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Change and continuity in Japanese corporate governance

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Abstract Previous studies on Japanese corporate governance were largely based on the agency theory framework, and can be seen as attempts to understand the unique monitoring mechanisms in the Japanese context. This paper briefly reviews prior research and then discusses the recent changes in the environment that have been affecting Japanese corporate governance. Our central argument is that there is both change and continuity in Japanese Corporate Governance. We also present emerging research from an institutional theory perspective. In this line of research, corporate governance is treated as part of a nation's institutional framework and hence, researchers need to understand unique institutional arrangements that affect corporate governance practices and their change or continuity.

Keywords Japan · Corporate governance · Institutional theory perspective

A large number of studies and commentaries regarding Japanese corporate governance have been published, but they led to no clear consensus regarding its comparative advantages, disadvantages, and continued persistence in the context of changing economic and social contexts. Indeed, a cynical interpretation may be that evaluations of Japanese corporate governance vary with the growth or decline of the Japanese economy. For example, prior to 1990 when the Japanese economy was the envy of the world, Japanese corporate governance, which was based on patient investors such as affiliated firms and banks, was widely praised as one of the sources of the nation's competitive advantage (Porter, 1992). More recently, however, Japanese corporate governance was blamed for Japan's long economic recessions since the early 1990s (Watanabe & Yamamoto, 1992). In order to understand corporate governance of

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Japanese firms, which is often seen as quite different from that of US firms, many researchers examined its various aspects mainly from an agency theory perspective.

Agency theory posits that there are several monitoring mechanisms, such as the external managerial labor market, performance-based compensation, the presence of outside members on the board, and the market for corporate control, that are theorized to control managerial behavior (Fama, 1980; Jensen, 1986). This perspective emphasizes the primacy of financial performance and shareholder interests, and identifies these mechanisms as means of narrowing the divergence of shareholder and managerial interests. However, corporate governance systems differ in the priority given to the interest of the primary corporate governance participants including shareholders, creditors, and employees. As will be outlined later, the Japanese system is one in which shareholder interests have not been dominant (Aguilera & Jackson, 2003; Fukao, 1999). As a result, while there is some empirical evidence that some of these mechanisms reduce agency problems in the US context, such mechanisms either do not exist or, where they exist, do not function well in the Japanese context. Instead, there have been different monitoring mechanisms in Japan more congruent with Japanese norms and industrial organization. Thus, much research on Japanese corporate governance has focused on such mechanisms as main bank monitoring, *keiretsu* affiliation and block ownership. Prior research has attempted to examine the effects of those mechanisms on such variables as firm strategies and performance.

However, both external and internal changes since the 1990s have been imposing rising pressures on Japanese corporate governance to evolve and adapt to such changes. In the context of the changing economic, social, and political context, therefore, we may need to reassess the relevance of these stakeholders and focus on the emergence of other stakeholders, especially more market-oriented investors. Further, the changing context is posing a question as to whether Japan is in the process of institutional change. If so, then it could have implications on the corporate governance system as it is part of the institutional context. We aim to address those issues in this paper. Overall, our central argument is that there is both change and continuity in Japanese corporate governance.

The objective of this paper is to review research on Japanese corporate governance and present promising research directions. We view corporate governance as a dynamic system that entails both change and continuity and also evolves over time. Japanese corporate governance practices are deeply embedded in the Japanese business system suggesting the existence of pressures toward continuity and persistence. Nevertheless, corporate governance practices are evolving in the context of social, economic, and political change. Thus, facing these opposing forces for change and continuity, Japanese corporate governance is undergoing a process of path-dependent evolution. Hence, our key research questions are: (1) What have been the key factors that are driving Japanese corporate governance to change? (2) How and how much has Japanese corporate governance changed? (3) More broadly, is the Japanese corporate governance system converging to the US model?

Corporate governance system in Japan

Japanese corporate governance practices have typically been characterized by several attributes: (1) the central role of banks and bank monitoring; (2) ownership characterized by a network of stable and reciprocal shareholdings often among *keiretsu* members; and (3) an insider dominated board (with a limited number of related outsiders) whose role differs significantly from that of the US board. Tables 1, 2 and 3 outline the research on Japanese corporate governance, some of which focus on major dimensions of the postwar Japanese model such as the main bank and *keiretsu* monitoring, while others deal with more recent developments such as the increasing effect of foreign investors. As we can see from the table, a majority of research studied the existing or post-war system of corporate governance.

Monitoring by the main bank

Along with the German system, Japanese corporate governance is often characterized as a bank-centered system (Dore, 2000; Jackson & Moerke, 2005). The Japanese system

Table 1 Selected studies of Japanese main bank monitoring.

