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Hugh Patrick

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Hugh Patrick

Director, Center on Japanese Economy and Business
Columbia University

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Abstract

Like the United States, managers of Japan's large companies since the early 1950s have had great autonomy because shareholding is dispersed. However, most Japanese companies have a significant portion of their shares stably held by other friendly financial institutions and businesses, a significant component of the integrated, synergistic "postwar economic system" embodied in the permanent employment system of industrial relations, the main bank system, and management independence. Employees rather than shareholders are the main potential constraint, so managers have given strong priority to employee interests.

Japan's mediocre economic performance since 1991, and a range of publicized corporate scandals, are now undermining this system. Government policies and public pressure have improved corporate disclosure and transparency, and have made corporate governance through capital markets feasible. While managers in the future will place greater weight on shareholder interests, only a few companies are likely to adopt the Anglo-American corporate governance model. More likely is the gradual development of a hybrid approach in which management retains considerable autonomy and employee interests remain important.

Corporate governance is a global hot topic. In Japan, committees consider, academics study, polls are taken, models compete, and rhetoric abounds. Still, while considerable change is underway, it is partial and inertia is powerful. It is premature to determine how key questions will be answered. Will companies shift from primary priority for employees and other inside stakeholders to greater emphasis on realizing value for those largely ignored stakeholders, the shareholders? Will outside directors play an essential role on corporate boards? Will capital markets provide a major source of external governance, a role once assigned to "main banks"? Will a market for corporate control emerge? Will market discipline become effective?

It is essential to understand the context with which corporate governance is changing and not changing. Governance in Japan evolved in two major states – prewar "Anglo-Saxon type" capitalism (Okazaki) and postwar "Japanese welfare" capitalism (Dore) and is now entering a third stage.

Until the end of World War II, Japanese companies were controlled by their owners, typically founders or their family successors. Some firms grew large; others failed, or were taken over in an active market for corporate control. Most finance was internal or based on new share issuance; banks did not play a significant monitoring role. By the early 1930s successful family-controlled business groups (zaibatsu) had become a major feature of Japanese big business industrial organization, as is the case today in Korea, Thailand, Malaysia, Indonesia, and other Asian economies. Each major zaibatsu family used a holding company and developed cadres of professional managers to monitor and to manage its industrial companies. The hierarchical governance of zaibatsu was effective, both in the performance of component companies and in the ability to take over under-performing non-group firms (Okazaki).

Government controls over the economy beginning in the mid 1930s substantially altered the economic system, and postwar Allied Occupation reforms reinforced a fundamental change in corporate governance. The government took over zaibatsu shares in companies at a pittance, imposed capital levies (often paid in corporate stock) on the wealthy, and war-time guarantees of corporate borrowing were abrogated. The shares were sold first to employees and then to other individuals.

In the atmosphere of zaibatsu dissolution and Occupation economic democratization reforms, management successfully argued that ownership and management should be separated, and that an independent management should reduce the status of (equity) capital and raise that of labor. Management claimed to be the mediator, serving the public interest. However, initially union leaders and management mistrusted each other. This was in part because Occupation reforms led to development of what became a highly politicized labor union movement. Strikes and other contentious confrontations persisted until the 1950s. Then new labor leaders gave priority to economic objectives, notably job security and wage increases, in an economy that was growing rapidly. By the mid 1950s what has been termed the postwar system of closely integrated economic institutions, including the corporate governance system, was in place.

Japan's corporate governance system is now in a third phase. It is more market-oriented and has substantially greater transparency and increased weight for shareholder interest relative to employee interests. Still, it is significantly different from the Anglo-American model, and is probably closer to the continental European approach than to U.S. practice.

The Postwar Economic System

Over the course of Japan's high-growth era, from the early 1950s to the mid-1970s, a highly complementary, rather tightly linked set of economic institutions, characterized as the postwar economic system, developed and evolved. In practice, this was a big-business system, focusing on the listed companies that are the locus of public discourse on corporate governance. Privately owned small and medium enterprises were a lesser part of the system, substantively and symbiotically, even though they provided the major share of output and employment.

The system was a rational economic and institutional response to conditions in the 1940s and 1950s, especially the opportunities for rapid growth as a low-income, well-educated, follower economy. The key elements were the permanent employment system of labor-management relations, enterprise unions, separation of ownership and management control, stable shareholdings, main bank external finance, and supportive government policies and regulations. As Aoki well analyzes, conceptually the system was founded on "contingent governance": control was entrusted to managers contingent on sound financial performance, and the main bank had the responsibility to lead the restructuring of any firm in distress.

