subject to immediate repayment or to repayment after a short period of time. It can be argued that only a bank's own capital assets should be used to acquire participations.

6. Effects on the capital market

The following will only summarize the significance that bank participations play in the capital market. In the discussion, earlier in this article, of the banks' motives for acquiring participations, attention was drawn to their present relationships with the capital market [65]. The banks' role as intermediary in the issuing of shares by companies is to facilitate effective public placement. They take the capacity of the market into consideration and through stabilization techniques are able to prevent undue price fluctuations until an orderly market for the particular security has come into being [66].

In this connection banks also perform a "mobilizing" role. They contribute to a process in which medium and long-term credit can be refinanced with equity capital. This contributes to the formation of capital by enterprises [67].

In comparison with other enterprises, banks have a particularly strong capacity to trade shares after collecting them into blocks. This increases the flexibility and depth of the capital market. This is particularly true in Germany, where other insti-
tutional investors do not play the role they play in other countries. In general, banks' securities activities form a link between small investors (savers) and companies that seek to broaden their capital base. To a certain degree, insurance companies and pension funds are assuming this function, too.

7. Evaluation

At the present time the practice of German universal banks to acquire shares in the non-banking sector is subject to widespread criticism. Unless one is satisfied to view the question of participations in a sweeping and unreflective manner, such as under the catchwords "power of the banks", the factors mentioned above should be decisive in the search for a solution. As far as discussions on a political level are concerned, there is little attention given to the relationship between share participations and depositors' protection from the standpoint of security risks and liquidity risks. This is perhaps because the aspect of "power" does not play a role in evaluating these risks and because there have been no spectacular events involving the realization of those risks. It becomes more and more apparent, however, that criticism is being directed toward the influence of banks over enterprises, including the practice of share participations.

However, there are positive aspects of share participations that should not be neglected when considering negative effects on enterprises, markets and depositors. As already mentioned, motives for acquisitions that are merely accessory to normal banking business cannot serve as fundamental justifications for the acquisition of share participations. The same is true for the potential of participations as supportive elements of an efficient capital market. Without doubt banks fulfill important functions in this respect, but these functions could just as well be assumed by other institutional investors. The goal of maintaining a flexible capital market can justify, at best, only transitory holdings of shares [68]. And even that does not justify the transformation of customers' bank deposits into participations by the bank.

It is not surprising that the issue of participations has become a part of the discussion about banking reform, although until now no concrete measures have been taken. From the outset it has been evident that this issue was not to be the crucial test of a continuing system of universal banks. It has thus been treated separately, or in connection with other factors relating to the banks' influence, such as depository voting or personnel interlocks. On the other hand, it has never been proposed that the acquisition of participations be absolutely prohibited. Its function in the capital market is too useful to permit such a radical solution.

Several years ago there was discussion of the possibility of solving the problem through divestiture of the banks' participations [69]. It would be a condition of such divestiture that the banks thereafter could not exercise any influence over the holding companies that would be created to facilitate the divestiture. But a transfer
of participations to these holding companies, whose shares would be issued to the shareholders of the banks, would create a considerable number of problems, both economic and under corporate and tax law [70].

The only open issue in the current public discussion concerns limits on bank participations. According to press reports such a measure is being considered by the banks themselves by way of self-regulation. This discussion is being encouraged by the recommendation of the Monopolies Commission, mentioned above, to limit participations to 5% of the capital of any one corporation. The deliberations of the Commission to Study Basic Issues in the Banking Sector are moving in the same direction but are less far-reaching. Where should such a limit be drawn?

8. Proposals

The Monopolies Commission supports strict limits and does so despite the fact that it is reacting only to the market effect of participations and not to the problems of protection of depositors. This position is grounded in the belief that a participation of 5% facilitates access to normal banking business [71]. To preserve open markets in the banking sector is the primary concern of the proposal.

Ownership of 5% of a company's capital stock does not permit direct influence upon its decisions. It may nevertheless be the fact that such a connection may serve to cement or intensify business relations in such a way that other banks are eliminated as potential offerors of banking services. Such a limitation, which has the effect of spreading the risk, can be an appropriate means of ameliorating the security risk from the potential devaluation of participations. Banks must also be considered, however, in their role as institutional investors. Their share participations are important factors in an efficient capital market. They act as intermediaries between the multitude of small investors and the corporations and thereby support the broadening of equity financing. If only temporary ownership of shares is permitted, this role as intermediary is curtailed.

