Jeffrey Fear and Christopher Kobrak

Banks on Board: German and American Corporate Governance, 1870–1914

This examination of the foundations of German and American corporate governance highlights the role of money-centered banks, both as board members in large corporations and as intermediaries on the stock exchange. German banks, by acting as surrogate regulators, became institutional stabilizers, and German regulators encouraged banks to participate in corporate boards in order to overcome agency problems in firms and to control speculation. American investment banks, prior to 1914, often managed to overcome regulatory obstacles, which enabled them to wield more power over corporations than their legendary German counterparts. American banks had more opportunities to intervene in the event of panics, bankruptcies, foreign investment, and corporate consolidation. In contrast to Germany, the United States increasingly imposed regulations that circumscribed the supervisory role of banks as board members.

Booming global investment patterns have inspired a flood of comparative corporate-governance studies on the proper control of corporations.[1] A century after the 1907 crisis that propelled many twentieth-century banking reforms, the financial crisis of 2008–09 has reignited debates about the appropriate role of financial institutions in corporate governance and capital-market regulation. Moreover, the

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[1] Henry Hansmann and Reinier Kraakman, "The End of History for Corporate Law," *Convergence and Persistence in Corporate Governance*, ed. Jeffrey N. Gordon and Mark J. Roe (Cambridge, U.K., 2004), 33–68; Randall Morck, ed., *A History of Corporate Governance around the World: Family Business Groups to Professional Managers* (Chicago, 2005); Robert Monks and Nell Minow, *Corporate Governance* (Cambridge, Mass., 1995); Klaus J. Hopt et al., eds., *Comparative Corporate Governance: The State of the Art and Emerging Research* (Oxford, 1998); Stanley W. Black and Mathias Moersch, eds., *Competition and Convergence in Financial Markets: The German and Anglo-American Models* (Amsterdam, 1998).

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issue has become acute as new markets search for an appropriate mixture of indigenous and imported institutions, as occurred in both the United States and Germany, the two most important markets to emerge prior to 1914.

How Americans and Germans coped at that time with massive cross-border capital flows, novel financial instruments, and the rise of big business during the first round of modern globalization had long-lasting ramifications for the varieties of capitalism adopted by these two countries. The contrast between these countries' financial systems is one of the central distinctions between, on the one hand, an archetypal American "Anglo-Saxon capitalism," and, on the other, German "Rhineland capitalism."[2] While social scientists tend to describe a stark and static contrast between them, both countries' financial systems have changed considerably over the course of the last century.[3]

Despite many regulatory differences between the United States and Germany before World War I, investment bankers played similar corporate-governance roles in large industrial (or nonfinancial) companies. In our analysis, we argue that, because they had more opportunities for intervention, the power wielded by the great American investment banks over U.S. corporations exceeded the influence that the legendary German banks exerted over German firms. In our analysis, we compare the role in corporate governance of major, mostly New York, investment banks with that function as performed by the mostly

[2] Glenn Morgan, Richard Whitley, and Eli Moen, eds., *Changing Capitalisms? Internationalization, Institutional Change, and Systems of Economic Organization* (Oxford, 2005); Bruno Amable, *The Diversity of Modern Capitalism* (Oxford, 2003); Peter A. Hall and David Soskice, *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford, 2001); Wolfgang Streeck and Kozo Yamamura, *The Origins of Nonliberal Capitalism: Germany and Japan in Comparison* (Ithaca, N.Y., 2001); Mary O'Sullivan, *Contests for Corporate Control: Corporate Governance and Economic Performance in the United States and Germany* (Oxford, 2000); Ronald Dore, *Stock Market Capitalism, Welfare Capitalism: Japan and Germany versus the Anglo-Saxons* (Oxford, 2000); Michel Albert, *Capitalism vs. Capitalism* (New York, 1993).

[3] Gary Herrigel, "A New Wave in the History of Corporate Governance," *Enterprise and Society* 8, no. 3 (2007): 475–88; Mary O'Sullivan, "The Expansion of the U.S. Stock Market, 1885–1930: Historical Facts and Theoretical Fashions," *Enterprise and Society* 8, no. 3 (2007): 489–542; Gary Herrigel, "Corporate Governance," *Oxford Handbook of Business History*, ed. Geoffrey Jones and Jonathan Zeitlin (Oxford, 2008), 470–97; Marie-Laure Djelic and Sigrid Quack, "Rethinking Path Dependency: The Crooked Path of Institutional Change in Post-War Germany," in *Changing Capitalisms? Internationalization, Institutional Change, and Systems of Economic Organization*, ed. Glenn Morgan, Richard Whitley, and Eli Moen (Oxford, 2005), 137–66; Volker R. Berghahn and Sigurt Vitols, eds., *Gibt es einen deutschen Kapitalismus? Tradition und Globale Perspektiven der sozialen Marktwirtschaft* (Frankfurt/Main, 2006); Colin Crouch, *Capitalist Diversity and Change: Recombinant Governance and Institutional Entrepreneurs* (Oxford, 2005). Similarly, see Aldo Musacchio, *Experiments in Financial Democracy: Corporate Governance and Financial Development in Brazil, 1882–1950* (New York, 2009).

Berlin-based "great banks," such as Deutsche Bank, the classic focus for debates about "banking power."[4]

Our argument builds on a twenty-year reassessment by German business historians, who have done much to dispel the view initially put forth by Alexander Gerschenkron that banks piloted Germany's rapid industrialization. Rudolf Hilferding's classic thesis, holding that large German universal banks dominated corporate decision-making, has also been discredited. Less appreciated is the fact that Hilferding regularly provided American examples of banks' power as evidence for "finance capitalism."[5] Recent comparisons have demonstrated that the traditional categorizations of both countries' financial systems do not fully capture the degree to which the two systems resembled one another.[6] Indeed, a transnational financial elite greased the wheels of international high finance, whose activities were epitomized by J. P. Morgan (who studied in Göttingen and was trained in London), by the German immigrants Jacob Schiff and Paul Warburg of Kuhn, Loeb & Co., or by Deutsche Bank activities in the United States.[7] Contemporary characterizations of the "varieties of capitalism" hardly do justice to the layout of financial markets before World War I in either country.[8] Finally, the standard

[4] Fritz Redlich, *The Molding of American Banking* (New York, 1968), 355–96; Lothar Gall, Gerald D. Feldman, Harold James, Carl-Ludwig Holtfrerich, and Hans E. Büschgen, *Die Deutsche Bank, 1870–1995* (Munich, 1995).

[5] Rudolf Hilferding, *Das Finanzkapital: Eine Studie über die jüngste Entwicklung des Kapitalismus* (Vienna, 1910) or *Finance Capital: A Study in the Latest Phase of Capitalist Development* (London, 1981). Armed with assumptions about inevitably declining profits combined with increasing fixed costs and investments, and (wrongly) identifying the supervisory board chair as the decisive figure, Hilferding concluded that banks dominated German industry.

[6] Sigurt Vitols, "Origins of Bank-Based and Market-Based Financial Systems," *Origins of Nonliberal Capitalism*, 171–99. Vitols calls both American and German financial regimes "laissez faire" until a divergence in the 1930s. We largely agree, but date the divergence to key decisions made prior to 1914 that did not have full effect until after World War I; Depression-era reforms formalized emerging developments.

[7] Christopher Kobrak, *Banking on Global Markets: Deutsche Bank and the United States, 1870 to the Present* (New York, 2008).

[8] A full historiographical discussion cannot be provided here. Caroline Fohlin offers the most sustained revision of the "orthodox" Gerschenkronian view in *Finance Capitalism and Germany's Rise to Industrial Power* (New York, 2007) and in the numerous articles listed in her bibliography. Overviews can be found in Gerald D. Feldman, "Banks, *Bankenmacht*, and Financial Institutions from 1900 to 1933," *Finanzmarkt-Kapitalismus: Analysen zum Wandel von Produktionsregimen* (Wiesbaden, 2005), 316–30; Timothy Guinnane, "Delegated Monitors, Large and Small: Germany's Banking System, 1800–1914," *Journal of Economic Literature* 40, no. 1 (2002): 73–124; Sheilagh Ogilvie and Jeremy Edwards, "Universal Banks and German Industrialization: A Reappraisal," *Economic History Review* 49, no. 3 (1996): 427–46. Even Gerschenkron did not think the guidance or influence of banks extended much past 1895: Alexander Gerschenkron, *Economic Backwardness in Historical Perspective* (Cambridge, Mass., 1966). For an argument about the importance of joint-stock investment banks prior to the 1880s, see Carsten Burhop, "Did Banks Cause the German Industrialization?" *Explorations in Economic History* 43, no. 1 (2006): 39–63. Key texts include: Carsten Burhop, *Die Kreditbanken in der Gründerzeit* (Stuttgart, 2004); Harald Wixforth, *Banken*

portrayals fail to give enough credit to the wide range of services provided by banks, including their monitoring of firms, prior to 1914.[9]

Instead, we find many similarities in the roles of these banks in corporate governance, and we stress the ways in which banks can (potentially) generate trust and mitigate risk, rather than emphasizing, as Gerschenkron did, their actions as substitutes for entrepreneurship or as insidious "money trust[s]" or bank "dominance," the labels placed on them by Louis Brandeis and Rudolf Hilferding, respectively.[10] To follow this line of thought, we are extending Gerald Feldman's suggestion to shift the question. Instead of seeking to answer "how financial systems promote growth [we ask] if and how they can produce greater stability."[11]

Section one points out that financial systems prior to 1914 *did not and could not* operate in the manner that we routinely expect today. Banks acted as special intermediaries on the basis of their close relations with major corporations and their roles as gatekeepers on stock exchanges that issued and traded corporate securities. Banks substituted not for entrepreneurship but for the lack of institutionalized trust in imperfect, nascent capital markets.

In section two, we make the case that leading New York investment banks played a more powerful, interventionist role in the corporate governance of large firms than did the (in)famous German banks. Their intervention helped lead to a greater backlash against bankers in the United States, where reforms were initiated largely in order to limit the power of insiders—especially powerful investment banks—and were driven by the fear of separating control from ownership. In Germany, by contrast, the fear of separating shareholding from ownership largely kept family owners and bankers on boards.[12]

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und Schwerindustrie in der Weimarer Republik (Cologne, 1995); Dietmar Petzina, ed., *Zur Geschichte der Unternehmensfinanzierung* (Berlin, 1990); Volker Wellhöner, *Großbanken und Großindustrie im Kaiserreich* (Göttingen, 1989). For differences in bank financing pre- and post-1945, see Bankhistorisches Archiv, ed., *Bankkredit oder Kapitalmarkt: Alternativen der Industriefinanzierung in Deutschland* (Stuttgart, 2002).

[9] To be clear, we are not discussing the obvious overall differences, including the prevalence of unit banking in the United States versus the ability to branch; the greater fragmentation of specialized banks (trust companies, buildings and loans, investment banks, etc.) versus "universal" banks; commercial banks' inability to own stock directly in the United States; or the higher percentage of private commercial banks in the United States versus public, municipally controlled savings banks (*Sparkassen*).

