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The Effects of Ownership and Capital Structure on Board Composition and Strategic Diversification in Japanese Corporations

Toru Yoshikawa* and Phillip H. Phan

The board of directors plays an important role in solving the agency problem between shareholders and management. This paper investigates the relationships between ownership and board structure with the diversification strategy of large Japanese firms. The results show that corporate nominee directors are associated with lower levels of product diversification of their investee firms. This suggests that nominee directors in large Japanese corporations see themselves representing specific interests and therefore investors should pay attention to board composition in order to assess the level of protection they can expect to receive. Even without any apparent agency problem with management, there remains a potential "principal-principal" problem.

Keywords: Corporate governance, ownership structure, board of directors, diversification, Japanese firm

Introduction

The board of directors plays an important role in solving the agency problem between shareholders and management. Prior studies have examined board characteristics that uphold the interests of shareholders by promoting corporate strategies that maximise shareholder value (Dalton *et al.*, 1998). These studies have been largely based on the Anglo-American model of corporate governance. Within the Japanese context the role of the board in influencing corporate strategy and performance has been less studied.[1] Partly, this is because Japanese corporate boards, which comprise mostly executives and former employees, do not traditionally see themselves as active monitors of top management. Hence, the Japanese board has not been as active as its American or UK counterparts. However, this situation may be changing with the globalisation of corporate governance standards.

In this study, we focus on a feature of the Japanese corporate boardroom that deserves attention because of its implications for both theory and practice. Specifically, we examine the role of the outside directors. There are a small number of outsider directors on many Japanese boards who act as representatives of corporate and banking institutional investors. Because these institutional shareholders commonly have commercial relationships with the firms to which they appoint nominee directors, it is likely that such directors represent the interests of those shareholders.[2] In short, such nominee directors serve to narrow the conflict of interests between management and certain classes of shareholders. Here we examine how Japanese domestic institutional inves-

tors, who are often business partners or affiliated firms, influence the corporate strategy of investee firms through the directors they appoint into the boardroom. Japan provides an ideal context to study the relationships between ownership structure, nominee directors and corporate strategy because of the prevalence of formal and strong inter-firm ties.

Literature review

Agency theory attempts to address the problems that arise from the conflict of interests between parties to a contract in which the agent has control over the transaction-specific assets of the principal (Fama, 1980; Jensen and Meckling, 1976). As residual risk bearers, shareholders have a right to claim the residual value[3] generated from the firm's productive activities. However, management decides how this residual is disbursed and, because it does not always own a significant amount of shares, has little incentive to disburse all back to the stockholders. To address this *agency problem* the corporate governance system incorporates a variety of monitoring mechanisms, such as the board of directors and direct action by large shareholders such as institutions and wealthy individuals (Fama, 1980; Fama and Jensen, 1983).

Institutionally, boards of directors owe a fiduciary duty to the shareholders of the firm (Monks and Minow, 1995). Thus, it becomes a matter of theoretical and practical interest to examine how effective and in what ways boards have been able to fulfil these duties. Consequently, a number of studies have investigated the impact of such factors as board size (Pfeffer, 1972; Pfeffer and Salancik, 1978; Singh and Harianto, 1989; Zahra and Pearce, 1989; Goodstein *et al.*, 1994; Dalton *et al.*, 1999) and composition (Chaganti *et al.*, 1985; Kosnik, 1987; Schellenger *et al.*, 1989; Baysinger *et al.*, 1991) on corporate strategy and firm performance. A number of literature reviews, concluding that evidence on what drives board effectiveness is mixed (cf. Dalton *et al.*, 1998), recommend that future studies adopt a more contextually sensitive approach because, for example, a difference in national context can limit the applicability of standard agency theory assumptions of investor risk preferences, managerial behaviours and board structures.

In Japan, as in most countries, the board of directors is legally responsible for the monitoring of the management. However, unlike their US counterparts, Japanese directors do not delegate their managerial duties to executive officers (Heftel, 1983). In part, this is because board positions are usually conferred to a firm's loyal current and former employees and are thus seen as part of the managerial hierarchy (Abegglen and Stalk, 1985; Charkham, 1994). Japanese board culture often views board members as *de facto* managers and thus subordinate to the CEO. In short, directors are not expected to question executive management in the boardroom.