Labor-Management

In the high-growth era, enterprise unions and management forged a win-win game in which workers made a no-strike commitment and accepted rapid technological changes and the development of firm-specific skills in exchange for permanent employment and seniority-based annual wage increases and promotions. Management and union leadership came to work closely together. Management realized that employees were, together with banks, the most important stakeholders. The relatively few instances in which a CEO and top management lost the trust of employees led to internal crisis and his resignation (Nitta).

In return for employee (and public) acceptance of management as the responsible power, top management compensation was good but not outrageous – some 10 to 20 times employee average wages. Managers also were rewarded with large expense accounts and excellent retirement benefits, and enjoyed prestige and high social status. When times became so difficult, as they have over the past decade, that the work force had to be reduced, it has been done by a negotiated combination of attrition, early retirement with special benefits, and transfer of workers to subsidiary or other related firms rather than with lay-offs.

Management control has been internal, hierarchical, and perpetual. Stereotypically, the president of a company, in consultation with colleagues, selects a successor on becoming chairman after serving as CEO for six to eight years. Boards have been large, a reward to the most successful managers in the seniority-based system. The external labor market for senior executives is virtually non-existent; managers try to remain in power until well-compensated retirement, which may involve a senior position in a subsidiary. Corporate performance is of course important; metrics include firm size and relative ranking, revenue growth rate, and reputation, as well as profitability.

Ownership and Control

Japan is the most extreme case of separation of ownership and control of listed companies. In general, management controls; shareholding is dispersed or passive. There are some relatively young companies that are controlled by their founders or successor families. There also are a number of spin-offs that are controlled by their parents, as well as a few foreign-controlled firms. Accordingly, one must be cautious of studies of corporate behavior that do not distinguish among types of firms. This chapter focuses on the large majority of companies in which ownership and control are separated.

The system is one of entrenched managerial autonomy and corporate governance by strong norms of managerial self-restraint. Of course company management is not completely autonomous. It is constrained by four major stakeholders, in order of importance: its customers, as is true everywhere; its employees, especially those on the managerial track; its creditors, particularly its banks; and its shareholders. Management has to ensure adequate performance to keep all the stakeholders reasonably content.

Japanese management has two fundamental, inter-related goals. The first is to maintain management independence and autonomy in a self-selected, self-perpetuating management system. The second is to ensure the independent survival of the firm in perpetuity. Bankruptcy and liquidation is the worst possible outcome; selling the firm (usually termed merger) is the second worst. Japanese managers are not unique in their desire for autonomous control and power. What is unique was that the early postwar economic and political environment enabled them to shape the evolving system to their great benefit.

Management preached the ideology that the company is a community which serves society, with responsibilities and reciprocal obligations in particular to its employees and its business and financial partners (Learmount; see also Dore). One result was a system of cozy back-scratching, some might say collusion, among the management of Japan's large industrial companies, financial institutions, and the government bureaucracies – particularly the Ministry of Finance. The system was opaque, with minimal disclosure; forbearance was the policy stance, since growth made it possible to write off mistakes and difficulties easily; and allocation of regulatory rents and budget redistribution to lagging sectors could solve other problems.

Profit maximization has virtually never been articulated by a Japanese manager as a primary objective. Indeed, for many Japanese, profit maximization is not an accepted value; it connotes anti-social, selfish behavior. In the early 1990s when Japanese senior managers were asked whose interest should be given first priority, inside stakeholders or shareholders, 97.1 percent responded stakeholders. This also was the reply of 82.7 percent of German, and 78.0 percent of French, senior managers. In contrast, only 24.4 percent of senior managers in the U.S. and 29.5 percent in the U.K. responded similarly. (Yoshimori, 1995, cited in Allen and Gale, p. 113.) When asked to choose between lay-offs or dividend reduction, Japanese managers overwhelmingly (97.1 percent) preferred employment maintenance, unlike the U.S. (10.8 percent) and the U.K. (10.7 percent). Germany was 59.1 percent, France, 60.4 percent.