Authors and publication year	Findings	Implications	Time period of data
Prowse, 1990	Debt ratios of US firms are negatively related risky sub-optimal investment, while no such relationship is found among Japanese firms	No evidence for agency costs of debt among Japanese firms	1984
Hoshi, Kashyap, & Scharfstein, 1991	Support benefits of main bank relations in terms of access to capital and reduced relevance of liquidity constraints on investments	Evidence of positive implications of bank ties	Pre 1991
Weinstein & Yafeh, 1995	Findings suggest that bank influence leads *keiretsu* firms toward overproduction, supporting arguments that bank monitoring promotes bank interests	Bank ties associated with decisions which benefit banks objectives over firm objectives	1988
Weinstein & Yafeh, 1998	Although bank ties increase availability of capital when access to capital markets is limited, the cost of capital for firms with bank ties higher than non-bank firms. This result dissipates with financial deregulation.	Evidence of weakening strength of bank monitoring	1977–1986
Morck & Nakamura, 1999	Appointment of bank representatives to the board associated with low liquidity. Evidence of positive monitoring effects of bank appointments among bank affiliated firms compared to independent firms	Bank representation on boards associated with monitoring primarily among affiliated firms	1981–1987
Anderson & Makhija, 1999	Bank debt positively associated with growth opportunities, positive market reaction to bank financing announcement	Evidence for positive market implications of bank ties	Late 1980s
Arisawa & Miyajima, 2005	Successful firms with strong bank ties are much more likely to issue public bonds than resort to bank borrowing	Financially strong firms seek non-bank financing	1996–2000

This table includes only selective journal articles

Table 2 Selected studies on Japanese ownership structure.

Authors and publication year	Findings	Implications	Time period of data
Prowse, 1992	Higher ownership concentration among Japanese firms compared to US firms. Positive ownership performance relationship among independent firms compared to *keiretsu* firms	Agency theory perspectives most relevant to independent firms	1984
Dow & McGuire, 1999	*Keiretsu* firms exhibit more dispersed ownership structure than non-*keiretsu* and US firms	Close ties among *keiretsu* owners reduce need for large shareholdings	1987–1997
Morck et al., 2000	Curvilinear relationship between bank ownership and firm performance. Corporate blockholdings positively associated with firm performance	Motives of bank and corporate owners differ. Agency formulations supported for corporate blockholdings	1986
Ahmadjian & Robbins, 2001	Negative relationship between foreign ownership and local embeddedness with acceptance of downsizing	Agency formulations most relevant to firms less subject to local stakeholder pressures	1990–1997
Gedajlovic & Shapiro, 2002	Positive relationship between ownership concentration and firm performance, evidence of wealth transfer from more to less profitable firms	Performance smoothing effects of ownership concentration do not support agency theory formulations	1986–1991
Phan & Yoshikawa, 2000	Foreign ownership and associated with shareholder wealth maximization	Foreign ownership pressures promote investor orientation	1990's
Yoshikawa & Gedajlovic, 2002	Foreign ownership and foreign listings are positively associated with investor orientations, while stable ownership and group affiliation do not have any impact	Foreign ownership promotes investor orientation	1999
Ahmadjian & Robbins, 2005	Foreign ownership associated with asset restructuring	Foreign ownership pressures congruent with agency theory formulations	1991–1998
Yoshikawa et al., 2005	During the recessionary time, domestic shareholdings associated with wage intensity, while foreign shareholdings associated with reduced wage intensity	Monitoring role of foreign investors congruent with agency theory formulations	1998–2002
Gedajlovic, Yoshikawa, & Hashimoto, 2005	Given heterogeneity in the investment preferences of major classes of owners, the relationship between ownership and firm investment decisions and capital structure depends upon the identity of major owners	Interests of Japanese institutional investors heterogeneous	1996–1998
Seki, 2005	Evidence for declining cross-shareholdings and growing shareholder activism among Japanese firms	Greater US corporate governance pressures during later time periods	1950–2003
Suto & Toshino, 2005	Based upon a survey of Japanese institutional investors, findings suggest that the forecasting time horizon of institutional investors	Interests of Japanese institutional investors heterogeneous.	2003

Table 2 (continued).

Authors and publication year	Findings	Implications	Time period of data
	differs with institutional and performance constraints		
David et al., 2006	Positive relationship between foreign ownership and R&D and capital intensity in the context of growth opportunities	Foreign ownership effects congruent with agency theory formulations	1991–1997
Isobe et al., 2006	Congruent with long-term perspective, membership in horizontal *keiretsu* associated with lower profitability, but no evidence of risk sharing effects	No evidence of performance smoothing effects	1977–2000

Italics indicates the articles published in *APJM*. This table includes only selective journal articles.

has usually been discussed around a main bank relationship, which is conventionally defined as a long-term relationship between a firm and a bank from which the firm borrows the largest share of its loans. The main bank relationship is not characterized by bank loans alone, however, as main banks often hold shares in their client firms and take care of the cash management accounts of these firms. Further, market participants and government regulators perceive the role of the main bank as monitoring its client firms and even intervene in the management of these firms if required (Aoki, Patrick, & Sheard, 1994; Sheard, 1989). The combination of debt and equity ties between banks and firms has been held to create a system which harmonizes the interests of debt and equity holders, reducing the agency conflict between them. Due to their multiple ties with the firm, it is argued that banks have incentives to work with troubled firms (Aoki et al., 1994; Hoshi, 1994). Although the main bank system was once praised as an effective system to promote long-term strategy of Japanese firms (Porter, 1992), it has been under strain due to several factors as will be discussed later. Table 1 provides a selected summary of this research

Table 3 Selected studies of Japanese board of directors.