The few outside directors that serve in the Japanese corporate governance system are usually nominees of the banks and corporations that invest in the firm (Kishida, 1996). According to the extant literature, such nominee directors often act as stewards of the commercial, rather than investment, interests of their institutional investors (Gerlach, 1992). These "stable" investors are not as driven to maximise returns on investments as the "market" investors. This is because the objectives of a commercial relationship and that of an investment relationship can sometimes conflict with the costs of protecting the commercial relationship ultimately borne by the investors. For example, a bank is usually concerned with protecting the quality of its loans, which translates to higher cash reserve requirements on the client's balance sheet. On the other hand, equity investors want the excess cash to be returned so they can be reinvested more productively (Jensen, 1986).

In short, every strategic objective has a corresponding claim on cash flows and the resulting conflict between the various interests and strategic objectives represented by nominee directors can be incompatible. The strategic objective that is eventually pursued will depend on the relative power of these groups of nominee directors to influence top management.

For example, bank and corporate shareholders may not have the same investment objectives because they have different strategic goals. Bank shareholders are interested in protecting their loan portfolios while corporate shareholders want to stabilise supplier–customer commitments or the strategic complementarity of their affiliated firms. The upshot is that different shareholders with different strategic objectives would attempt to influence where and when managers invest the firm's resources. This theoretical framework forms the basis for our research model.

Hypotheses

Figure 1 illustrates our research model. This is a two stage temporal model in which we first hypothesise the effects of ownership and capital structure on board composition, followed

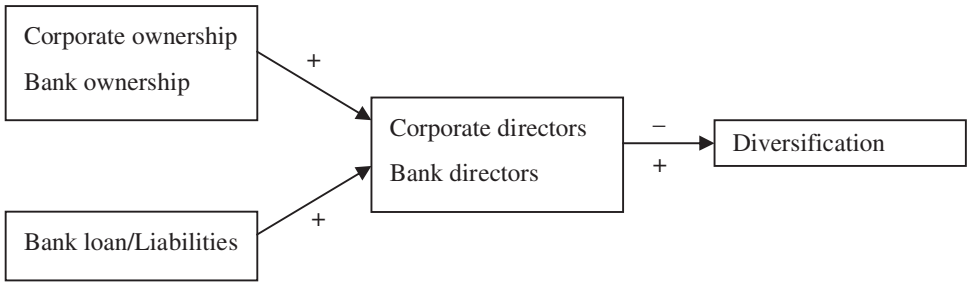

Figure 1: The impact of ownership and capital structure on board structure and strategic diversification in Japanese corporations

by the effects of board composition on diversification strategy. This approach isolates the effects of ownership and control and board composition on strategy, which allows us to examine the relative impact of each variable and to make conclusions about causality.

Effects of ownership and capital structure on board composition

Japanese shareholders can be broadly classified into two categories known as "stable investors", who are mostly domestic institutions, and "market investors", who are mostly foreign institutions (Gerlach, 1992). In 1999, stable investors such as *keiretsu* firms, main banks and insurance companies controlled approximately 38 per cent of the equity in Japanese firms (NLI Research Institute, 2002). Conventional thinking suggests that stable investors own shares as a means to *stabilise* commercial relationships rather than to earn returns on investments (Clark, 1979; Gerlach, 1992). Therefore, when stable investors appoint outside directors, known as nominee directors, it is with the objective of protecting their commercial relationships. Because a firm's or a bank's commercial relationship is impacted by its cash flows, which are the result of its business strategies, nominee directors can stabilise a firm's relationships by influencing its strategies (Prowse, 1990; Gerlach, 1992; Kaplan and Minton, 1994). For example, a number of publicly listed Japanese firms such as Aiwa and JVC are affiliated with Sony and Matsushita, respectively. Thus, by nominating directors to these firms, Sony and Matsushita can more easily influence the strategies of their affiliated firms. In sum, we expect to see a relationship between a firm's ownership patterns and the structure of the board, such that:

> *Hypothesis 1a: Corporate ownership is positively associated with the number of corporation-nominated directors.*

> *Hypothesis 1b: Bank ownership is positively associated with the number of bank-nominated directors.*

In addition to equity holdings in their corporate partners and clients, banks are also financially exposed to their clients' strategic decisions through the loans they carry. Thus, the higher the exposure, the greater the incentive for the bank to exert direct influence over the firms' strategic objectives, which they can attempt to do through nominee directors. Moreover, because a bank's loan exposure is typically larger than its equity holdings and because these loans represent "leveraged" liabilities with corresponding obligations to depositors, the incentive to protect the downside risk is higher than the incentive to maximise its upside gains from their shareholdings. Therefore, we would expect a relationship between a firm's financial structure and its board structure such that:

> *Hypothesis 1c: A higher proportion of bank loans in the firm's capital structure is positively associated with the number of bank-nominated directors.*

The effects of nominee directors on diversification

Corporate and bank nominee directors exert influence on the direction of an investee firm's growth strategies according to the interests of their parent companies and banks, and in proportion to the degree of control they exercise in the boardroom. Within the portfolio of available strategies for growth, firms can choose diversification.