[10] Louis Brandeis, *Other People's Money and How the Bankers Use It* (New York, 1914); Hilferding, *Finanzkapital*.

[11] Gerald D. Feldman, "Business History, Comparative History, Transnational History," *Transnationale Geschichte*, ed. Gunilla Budde (Göttingen, 2006), 254–64, quote from 263.

[12] Our discussion is limited to those firms and banks with such ties at the heart of the traditional paradigms, not the broad base of limited liability (GmbHs) or family-owned *Mittelstand* firms, which would only further minimize the piloting role of banks in the German economy. See Guinnane, "Delegated Monitors"; Timothy Guinnane et al., "Putting the Corporation in its Place," *Enterprise and Society* 8, no. 3 (2007): 687–729.

Prior to 1914, banks in both countries served as a kind of insurance for investors. Like insurance companies, banks became more extensively involved when there was a problem. German banks interceded to provide economic services to others that became distressed, a role that J. P. Morgan famously played as well. Over time, German investment banks increasingly occupied a different qualitative space in the country's financial system than the space inhabited by their American counterparts; they played a surrogate regulatory role that neither the traditional Gerschenkronian or Hilferding viewpoints nor their critics succeeded in capturing. In the United States, reforms led to the increasing circumscription of insiders and created transparent securities-market regulation that partially substituted for bank supervision.[13]

Investment Banks on Board ca. 1900

Before World War I, both countries had hybrid bank-based and capital-market systems. Banks and stock exchanges were entwined with one another, but increasingly in different ways.[14] Banks offered wide-ranging services as "gatekeepers" when equity and bond markets were in their infancies. Professional activities had not yet been divided into specialized firms, such as management consultants, financial advisers, ratings agencies, accountants, private-equity managers, and stockbrokers. Even in the United States, where long before Glass-Steagall regulations limited bankers' activities, banks individually or in consortia performed such functions. Some services only became important during an economic downturn or when a single firm was experiencing financial stress.[15] Money-center banks in both countries provided their clients with investment credit and essential services, such as domestic and international transfers, which were less routine than they are today. The rise of big business created greater financial complexity, and investment banks

[13] Jeffrey Fear and Christopher Kobrak, "Diverging Paths: Accounting for Corporate Governance in America and Germany," *Business History Review* 80 (Spring 2006): 1–48.

[14] The vibrancy of the pre-1914 German stock exchange has been well established. See Fohlin, *Finance Capitalism*; Caroline Fohlin, "Does Civil Law Tradition and Universal Banking Crowd Out Securities Markets? Pre–World War I Germany as Counter-Example," *Enterprise and Society* 8, no. 3 (2007): 602–41; Christoph Buchheim, "Deutsche Finanzmetropole von internationalem Rang (1870–1914)," *Geschichte des Finanzplatzes Berlin* (Frankfurt/Main, 2002), 103–56; Steffen Eube, *Der Aktienmarkt in Deutschland vor dem Ersten Weltkrieg—Eine Indexanalyse* (Frankfurt/Main, 1998); Raghuram G. Rajan and Luigi Zingales, "The Great Reversals: The Politics of Financial Development in the Twentieth Century," *Journal of Financial Economics* 69 (July 2003): 5–50.

[15] See John C. Coffee, *Gatekeepers: The Professions and Corporate Governance* (Oxford, 2006); Eugene N. White, "Were Banks Special Intermediaries in Late Nineteenth Century America?" *Federal Reserve Bank of St. Louis Review* (May/June 1998): 13–36. In Germany, they still play such roles with small businesses. See Sigurt Vitols, "Are German Banks Different?" *Small Business Economics* 10, no. 2 (1998): 79–91.

were the main providers of financial advice. Few companies, if any, had a chief financial officer in the modern sense.

Banks in both countries played a crucial intermediary role, whether they did so by assuming official roles on corporate boards or by acting informally as personal advisors, even for closely held companies with little need for external financing. This was not unusual, but it was the norm: an efficient capital market was, and still is, the historical exception to the rule. Not until the development of new accounting methods, more fluid commercial paper and securities markets, management-consulting firms, and credit-rating agencies were banks slowly dislodged from their central position, "even when [they were] disadvantaged by regulation and challenged by competitors."[16]

Clearly, large German universal banks did not have to work around as much disadvantageous regulation, either before or after 1914, as their American counterparts. Their geographic, organizational, and expansive services were not matched in the United States, which enhanced the corporate governance services they provided to firms. As universal banks, the big Berlin investment banks could take deposits from across Germany, lend to corporations, extend export credits, own securities, sit on supervisory boards, and perform numerous kinds of consulting services, which reinforced their efficacy in syndicates for launching domestic and foreign securities.[17] German banks' universalism was both an outcome of political choices and a desired quality, just as American banks' fragmentation and specialization was a political choice, not a result of efficiency.[18] German banks, however, largely differentiated themselves along

[16] White, "Were Banks Special Intermediaries?" 13; Naomi R. Lamoreaux, *Insider Lending: Banks, Personal Connections, and Economic Development in Industrial New England, 1784–1912* (New York, 1994).

[17] Youssef Cassis, *Capitals of Capital: A History of International Financial Centres, 1780–2005* (Cambridge, U.K., 2006), 110–13; Fohlin, *Finance Capitalism*, 65–80.

[18] Charles W. Calomiris, "The Costs of Rejecting Universal Banking: American Finance in the German Mirror, 1870–1914," in his *U.S. Bank Deregulation in Historical Perspective* (New York, 2000), 212–79; Mark Roe, *Strong Managers, Weak Owners* (Princeton, 1994); Carlos D. Ramirez and Marco Becht, "Does Bank Monitoring Mitigate Liquidity Constraints? Evidence from Germany's Universal Banks in the Pre–World War I Period," *Southern Economic Journal* 70, no. 2 (2003): 254–72; Dieter Ziegler, "Das Deutsche Modell bankorientierter Finanzsysteme (1848–1957)," in *Finanzmarkt-Kapitalismus*, ed. Paul Windolf (Wiesbaden, 2005), 276–93; Richard Tilly, "Universal Banking in Historical Perspective," *Journal for Institutional Theoretical Economics* 154, no. 1 (1998): 7–32; Gerald D. Feldman, "Responses to Banking Concentration in Germany, 1900–1933," in *A Century of Banking Consolidation in Europe*, ed. Manfred Pohl, Teresa Tortella, and Herman van der Wee (Aldershot, 2001), 195–212; Gerald D. Feldman, "Banks and Banking in Germany after the First World War: Strategies of Defence," in *Finance and Financiers in European History, 1880–1960*, ed. Youssef Cassis (Cambridge, U.K., 1992), 243–62; Manfred Pohl, *Entstehung und Entwicklung des Universalbankensystems: Konzentration und Krise als wichtige Faktoren* (Frankfurg/Main, 1986).

class, client, federal, and public–private lines, rather than by American-style functional specialization.[19]

The fragmented nature of America's banking services and their dependence on foreign capital sluiced through the major investment banks, such as J. P. Morgan, Kuhn, or Loeb & Co., which raised money and sold U.S. securities on European markets, creating a complicated maze of banking relations. Unlike German universal banks that internalized such functions, New York investment banks had to work through an array of specialized institutions, such as trust companies, security affiliates that owned equity and voted, or syndicates of banks and private investors. Paradoxically, the fragmentation of American banking gave rise to the shadowy, dense network of cross-directorships and financial ties that was pilloried by the Congressional Pujo Committee of 1912/13 designed to investigate banking abuse. Investment banks came to be viewed as spiders weaving a web of financial manipulation. A less ominous interpretation was that American investment banks were simply attempting to overcome the problems caused by this fragmentation of the functions that German universal banks provided in house. Moreover, the scale of foreign capital inflows and corporate consolidation led to a powerful concentration of finance that had little precedent in Germany. The president of New York First National Bank, George F. Baker, once stated that four investment banks (J. P. Morgan; Kuhn, Loeb & Co.; Kidder, Peabody; and Lee, Higgenson) were involved in every securities issue that exceeded more than $10 million, which brought the total value of securities issued each year to well over $500 million.[20]

As intermediaries, American investment banks played a controversial, high-profile role in providing private finance for infrastructural, massive "public service" corporations, such as railroads and utilities, where much of the modern securities regulation, financial innovations, and accounting reforms took place. These reforms led to a process of disintermediation that drove American investment banks out of their corporate governance roles, which German banks managed to retain. In Germany, these infrastructural sectors largely remained under direct state or municipal control for a long time.[21] With these politically sensitive

[19] Guinnane, "Delegated Monitors"; Eckhard Wandel, *Banken und Versicherungen im 19. und 20. Jahrhundert* (Munich, 1998).

[20] [Pujo] *Report of the Committee Appointed Pursuant to House Resolutions 429 and 504 to Investigate the Concentration of Control of Money and Credit* (Washington, D.C., 1913), esp. exhibits 134 and 244; J. Bradford DeLong, "Did J. P. Morgan's Men Add Value?" in *Inside the Business Enterprise*, ed. Peter Temin, Naomi Lamoreaux, and Daniel Raff (Chicago, 1991), 205–36; Paul Miranti, "The Mind's Eye of Reform: The ICC's Bureau of Statistics and Accounts and a Vision of Regulation, 1887–1940," *Business History Review* 63 (Autumn 1989): 469–509.

[21] This will be discussed in section two.

sectors under government control, German banks had an easier time preserving their universalism and intermediary control functions for other activities.

Due to their universalism, the pure investment-banking function was just "one track" of German banks' comprehensive corporate governance relations, according to Otto Jeidels, one of Germany's leading bankers and economists.[22] Underwriting securities, a critical element of investment banking, was an important but not exclusive aspect of the services they delivered. In 1903, investment-banking services accounted for less than 25 percent of the total profits of the three largest German banks. In 1900, for example, approximately 80 percent of Deutsche Bank's revenues came from discounting and interest on short-term instruments. Around 1900, Deutsche Bank, Discontogesellschaft, and Dresdner Bank derived roughly one-third of their revenues (the single largest portion) from current account credits.[23] This short-term lending activity was most useful as a means of building long-term relations with firms in order to position banks for future securities emissions, while American investment banks focused more narrowly on equity and bonds.

When issuing securities and holding equity, banks bore great risks, which were diversified by universal banking. The scale of industrial securities (though much smaller than that of American issuances) meant that even the largest German banks normally worked with other banks in cooperative underwriting consortia, which, because they were often unwieldy, became competitive, allowing major industrialists to play banks against one another.[24] Apart from short periods, most often acquired following a company's financial distress, the securities directly owned by Deutsche Bank rarely exceeded 10 percent of the bank's total assets before 1910. Far more assets—roughly three to four times more—were tied up in bank acceptances and bills of exchange, which were affiliated with foreign-exchange trading. By 1900, trading in securities had fallen to approximately 6 percent of total revenues, an amount roughly the equivalent of bank acceptances and about one-third of the revenue contribution from dealing in bills of exchange. According to the German banker Otto Jeidels, banks recognized that taking positions in their customers' securities was riskier for them than other activities, requiring greater involvement in their customers' affairs. Banks were

[22] Otto Jeidels, *Das Verhältnis der deutschen Grossbanken zur Industrie mit besonderer Berücksichtigung der Eisenindustrie* (Leipzig, 1905), 129–30.