While the objective is not maximization of profits or shareholder value, in practice good profits are necessary to buy off all stakeholders. This was well understood by Japanese management in the 1960s and 1970s when corporate growth was rapid and profit rates were high. However, in the 1980s focus on operating profits faded and return on corporate assets (ROA) declined significantly. The continuing rise in land and stock prices, culminating in the boom of the late 1980s, flooded companies with paper capital gains. These not only provided the resources to continue satisfying stakeholders but shifted management attention away from operating profits, while continuing ever-more investment in plant and equipment and R&D. Furthermore, they generated managerial self-confidence in the system that at times crossed over to hubris. Then the huge twin bubbles of stock and urban real estate prices burst at the beginning of the 1990s.

Stable Shareholding

The foremost management priority regarding shareholding was to ensure that a controlling interest was held by friendly companies – suppliers, customers, and especially financial institutions – that would not intervene in management and otherwise be passive unless called on to block a take-over. The horizontal financial keiretsu epitomized this system, which embodied considerable cross-shareholding among companies, but stable shareholding was implemented by virtually every company. At least equally important, shareholding reinforced ongoing business relationships.

The Role of Banks

Until the 1980s, bank loans were the dominant source of much-needed external finance for large companies as well as small. Relationship banking, epitomized by the main bank system, was the norm. The main bank relationship was a "more or less informal set of regular practices, institutional arrangements, and behavior that constitute a system of corporate finance and governance" (Aoki and Patrick, p. xxi). The main bank was presumed to have access to privileged information from its clients and to monitor corporate performance and behavior on behalf of all creditors. Banks could and did intervene to replace managers (Sheard), substituting for missing external markets for corporate control. However, there were few cases of large-firm failure or even major difficulties until the 1990s (Sheard; Hoshi and Kashyap, chapter 5).

Japanese banks are controlled by their management. Their shares are dispersed among a wide range of client firms, none with a significant ownership position. Even for the banks at the core of the Big Six financial keiretsu, where group ownership was 20 to 30 percent, group firms have abstained from substantial monitoring.

In the postwar system, the monitors of bank corporate governance were Ministry of Finance regulators. Highly risk averse since the 1927 banking crisis, their policy was that no bank should fail. They achieved this by restrictions on capital market development, wide regulated spreads between deposit and loan interest rates, and a convoy system in which all banks were to grow at about the same rate and the strong were to rescue the weak. It came to be very costly and even dangerous because of the forbearance it engendered (Hoshi and Patrick).

For decades the operating profits of banks have been extraordinarily low. Since the 1990s, losses on loans have been partly offset by realizing capital gains on relationship holdings of corporate shares, but depressed share prices have produced an ironic twist. Banks that repurchased relationship shares now often have losses on them!

System Overview

The postwar economic system and, indeed, Japanese society are imbued with networks of strong embedded relationships – between suppliers and assemblers, sellers and buyers, banks and borrowers, management and employees, bureaucrats and businessmen, bureaucrats and politicians, politicians and support groups, and among schoolmates. In a rapidly growing economy, good relationships build trust, reduce transaction costs, and provide incentives for specific investments and R&D activities among networks of firms. Because Japanese do not much trust outsiders – whether other Japanese or foreigners – individuals and institutions invest great time and effort to build these relationships. They become embedded in normal economic intercourse and significantly reduce the cost of doing business. The norms of relationships replace the rule of law, which mainly protects outsiders who rely more on contracts and the courts (Milhaupt, 2001). Embedded relationships lock the participants into each other; over time these become reputational, even moral, commitments. The downsides of relationships are the loss of flexibility and susceptibility to moral hazard. Breaking these relationships without strong reason means serious reputation loss; exit is difficult. Japanese managers have found it hard to terminate supplier relationships and virtually impossible to lay off workers outright.

The system worked well when the economy and companies grew rapidly. All stakeholders were being rewarded, mistakes were papered over, and the few firms that fell into distress were readily handled by their main bank and the government. While opaque, the corporate and public governance systems were widely trusted and accepted. However, successful catch-up growth eventually undermined the system. In the 1970s, domestic saving began to exceed business investment; credit became easy. Financial deregulation, first of interest rates and then of the bond market, undermined the regulatory system, and prudential regulation was not developed to replace it. The bursting of the immense urban real estate and stock market bubbles in 1990-91 created huge balance sheet problems for corporations and financial institutions. Business and government responded poorly in the 1990s, engaging in delay and forbearance in the vain hope that the economy would soon recover. Japan's mediocre growth, about 1.1 percent since 1992, and spreading public awareness of corporate and bureaucratic problems and misbehavior, led to significant erosion of confidence in management and in the postwar governance system (Fukao, 2003). It has come to be more widely accepted that good corporate governance and good economic performance have to be founded on disclosure, transparency, and competitive markets. The noblesse oblige that yoked the business and bureaucratic elites to a growing economy is now selfish vested interest that chokes Japan's recovery.