Diversification, or the entry of the firm into new businesses or product lines not directly connected to its primary business, is a way to increase the scope and size of the firm while at the same time reduce its dependence on the core business. Diversification can help the firm lower overall operating risks by creating a portfolio of businesses with uncorrelated cash

flows, i.e. smooth out earnings fluctuations. However, *ceteris paribus*, diversification requires a firm to reduce the intensity of its investments in a single business and therefore may compromise the building of a sustainable competitive advantage in that business (Wernerfelt, 1984; Porter, 1985).

Since corporate shareholders have less direct *financial* exposure to their partner firms, we expect that they will be more willing to accept higher operating risks (i.e. instability in cash flows) than bank shareholders, in exchange for a focused business strategy that increases the potential for competitive advantage. Therefore, we posit that the pressure for strategic diversification is lower for corporate shareholders than it is for bank shareholders. Further, strategic complementarity, defined as the coherence of an investee firm's strategy with that of the parent's overall corporate strategy, is an important consideration for corporate nominee directors. For example, a parent corporation might find a diversified affiliate more complicated and costly to manage than one that is less diversified. The corporation may also run the risk of a diversified affiliate cannibalising its product markets if there are similarities in technology or geographic scope between the two organisations. From a strategic perspective, therefore, a corporation would prefer its affiliate to focus on a defined set of businesses that can add value to its overall strategic portfolio. In sum, we expect to find a relationship between board structure and corporate strategy such that:

Hypothesis 2a: The number of corporation-nominated directors on the board is negatively associated with diversification.

The theory of incomplete contracts holds that a firm requires predictable cash flows to discharge its implied and explicit obligations to lenders, employees, suppliers and customers in exchange for their willingness to commit long-term, transaction-specific resources to the firm. For example, stable employment is necessary if the firm expects employees to reduce their investments in general human capital in favour of firm-specific human capital. Therefore, from the perspective of the bank nominee director, stable cash flows are a necessary condition for a bank's objective of reducing the default risk of its loan portfolio. Cash flow stabilisation at the corporate level can be achieved through strategic diversification into other businesses. Thus, we expect to see a relationship between board structure and corporate strategy such that:

Hypothesis 2b: The number of bank-nominated directors on the board is positively associated with diversification.

Data and methods

Sample and data

The sample for this study consists of 228 publicly traded Japanese firms taken from the population of the 300 largest manufacturing firms listed on the Tokyo Stock Exchange for the period between 1996 and 1998. Thus, we have 684 observations for the panel analysis. We focused on manufacturing sectors to limit industry level effects and exclude those firms for which we could not collect complete data between 1996 and 1998. The Internet boom and subsequent crash between 1999 and 2001 would have substantively influenced the investment decisions of Japanese corporations, which is why we limited our observations through to 1998. Sample firms are categorised into one of the following eight industries; textiles, chemicals, pharmaceutical, ceramics, steel and metals, machinery, electronics and automotive. Data for this study were collected from the following sources: *Kaisha Shikiho* (Japan Company Handbook), *Yakuin Shikiho* (Board of Director Handbook) and *Kigyo Keiretsu Soran* (List of Corporate Keiretsu). These sources are the same ones used by other researchers and industry analysts have culled information and they contained the latest financial and organisational data for the sample firms.

Measurement

(a) Dependent variables

We used two dependent variables in the first stage of the model: the number of outside directors nominated by corporations (*corporate directors*) and the number of outside directors nominated by banks (*bank directors*). Many studies in corporate governance commonly use ratios of outside to inside directors, although there is little consistency on how these measures are computed (Johnson *et al.*, 1996). Since we are trying to measure the power of *shareholders* over their investee firms, we chose to use the number of directors as this reflects the ability of shareholders to get their nominees appointment to the board. Furthermore, coalition theory suggests that regardless of total board size, a few individuals with a common goal can build a coalition that can exert influence disproportional to their relative size. Finally, when directors have the backing of major shareholders such as the corporate parent or main bank, their influence as a coalition is even greater. The data source for these variables is *Yakuin Shikiho* (Board of Director Handbook).