In France the ceiling on share participation by commercial banks was increased from 10% to 20% in 1966/67 as part of a general program of promoting long-term financing [72]. This was aimed at making a "transformation", to facilitate the change from excessive savings to long-term risk capital [73]. In Belgium in 1975 the same considerations led to the loosening of the ban on share participation by administrative rule [74]. In Germany as well, this bank function should be considered in setting limitations to participations. From this standpoint a limit of 10% seems appropriate. A more general allowance would be unacceptable, in view of the consequent increased risk of loss from declining share values and the banks' increased potential for influence over enterprises. Shareholdings permissible under such a limitation would not reach up to the level permitted in France and Eire [75]. But for an international comparison it should be recalled that in countries with a system that separates commercial banking from investment banking, com-
mercial banks are normally forbidden to hold share participations.

Limiting the ownership of shares in any one company does not avoid the liquidity risk connected with participations. It has been shown above that the use of clients' funds for participations can endanger the liquidity that banks need. This risk can be governed by varying the ratio between a bank's total shareholdings and its equity. There are no absolute standards for determining this ratio. It seems sensible, however, to allow banks to acquire participations only to the extent that they can be covered by their equity (capital and reserves). Any further limitation does not appear necessary, in view of the fact that bank equity in general is only a small percentage of total banking assets. Furthermore, it should be noted that even with funds on daily or short-term calls, a certain percentage will always remain with the bank.

Setting a limit for participations that is not excessively low is meant to account for the fact that shareholdings by banks financed from clients' funds deepen the capital market and thus help meet the needs for equity financing by corporations. Beyond this, from the point of view of the capital market, the ability of banks to hold shares facilitates block trading and the placement of new issues. A further justification for permitting participations is their use as replacements for loans that companies in need of reorganization are currently unable to pay in cash. These cases of block trading, new issues and loan replacements might require participations exceeding the general limits for a certain period of time. This could be provided for by a rule permitting shareholdings for up to one year and allowing extensions [76]. To reduce the potential for influence from block holdings, holdings exceeding 10% could be banned from voting; this would induce the sale of such holdings. The need for the protection of investors would be provided for if, for temporary holdings, a ceiling is fixed at 50% of the capital of a corporation.

9. Comparative survey

As already indicated above, such a limitation on participations by German universal banks would come close to the regulations in other European countries.

In Belgium, France and Italy, participations are regulated in the context of a more or less distinct functional division within the banking system. There are no universal banks; the banking laws make a fundamental distinction between deposit banks for short-term business and investment banks concentrating on medium- and long-term business. Under these circumstances the holdings of share participations are to be found in the investment banks. The deposit banks are limited in their ability to invest, although in these countries there is no absolute ban on shareholding. In France a rather permissive regulation is in effect. Up to 20% of the capital of a company may be acquired. However, the total of its participations must not exceed the bank's equity [77]. In Italy investments by commercial banks are severely limited. They are subject to the supervision of the Bank of Italy and must
be notified. Permissions are granted for temporary investments and if distribution to the investing public is intended [78].

Similarly considering the needs of the capital market, the ban on participations in Belgium has been relaxed by law. Shares may remain in a bank's portfolio for up to one year. However, the Commission Bancaire can extend this period. There is an interesting exception, which exists only in Belgium, for acquisition that merely serve to replace bad loans and are therefore meant to strengthen a corporation's equity. As already mentioned, a further liberalization of the ban can be expected, because the banking law, since 1975, permits participations within certain limits that are to be defined by administrative rule in cooperation with the Commission Bancaire [79].

In England the separation system has developed as a matter of tradition and is not based on law. The Clearing Banks are engaged mainly in taking deposits and the Merchant Banks in long-term industrial business. This is reflected in a concentration of share portfolios in the Merchant Banks. An unwritten code of behavior, which is now relaxing to a certain degree, is the principal barrier to participations by Clearing Banks. Since 1972, however, this form of investment has been somewhat promoted by the Bank of England, reflecting an increasing trend toward universalization of the banking business [80]. The proposed enactment of a British banking law will have to reveal how this problem should be solved.

Banks in Eire, Denmark and the Netherlands have the character of universal banks. Nevertheless, shares cannot be held without limitation. Denmark has the most extensive regulation. Since 1975 the Banking Law prohibits banks and savings associations from engaging in business other than banking. This is meant to prevent the exercise of control over other enterprises through participations. Majority holdings are incompatible with this objective. The regulation is designed to eliminate conflicts of interest between banks and business enterprises. For the same reason, personnel interlocks are not permitted. Furthermore the Danish banking law pursues banking objectives when it forbids a bank to acquire shares in any one enterprise with a book value in excess of 15% of the bank's equity. And the total amount of share participations must not exceed 50% of the bank's equity [81].