[23] Walter Hook, *Die wirtschaftliche Entwicklung der ehemaligen Deutschen Bank im Spiegel ihrer Bilanzen* (Heidelberg, 1956), Tables 9–10.

[24] The important German industrialist Hugo Stinnes was often annoyed at such bank "jostling." See Feldman, "Banks, *Bankenmacht*, and Financial Institutions," 319–23. More examples can be found in Wellhöner, *Grossbanken und Grossindustrie im Kaiserreich*, and in Wixforth, *Banken und Schwerindustrie in der Weimarer Republik*.

often obliged to manipulate the market, in order to preserve share-price stability and to hold the security for a time, but holding industrial stock too long was often a sign of failure. However, once the relation was created, the bank could offer other services for good fees and at less risk.[25] For instance, any client engaged in foreign business needed the services of a large bank to process trade payments and vouchsafe the client's creditworthiness to others. Indeed, one American bank president lamented the inability, or outright refusal, of American banks, in contrast to their German and English counterparts, to support American exporters in Latin America with long-term credits.[26] Issuing bank acceptances, which were short-term credits created by nonfinancial firms, guaranteed by a bank, and able to be traded at a discount, like commercial paper, was an integral part of German banking, providing greater overall liquidity than existed in the United States, where acceptances were less prevalent.[27]

Despite some contemporary debates about separating commercial from investment banking, for the most part, Germans prized the perceived stability of universal banking, and, unlike in the United States, the system was never called into question. The system, in which relations were mediated through ongoing current-account lending, was based on in-house cross-selling, from straight bank loans to international foreign-exchange transactions—a business plan replicated by Citigroup and the Bank of America today. Notwithstanding *Finanzkapital* theories, German banks rarely controlled German companies. (This claim is discussed in more depth below.) But the range of services banks provided businesses, and the intimate relations that existed between the two sectors, were considered regulatory and political virtues, not vices, so much so that other types of banks in Germany, such as savings banks, eventually adopted these practices.[28]

Above all, having a seat on the boards of directors of client companies symbolized this fiduciary role and institutionalized relationship

[25] Jeidels, *Verhältnis*, 127–39; Jacob Riesser, *Zur Entwicklungsgeschichte der deutschen Grossbanken mit besonderer Rücksicht auf die Konzentrationsbestrebungen* (Jena, 1906), 292.

[26] See "Why Our Trade Lags in Latin America," *New York Times*, 22 Aug. 1909, 8.

[27] "German Banking," *New York Times*, 23 Aug. 1903, WF2. On acceptances, see "German and American Relations Growing Intimate: Fr. Hessenberg, President of the American Association of Commerce and Trade in Berlin, Tells What German Bankers Think of Our Problem," *New York Times*, 5 Jan. 1908, AFR18.

[28] Franz Padberg, *Kritik der neueren Vorschläge zur Reform des deutschen Depositenwesens* (Freiburg/Breisgau, 1912); Adolf Weber, *Depositenbanken und Spekulationsbanken: Ein Vergleich deutschen und englischen Bankwesens* (Munich, 1915); Vladimir Georgewitsch, *Zur Frage der Trennung des Depositengeschäfts von den Effekten- und Spekulationsbanken in Deutschland* (Halle, 1912). On savings banks, see Günther Ashauer, *Von der Ersparungscasse zur Sparkassen-Finanzgruppe* (Stuttgart, 1991).

banking. Sitting on the boards gave bankers access to inside knowledge and allowed them some influence over decisions. Not surprisingly, such interlocking directorates became the most visible symbol of a money trust in the United States or, alternatively, of *Finanzkapital* in Germany. To quote Louis Brandeis, "The banker, who holds the purse strings, becomes usually the dominant spirit."[29] After 1900, both Germans and Americans hotly debated banking power. Banks found themselves caught up in embarrassing conflicts of interests while they were in charge of securities for competing firms. In 1906, Kuhn, Loeb & Co. withdrew from all their railroad directorates after one such conflict of interest became public knowledge, although it did not withdraw from its prominent financing activity.[30] While bank participation might have inspired investor confidence, it also invited public scrutiny and suspicion.[31]

Table 1 charts the degree of interlocking that existed among directories of publicly listed banks and firms in both countries. The number of firms refers only to the largest, publicly listed joint-stock companies in both countries. It does not include all private large firms with little formal bank representation. The sample captures neither the increasing popularity of the limited-liability company in Germany (GmbH) nor the informal influence exerted by banks through lending practices or personal relations. Approximately 80 percent of industrial stock in Germany was controlled by firms that were not joint-stock companies and had no formal supervisory boards.[32] The sample is, however, representative of the commanding heights occupied by industry, where banks theoretically were most likely to play a significant role.

In general, interlocks became stronger in Germany than in the United States after 1900, but especially after 1914. (See Table 1.) Superficially, one might argue that around 1900 the United States had the more "organized capitalism," as it had more interlocks, larger boards, and more bankers on the boards. Just over one-quarter of the largest German firms had no interlocking directorates at all, as opposed to just 9 percent of American firms, but these figures were nearly reversed by 1914. Surprisingly, German firms had smaller board sizes in 1900; however, by 1914, the boards of German and American firms were roughly equal in size and had about the same proportion of bankers. However, by 1928, Germany was more heavily interlocked, its boards were larger, and its banks had achieved stronger representation, particularly as bank-

[29] Contrast Hilferding, *Finanzkapital*, 123–35, with Brandeis, *Other People's Money*, quote from 12.

[30] "Bankers as Directors," *New York Times*, 5 Mar. 1906, 14.

[31] The formative tracts of German banking history all appeared to address such questions. See Hilferding's *Finanzkapital*, Jeidels's *Verhältnis*, and Riesser's *Entwicklungsgeschichte*. See also Feldman, "Responses to Banking Concentration in Germany."

[32] Ogilvie and Edwards, "Universal Banks and German Industrialization," 435–37.

Table 1

Banking Networks of Largest Firms in the United States and Germany, 1896–1938 (U.S./*Germany*)

Dimension	*Year* 1896/1900	1914	1928	1938
Firms				
No. of firms in sample	249/*212*	242/*323*	369/*377*	409/*361*
Stand-alone firms (not interlocked; in percent)	9.2/*26.4*	20.2/*9.6*	10.8/*2.9*	8.3/*4.2*
Average size of board of directors	13.3/*7.9*	14.4/*12.7*	17.5/*21.7*	16.5/*15.0*
Average interlocks per firm	6.34/*2.42*	6.05/*9.54*	6.88/*32.8*	5.11/*19.3*
Average directed interlocks per firm[a]	1.88/*0.64*	1.63/*1.36*	2.2/*3.76*	1.75/*3.2*
Banks				
Number of banks in sample	46/*30*	49/*47*	62/*59*	77/*47*
Directed banking interlocks to industrial firms	122/*76*	137/*207*	258/*426*	262/*252*
Industrial firms with banker on board (in percent)	32.5/*25.3*	36.2/*40.9*	43.0/*59.4*	46.1/*48.4*
Industrial firms with 3+ bankers on board (in percent)	6.9/*3.8*	8.3/*7.2*	11.4/*18.9*	7.5/*7.6*
Banker as chairman/president (in percent)	2.5/*13.7*	2.1/*14.5*	8.5/*23.0*	10.2/*24.8*

Source: Adapted from Paul Windolf, "Unternehmensverflechtung im organisierten Kapitalismus: Deutschland und USA im Vergleich, 1896–1938," *Zeitschrift für Unternehmensgeschichte* (ZUG) 51, no. 2 (2006): 191–222, Tables 1, 4. Some figures, such as the average size of boards, are derived from the unpublished paper of the same name. See Table 2 in that paper.

[a] Directed interlocks signify that a member of the executive board of firm A holds a position in the supervisory firm of firm B. Nondirected interlocks mean that one person sits on the supervisory board of firms A and B. The distinction measures the degree of potential control over another firm.

ers increasingly acted as supervisory board chairs. The greater number of interlocks around 1900 reflects the turn-of-the-century merger movement in American business, while German firms increasingly formed complex networks, alliances, joint ventures, cartels, and communities of interest (*Interessengemeinschaften*, or IGs), instead of becoming fully consolidated; full mergers became more prevalent in the 1920s.[33]

At least along these dimensions, the two capitalisms began to diverge, although the differences should not be exaggerated, particularly before 1914. In that year, American and German banks had a roughly comparable percentage of firms with three or more bankers on board (8 percent and 7 percent, respectively). By 1928, bank representation

[33] Jeffrey R. Fear, *Organizing Control: August Thyssen and the Construction of German Corporate Management* (Cambridge, Mass., 2005), 235–60.

on boards was higher in Germany: banks held seats in 43 percent of the largest American firms, compared with 60 percent of German firms. The most telling trend was the increasing number of German firms whose supervisory boards were chaired by a banker—almost one-quarter of the largest firms by 1928. Hilferding stressed that this trend in particular showed the degree to which banks dominated industry.

But what did these banks' positions on boards signify? To assert that the occupation of board seats reflected greater power is especially problematic, because, in the 1920s, German banks were at their weakest after the wreckage resulting from war and hyperinflation. Yet representation on boards grew dramatically.[34] Modern economic reasoning theorizes three broad reasons for banks taking seats on corporate boards. First, related lending enhances firms' access to capital and reduces banks' monitoring costs, as it allows them access to inside information. Second, a bank represented on a corporate board might act as a certification mechanism, signaling that the company is a safe investment or reassuring other lenders of its creditworthiness. The bank then acts as a delegated monitor for other investors. Third, entrepreneurs or corporate executives might want regular access to the bankers' advice regarding their firms' financial structure or new security issues. Bankers' presence correlated most closely with new issues of stock or new equity listings.[35] But there were other reasons as well.

Social capital or network advantages supplemented these economic calculations. Interlocking directories formed a network of reciprocal social and personal relations that lowered economic transaction costs across firms. In the more personalized business world of the prewar period, the presence of prominent banks or bankers on board might have enhanced a firm's reputation in ways that went beyond pure financial considerations (and vice versa). Private banks, such as Dreyfuss & Co. or Sal. Oppenheim, whose names evoked class and reputation, conveyed intangible prestige, as well as offering concrete business opportunities or political contacts. German firms often utilized these smaller, but still influential, bankers as outside moderators or referees, balancing the larger banks on their boards that acted as the firms' main creditors and/or shareholder representatives. [36] As they gained more places

[34] Wixforth, *Banken und Schwerindustrie in der Weimarer Republik*.