Diversification is the dependent variable for stage two of the model. Following previous studies on diversification strategy in Japanese firms (Geringer *et al*., 2000; Lu and Beamish, 2004), we measured diversification with a Herfindahl index, which is the sums of squares of sales contribution to total sales by the individual product groups as classified by the *Kaisha Shikiho* (Japan Company Handbook). Geringer *et al*. (2000) calculated a similar diversification measure from the *Kaisha Shikiho* data. This measure of diversification differs from those using Standard Industrial Classification (SIC) codes in the US because it measures diversity at the product rather than business level. Our measure is finer grained because it differentiates between different product lines in a single business that an SIC based measure would not ordinarily detect because many businesses have multiple products within an industrial class. Therefore, we expect more variance in our measure relative to other measures using standard SIC codes.

(b) Independent variables

There are three independent variables in the first stage of the model: corporate ownership, bank ownership and bank debt. *Corporate ownership* is measured as the ratio of the total number of shares held by non-financial corporations to total outstanding common shares. Similarly, *bank ownership* is measured as the ratio of number of shares owned by banks to total outstanding common shares. *Bank debt* is the proportion of bank loans to total liabilities. A higher ratio indicates a heavier reliance on bank loans for debt financing, and thus more exposure to the influence of bank nominated directors.

At the second stage of the model, we included *board composition* as the numbers of nominee corporate directors and nominee bank directors. This is the same measure we used for the dependent variables in the first stage of the model.

(c) Control variables

In this study, we used four control variables. *Foreign ownership* is the ratio of shares owned by foreign investors to total outstanding shares. This variable indicates the degree to which a firm is exposed to pressures from market-oriented investors and is therefore less free to respond to the strategic interests of domestic stable investors. Since most foreign shareholders are arm's-length investors with no on-going business ties, we expect that their greater holdings will lead the firm and its directors to respond with efficiency-maximising resource allocation policies.

The log of *sales* controlled for the effects of economies of scale and scope. *Debt ratio* was included to control for the effects of debt financing. In a fixed effects model, one does not include variables such as "industry" that are independent of time. In an approach suggested by Dess *et al*. (1990), we accounted for the systematic impact of industry effects by using an industry mean value of Tobin's Q (Industry Q) based on the categorisation provided by the *Kaisha Shikiho*.

Data analysis

To test our hypotheses, we report the results of the panel analysis using fixed effects General Least Squares (GLS) regression for the 1996–1998 dataset. A Hausman Test suggests that a fixed-effects model is preferred over a random-effects model because the null hypotheses for both models were rejected, i.e. the random effects estimator is biased (Kennedy, 1998, pp. 305–307). Hence, we used the fixed-effects model.

Table 1 reports the Pearson correlations of the variables. It shows that the number of nominee corporate directors is positively correlated with corporate ownership and negatively correlated with bank ownership. The number of nominee bank directors was negatively correlated with corporate ownership but positively corrected with bank loans. There was no relationship between bank ownership and the number of bank nominee directors, which seems to suggest that banks with greater loan exposure are more likely to seek the appointment of directors. Finally, we note that the number of corporate nominees is negatively correlated to the number of bank nominee directors, suggesting a limit to the size of the board. Overall, the picture suggests that bank and corporate nominee directors play different roles in the boardroom.

Results

Table 2 reports on part one of the panel data analysis. As seen from this table, corporate ownership is strongly and positively associated with the number of nominee corporate directors, supporting Hypothesis 1a. Corporate ownership is negatively related to the number of bank nominee directors, suggesting that corporate owners are able to exert their claims to the exclusion of the bankers if their ownership stakes are high. The result also hints at the possibility that bank and corporate nominees have opposing interests.