Changes in the Corporate Governance Environment

Japan is slowly but substantially transforming its corporate governance system, a process begun in the early 1990s. Each of the major elements is changing – company top management, labor-management relations, shareholders, the main bank system, capital markets, outside auditors, and government policy. Given space limitations, I focus on the current state of corporate governance without much discussion of the process of change. For my evaluation of the contemporary Japanese economy see Patrick (2003).

Government Policy

Change has been driven significantly by government bureaucrat-led reforms of corporate and related laws and institutions. The rules of the game have changed substantially, much more comprehensively so far than the way the game is actually being played. Milhaupt (2003), on which the following paragraphs are based, well describes and analyzes the formal institutional environment for corporate governance today, which has become significantly more flexible and enhancing of disclosure and transparency. He appropriately focuses on the major changes in corporate law, especially on amendments to the commercial code.

Table 1: Distribution of Listed Company Shareholding (in percent)

A. Shareholders	**1991**	**1996**	**2003**
Financial Institutions	43.0	41.1	39.1
Commercial banks	15.7	15.1	7.7
Trust banks	9.8	10.3	21.4
Life insurance companies	12.0	11.1	6.7
Other financial institutions	5.5	4.6	3.3
Securities Companies	1.7	1.4	0.9
Industrial Companies	30.1	27.2	21.5
Japanese Individuals	20.4	19.4	20.6
Foreigners	4.7	10.5	17.7
Government	0.3	0.3	0.2
B. Stable and cross shareholding[a]			
Stable shareholding (total)	45.6	43.4	27.1
Cross shareholding (total)	18.0	17.1	7.4
Banks	15.7	15.0	7.7
cross-shareholding	7.4	7.4	3.7
Life insurance companies	11.9	11.2	6.7 *
Industrial companies	14.0	13.5	10.0
cross-shareholding	9.6	8.8	3.2
related companies	3.7	4.1	6.9
Other financial institutions	4.0	3.7	2.7
cross-shareholding	0.9	0.9	0.5

* Estimated

Note: Data are for March year shown (March 1991 is the end of fiscal 1990, and so forth.)
a: Stable shareholders are financial institutions and industrial corporations that hold shares on a long-term basis for businesses and managerial relationship reasons. Cross-shareholding is a subset of firms holding each other's shares, typically banks and their corporate clients.
Sources: Nippon Life Insurance Research Institute, National Stock Exchanges.

Milhaupt categorizes these legal changes into two groups: flexibility enhancing amendments and monitoring enhancing amendments. Firms now have greater organizational flexibility in rewarding employees and in mergers, divestitures, and reorganizations. They can issue stock options. They can use share exchanges in a more permissive M&A system. The prohibition on holding companies has been eliminated, thereby promoting spin-offs, mergers, corporate reorganizations, and more diverse employment arrangements among the subsidiaries of a holding company. Firms can now buy back their shares, and issue tracking shares. The Civil Rehabilitation Act, roughly comparable to U.S. Chapter 11 of the bankruptcy code, makes possible more effective reorganization procedures, including prepackaged bankruptcies.

The legal basis for better monitoring has strengthened substantially, with important implications. The prohibitive filing fee for stockholder derivative suits against management was eliminated in 1993. The traditional insider statutory auditor system is a key institution of corporate governance; its basic function is to monitor compliance with the law. The statutory auditor system has been strengthened. Now the board of audit must have at least three members, including at least one outsider, and by 2005 at least half of the members must be outside auditors.

Reforms of corporate boards are significant in principle, if not yet in practice. Instead of the statutory auditor system, companies now can opt for a committee system of board organization based on the U.S. model, replacing statutory auditors with board committees for audit, nomination, and compensation (Nakamura). A majority of committee members must be independent directors. An executive officer system has been established for the senior managers who run the company operations but typically no longer serve on the board. This enables the board to focus on oversight and strategy, as distinct from internal supervision and operational decision making.