[35] Fohlin, *Finance Capitalism*, 48–64, 336. Ramirez and Becht, "Does Bank Monitoring Mitigate Financing Constraints?" 254–72; Carlos D. Ramirez, "Did J. Morgan's Men Add Liquidity?" *Journal of Finance* 50, no. 2 (1995): 661–78.

[36] Dieter Ziegler, "Die Aufsichtsräte der deutschen Aktiengesellschaften in den Zwanziger Jahren: Eine empirische Untersuchung zum Problem der 'Bankenmacht,'" *Zeitschrift für Unternehmensgeschichte* (ZUG) 43, no. 2 (1998): 194–215; Harald Wixforth and Dieter Ziegler, "Deutsche Privatbanken und Privatbankiers im 20. Jahrhundert," *Geschichte und Gesellschaft* 23, no. 2 (1997): 205–35.

on boards, firms were able to generate competition between the banks and cultivate less exclusive relations, hoping to drive down the cost of services. One contemporary analyst reminded readers that, in spite of the "dominant position of banks in important areas of the economy, one should not forget that the banks are reliant on industry. Banks chase industrial firms and seek their friendship."[37]

Finally, equity shareholding, or directorships, were a consequence more of banks' underwriting activities and attempts to improve returns on the securities they issued than of their control. Equity holdings had many costs for a bank, including reputational ones, as they might have been interpreted as a sign either of issuing failure or of the bank's speculating on its own account.[38] Speculating on productive assets was a public-relations nightmare for German bankers. Moreover, unlike small- or medium-sized firms, few major companies relied on just one bank as a paternalist *Hausbank*. Family-controlled firms were especially careful to minimize banking influence.[39] The specific organization, statutes, and members of corporate boards of directors mattered greatly.[40]

Banks on boards also reflected regulatory preferences. Indeed, one motivation for German corporate governance reform in 1884 and 1896, following the disastrous 1873 founders' crisis, was to have banks on boards to vet and certify that ventures were worthy of investment on stock markets.[41] If banks were on boards, they vouchsafed to outsiders that a firm was not just an unsecured piece of paper floating on the speculative winds of the stock market. In times of distress too, banks had incentives to save the firms and their shareholders, loans, and employees, and they acted as delegated monitors with a stake in a firm's success. Acting as both monitors and creditors, banks on boards also potentially overcame informational asymmetries, possibly lowering the cost of capital.

Yet having seats on boards did not necessarily mean that bank directors were informed, let alone influential, a problem on both sides of the Atlantic. As Jacob Schiff of Kuhn, Loeb & Co. stated: "for the most part a Director's advice is sought by the executive officers only when they choose to do so, and . . . the Director under ordinary circumstances is powerless to detect irregularities in the management owing to the

[37] Carl Otto Stünzner, *Banken und Wertpapierbörse* (Altenburg, 1911), 30; "Banking and Finance in Germany," *Bankers' Magazine* 77 (Jan.–June 1904): 701.

[38] Fohlin, *Finance Capitalism*, 107.

[39] Ziegler, "Die Aufsichtsräte," 213–15; Wellhöner, *Grossbanken und Grossindustrie*.

[40] Feldman, "Banks, *Bankenmacht*, and Financial Institutions."

[41] Peter Hommelhoff, "Eigenkontrolle statt Staatskontrolle—Rechtsdogmatischer Überblick zur Aktienrechtsreform 1884," *Hundert Jahre modernes Aktienrecht* (Berlin, 1985), 56; Werner Schubert, "Die Entstehung des Aktiengesetzes vom 18. Juli 1884," *Hundert Jahre modernes Aktienrecht*, 1–13.

ease with which these may be concealed by the officers in actual charge of a [corporation's] affairs." Often board members lacked the necessary financial or technical competence to uncover anomalies, met only a few times a year, held seats just to earn directors' fees, or were overly dependent on information provided by executives. Board members who provided a critical perspective were "not very popular."[42] Banks had to behave as loyal clients and reliable financing partners, not as controllers or guides. This was precisely the reason that the immense power and interventions of J. P. Morgan attracted such unwanted attention.

The power, both actual and perceived, of American investment banks fueled popular and regulatory pressure to reduce their influence and strengthen securities regulation (i.e., capital markets). As early as the 1914 Clayton Act, which prohibited banks from sitting concurrently on the boards of rival firms in order to hinder collusion, the resulting changes in American regulation reduced the ability and economic interest of banks to participate in board meetings in order to monitor company management. By the early 1930s, the Glass-Steagall Act finalized the separation of commercial and investment banking and launched the Securities and Exchange Commission (SEC), which interfered with the ability of banking intermediaries to act on behalf of shareholders. In contrast to the German response to new regulation, U.S. banks' role as special intermediaries declined precipitously.[43]

Other Countries' Money: America in the German *Finanzkapital* Mirror

Despite the pre-1914 statistical similarities in board representation, important qualitative differences emerged prior to the war that became standard institutional features after World War I. Because of the increased power of American investment banks such as J. P. Morgan, the greater financial volatility resulting from fundamental flaws in the American banking system, the trend toward greater corporate consolidation, and intensified public antipathy toward concentrated power of all sorts, the backlash against banks holding positions on corporate boards was greater than in Germany. American bankers symbolized many social and economic ills, and they were highly visible political targets.[44]

[42] "Bankers as Directors," *New York Times*, 5 Mar. 1906. Quoted in Richard Passow, *Die Aktiengesellschaft: Eine Wirtschaftswissenschaftliche Studie* (Jena, 1922), esp. 419–22, 444–47.

[43] Mark Roe, *Strong Managers, Weak Owners* (Princeton, 1994).

[44] One British commentary noted that Americans were "champion earners, champion spenders, and champion speculators," characteristics that led to "violent extremes of wealth and poverty." See "Banking in Finance in Germany," *Bankers' Magazine* 82 (July–Dec. 1906): 24.

Despite homegrown populist fears about the power of the banks, Germans generally affirmed their gatekeeping role and slowly extended this activity to other types of banks, such as cooperatives and savings banks, in the twentieth century.[45] German regulators encouraged the type of insider governance that caused such a furor in the United States, because they thought—rightly or wrongly—that this would help to tame the volatility of capital markets, to maintain the quality of securities, to ensure the financial stability of firms, to keep family owners involved, and (only after World War I) to prevent German industrial capital from being absorbed by foreigners through takeovers.[46] This notion of taming, or smoothing, inherently anarchic markets underlay much of German regulation, whether it took the form of creating cartels, shaping accounting policy that would enable companies to build hidden reserves, stabilizing dividends or share prices, maintaining corporate interlocks, or having banks on board.

Three major economic factors accounted for the greater visibility and potential threat of bank governance in the United States. First, because a good proportion of capital flowed in from distant international investors who were unable to oversee companies directly, banks acted as fiduciary intermediaries. Second, American banks were active in quasi-public areas, both by managing particular firms that had public infrastructure functions, such as utilities or railroads, and, more generally, by intervening in macroeconomic issues, such as maintaining the money supply. This private control of basic public services exacerbated an already potent populist backlash. Third, volatile business conditions in the United States necessitated direct, activist management, requiring more bank interventions because there was more opportunity—or need—for them. By contrast, German firms generally found ways to limit bank involvement, and banks voluntarily restricted their interventions to extraordinary situations.

Channeling Foreign Investment. In 1914, America played host to more foreign direct investment than all of Western Europe combined.[47] Although the amounts of capital that came from Europe, primarily Britain, varied, powerful New York banking houses had to establish

[45] Gall, *The Deutsche Bank*, 28; Wandel, *Banken und Versicherungen*; Ashauer, *Ersparungscasse*.

[46] Donald J. S. Brean and Christopher Kobrak, "Corporate Governance in the Twenty-First Century," *Corporate, Public and Global Governance: The G8 Contribution*, ed. Michele Fratianni, Paola Savona, and John J. Kirton (Aldershot, 2007), 55–77. On the threat of "foreignization," see Gerald D. Feldman, *The Great Disorder: Politics, Economics, and Society in the German Inflation, 1914–1924* (Oxford, 1993), esp. 255–305.

[47] Mira Wilkins, *The History of Foreign Investment in the United States to 1914* (Cambridge, Mass., 1989), 147 and 198. These figures include portfolio and foreign direct investment. See Geoffrey Jones, *The Evolution of International Business: An Introduction* (London, 1996), 31.

a foothold with investors in London, Berlin, Paris, and other European centers of capital.[48] By 1914, foreigners owned over $7.0 billion in U.S. securities: the largest single sector was in railroads, but other investments made up approximately 60 percent. Given the poor state of accounting information and the dismal, patchwork state of America regulations, drawing foreign investors into American securities posed special responsibilities. Private bankers, such as Morgan, Speyer, Belmont, and Kuhn, Loeb & Co., who drew on their mostly European contacts to seek funds, had to give their personal assurances that errant companies would be sorted out, and affirm that they would do their utmost to limit the damage caused by America's poor macroeconomic policymaking. In contemporary *Wall Street Journal* or *New York Times* articles, considerable attention was paid to Germany's banking system, particularly the role of its central bank. German bankers lamented the disorderly American "inelastic and antiquated currency and monetary methods which break down as soon as any great strain is put upon them."[49] Exceptional by international standards, relatively loose American bankruptcy laws also created misunderstandings, which placed more weight on local financial intermediaries to sort out the problems.

The link between foreign funds and local active bank management advanced the formation of new investment services in both Germany and the United States. For instance, when Edison General Electric was launched in 1889, bankers and other sponsors (many of whom were German) reluctantly agreed to hold their shares until the moment was ripe for a public sale. At a minimum, other investors in the project expected the banks to hold onto the securities, even though bankers' efforts to keep the company on a short leash had mixed results.[50]

As a result of its American investments, the Deutsche Bank established Germany's first auditing firm, the Deutsch-Amerikanische Treuhand-Gesellschaft (eventually Deutsche Treuhand Gesellschaft [DTG]). Although the bank initially focused on foreign investments, by 1900 it had become involved in a wide range of domestic and foreign activities. Under the ownership of Deutsche Bank and some other investors, DTG worked closely with the bank, handled the affairs of firms

[48] Cassis, *Capitals of Capital*, 117.

[49] Quoted in "German and American Relations Growing Intimate," *New York Times*, 5 Jan. 1908. Other examples, "Aldrich in Berlin Not Talking Tariff," *New York Times*, 31 Aug. 1904, 4; "Busy with German Banking: Monetary Commission Finds Much to Learn in Berlin," *New York Times*, 4 Sept. 1908, 4; "Growth of German Banking," *New York Times*, 21 June 1910, 18; "The German 'Money Trust,'" *New York Times*, 30 July 1911, 8; "The German System," *Wall Street Journal*, 27 Oct. 1903, 1; "Elastic Clause of the German Bank Act," *Wall Street Journal*, 15 Apr. 1905, 6; "Translation of German Imperial Banking Laws," *Wall Street Journal*, 18 July 1910, 7. Redlich, *Molding of American Banking*, 221–22, notes 392–397.