Table 1: Pearson correlations and descriptive statistics

	Mean	SD	Min	Max	1	2	3	4	5	6	7	8	9
1. Corp. director	0.94	2.31	0	16	1.000								
2. Bank director	1.01	1.11	0	6	–0.144*	1.000							
3. Diversification	44.69	23.09	0	89.15	–0.146*	0.033	1.000						
4. Corp. own	20.04	14.18	2.9	64.60	0.605‡	–0.113*	–0.178*	1.000					
5. Bank own	42.28	11.27	8.5	68.40	–0.384‡	–0.027	0.162*	–0.637‡	1.000				
6. Bank loan	27.14	20.61	0	88.00	–0.109*	0.248†	–0.033	0.009	–0.180*	1.000			
7. Foreign own	12.42	9.19	0.54	64.59	–0.216†	0.019	0.029	–0.394‡	0.024	–0.276†	1.000		
8. Debt ratio	55.28	17.78	6.19	96.18	0.009	0.213†	0.104*	0.069	–0.086	0.608‡	–0.322‡	1.000	
9. Sales log	11.39	0.47	10.22	12.96	–0.042	–0.033	0.254†	–0.133*	0.271†	–0.183*	0.238†	0.195†	1.000
10. Industry Q	1.93	0.66	0.70	3.88	–0.033	0.071	–0.061	–0.110*	0.102*	–0.299‡	0.116*	–0.262†	–0.015

‡p < 0.001, †p < 0.010, *p < 0.050.

Bank ownership is not related to the number of nominee bank directors, rejecting Hypothesis 1b. We also do not find a statistically significant positive association between the bank loan ratio and the number of nominee bank directors, thus there is no support for Hypothesis 1c. Overall, we find that the part of the model related to bank directors is not supported by the data. The variance explained is small and more importantly, the regression model is not statistically significant.

We find an unexpected positive relationship between bank ownership and corporate director and a negative relationship between corporate ownership and bank director. This finding will be explored in greater depth in the discussion.

Table 3 reports the second part of the panel data analysis. It shows that the number of corporate directors and diversification strategy are negatively associated, which provides support for hypothesis 2a. However, we do not find any relationship between the number of bank directors and diversification strategy, rejecting Hypothesis 2b. The results also report that corporate director accounted for an additional 2 per cent of variance explained, which is significant, given that the model is constrained with only 3 per cent of variance explained by the control variables. In terms of the control variables, Industry Q is negatively associated with diversification implying that industries populated by more diversified firms are less profitable.

Discussion and conclusions

Overall, we found that the data provided support for about half the research model. We argued that Japanese institutional investors are able to exert their strategic preferences in the boardroom through nominee director appointments. In some ways, our approach is classic agency theory because it assumes that directors act to represent the interests of those investors who appoint them. However, as part of a growing stream of research (e.g. Gedajlovic *et al*., 2005; Thomsen and Pedersen, 2000), our approach moves us away from the standard agency theory treatment of shareholders as either atomistic investors with no influence over management or concentrated investors who coordinate their actions to maximise shareholder value. We attempted to show that Japanese outside directors serve their parent or affiliated institutional shareholders whose interests are not always to maximise their equity investment returns. In this study, we recognise that directors, when confronted with an identifiable shareholder

Table 2: Results of fixed effects panel analysis of ownership structure on nominee directors

	Corporate director		Bank director	
	Beta	T-value	Beta	T-value
Debt ratio	–0.008	–1.16	–0.010	–1.43
Foreign ownership	0.007	0.94	–0.017	–2.30*
Log sales (size)	1.334	4.04‡	0.050	0.16
Industry Q	–0.032	–0.21	0.054	0.38
Corporate ownership	0.105	9.88‡	–0.021	–2.04*
Bank ownership	0.021	3.21†	–0.003	–0.46
Bank loan	0.001	0.33	0.004	1.55
	R^2 = 0.23; F = 18.97‡; Obs = 684		R^2 = 0.02; F = 1.62; Obs = 684	

‡p < 0.001, †p < 0.010, *p < 0.050.

Table 3: Results of fixed effects panel analysis of nominee directors on diversification

	Diversification			
	Beta	T-value	Beta	T-value
Debt ratio	–0.022	–0.36	–0.035	–0.58
Log sales (size)	–7.511	–2.63†	–5.291	–1.82
Foreign ownership	–0.068	–1.01	–0.083	–1.23
Industry Q	–3.632	–2.87†	–3.380	–2.69*
Corporate director			–1.207	–3.20†
Bank director			–0.183	–0.42
	R^2 = 0.03; F = 3.67†; Obs = 684		R^2 = 0.05; F = 4.21†; Obs = 684	

†p < 0.010, *p < 0.050.

constituency, will likely act to advance that group's narrow interests.