Authors and publication year	Findings	Implications	Time period of data
Yoshikawa & Phan, 2003	Although outside directors' involvement in strategic decision-making was associated with positive stock returns, adoption of US board structure was not related to firm performance	Limited support for performance implications of adoption of US board of director structures	2000
Aoki, 2004	No evidence for positive relationship between board reform and firm performance	No support for performance implications of adoption of US board of director structures	2002–2004
Miwa & Ramseyer, 2005	Choice of outside board members reflects resource dependencies. No evidence of board composition-firm performance relationship	Resource dependence role of board, rather than agency theory formulations supported	1986–1994

This table includes only selective journal articles.

Ownership structure and *keiretsu* affiliation

Many Japanese firms are linked through extensive cross-shareholding arrangements with their main banks, business partners, and client firms, and also a large portion of Japanese stocks are owned by "stable" investors (Gerlach, 1992; Sheard, 1994a). It is often argued that stable investors own shares primarily to cement and grow stable business relationships rather than to earn a return on their stock investments (Charkham, 1994; Kester, 1991). It is also suggested that they own shares in other firms to ensure stability in earnings and sales so that they can protect the interests of important stakeholders including employees, management, business partners that are often members of the same *keiretsu* group (Caves & Uekusa, 1976; Nakatani, 1984). Because of these characteristics, Japanese corporate governance is often seen as stakeholder-oriented as opposed to shareholder-oriented (Buhner, Rasheed, Rosenstein, & Yoshikawa, 1998; Weimer & Pape, 1999).

The differing objectives of Japanese equity owners lead to outcomes which differ from agency theory formulations. In the US, large ownership blocks serve to monitor the firm and promote shareholder interests. In contrast, several studies find ownership concentration in Japan to be associated with greater mutual assistance and monitoring (Gedajlovic & Shapiro, 2002; Nakatani, 1984). Findings regarding ownership concentration provide mixed findings on performance implications, with some studies suggesting little ownership effects on firm performance (Prowse, 1992), positive effects (Gedajlovic & Shapiro, 2002), and negative effects (McGuire & Dow, 2003). Table 2 outlines selected studies on Japanese ownership structure.

As indicated in Table 2, other early studies compared *keiretsu* and independent firms in terms of performance characteristics, often finding that affiliated firms exhibited lower but perhaps more stable performance (e.g., McGuire and Dow, 2003; Nakatani, 1984; Prowse, 1992). More recent studies have expanded upon this research. For example, Kim, Hoskisson, and Wan (2004) focus on the moderating role of strength of *keiretsu* affiliation and compared the group monitoring effects between peripheral members and core members. Studies making use of more recent data have also challenged the traditional risk-reducing role of *keiretsu* membership. Isobe, Makino, and Goerzen (2006) show that horizontal *keiretsu* membership does not enable member firms to reduce risks through mutual assistance, which contradicts prior studies. We will return to this issue when discussing the evolution of Japanese corporate governance.

Board of directors

In Japan, as in many other countries, the board of directors is legally responsible for the monitoring of management. However, the Japanese board has not traditionally defined its primary role as that of monitoring top management (Gilson & Milhaupt, 2004; Heftel, 1983). In part, this is because Japanese boards are often composed of mainly executives, former employees, and only a small number of affiliated or related outsiders (Kaplan & Minton, 1994; Sheard, 1994b). Since inside directors are viewed as a representative of employees, researchers suggest that they lack incentives and capability to monitor top executives to improve shareholder value (Kubo, 2005).

However, there is a possible evolution in the board's role in the context of changing ownership pressures.

In analyzing the increasing role of (mostly related) outside board members, as Table 3 suggests, two perspectives, resource dependence/networking and the agency theory emphasis on monitoring, have informed research on the Japanese board. Miwa and Ramseyer (2005) argue that firm characteristics determine board structure; i.e., the appointment of outside directors is endogenous. Their study finds that firms' appointments of outside directors are related to their external resource reliance. In contrast, studies by Abe, Gaston, and Kubo (2005), Kaplan and Minton (1994), and Morck and Nakamura (1999) suggest that directors appointed by banks play some monitoring role. Hence, we have two perspectives on the board structure. In the Japanese context of stable shareholdings and mutual support, however, these views are not necessarily mutually exclusive.

Pressures for change and responses

Weakening main bank system

One of the most significant changes in Japanese industrial organization has been a decline in the role of bank financing. Spurred by regulatory changes which increased access to non-bank debt in both domestic and foreign capital markets, reliance on bank debt has gradually been declining since the 1980s (Fukao, 1999; Paker & Hodder, 2002). These regulatory changes were, in many respects, a response to growing realization of higher cost implied by reliance on bank financing (Weinstein & Yafeh, 1995), which made use of non-bank financing particularly attractive in the context of economic downturn during the 1990s. The availability of alternative sources of financing made the costs of reliance on bank financing particularly relevant. The increased relevance of the high costs incurred for bank support (which might be viewed as a monitoring and insurance "premium") led to increased questioning of established practices.