[50] Kobrak, *Banking on Global Markets*.

in financial distress, and became a mainstay of the German accounting profession for decades. Other German banks established similar auditing firms. Germany's internalization of the auditing profession through bank affiliation provided a sharp contrast to the independent auditing profession (later consulting firms) of the United States or the United Kingdom. The Deutsche Bank was arguably more active in restructuring its U.S. investments than its German counterparts. Deutsche Bank's representatives, in some cases, became presidents of U.S. companies, chaired boards of directors, and helped to create new companies. One contemporary critic of large universal banks gave credit to Deutsche Bank's exemplary ability to manage risk through DTG and its overseas investment subsidiary.[51] Although, in the United States, the accounting profession remained independent of banking, overseeing the assembly and deciphering complex financial statements for distant shareholders were services demanded by investors in U.S. securities. Even clients from countries, such as Britain, whose corporate governance institutions were more sophisticated, shared with German and American investors a transnational understanding of bankers' special responsibilities in mitigating institutional voids that were particularly extant in the United States, due to its patchwork regulation.[52]

Private Bank Control over Public Service Infrastructure. The transportation sector best illustrates how America's hunger for capital and high returns combined with its financial fragility to expand the role of its banks. The differences between Germany and the United States were striking. Whereas U.S. railroads called for maximum bank intervention, by 1900 virtually all German rail lines were under state control, which removed them from the stock market. Prior to the early 1870s, railroad failures also had a great impact on German capital markets.[53] German banks and their clients thus had to look elsewhere for

[51] See Georgewitsch, *Zur Frage der Trennung des Depositengeschäfts*, 64; Reiner Quick, "The Formation and Early Development of German Audit Firms," *Accounting, Business & Financial History* 15, no. 3 (2005): 317–43; Fear and Kobrak, "Diverging Paths"; Stephen E. Loeb and Paul J. Miranti Jr., *The Institute of Accounts: Nineteenth-Century Origins of Accounting Professionalism in the United States* (London, 2004); Christopher D. McKenna, *The World's Newest Profession: Management Consulting in the Twentieth Century* (Cambridge, U.K., 2006).

[52] Leslie Hannah, "Pioneering Modern Corporate Governance: A View from London in 1900," *Enterprise and Society* 8, no. 3 (2007): 642–86; Leslie Hannah, "What did Morgan's Men Really Do?" Business History Conference (2007), www.e.u-tokyo.ac.jp/cirje/research/dp/2007/2007cf465.pdf, accessed Jan. 15, 2010. Colleen A. Dunlavy and Thomas Welskopp, "Myths and Peculiarities: Comparing U.S. and German Capitalism," *German Historical Institute Bulletin* 41 (Fall 2007): 33–64.

[53] Rainer Gömmel, "Entstehung und Entwicklung der Effektenbörse im 19. Jahrhundert bis 1914," in *Deutsche Börsengeschichte*, ed. Hans Pohl (Frankfurt/Main, 1992), 144; Fritz Stern, *Gold and Iron: Bismarck, Bleichröder, and the Building of the German Empire* (New York, 1977).

large transportation investments, so the German banks became leaders in U.S. capital markets and were active agents for American railroad securities in German markets.

The importance of railroads in capital markets, and their frequent episodes of financial distress, created opportunities for banks' involvement in the United States that were unmatched in Germany. In 1885, railroad shares accounted for 81 percent of the total stocks on the New York Stock Exchange (NYSE); in 1900, their shares came to 54 percent, and by 1910, they reached 44 percent.[54] Circa 1900, railroads accounted for approximately 35 percent of American equity-market capitalization for 180,000 miles of track, nearly seven times the amount in Germany. By the early 1890s, a third of U.S. rail securities were in foreign hands. However, seventy-four rail companies were in receivership, and they owed $1.8 billion in capital responsible for 30,000 miles of track.[55] This level of bankruptcy forced New York investment banks to behave like private-equity firms, micromanaging companies that required loan extensions, restructurings, mergers, and acquisitions, all complicated solutions to the extreme financial distress caused by volatile markets and "excessive competition." In contrast to Germany, whose utilities were largely managed by municipal or state overseers, approximately 10 percent of U.S. stocks traded on the NYSE were in this sector. As late as 1915, U.S. railroads and utilities still represented the majority of stocks traded on the NYSE and attracted large amounts of distant foreign investment.[56] The level of private financial control over "public service" infrastructural projects appeared to the American public both to represent a deep conflict of interest and to pose a threat to democracy. In 1915, the prominent corporate-reform lawyer, Samuel Untermyer, noted that over 80,000 miles of railroads had been involved in bankruptcy proceedings; of these, two-thirds were reorganized under the domination of J. P. Morgan and Kuhn, Loeb & Co.[57]

While Untermyer (among others) stressed that the proxy-voting trust system created by these banks was a particularly egregious abuse of corporate power, distant shareholders made it a condition of entry. During the early stages of the Northern Pacific Railroad reorganization in the mid-1890s, German and other foreign investors—at least in the early stages—took comfort from Deutsche Bank's initiative, acting in

[54] O'Sullivan, "The Expansion of the U.S. Stock Market."

[55] Wilkins, *History of Foreign Investment*, 197–98; Karl Helfferich, *Georg von Siemens: Ein Lebensbild aus Deutschlands großer Zeit* (Berlin, 1923), 2: 223, 253–54.

[56] O'Sullivan, "The Expansion of the U.S. Stock Market," 499, Table 2.

[57] "Lays Railroads Ills to Banking Control," *New York Times*, 1 Feb. 1915; Jerry W. Markham, *A Financial History of the United States*, vol. 1 (Armonk, N.Y., 2001), 360; William G. Roy, *Socializing Capital: The Rise of the Large Industrial Corporation in America* (Princeton, 1997), 100–43.

concert with J. P. Morgan and other American bankers to create a five-year voting trust, which would manage the newly capitalized line.[58] As one of the chief conduits of European and American money into the fast-growing, often troubled railroad sector, Morgan and his men gave financial advice, hired and fired managers, engineered or fended off takeovers, and monitored investment to prevent "ruinous" competition for dozens of lines. Cooperation was Morgan's mantra, and strict fiduciary responsibility his game; he had little patience for interference in his rule setting.[59] Morgan's high-handed treatment of businessmen on both sides of the Atlantic was increasingly resented. Even some prominent American businessmen joined the public chorus against the evils of Wall Street. One railroad company promoter called investment bankers "cannibals of finance."[60]

Uniquely in America, investment bankers were also tasked with shoring up periodic crises of faith in the value of the dollar and the soundness of the banking system. To be sure, Germany had bouts of deflation and financial crises, but there were fewer "panics," and they did not reach the magnitude of such eruptions in the United States, which witnessed five between 1884 and 1907. Within twelve years, J. P. Morgan spearheaded three efforts to save the American currency and banking system, from which he earned large financial rewards and public outrage each time. By some accounts, through a deal that Morgan signed with President Grover Cleveland in 1895, which saved the United States Gold Reserves, he earned for his syndicate $6 to $7 million in 22 minutes and, less pleasantly, a chorus of congressional denunciations. With each undertaking, Morgan's reward grew smaller and the public acrimony louder. Like most U.S. private bankers, Morgan's success in this, as in many other transactions, depended on his ability to forge tight relations with European bankers, especially in Britain and Germany.[61]

After 1873, no downturn in Germany could be called a market "panic," the type of phenomenon that leads to sharp questions about

[58] Kobrak, *Banking on Global Markets*.

[59] Quoted in Jean Strouse, *Morgan: American Financier* (New York, 1988), 196. For a detailed discussion of how Morgan and Deutsche Bank actively managed the affairs of the Northern Pacific, see Kobrak, *Banking on Global Markets*.

[60] Quote from Arthur Edward Stillwell (builder of the Kansas City Southern Railroad, the Kansas City, Mexico and Orient Railroad, the Port Arthur Channel and Dock), *Cannibals of Finance: Fifteen Years' Contest with the Money Trust* (Chicago, 1912).

[61] Richard Tilly, "Banking Crises in Three Countries, 1800–1933: An Historical and Comparative Perspective," *Bulletin of the German Historical Institute* (Spring 2010): 77–89; Robert F. Bruner and Sean D. Carr, *The Panic of 1907* (Hoboken, N.J., 2007); Ron Chernow, *The House of Morgan* (New York, 1990); Redlich, *Molding of American Banking*, 381–88. On these transatlantic links, see Claudia Langen, *Tradition, Expansion und Kooperation: Deutsch-Amerikanische Bankenbeziehungen von 1900 bis 1917* (Cologne, 1995).

the basic character of the banking system, and to widespread bankruptcies, huge market price swings, or employment volatility, of a kind that seemed all too commonplace in the United States. At most, the 1907 panic, and the continuing trend toward further concentration, led to government inquiries that tended to affirm the German system, and even began to extend the universal banking model to other types of banks.[62] Many economic historians were struck by the relatively mild nature of Germany's business cycles, its steady industrial growth, and its price fluctuations that reached less extreme levels than those in the United States. The economic historian, Alexander Field, attributes the difference to the volatility of American railroad investment. The building blocks of the second industrial revolution—coal, pig iron, and steel—were "relatively stable" in Germany. America suffered six recurrent panics between 1873 and 1914: three were especially severe, while Germany witnessed only one. The United States nearly abandoned the gold standard, the "cross of gold," many times under intense political pressure. In Germany, adherence to gold was not a political issue until World War I.[63] Contemporaries were amazed by what the German economist Robert Liefmann called the "unbelievably ruthless" American practice of "throwing workers into the streets." While American firms, exemplified by the steel industry, shed over 20 percent of their workforces during the 1901 and 1907 crises, German firms maintained steady overall employment levels, in spite of the global downturns.[64]

Activist Management: American versus German Capitalism. No German bank ever wielded the power of J. P. Morgan, who restructured whole industries, particularly railroads and steel, which composed the heart of the new economy. Morgan's pricing of issues and

[62] Jeffrey Fear and R. Daniel Wadhwani, "Populism and Political Entrepreneurship: The Universalization of German Savings Banks and the Decline of American Savings Banks, 1907–1934," *Doing Business in the Age of Extremes: Essays on the Economic History of Germany and Austria in Memoriam Gerald Feldman*, ed. Hartmut Berghoff, Jürgen Kocka, and Dieter Ziegler (Cambridge, U.K., forthcoming). Hans Pohl, Bernd Rudolph, and Günther Schulz, *Wirtschafts- und Sozialgeschichte der deutschen Sparkassen im 20. Jahrhundert* (Stuttgart, 2005).