Corporate accounting standards and requirements have been revised significantly to bring them into broad conformity with international standards, thereby substantially enhancing transparency. Now required are cash flow statements, mark-to-market of financial assets, and reporting of pension liabilities on balance sheets. Consolidated accounting has been tightened.

Spring 2003 legislation enhances Financial Supervisory Agency (FSA) regulatory oversight and monitoring of the accounting industry, despite its desire to preserve self-regulation.

The Big Bang legislation of 1996 aimed to make capital markets "free, fair, open and competitive", and follow-on laws and newly created institutions have helped to accelerate the process of bank and corporate restructuring. These include the RCC (Resolution and Collection Corporation), the IRCJ (Industrial Revitalization Corporate of Japan), and the Civil Rehabilitation Law. The government reorganized and strengthened financial system regulatory oversight by splitting it off from the Ministry of Finance to the newly created FSA.

Shareholding and Shareholders

The pattern of shareholding is substantially different now than a decade ago. The most dramatic changes have been the declining share of commercial bank and life insurance company ownership, and the rise of foreign institutional investors and trust banks.

With declining share prices, very low dividend rates, and particularly the new mark-to-market rules, commercial banks have been under great balance sheet and profitability pressure to sell their stockholdings. This has been somewhat offset by a desire to maintain established relationships with major long-term clients. In any case, as Table 1 shows, from March 1991 to March 2003 commercial bank and life insurance companies' shares of listed companies' stock declined sharply. Trust banks increased the share substantially, primarily reflecting their pension fund management business. For all three groups, most of the change is since the 1996 Big Bang. Foreign holdings have been volatile but rising – going from 4.7 percent in 1991 to 17.7 percent in 2003.

Even more revealing and important are the declines in stable shareholding (down over 18 percentage points) and cross-shareholding (down almost 11 points). These declines are also mostly since 1996. Banks and industrial companies have sold shares in each other, though apparently the former much more than the latter. The story for industrial companies is more mixed; they have reduced cross-shareholding with banks, but have substantially increased holdings in related firms, in part because of newly listed subsidiaries. Even so, in a 1999 survey of 731 responding companies (out of 1307) listed on the Tokyo Stock Exchange first section, over 98 percent (719) indicated they had stable shareholders. For almost two-thirds**,** stable holders had more than half of all shares (Nitta).

The changing patterns of stock ownership and the new institutional environment and rules have made meaningful shareholder activism possible for the first time. One important form has been shareholder derivative suits. As in the U.S., this litigation is driven mainly by lawyer fees; shareholders have obtained few direct gains (West). However, the successful suit in 2000 against Daiwa Bank directors, resulting in an award of $775 million in damages, has had a huge shock effect. The threat of shareholder suits has significantly altered the mind-set of corporate directors and audit firms, even though business and Keidanren have now successfully lobbied for legal limitations on director liability.

Foreign investors, who have focused on blue-chip Japanese companies, particularly those with better corporate governance, also are having an impact. Japanese CEOs have begun engaging in investor relations, traveling regularly to the U.S. to meet with institutional investors. For a sample of 1100 non-financial companies listed on the first section of the Tokyo Stock Exchange in the 1990s, Ahmadjian and Robbins show that the greater the percentage of a firm's shares held by foreigners, the more likely it is to engage in the profit-enhancing activities of employee downsizing and asset divestiture. While the causal flow is not clear, they find no significant relationship between downsizing in one year and changes in foreign ownership the next; nor was foreign ownership likely to increase in troubled firms.

The Main Bank System

The heyday of the main bank system was in the 1960s and 1970s; it had weakened even prior to the late 1980s asset bubble. The burst bubble was disastrous for banks, corporate borrowers, and home owners; a huge amount of paper wealth was destroyed. From its December 1989 high to October 2003, the Nikkei 225 stock index was down almost 75 percent and had been even lower. Nationwide land prices have declined for 12 consecutive years since 1991: by 39.7 percent for residential land, 65 percent for commercial land, and even more in major urban regions.

The main bank system – indeed the entire banking system – were subject to a severe stress test and, given the balance sheet effects of the huge decreases in asset values, not surprisingly were found seriously wanting. Non-performing loans (NPLs) have overwhelmed banks; despite write-offs of some four times their capital, banks have not yet overcome their NPL difficulties. Banks do not have sufficient capital to absorb the costs of supporting the restructuring of their distressed large corporate borrowers. Their commitments have become an albatross around the necks of main banks; they certainly no longer can be effective monitors. At the extreme, zombie main banks and their zombie industrial clients are locked in a deep embrace, both staying alive by rolling over and even increasing loans, something made feasible by the extraordinary low interest rate structure.