These changes occurred at a time when banks were themselves facing major financial crises. Spurred by significant amounts of non-performing loans, the banking industry was faced with restructuring on an unprecedented scale (Morck & Yeung, 2006; Seki, 2005). Indeed, the 1990s was marked by bank failures and mergers which drastically changed the banking landscape in Japan. This has important repercussions. First, bank influence on industrial firms decreased, particularly in export industries and among high growth sectors where flexibility and risk taking were particularly important (Inoue, 1999; Morck & Yeung, 2006). Increased reliance on non-bank debt among these firms can be traced not only to their greater access to such financing, but also to the inconsistency between their strategic needs for innovation and risk-taking and bank preference for low risk and tangible investments (Wu & Xu, 2005).

Second, reductions in debt financing were most prevalent among financially sound firms (Arisawa & Miyajima, 2005; Suto & Toshino, 2005). Not only did this place greater financial pressures on Japanese banks, but it created a situation in which increasingly distressed banks were unwilling and/or unable to assist distressed firms or restructure their loan portfolios. Amid these changes, there are also firms, mostly those without access to capital market financing, which maintain or even strengthen their bank ties. Arisawa and Miyajima (2005) suggest that even among bank-linked firms, financially strong firms made increasing use of non-bank debt. In general, Table 1 suggests increased recognition of the costs of reliance on bank financing, particularly in the context of increased access to alternative financing and Japan's continued economic downturn. Thus, the traditional homogeneity of Japanese banking relations began to unravel, with certain firm maintaining bank ties, others loosening them (Arisawa & Miyajima, 2005; Inoue, 1999).

Rising capital market pressures

The ownership of Japanese firms has been dominated by domestic institutional and corporate shareholders who are often long-standing business partners or *keiretsu* member firms. However, changes in the capital markets have exerted pressures toward evolution in this aspect as well. The prolonged Japanese economic downturn and regulatory changes, which require Japanese firms and banks to report their shareholdings in market value instead of book value, has had significant implications for traditional stable shareholdings. According to data from the NLI Research Institute (2004), stable shareholdings have dropped from 45 to 24%, and reciprocal holdings dropped from 18 to 7% during the period 1990–2003. While a certain percentage of these shares were redistributed to existing or new stable shareholders, many were acquired by foreign and domestic arm's-length investors. In particular pension funds and investment trusts have gained increased prominence in the Japanese market (Fukao, 1999; Inoue, 1999). In contrast to affiliated investors, these market investors are more performance-oriented, particularly given regulation for increased financial disclosure for pension funds (Suto & Toshino, 2005).

Another conspicuous capital market change facing Japanese firms since the 1990s is the rise of foreign ownership. Since the mid-1990s, foreign ownership of Japanese firms has been rising, climbing to 22% of all listed Japanese shares in March 2004.[1] These changes have had significant impact on not only performance expectations, but on social and political pressures on corporate governance. Since these foreign investors have only arm's-length relationships with firms in which they own shares, they look for higher investment returns and more shareholder-oriented corporate governance model (Jackson & Moerke, 2005; Yoshikawa & Phan, 2001). Table 2 shows that several studies have found a positive association between foreign ownership and firm performance, which is congruent with the stronger performance orientation of foreign owners (Miyajima & Kuroki, 2005; Nitta, 2000; Yoshikawa & Phan, 2003).

Table 2 also provides evidence that foreign ownership is creating pressures toward more "US" style corporate governance practices—for example, investor relation practices (Yoshikawa and Gedajlovic, 2002). David, Yoshikawa, Chari and Rasheed (2006) examine the interaction effects of foreign ownership and growth opportunities on R&D and capital investments and reveal that foreign investors promote such investments primarily in firms with higher growth opportunities. In addition, foreign

[1] *Kabushiki Bunpu Chosa* (Stock distribution survey), 2004.

investors are more likely to demand Japanese firms to adopt global standards of corporate information disclosure (Useem, 1998) since, unlike domestic affiliated investors, they do not have other means to gather such information. Further, they may pressure Japanese firms to restructure their operations during poor performance. In fact, Ahmadjian and Robinson (2001) and Ahmadjian and Robbins (2005) find that firms with larger foreign ownership are more likely to downsize by reducing the number of employees and divest their assets during the 1990s. Similarly, Yoshikawa, Phan, and David (2005) find that foreign ownership reduces employee wage payments when firm performance is low. These findings suggest that foreign investors tend to promote firm restructuring during poor performance.

As a result of these changes, Japanese firms are facing an increasingly heterogeneous set of shareholder expectations (Hoskisson, Hitt, Johnson, & Grossman, 2002; Thomsen & Pedersen, 2000; Suto & Toshino, 2005). The interests of institutional investors can no longer be considered homogeneous, with a sharp increase in the role of arm's-length institutional investors from foreign and domestic origins. Therefore, Japanese firms have begun to face a different capital market environment. This changing equity landscape also implies significant changes in the social and political pressures faced by firms and government regulators. Investor activism has increased (Milhaupt, 2003; Seki, 2005). For example, the Japanese Pension Fund Association revised its principals of fund management in 1999 to emphasize performance concerns (Seki, 2005).