[63] "Translation of German Imperial Banking Laws," *Wall Street Journal*, 18 July 1910, 7; Alexander J. Field, "The Relative Stability of German and American Industrial Growth, 1880–1913: A Comparative Analysis," *Historische Konjunkturforschung*, ed. Wilhelm Heinz Schröder and Reinhard Spree (Stuttgart, 1980), 208–33, quotes from 208, 220; Charles P. Kindelberger, *Manias, Panics, and Crashes: A History of Financial Crises* (New York, 2000), 228–29; Steven B. Webb, "Cartels and Business Cycles in Germany, 1880–1914," *Selected Cliometric Studies on German Economic History*, ed. John Komlos and Scott Eddie (Stuttgart, 1997), 83–100.

[64] Quoted in Robert Liefmann, *Kartelle und Trusts und die Weiterbildung der volkswirtschaftlichen Organisation* (Stuttgart 1910), esp. 109–42. Compare the average employment levels between 1907 and 1914 in Feldenkirchen, *Eisen- und Stahlindustrie*, Table 104 a/b with Gertrude G. Schroeder, *The Growth of Major Steel Companies, 1900–1950* (Baltimore, 1953), 216–18.

immense profits appeared to many as an abuse of financial power, to the detriment of the public good. Even many American bankers recognized the need for more public control of the financial system.[65]

Like his German counterparts, Morgan helped to create new commercial enterprises as a venture capitalist, which increased the scope of banks' active management, much like the situation today.[66] But American markets provided an additional opportunity for the kind of activist bank management that was far less prevalent in Germany, and it entailed mergers and acquisitions—epitomized by U.S. Steel. Both Germany and the United States witnessed an upsurge in merger activity at the very end of the nineteenth century, but the number of companies lost to mergers in the United States was one hundred times higher than in Germany.[67] German companies preferred to rely on cartels, or "communities of interest," to dampen competitive pressures; cartels were designed to slow merger activity that might lead to American-style trusts.[68] Cartelization of business left room for many banking services but reduced the need for active bank management in the complicated corporate restructurings, new stock issues, or bankruptcies that promoted many financial innovations in the United States.[69] Since more founding families remained active in German businesses, there was less call for an external institution to adjudicate conflicts or manage transitions.

Consider, for example, a contrast between the corporate governance activities of Deutsche Bank and J. P. Morgan. Founded in 1870, Deutsche Bank became Germany's largest bank by the end of the century, as measured by assets.[70] Deutsche Bank cultivated close corporate clients, at first forming communities of interest (*Interessengemeinschaften*) with independent banks and then later building a large network of its own branches. Nonetheless, the bank could hardly be said to have dominated the management of its closest corporate clients, let alone to have run roughshod over them, as Morgan did. At Krupp,

[65] Harold Cleveland and Thomas Huertas, *Citibank*, 1812–1970 (Cambridge, Mass., 1986), 60–61. J. P. Morgan, Benjamin Strong of Bankers Trust, and Paul M. Warburg of Kuhn Loeb were among those who helped to reform the central banking system. See Roy, *Socializing Capital*, 197–258.

[66] Gall, "Deutsche Bank," 30–77; Peter Hertner, "The Balkan Railways, International Capital and Banking from the End of the Nineteenth Century until the Outbreak of the First World War," in *Finance and Modernization*, ed. Gerald D. Feldman and Peter Hertner (Surrey, 2008), 125–53.

[67] C. J. Schmitz, *The Growth of Big Business in the United States and Western Europe, 1850–1939* (New York, 1993), 40.

[68] Hilferding, *Finanzkapital*; Fear, *Organizing Control*, 235–53.

[69] Peter Tufano, "Business Failure, Judicial Intervention, and Financial Innovation: Restructuring U.S. Railroads in the Nineteenth Century," *Business History Review* 71 (Spring 1997): 1–40.

[70] Gall, "Deutsche Bank."

whose first public bond issue, in 1879, was launched by Deutsche Bank, and at Siemens & Halske, which Deutsche Bank took public in 1896 and with which the bank enjoyed a strong familial bond, the bank nevertheless did not hold sway over management matters. Krupp's owners were so humiliated by the financial distress that the firm fell into during the 1870s that they adopted a policy of refusing ever again to accord banks the same degree of leverage. As a creditor and an investor in both Siemens and AEG (General Electric of Germany), Deutsche Bank had to act as a careful diplomat.[71] A few dramatic examples of bank control of German firms did resemble those troubled American firms. Mannesmann, a manufacturer of steel tubes, and Phoenix Steel are the two most famous. Fearing the wrath of industrialist August Thyssen, who threatened to cut out bankers from cartel business if they did not force Phoenix into the cartel, bankers caved in to his demands; in the case of Mannesmann, Deutsche Bank pushed the founders out of the company due to its lack of profitability. However, according to most research on bank–industry relations, these were exceptions to the rule.[72] Overall, Deutsche Bank managers apparently had little involvement in the day-to-day management of companies. Only when established firms—such as Krupp, Siemens, or Hoechst in the 1870s, AEG in the 1880s, or Mannesmann in the 1890s—ran into financial difficulty did bankers step in, and they often did so through affiliated intermediaries, such as DTG.

Although German bankers possessed many levers for exerting both formal and informal influence, supervisory board (*Aufsichtsrat*) members were formally forbidden to engage in activist management under the 1884 German corporate governance law. The German two-tiered board structure circumscribed activist bank and shareholder control; banks represented both shareholder and public interests—in theory. The two-tiered board was supposed to "prevent 'unsolid foundings' or abuses in the administration of joint-stock companies."[73] As trustees, banks

[71] Hugh Neuburger, "The Industrial Politics of the Kreditbanken, 1880–1914," *Business History Review* 51 (Summer 1977): 190–207.

[72] On Phoenix and the relation between banks and cartelization, see Wellhöner, *Grossbanken und Grossindustrie*; Fear, *Organizing Control*, 235–60. On Mannesmann, see Horst A. Wessel, *Kontinuität im Wandel: 100 Jahre Mannesmann, 1890–1990* (Düsseldorf, 1990); Horst A. Wessel, "Finanzierungsprobleme in der Gründungs- und Ausbauphase der Deutsch-Österreichischen Mannesmannröhren-Werke AG, 1890–1907," in *Zur Geschichte der Unternehmensfinanzierung* (Berlin, 1990), 119–71.

[73] Quoted in Hommelhoff, "Eigenkontrolle statt Staatskontrolle," 56; Hanno Merkt, *Unternehmenspublizität: Offenlegung von Unternehmensdaten als Korrelat der Marktteilnahme* (Tübingen, 2001); Christian Bayer and Carsten Burhop, "Corporate Governance and Incentive Contracts: Historical Evidence from a Legal Reform," *Explorations in Economic History* 46, no. 4 (2009): 464–81; Carsten Burhop, "Executive Remuneration and Firm Performance: The Case of Large German Banks, 1854–1910," *Business History* 46, no. 4 (2004): 525–43.

were required to provide investors and creditors with acceptable trade-offs between security, liquidity, and overall returns by monitoring the management of both capital markets and companies. Their gatekeeper role was legally institutionalized. Banks were supposed to act as qualified experts, operating as "advisory boards" that stressed consultancy and monitoring, rather than merely imposing control or managing firms.[74] This institutionalized preference permitted banks to remain on boards, rather than being driven off, as occurred in the United States.

In contrast to their American counterparts, German bankers were encouraged by legislation, regulation, and informal norms to take responsibility for the securities they issued and recommended, and to intervene when problems arose. They were instructed to serve productive capital, rather than to speculate. Commonly at that time, the distinction was made between "deposit banks" (commercial-retail banking) and "speculation banks" (investment banks). Speculation banks were viewed with suspicion by the broad public, which helped to discourage the tendency to engage in more ruthless financial machinations.[75] Although there were several governmental inquiries into the banks' role in German society, voters and regulators generally accepted the social utility of these institutions, as long as they did not "speculate" with healthy, productive companies.[76]

Now and then, the political costs of high-profile corporate governance were significant. Partly as a public-relations stance and partly because of strictures on the country's national, regional, and municipal banking, German bankers were more socialized than U.S. investment bankers on Wall Street, which were known for their rapaciousness, even among their clients. Much German corporate-governance legislation was designed to counteract the causes of the 1873 crash. Many new firms were revealed to be merely speculative investment shells set up by unscrupulous promoters, because responsible organizations failed either to vet them or legislation failed to provide adequate transparency. This crash reinforced awareness of the dividing line between productive and speculative investments, which many respectable banks were loath to cross. After the 1907 financial crisis, one contemporary summarized the conclusions reached by the 1908 banking commission: "It was expressly shown directly to the leaders of our banks that they not

[74] The German word *kontrollieren* connotes monitoring or supervision, not control. *Rat* means board as well as advice. Mark Roe, "German 'Populism' and the Large Public Corporation," *International Review of Law and Economics* 14, no. 2 (1994): 187–202; Carsten Burhop, "Banken, Aufsichtsräte und Corporate Governance im Deutschen Reich (1871–1913)," *Bankhistorisches Archiv* 32, no. 1 (2006): 1–25.

[75] Weber, *Depositenbanken und Spekulationsbanken*.

[76] Gall, *Deutsche Bank*, 1–127.

only have a responsibility to their shareholders, but [also] that their task extends well beyond their private business activity; they must also fulfill a broader economic function, which leads them to bear a responsibility and accountability towards the entire economy and nation."[77] As a final observation, Jewish bankers were disproportionately represented in the upper-tier banking community. Approximately 25 percent of all board members at the center of the German corporate network were Jewish, as were eight of the top ten corporations that were the most networked, highest-profile board members. Yet Jews comprised just 1 percent of the German population. They were well aware that strong bank interventions could elicit a populist, anti-Semitic reaction. The debate about "the power of banks" carried anti-Semitic undertones, and Jewish bankers, in self-defense, cultivated the most refined, educated upper-class profiles in order to counteract the unholy association with base money.[78]

The bottom line was that, while some German bankers were being given titles of nobility and elected to Parliament, their American counterparts were being hauled in front of U.S. congressional commissions to answer accusations that they were engaging in financial conspiracies against the public.

The German Banking Difference. The paradoxical aspect of our thesis is that although German banks enjoyed institutional advantages that their American counterparts did not share, they rarely exploited their leverage in order to manage or control companies. While they excelled at investment-banking functions and at rescuing distressed firms, they supplemented these activities with an array of services that, in the United States, were largely performed by different types of banks. In fact, one measure of the potential level of banking power was the immediate attempt by owners or managers to minimize the leverage that the banks held over them once the firms had recovered.

Yet, even the most independent German entrepreneurs made good use of large universal banks. In the United States, many of the services routinely provided by German banks were statutorily, or for other reasons, open only to private banks, trust companies, or specialized-service companies, whose sources of capital and control of companies were more limited than those of large universal banks in Germany. American investment banks' ties to these specialized companies through

[77] Padberg, *Kritik der neueren Vorschläge*, 127 (author's translation).