In Eire the task of protecting depositors from excessive bank participations is committed to the banking authority. In order to promote "orderly and proper regulation of banking", the Central Bank, since 1971, has directed that, without its permission, not more than 20% of the shares of another corporation can be acquired. Obtaining permission is excused only where the value of the shareholdings does not exceed 2% of the total of the bank's assets [82].

The Netherlands, a country with a typical universal banking system, has a general regulation applicable only to savings associations, whose ownership of listed shares may not exceed 50% of their equity. Participations by banks are dealt with only indirectly in course of the Nederlandsche Bank's (Central National Bank) supervision of mergers. They are sometimes granted under the condition that the surviving bank may acquire participations only with the permission of the banking
authority. This potential for control should not be underestimated, since there has been a strong movement toward concentration in recent years. Furthermore, plans in the Netherlands for a reform should be mentioned that would subject all acquisitions exceeding 5% of the capital of any one company to an authorization [83].

A limitation on participations in Germany would therefore tend to fit into the existing European framework, though significant differences in the laws of the European Community are still existing. A harmonization is essential for an integration of the markets for banking services.

Share participations can result in competitive advantages. Influence over business enterprises stabilizes and broadens the business relationships of a bank. This can serve to eliminate foreign banks from competition for the business of enterprises, at least if they do not themselves have participations. Harmonization of national regulation would serve to equalize the conditions on the capital markets of the member states, which in turn would promote a balanced development of a common market for equity capital [84]. The European Commission has taken the first steps toward harmonizing the laws in the banking section [85]; however, it will take more time before a consensus will be achieved with respect to a Community directive including participatory investments of banks.

Notes


[24] For criticism of this point, see Monopolkommission, sec. 559.
[25] Willners, supra n. 19, at 199; Möschel, supra n. 15, at 366; Roth, Das Treuhandmodell des Investmentrechts – Eine Alternative zur Aktiengesellschaft 308 (1972); Hagenmüller, Der Bankbetrieb 172 (1964).
[27] Willners, supra n. 19, at 199.
[28] See also A. Weber, Depositenbanken und Spekulationsbanken 270 (1938); Willners, supra n. 19, at 199; Monopolkommission, sec. 563.
[32] As to this issue, see also Monopolkommission, sec. 562.
[33] See Part 1 B supra.
[34] Roth, supra n. 25, at 156 (with references).
[37] Cf. the proxy system in England and the United States and the blank proxy form given to management in France and Belgium.
[40] Möschel, supra n. 15, at 46.
[41] On this point, Hopt, supra n. 4, at 141 passim.
[42] See Monopolkommission, sec. 508 passim.
[45] Survey by Hopt, supra n. 4, at 141 passim; Püttner, Das Depotstimmrecht der Banken (1962).
[46] Roth, supra n. 25, at 206 passim.
[51] Aust, supra n. 16, at 156 passim; Möschel, supra n. 15, at 366.
[53] Immenga, supra n. 12, at 139 passim.
[54] As to competition in the banking field, the most recent commentary is Hopt, supra n. 4, at 175 passim.
[56] Id., sec 565.
[57] As to the market in undertakings, from the economic point of view, the most recent commentary is Kaufer, Konzentration und Fusionskontrolle (1977); as to bank influence in this connection, see Immenga, supra n. 12, at 113 passim.
[59] Aktiengesetz §17.
[60] Gesetz gegen Wettbewerbsbeschränkungen §25(1).
[61] Id., §24(1).
[63] See Part 9 infra.
[64] Büschgen, Bankbetriebslehre 454 (1972); Willners, supra n. 19, at 124.
[65] See also Monopolkommission, sec. 561.
[66] This proposition has also been stressed in the Segré Report, supra n. 49, at 263.
[67] Müllhaupt and Weleens, supra n. 22, at 223.
[69] Günther, Zeitschrift für das gesamte Kreditwesen 29 (1970); on this point see Hopt, supra n. 4, at 204; Büschgen, supra n. 17, at 791 passim.
[70] Büschgen, id. at 798 passim.
[71] Monopolkommission, sec. 567.
[74] Amendment to the Banking Law (Arrêté royal, June 30, 1975); Aug. 2, 1975 Moniteur Belge 9471.
[75] As to France, see supra n. 72; as to Eire, see Autumn 1971 Central Bank Quarterly Bulletin 68.
[76] Such a rule has been considered by the Monopolies Commission, but it has not yet been formulated.
[77] Supra n. 72.
[78] Banking Law Art. 35(2) (a) (1938 n. 636); Istruzioni Vigilanza -- b par. 17.
[84] Immenga, supra n. 12, at 142.

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