Further evidence of the beginnings of a more fundamental change in the Japanese approach to corporate governance is the increased role of political (in contrast to regulatory) forces in proposing corporate governance change and the growing prominence of non-profit corporate reform organizations. Various government agencies, business associations, and investors groups have become active in attempting to influence corporate governance practices and regulations. The 2002 corporate governance reforms were, for example, championed by the Ministry of Justice, but opposed by the Ministry of Finance and certain business associations. Indeed, Milhaupt (2003) suggests a growing rate of corporate governance regulation resulting from political and cultural changes permitting a more active regulatory role for a wide range of actors: "...the market for production of corporate law became more competitive" (p.23). These changes are significant in that they may suggest a more fundamental change in the functioning of the Japanese business system. In addition to the changes in investor pressures noted earlier, new social and regulatory forces have become relevant to the evolution of Japanese corporate governance.

Responses to external pressures: Boardroom reform—what has changed and what has not?

Efforts to reform the Japanese board of directors provide an excellent illustration of the implications of these changes. The first such boardroom reform was initiated by Sony in 1997. Sony reduced the number of board members from 38 to 10 and separated the role of executive officers and directors. This practice has gradually been adopted by many other Japanese firms. The separation of directors and executive officers often results in the reduction of the board size since many directors are also executive officers in Japanese firms. There are also firms that started to appoint more outside directors on their boards. The motives for these changes however are uncertain. One argument is that firms adopted this practice in order to improve the quality of decision-making and the effectiveness of managerial monitoring (Aoki, 2004). In other cases, outside board appointments reflect monitoring by banks, parent firms, or government agencies. However, this is still a major move for Japanese firms whose boards have been largely reserved for internally promoted employees (Gilson & Milhaupt, 2004). Nevertheless, the adoption of outside board members has not been that dramatic (Seki, 2005). For example, the average number of outside directors among large Japanese firms was only 0.6 out of the average total number of 10.5 directors in 2004. Even for those firms appointing at least one outsider, the average number of outsiders was only 1.7.

There have also been reform measures at the legal level. In the existing system (an auditor system), Japanese firms have the board of directors (*torishimariyaku-kai*) and the board of statutory auditors (*kansayaku-kai*). While the board of statutory auditors is in charge of monitoring the board, its effectiveness is often seen with skepticism because those employees who did not excel enough to become a director are often appointed as statutory auditors (Heftel, 1983). Hence, the system was criticized as being inadequate to play an effective governance role. The most recent revision of Commercial Code, which took effect in April 2003, represents a compromise between the existing auditor system and the "US" system advocated by critics. It offers large Japanese firms the choice between the auditor system and a committee system similar to the system adopted by listed US firms. In this system, there is a clear legal separation between monitoring and execution functions that had been practiced informally by those firms which adopted the executive officer system initiated by Sony. In addition to the legal separation of directors and executive officers, the board of directors is required to have the three committees; i.e., nominating committee, audit committee, and compensation committee. Although the definition of outsiders allows a firm to appoint employees from affiliated firms, each committee consists of at least three directors of which a majority of them must be outsiders. Adoption of the committee system among Japanese firms has been very slow however; only 71 firms (only 41 listed companies) adopted this in its first year (Gilson & Milhaupt, 2004) and by 2004, less than 3% of listed firms had adopted it.

Despite the rising pressures from changing market context, we can argue that Japanese corporate governance contains both change and continuity. Several reasons for the slow pace of corporate governance change can be suggested. First, new stakeholder expectations may have been insufficient to overcome traditional stakeholder pressures and existing practices. Second, even in a more competitive regulatory marketplace, traditional regulatory forces likely have greater weight than less well-established forces. Regulatory reform does not occur in a vacuum. In the absence of parallel changes among related and supporting aspects of the national business system (for example, disclosure regulations, which facilitates outside monitoring), the impact of new stakeholder pressures may be muted. This is consistent with the argument that institutional change is often gradual and path dependent. We will discuss this issue further later.

Finally, the absence of clear evidence of the superiority of one corporate governance model may also have slowed the diffusion of change. Since boardroom reforms in Japanese firms started only in the late 1990s, there are not many empirical studies that examine the performance implications of such reforms. Based on the limited existing studies, the recent boardroom reforms initiated by Japanese firms do not appear to have had any positive effects on firm performance so far. Yoshikawa and Phan (2003) examine the effects of outside directors, the separation of the board members and executives officers, and the reduction of board size on firm performance. They found that these reform measures had no impact on firm performance. Aoki (2004) also investigates the effect of the executive officer system (informal separation of the board members and executive officers) and found that such reform had no positive influence on firm performance. Gilson and Milhaupt (2004) find that the announcement of the adoption of the committee system did not lead to significant stock price movements.