[78] We are grateful to Paul Windolf for calling this to our attention, "The German-Jewish Economic Elite (1900–1933)," www.uni-trier.de/fileadmin/fb4/prof/SOZ/APO/JewishNetwork.pdf. Jakob Tanner, "'Bankenmacht': Politischer Popanz, antisemitischer Stereotyp oder analytische Kategorie?" *Zeitschrift für Unternehmensgeschichte*, 43, no. 1 (1998): 19–34; Morten Reitmayer, *Bankiers im Kaiserreich: Sozialprofil und Habitus der deutschen Hochfinanz* (Göttingen, 1999).

interlocking ownerships or voting trusts created the perception of a spidery, opaque "money trust" that was manipulated by the money-center banks.

To be sure, the concentration of banks, and their alleged role in forming cartels, excited populist fears in Germany. Yet, unlike the vilification directed toward them in the United States, and in spite of the enormous size and market reach of universal banks before World War I, when German capitalism reached commanding heights (Germany's three largest enterprises, as measured by capital, plus seventeen of the top twenty-five joint-stock companies, were banks), they were generally seen as positive contributors to the country's economy and as upholders of the fabric of German society, not as "cannibals."[79] Even critics on the left, such as Rudolf Hilferding, viewed large banks as an inevitable phenomenon of capitalist concentration, and he advanced the idea that a few large banks could be more easily socialized than many smaller banks. Another criticism directed toward the large banks' power was deflected by a consensus that the alternative was worse, likely to turn into a casino like the American stock exchange, or *capitalisme á l'Americaine*. Despite the intense lobbying conducted by the large private commercial banks (*Grossbanken*), over the course of the twentieth century the virtues of universal banking services became apparent and were slowly extended to savings banks and cooperatives. And in spite of their imposing individual size, large private and commercial banks, such as Deutsche Bank, controlled just 10 percent of total banking assets in 1913 (and just 15 percent in 2001).[80] Populist *Mittelstand* (small to medium-sized companies) pressures strengthened other types of banks.

Although reform debates prior to 1914 reflected concerns about bank concentration, there was little serious discussion about separating commercial and investment banking or removing banks from boards.[81] Viewed within the American context, it was surprising that one of the German banks' most important potential levers of control never became an issue: their proxy voting rights. If there was a way for banks to bend corporations to their wills, they were able to do so through their proxy votes at shareholders' meetings. A widespread practice had clients

[79] Germany's three largest enterprises, as measured by capital, were banks, as were seventeen of its twenty-five top joint-stock companies.

[80] Richard Tilly, "An Overview on the Role of the Large German Banks up to 1914," in *Finance and Financiers in European History, 1880–1960*, 94; Richard Tilly, "A Short History of the German Banking System," *Handbook on the History of European Banks* (Aldershot, 1994), 299–312.

[81] Georgewitsch, *Zur Frage der Trennung des Depositengeschäfts*; Padberg, *Kritik der neueren Vorschläge*; Paul Schwartz, *Die Entwickelungstendenzen im deutschen Privatbankiergewerbe* (Strassburg, 1915).

ceding their votes to their banks at shareholder meetings; some banks even required clients to do so. As a practice that most closely resembled American voting trusts, it gave banks unparalleled power over firms. Even some scholars who have cast doubt on the degree of power held by banks in the German economy have acknowledged the importance of proxy voting. Given the potential power German banks had over companies with the practice of automatically voting their clients' shares, interestingly, the German banking commission of 1908 made little or no mention of this powerful institutional control lever, a glaring contrast to America's acrimonious, high-profile, and wide-ranging congressional investigation into bank power over industrial corporations.[82]

This quasi-fiduciary practice was enshrined as one of the first principles of German banking. By administering their customers' security deposits, German banks acted as trustees for their clients' investments in firms. As an off-balance-sheet activity that was neither discussed in annual reports, nor highly regulated, nor outlined by official bank policies, it is difficult to figure out the degree of proxy voting in Germany, though it was extensive. With few exceptions, large banks cast the majority of votes at annual meetings, although the actual amount varied widely from year to year.[83] To vote at the meetings, shareholders had to have their ownership interest certified by the company, by designated banks, or by a German notary, a process that was facilitated for those whose shares were already deposited with a bank.[84] While agreements prior to 1900 made no mention of voting at annual meetings, by 1910 Deutsche Bank set out deposit conditions for clients, stipulating that the bank maintained the right to vote shares in the interest of its "business friends," unless "in individual cases the client intends to."[85] At some meetings, large banks cast most of the votes.[86]

The strategy of entrusting the administration of securities and proxy voting to banks had obvious advantages for clients: safety; easy collection of dividends and interest, especially for foreign securities; oversight of legal changes to the form of securities, as, for example, when debt was exchanged for equity; or merely savings on travel expenses.[87] Few shareholders had the time to review financial information, oversee

[82] Fohlin, *Finance Capitalism*, 144–67; *Bankenquete 1908, Stenographische Berichte* (Berlin, 1909).

[83] Wellhöner, *Grossbanken und Grossindustrie*, 80.

[84] *Reichsanzeige und Königliche Preussische Staatenanzeige*, 6 Mar. 1911, BO/311/2, Schering AG Archive.

[85] "Geschäftsbedingungen," Deutsche Bank, Filiale Frankfurt, Historical Archive of Deutsche Bank.

[86] Anmeldung an der am 30 März 1911 General Versammlung, Oberschleschische Kokswerke & Chemische Fabriken AG, BO-311/2, Schering AG Archive.

[87] Stünzner, *Banken und Wertpapierbörse*, 1–23, esp. 12–17.

managers, and attend shareholder meetings in order to vote their opinions. Yet the practice also led to considerable concentration of decision-making power.

Banks' influence on companies, therefore, was not built solely on their power to lend or to bring issues to market. Although custodial accounts were no doubt useful for the performance of these functions, the banks' influence rested mainly on a growing network of branches, which allowed them to expand their pools of customers whose voting power was controlled by the bank. Indeed, the post-1891 initiative that led to the passing of the Bank Deposit Law of 1896 (*Bankdepotgesetz*) began as the large Berlin banks, such as Deutsche Bank or the Berliner Handels-Gesellschaft, with their seats on the Berlin stock exchange, were voting and trading shares of stock held in deposit for provincial bankers (who in turn held shares for individual customers), without the permission of the individual shareholders, sometimes with disastrous results.[88]

American commercial banks were unable to perform this function. Only trust companies or security affiliates were allowed to hold securities accounts. Some trust companies even became active managers of the funds that they oversaw. Originally designed to serve the relatively wealthy after passage of the National Banking Act (1864), trust companies could accept deposits of money or securities to purchase securities of firms, but they increasingly moved into traditional banking activities. Reflecting their important market niche, their number grew from 42 in 1886 to 1,564 in 1914. By one estimate, they enjoyed a twenty-five-fold increase in their assets during the same period.[89] They performed many of the same securities administrative functions in the United States that universal banks carried out in Germany.

Without sufficient holdings themselves, lacking the trust accounts that supplied German banks with voting privileges, and limited by other regulatory barriers, private American banks had to invent elaborate schemes to reassure investors of their ability to maintain control. Paradoxically, these complex schemes designed to create investor trust created deep distrust among the broader public. J. P. Morgan came up with another of his great innovations that was similar to German proxy voting, which was to install a voting-trust agreement. The agreement stipulated that shareholders who benefited from his financial engineering had to assign the voting rights for their shares to bankers for a period that Morgan deemed sufficient to ensure the future health of the company involved. Morgan employed this device numerous times.

[88] Jacob Riesser, *Das Bankdepotgesetz* (Berlin, 1924).

[89] Eugene Nelson White, *The Regulation and Reform of the American Banking System, 1900–1929* (Princeton, 1983), 70–71.

As occurred in German proxy voting, such agreements were put in place not only in situations that seemed to call for active investor management, but also when shareholders were unable or did not want to participate.[90] Statistics about interlocking shareholdings and directorships alone fail to capture the importance of these arrangements.

Like the reaction to their German counterparts, opinions about American banks' practice of holding securities were not uniformly positive. In 1900, the majority of the assets of National City Bank were in standard short-term or long-term loans and government securities; just over 10 percent were in the form of securities issued by private companies—a figure roughly comparable to German banks' equity holdings.[91] National City earned a great deal of its income from foreign-exchange trading and discounting bank acceptances drafted in London. Unlike European continental banks, National City's powerful position as a U.S. investment bank was based on the combination of its corporate deposits, correspondent relations, and partnerships with private banks whose own funds were more limited. Private banks had to borrow from banks like National City in order to hold securities, even those they were merely distributing to other investors. Like private equity today that rides out the downturns in the market in order to sell later at better prices, private banks had to obtain financial support from joint-stock banks.[92] These loans added to the costs and risks of issuing securities, a problem that was alleviated in Germany by internalizing the source of funds as well as distributing securities. Although German banks worked in syndicates too, the capacity of the big banks like Deutsche Bank to underwrite the issue, finance the holding period, and speed up distribution internally gave them a huge advantage over their smaller competitors, an advantage that was available to neither private nor public banks in the United States. In Germany, banks moreover were expected to hold enough of their clients' securities to enable them to gradually bring issues onto the market and to keep share prices stable.[93] Despite being more specialized, American banks attempted to fulfill the same function of protecting investments for themselves and their clients. Although regulators tried to fragment the American banking system, the financial historians Marco Becht and J. Bradford DeLong stressed that the impact of pre-1933 restrictions on American banks should not be overstated: New York banks could still act as "nationwide financial intermediaries from their Manhattan bases."[94] A highly respected analyst

[90] Strouse, *Morgan*, 246–53.

[91] Cleveland and Huertas, *Citibank*, 50; Fohlin, *Finance Capitalism*, 107–20.

[92] Cleveland and Huertas, *Citibank*, 43, 46–47.

[93] Stünzner, *Banken und Wertpapierbörse*, 37–39.

[94] Quoted in Marco Becht and J. Bradford DeLong, "Why has There Been so Little Block Holding in America," *A History of Corporate Governance around the World*, 637n37.

of the American securities market stressed the fiduciary role of banks and condemned the "disastrous relaxation of the standards of safety [by 1928–29] previously observed by the reputable houses of issue."[95]

In spite of a range of formal options for imposing terms on their clients, German banks did not intervene in firms in ways that might be expected. Industrialists expected that bankers would not interfere with strategic investment decisions, but would instead support entrepreneurial decisions as finance specialists and supply lines of credit at attractive interest rates.[96] Banks took great pains to represent themselves as reliable partners of productive capital, not least because of the public antipathy that might have ensued were they viewed otherwise, but, more critically, because they needed the industrialists' business. Although bankers rarely wanted to run companies, German investors, regulators, and the general public nevertheless counted on the ability of German banks to intervene and offer their expertise in times of financial distress—if necessary. Expectations about banks' role as financial stabilizers probably constituted the biggest difference between the United States and Germany. This was a question less of their power, per se, than of the difference in expectations that created the regulatory space accorded to banks in German corporate governance and stock exchanges —a space that was increasingly restricted in the United States.