We found that Japanese corporate ownership is positively related to the number of nominee corporate directors and, not unexpectedly, negatively associated with the number of nominee bank directors. This result seems to strengthen the argument that shareholders attempt to exert influence in the boardroom through the nomination of directors who can represent their interests. This conclusion is further strengthened by the finding that corporate directors preferred less strategic diversification, and instead focused the firm's resources toward core business activities.

We found a puzzling positive correlation between Japanese bank ownership and the number of corporate directors. However, the effect size is only about 20 per cent of the relationship between bank ownership and corporate directors. We note that the correlation table (Table 1) reports a positive correlation between debt and bank directors, which is in line with our research model. It turns out that those firms with corporate nominees are usually affiliated with corporate groups or are subsidiaries of larger parents. This finding deserves further research, but we can speculate that banks may be viewing these affiliations as implicit hedges against loan risks, since the hub firms of Japanese business groups or *keiretsu* have traditionally bailed out affiliates that run into financial difficulties (Sheard, 1994).

We did not find any relationship between the number of bank nominee directors and diversification. A possible reason is that Japanese firms performed poorly in the late 1990s because of a prolonged domestic recession

lasting almost 10 years. Many Japanese firms did not have sufficient cash flow to engage in meaningful diversification and thus Japanese firms under the control of the banks did not have the resources to increase the level of diversification even if they had the intentions to do so.

Finally, we note that the data did not provide any support for the relationship between bank ownership and bank nominee directors in Japan. In hindsight, this may be attributed to the fact that Japanese banks tend to send directors to their investee firms only during periods of financial distress (Sheard, 1994). Such "rescue" operations do not result in a permanent appointment of such directors and are usually reversed when the situation has been stabilised. Therefore, although a bank may have ownership, these equity risks are small relative to their debt exposures, the latter of which are likely to be secured by collaterals and legal covenants that work to attenuate the need for ongoing representation in the boardroom. Further, the globalisation of the capital market, and declining ability of the Japanese banks to rescue troubled client companies have made the commercial banking relationship more arm's length and less relational, with the result that banks may have become less inclined to be involved with their client firms' management.

Overall, our model seems to suggest that Japanese corporations holding equity in other firms are just as interested in efficiency, from the standpoint of strategic diversification, in the use of resources as other financially driven investors. The difference is that they have the ability to nominate directors that have a direct influence on their investee firms' strategies. This study also suggests that we have to pay particular attention to the institutional context in which investors make their decisions. We show that the identity of the investor is an important consideration for future studies because bank and corporate owners in Japan seem to have different preferences for board composition and strategy choice.

On a practical level, this study suggests that because nominee directors in large Japanese corporations see themselves representing specific interests, investors would be wise to pay attention to the composition of the board in order to assess the level of protection they can expect to receive as owners. Even without any apparent agency problem between management and shareholders, there remains a potential "principal-principal" or shareholders' conflicts of interest problem. These conflicts can lead to the inefficient allocation of resources. This is particularly true of companies in Japan and other countries (e.g. continental Europe and Asia) where dominant shareholders are common.

Finally, we note a couple of interesting opportunities for future research. First, it would be instructive to document whether minority shareholders care about the presence of nominee directors in the Japanese boardroom. Increasingly, these minority shareholders are foreign institutional investors such as CalPers (California Public Employees Retirement System) and major fund management companies. The relationship between these foreign investors are more likely to be arm's length rather than relational. Thus, we would expect the increase in minority ownership to result in a systematic discount, equal to the potential for expropriation by nominee directors that represent majority interests, of the share price.

We can also expand the categories of institutional investors, for example by subclassifying "market investors" into "retail", "mutual", "insurance", "pension" and so on, to assess the impact of investment horizon on strategy preferences. Standard CAPM theory says that the relationship between risk/return preferences should be reflected in the stock portfolio that investors choose. However, large Japanese and foreign corporate investors that have commercial relationships with their investee firms cannot exercise those choices freely because the movement of large blocks of shares will affect the value of the company. Thus, these investors may be forced to exercise their strategic preferences by direct action in the boardroom so that a Japanese firm's strategy may be the result of board composition rather than that of a rationally driven economic decision-making process.

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Notes

1. Exceptions include Suzuki and Sho (2000).
2. Similar situations exist in other parts of the world. In Germany, for example, the *Aufsichsrat* or supervisory board is not chosen for its strict commitment to shareholder interests. Instead, bankers, unions and affiliate firms often have an influence through their director appointments.

3. Defined, according to Jensen (1986), as free cash flow or the cash from operations and investments net of contractual obligations and future projects with positive net present values.

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