Here again, there may be various reasons why these boardroom reforms at the firm level had no impact on firm performance. First, although many firms claimed that they had separated the role of directors and executive officers, these two positions were sometimes held by the same individuals (Aoki, 2004). Hence, in actual practice, the separation had not taken place in many firms. Further, the lack of significant market movement in reaction to the adoption of the committee system suggests that investors did not see such a move as a meaningful change (Gilson and Milhaupt, 2004). This is perhaps due to the uncertain independence of outside members (as they can include employees from affiliated or parent firms) or due to lack of concurrent changes in other aspects of board processes (e.g., disclosure and communication, frequency and conduct of meetings, etc.).[2]

Finally, it is important to consider the role of choice of corporate governance mechanism. In view of the lack of clear evidence for the superiority of one corporate governance model, the emphasis on choice served to legitimate both models. This had important implications. First, choice of one or the other mechanism did not "signal" good or poor firm performance or performance aspirations. Secondly, choice of an appropriate board structure, particularly in the changing Japanese context, likely involved balancing a number of possibly competing interests and demands. Choice allowed firms to select the board structure most appropriate to their particular set of stakeholder demands. Hence, investors may not have seen the new system as superior and hence suitable to all firms.

Evolution of Japanese corporate governance as institutional change: Convergence of corporate governance?

Many of the studies discussed in this review have attempted to address the agency relationship in the Japanese institutional context in which some institution specific factors such as the bank monitoring and *keiretsu* affiliation play an important role. However, these studies also raise boarder theoretical issues. Whitley (1992) proposes that corporate governance must be considered in the context of interrelated "national business system." From the perspective of institutional theory, corporate governance can be treated as one aspect of the national business system, or the institutional framework most relevant to the conduct of business. Corporate governance practices are embedded in a local institutional environment and hence they have complementary relationships with other institutional elements (Aoki, 2001). For example,

[2] In Asia, Japan is not alone in this regard. In China, Peng (2004) finds that outside directors do not contribute to improvement of firms' financial performance.

Japanese corporate governance is complemented by employment and corporate finance practices of Japanese firms as well as other supporting elements in the system. Because of these complementarities corporate governance practices are usually hard to change. Also, there are often forces that oppose to institutional change because they have vested interests or see more benefits in the existing system.

However, institutions do change from time to time. Corporate governance is part of the institutional system and therefore, its changes need to be treated as institutional change (Fiss & Zajac, 2004; Yoshikawa, Tsui-Auch, & McGuire, 2007). As the institution evolves or develops, the existing practices may also need to change as they are often not consistent with the emerging institutional context and this gap may entail costs (Peng & Delios, 2006). According to institutional theory, deinstitutionalization of established procedures stems from pressures on institutionalized practices from functional, political, or social sources at both the firm and environmental levels (Oliver, 1992). Pressures from one or all of these sources *may* trigger institutional change.

In the Japanese context, there is a skeptical view that the shift to shareholder-oriented corporate governance is desirable, as some believe that the competitive advantage of Japanese firms lies in their employees' commitment to their employer firms and their firm specific skills and knowledge (Itami, 2000; Yoshimori, 2005). For example, management of Toyota and Cannon claim that outside directors with limited industry knowledge bring little benefits and that support for long-term employment security enhances firm competitiveness. Further, there is no consensus among the key players in Japan on the direction of corporate governance reform (Gilson & Milhaupt, 2004). All these factors function to maintain continuity.

We noted in the previous section that Japanese corporate governance practices are also facing rising pressures from multiple sources. Japanese firms are also under greater market pressure to shift their corporate governance and to focus on shareholders' interests (Jackson & Moerke, 2005; Yoshikawa & Phan, 2001). These pressures were reinforced by changes in public sentiments on corporate governance practices after the collapse of stock prices in 1990 and continued poor performance of many Japanese firms throughout the 1990s. During this period, there were demands for greater transparency of corporate practices and more attention paid to the interests of shareholders from various groups such as the stock market regulators and some government agencies. These pressures facilitated the involvement of a wider range of stakeholders and institutional actors (see Figure 1). Hence, we can see forces for both change and continuity.

From this perspective, the evolution of corporate governance is more complex than a simple convergence-divergence debate: whether corporate governance of non Anglo-American countries including Japan is moving toward the shareholder-oriented corporate governance model due to globalization of capital and product markets (Bebchuck & Roe, 1999; Coffee, 1999; Hansmann & Kraakman, 2001). Organization theorists generally do not support the argument that strong convergence is taking place, but suggest that continuity and change often co-exist (Guillen, 2000; Jackson & Moerke, 2005; Yeung, 2006; Yoshikawa et al., 2007). This is partly because local stakeholder expectations will likely persist, and attention to the demands of global investors may imply significant risk in terms of distancing the firm from its traditional