Finally, German banks' vaunted corporate-governance relations in joint-stock companies prior to 1914 were probably less important than their role as conduits and managers of the stock exchange. Partly through legislation and partly through evolving business practice, large banks played a critical role as stock-exchange regulators in a world where state supervision did not yet exist. With some important exceptions, such as the 1896 Stock Exchange Law, the German state tended to delegate stock-exchange regulation to banks. Even that law, looked at from an American perspective, ceded more, not less, dangerous power to the banks.[97] Much of Germany's capital-market legislation gave large

[95] Benjamin Graham and David Dodd, *Security Analysis* (London, 1934), 9.

[96] Hartmut Berghoff, "The End of Family Business? Mittelstand and German Capitalism in Transition, 1949–2000," *Business History Review* 80 (Summer 2006): 263–95. Similar attitudes toward banks pervaded *Mittelstand* firms at the turn of the twenty-first century. Vitols, "Are German Banks Different?"

[97] See the contemporary critique by Henry Crosby Emery, "The Results of the German Exchange Act of 1896," *Political Science Quarterly* 13 (1898): 286–320; Johann Christian Meier, *Die Entstehung des Börsengesetzes vom 22. Juni 1896* (St. Katharinen, 1992); Max Weber, *Börsenwesen, Schriften und Reden 1893–1898*, ed. Knut Borchardt (Tübingen, 1999); Caroline Fohlin, "Regulation, Taxation and the Development of the German Universal Banking System, 1884–1913," *European Review of Economic History* 6 (2002): 221–54; Sergey Gelman and Carsten Burhop, "Taxation, Regulation and the Information Efficiency of the Berlin Stock Exchange, 1892–1913," *European Review of Economic History* 12, no. 1 (2008): 39–66.

banks a privileged role in equity transactions in order to enhance corporate solidity, dampen unhealthy speculation, and mitigate volatility. Recent work has shown that powerful universal banks did not "crowd out" the development of securities markets.[98] However, in contrast to American banks, German banks became ensconced in the market regulatory framework, for good or for ill.

The 1884 joint-stock company law, which created the two-tiered board, not only strengthened the authority of independent directors and enhanced shareholder protections, but also reinforced the position of banks in corporate and market governance. The law required an initial prospectus, and mandatory audits on financial reports, for new share issues, in order to counteract the outright fraud that was discovered after the 1873 crisis. The prospectus had to list the banks involved and report on their financial participation.[99] The issuing bank could be held liable for the accuracy of the new company's prospectus and audits. Official stock-exchange representatives, only half of whom could be from private brokers or investment houses, were entrusted with deciding whether a stock was worth issuing and had met its legal obligations. Only banks with seats on the exchange could be involved with admitting securities. To ensure the solidity and seriousness of the new firm, certain levels of a stock issue had to be paid up prior to its founding; on the largest exchanges (Berlin, Frankfurt, Hamburg), a minimum par value for the entire shares issued of one million marks was required in order to minimize the risk of short selling. As it did in passing the Stamp Tax of 1881, which was modified over the next two decades, the state tried to discourage frequent securities and futures trading in the interest of social and economic stability. However, because of the information requirements, the regulations encouraged scale, which inadvertently drove securities trading into large universal banks. Lacking state supervisory agencies, banks conducted much of this oversight.[100]

The 1896 Stock Exchange Act tightened listing regulations still further by providing for a stronger supervisory authority, raising trading taxes, and banning futures trading. It introduced a "lock-up year" (*Sperrjahr*) between the time of the firm's registration and first-year financial reports, before admitting it onto the exchange for active trading. The freeze year helped to suppress early securities trading and increased the importance of large banks involved in issuing shares, since they could more easily endure a temporary lock-up of capital. The lock-up year

[98] Fohlin, "Does Civil Law Tradition and Universal Banking Crowd Out Securities Markets?" and *Finance Capitalism*, 222–76.

[99] The following discussion and quotes are from Stünzner, *Banken und Wertpapierbörse*, 33–44.

[100] Ibid., 37–39.

also encouraged the formation of trust companies. Moreover, because banks held securities on deposit and were brokers on exchanges, and because the stamp tax applied only to market transactions (not to internal bank transactions), customers could buy or sell shares through the bank, in house, thereby circumventing open-market transactions and conveniently avoiding the stamp tax. The combination of such regulations unintentionally strengthened large universal banks vis-à-vis the exchange. Finally, because important bank customers expected to be the recipients of privileged information, or at least to have the first shot at new issues that the bank brought to market, the bank itself gave assurances about the quality of the issue. How much banks internalized stock-exchanged transactions is difficult to answer, but the practice of internal bank transactions did not stop Berlin from becoming one of the leading exchanges in the world.

Both customers, particularly owners and managers of firms, and the government expected that banks would use their power to maintain fair, stable prices for securities, and thus avoid haphazard, volatile short-term price fluctuations. Whether or not they could actually accomplish this over time is unclear and difficult to discern, but, unlike banks in the United States, they were expected to act as stabilizers.[101] The process also raised suspicions of *Finanzkapital*, or insider trading. To be sure, in Germany, banking power was a double-edged sword. Voting shares added to the perception that the banks were carefully overseeing a company's activities, making them more responsible should the company fail to fulfill expectations. Ironically, J. P. Morgan made similar—but politically unconvincing—arguments to justify banks' representation on boards and exchanges. In the final analysis, however, for Germans, enhancing investor protections, instilling confidence in markets and firms, and reducing unwanted, dangerous speculation of productive assets meant keeping banks on boards—and on the stock exchange—as gatekeepers, not driving them off.

Conclusion

We have argued that our standard portrayals of varieties of finance that contrast an American-style, capital market–oriented system with a German bank-based system prior to 1914 are misleading, because banks played an important role as "special intermediaries" in the corporate governance of firms and stock exchanges in both countries. Initially, the

[101] Stünzner, *Banken und Wertpapierbörse*, 38–44, argues that banks manipulated share prices frequently. Fohlin, "Does Civil Law Tradition and Universal Banking Crowd Out Securities Markets?" 631–33, finds little evidence for the effectiveness of price manipulation.

two countries' financial systems shared many features of the gatekeeping duties performed by their major money-centered banks. Before the tortuous evolution of more efficient, transparent equity markets took place, banks (to overstate the point) were the only game in town. Firms had bank representatives on boards in roughly equal levels; intermediary relations supplemented formal accounting information, which, in both countries, remained an inadequate control mechanism. Despite the lack of consistent, sufficiently detailed public financial information, both countries maintained vibrant public capital markets, an achievement that owed a lot to the investor confidence engendered by banks.

Although there were obvious differences between the two financial systems, major New York investment banks and the classic Berlin *Grossbanken* substituted not for insufficient capital or entrepreneurship, but, rather, for the lack of trustworthy equity-market regulation. Before World War I, both countries had dynamic equity markets of roughly equal importance to their national economies, but with some crucial institutional differences, particularly in connection with their banks. Banks funneled credit to firms, created trust for distant and sometimes dispersed investors, and enhanced confidence in capital markets. American investment banks played just as important a role as Gerschenkron's vaunted German banks in the development of American industrialization, until alternative sources of funds and political populism drove them off boards and out of their supervisory role. Gerschenkron was right in viewing banks as a crucial conduit of industrial development, but his observation did not only apply to Germany. If American investment bankers had had their way (and many were German-Jewish immigrants), they might have developed a system closer to the German-style system that was based on relationship banking and provided a broader range of services.

One of the main virtues of relationship banking is that it offers banks the ability to rescue firms during times of distress or financial overextension (voice and restructuring instead of exit, in the terms of economist Albert Hirschmann). We argue that more volatile circumstances actually led to more voice and restructuring by investment banks in the United States prior to 1914. This ability gave New York investment banks more control over U.S. corporations than Berlin banks had over German firms.[102] This concentration of power, this American

[102] For an insightful discussion, see Ralf Elsas and Jan Pieter Krahnen, "Universal Banks and Relationships with Firms," in *The German Financial System*, ed. Jan Pieter Krahnen and Reinhard H. Schmidt (Oxford, 2004), 197–232. Also, Albert O. Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (Cambridge, Mass., 1970). The case for exit is made by Michael C. Jensen, "The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems," *Journal of Finance* 48, no. 3 (1993): 831–80.

Finanzkapital, triggered more of a backlash against banking power than occurred in Germany, paradoxically despite the fact that German banks had more formal levers of power available to them. Germans tended to view banks on boards as institutional stabilizers, rather than as insiders out to fleece investors. Criticisms of "money trusts," or *Finanzkapital*, ensued at roughly the same time in both countries. Indeed, surprisingly parallel debates about the issues of futures, universal banking, banking concentration, interlocking directories, and trusts versus cartels surfaced in both countries. Yet the regulatory solutions took dramatically different forms.

Only after World War I did these differences in institutions and expectations lead to the divergent forms of corporate governance that continue to characterize capitalism in the two countries. Whereas America, by the 1930s, had opted for securities markets that were controlled by public regulators, and for accounting information that provided transparency for outside investors and the broader public, Germany came to rely more on its private financial experts, choosing, as a matter of public policy, to install responsible bankers dedicated to firms as ongoing concerns. The choice to keep banks on board was one possible answer to the question of how to enhance investor protection in firms and to ensure greater confidence in markets. The loss of the war and hyperinflation destroyed people's faith in financial securities and institutions, leaving large private and commercial banks in the precarious role of having to manage greater capital needs, of being more dependent on foreign capital, and of becoming objects of greater expectations—of external financing, supervision, and stabilization—precisely when their governance power and financing capacity were considerably weakened.

From the moment owners felt compelled to move from internal sources, simple forms of short-term financing, or private-equity funding, new sources of financing had to be invented, and distant investors had to be convinced that their investments had a reasonable chance of bearing fruit. But new forms of informational asymmetries and conflicts of interest arose. Banks initially played this intermediary role for investors —a role that intermediaries, such as pension funds and money managers, ostensibly now play for distant investors, but in a very different form. We still have not solved the problems of intermediation or agency. Arguably we live in an "agency society" (with chains of intermediaries), rather than in an ownership society, and we are therefore even more dependent on the fiduciary and ethical standards of our selected intermediaries.[103]

[103] "He [John C. Bogle of Vanguard] Doesn't Let Money Managers Off the Hook," *New York Times*, 12 Apr. 2009.

Although financial theorists are beginning to understand the real-world policy ramifications of their narrowly defined conditions for indifference—pricing efficiency and reliance on automatic corrective measures to asset misallocations—the ways in which institutional development facilitated the broadening of choices, instilling investor confidence, and generally dealing with the agency problem, are less well appreciated. Investors still need someone to mind the store and make good decisions for them. For a better understanding of the options for addressing the agency problem, history has much to offer. We might have more technology, financial theory, and regulation today, but policymakers can still profit from broader knowledge of the past. Paradoxically, given our banking crisis, we can learn from a largely jettisoned corporate governance configuration, in which well-informed, active, committed, and responsible corporate monitors added a dimension of control that is often sadly lacking at the beginning of the twenty-first century.