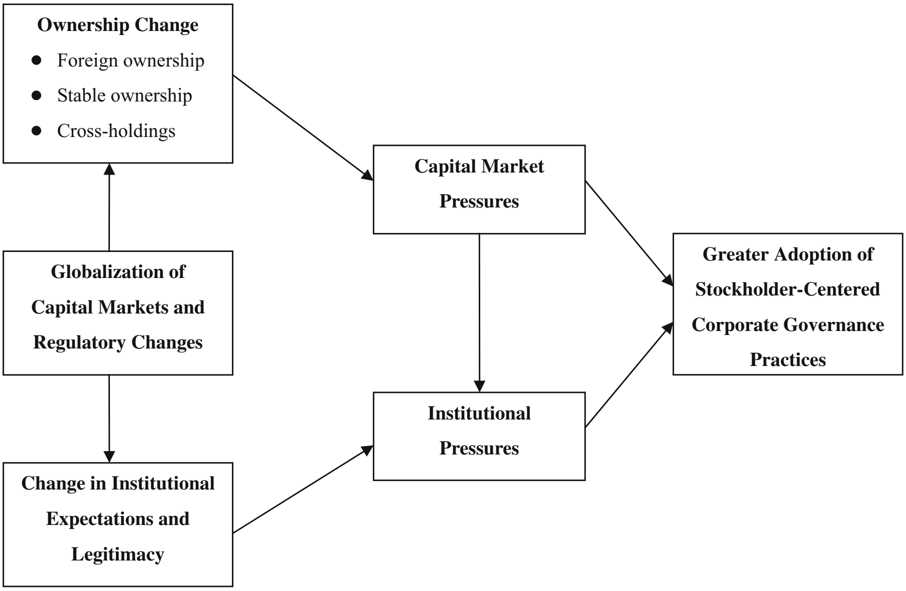

Figure 1 The Transition from stakeholder-centered to stockholder-centered corporate governance system in Japanese firms (Figure modified from Yoshikawa & Phan 2001: 200)

network of local support (Matta & McGuire, 2006). Hence, the convergence debate may be rather too simplistic, as it does not capture dynamic changes in corporate governance in each institutional environment. Perhaps research issues that are more pertinent and interesting include: (1) areas in which major changes have been taking place, (2) the way those changes have been implemented at the institutional and firm levels, and (3) directions of those changes.

Toward a comparative institutional theory of corporate governance change

Research tends to treat globalization of market forces, especially capital markets, as the dominant force that push corporate governance practices of non-Anglo-American countries toward the US models of corporate governance (e.g., Ahmadjian & Robbins, 2005; Seki, 2005; Yoshikawa & Gedajlovic, 2002). While many non-Anglo-American countries started to implement some elements of the US models, there is still a wide divergence in their corporate governance practices and models (Guillen, 2000). This is partly because the degree of external pressures varies from a country to another. Simply, some countries are more exposed to global market forces than others. But also, each institutional context or country has its own internal players; some of them may strongly resist any changes in corporate governance while others may accept some elements of foreign models if they can modify those models to fit their own institutional context. Further, each national context may vary in the extent to which corporate governance practices are embedded and supported by other elements of the institutional environment (Aoki, 2001). This suggests that changes in corporate governance take place not only through the interactions between external and internal forces but also through the interactions among internal forces or players. Hence, if we want to analyze how corporate governance practices are changing, it is critical that we understand specific institutional contexts.

While these interactions strongly influence the institutional level changes, such changes also affect how each firm can respond (or not respond) to external market pressures (Peng, 2003). Within the boundaries of institutional and legal framework, each firm has a choice as to how much it changes its practices facing those external pressures. In other words, firms can decide how they form their own hybrid models within the institutional boundaries in which they operate. Each firm has its own firm specific characteristics, for example in terms of the exposure to external forces, industry requirements, and inter-firm relations. Those firms that are more globally exposed may be more willing to accept shareholder-oriented corporate governance practices, while other firms that are more embedded in the domestic institutional arrangements are more resistant to change (Gilson & Milhaupt, 2004). For example, the evolution of corporate governance practices in Sony (Yoshikawa et al., 2007) and Infosys (Khanna & Palepu, 2004) reflect firm-specific pressures and managerial decisions. Therefore, the best practice may differ from one firm to another. This suggests that there is a growing heterogeneity in corporate governance practices among firms even within the same country (Aguilera & Jackson, 2003; Jackson & Moerke, 2005). This heterogeneity or divergence of corporate governance practices within the same institutional context is another area of research which is still unexplored by researchers.

Future research directions

We have reviewed the existing Japanese corporate governance system and discussed the main bank monitoring, the effects of ownership structure and group affiliation, and the role of the board. We have also examined the impact of recent ownership changes, especially rising foreign ownership, and corporate governance reforms. Many of these studies attempted to investigate the performance and strategy implications of these unique monitoring mechanisms in the Japanese context. Our discussion has highlighted the significant institutional differences in Japanese and US corporate governance practices, which imply different monitoring mechanisms such as main banks and group membership in Japan.

We view this increasing recognition of these institutional differences as an important foundation for future research. The growing recognition that context “matters” implies that corporate governance models and research must become increasingly complex. One important future direction is to expand the scope of corporate governance variables examined, and interactions among these mechanisms. For example, despite some promising initial steps, the role of some of the US corporate governance mechanisms such as executive compensation in Japan has remained relatively unexplored (c.f., Kaplan, 1994; Kato, 1997; Kato & Kubo, 2006). Table 4 outlines some of this emerging literature.

One reason for this relative lack of attention is the limited availability of detailed and longitudinal data in Japan. As Japanese firms began to improve their disclosure, however, there will be more future opportunities to examine this aspect. As Japanese

Table 4 Pay, incentives, management turnover, strategy.

Authors and publication year	Findings	Implications	Time period of data
Kaplan, 1994	While the pay-performance sensitivities of compensation of US and Japanese executives were similar, Japanese compensation more sensitive to low earnings, and equity-based compensation less significant	Although equity compensation less prevalent, there are similarities in pay-performance sensitivity in Japanese and US firms	1980
Kato, 1997	CEO's of *keiretsu* firms earn 20–30% less than those of independent firms	Lower pay among *keiretsu* CEO's may imply importance of other rewards	1985
Kato & Kubo, 2006	Compensation more sensitive to accounting performance than stock market performance	Does not support investor orientation in pay-performance sensitivity	1986–1995
Abe et al., 2005	Negative relationship between bank board membership and incentive compensation	Possible trade-off between bank monitoring and incentive compensation	1989–1999
Kubo, 2005	Director compensation insensitive to firm performance	Does not support monitoring role or Japanese boards	1994–1995
Kang & Shivadasni, 1995	Non-routine executive turnover associated with return on assets, stock returns and operating income, but unrelated to industry	Evidence for monitoring role of banks and large firms	1985–1990
Kang & Shivdasani, 1997	Findings of fewer and less significant downsizing among Japanese firms compared to US firms. Downsizing associated with main bank and blockholder ownership	Main bank and block shareholdings associated with shareholder orientation	1986–1990

This table includes only selective journal articles.

corporate governance evolves and if it moves closer to the US models or implements more elements of them, then executive compensation, along with other governance variables such as outside directors, may become an increasingly important variable to study. This implies that there is still large room to continue agency theory-based studies in the Japanese context. As the scope of corporate governance mechanisms increases, the interaction among corporate governance dimensions (e.g., compensation, ownership, the board of directors) becomes critical, and will provide valuable insight into the integration of "external" models into the Japanese system. The differences in institutional context and the growing availability of data on a wider range of corporate governance mechanism suggest several important areas for future research (See Table 5).

As globalization of capital and product markets will likely continue and impose further pressures for change in corporate governance in various countries, studies that look into national differences in institutional arrangements and responses from key internal players, through the interactions among themselves, to the external pressures will increasingly be an important research agenda. This is quite relevant not only to the Japanese context but also to other national contexts that are in institutional transition. Hence, along with the agency theory-based research, this

Table 5 Future research directions.

Research Areas	Questions
Broader range of corporate governance mechanisms	What is the role of executive compensation in Japanese corporate governance?
	To what extent does management turnover play a role in corporate governance?
	Has the market for corporate control become a more relevant factor in Japanese corporate governance?
	Is there evidence of "substitution effects" or do unique aspects of the Japanese system serve as substitutes for US governance mechanisms?
Institutional context	To what extent does the Japanese context imply differences in the role of corporate governance mechanisms postulated in agency theory?
	What are the interactions and interrelations among corporate governance mechanisms in Japan?
	What is the impact of regulatory and economic change on Japanese corporate governance?
	What are the implications of the increasing globalization of financial markets for Japanese corporate governance?
	To what extent are non-agency theory perspectives useful in understanding corporate governance in different contexts?
	To what extent is the Japanese experience relevant to understanding other "bank-based" or "relation-based" governance systems in Asia and elsewhere?
Organizational choice	To what extent is there diversity (both in form and function) within corporate governance regimes?
	What is the role of institutional entrepreneurship in promoting diversity and change in corporate governance?
	What institutional forces (e.g., political, economic, cultural) play a role in the evolution of corporate governance and organizational responses to institutional pressures?

theoretical line of studies provides great opportunities to investigate corporate governance and its change in Japan as well as in other countries. Indeed, it may provide important insights into the context under which alternative theoretical perspectives can supplement or complement agency theory in understanding corporate governance.

Another future direction in corporate governance research is that of organizational choice. Japanese regulatory reform (for example, the 2002 revision of the Japanese Commercial Code) provides Japanese firms with the choices along several dimensions of corporate governance. This provides researchers with an excellent opportunity to examine not only the antecedents of corporate governance change, but their implications as well. We have presented some recent changes in the Japanese context, especially since the 1990s. As discussed, there have been growing pressures on Japanese firms and Japanese model of corporate governance for change. This choice model implies the coexistence of alternative models of corporate governance. This provides researchers with an opportunity to expand beyond the traditional agency-based research model and to examine corporate governance from the perspective of institutional theory. From this perspective, corporate governance is treated as part of a nation's institutional framework and researchers need to attempt to understand unique institutional arrangements that affects corporate governance practices. As a result, researchers should examine the interdependence of various elements of the business system, for example the banking sector, regulation, financial intermediation, and politics.

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