Politicians, government bureaucrats, and bank management are all responsible for Japan's banking mess. To have been effective, main bank responsibility for restructuring distressed client companies required strong Ministry of Finance and Bank of Japan support and much larger injections of government capital than occurred. While the myth of the 1980s was that land prices would never decline, the myth of the 1990s was that the economy would soon naturally return to its growth path.

Forbearance and procrastination have prevailed because of a perverse incentive structure: politicians do not want to be accused of using more taxpayer money to bail out rich bankers; regulators do not want to admit past mistakes; bank managers do not want to lose their jobs and pensions. The 2003 Resona Bank bail-out provides a new and better model for bank restructuring. The government injected sufficient capital that Resona can write off its NPLs and restore operational effectiveness; management was replaced; a U.S.-style corporate board system with outside directors was installed; and employment is being cut and wages sharply reduced. Importantly, the Resona crisis was caused by an external auditor's tough stance. The main downside was that shareholders received a windfall rather than sharing the costs. Such makeshift and partial government policies have made for widespread moral hazards in the financial system.

It is a mistake to think that bank-business relationships will become arm's-length, and thus highly unlikely that a main bank system with pre-emptive effective monitoring of large companies will be created. Instead, serious monitoring is being undertaken by Japan's capital markets, although this is still in its early stages.

Capital Markets

Japan's capital markets are now quite well developed in some respects, but market discipline and monitoring are not yet strong. Financial deregulation culminated in the implementation of the Japanese Big Bang policy of the late 1990s to develop capital markets. Foreign financial institutions are active participants. Institutional gatekeepers – securities analysts, credit rating agencies, investment banks, and knowledgeable financial media – are increasing in number and activity. Accounting standards and auditing requirements and procedures have been strengthened. The rules and their regulation are solid. Stock prices now have an important signaling effect for investors and for company managers. However, in the mediocre growth environment, viable companies are repaying debt, and the supply of equity or bond issues is limited.

A merger and acquisition market has been developing, both between Japanese firms and with foreign firms. The most notable industries involved are banking, where mergers have created four mega-banks, and automobiles, where only two domestically controlled assemblers (Toyota and Honda) remain of eight a decade ago. However, virtually all mergers have been friendly. There have not yet been any successful hostile take-over bids or shareholder proxy fights. But, unlike a decade ago, they are now thinkable. The failure of Yoshiaki Murakami, a shareholder activist, to win a second, widely publicized proxy fight against Tokyo Style Company in spring 2003 is suggestive both of continuing obstacles and future trends. Tokyo Style is an apparel company with huge cash reserves and a stock price below its cash-equivalent holdings. Despite the economic logic of a huge dividend or a major stock buy-back, the company's banks and domestic institutional investors sided with management.

Japanese institutional investor activism in corporate governance is nascent but gradually increasing. Even more than in the United States, Japanese institutional investors vote with management. The U.S. Pension Fund CalPERS is actively promoting its corporate governance guidelines in Japan, but it has no Japanese counterpart yet. The closest is the increasingly active Pension Fund Association. It has promulgated guidelines for its 1700 members which emphasize shareholder value and urge members to vote proxies accordingly.

In 2002 CalPERS invested $200 million in a corporate governance-oriented fund with Shuhei Abe's SPARK Asset Management Company and, in 2003, $200 million in the $1 billion U.S.-based Taiyo Fund with Wilbur Ross to employ friendly approaches to corporate governance to build value in listed Japanese companies. Morningstar Japan has created an index of 150 socially responsible firms. While their quantitative impact is limited, these activities receive considerable publicity and are influencing the mind set of market participants.

West and Milhaupt have noted the quite successful activist role of a non-profit corporate reform organization called Shareholder Ombudsman, which has been involved in high profile shareholder derivative suits, and has negotiated substantial monetary settlements and management commitments to improve practices. This organization has not sought publicity, but Milhaupt argues that managers cannot afford to ignore it.

The capital market still has major lacunae. As the Tokyo Style case attests, there is not yet a market for corporate control. This is despite the fact that a number of companies have a market capitalization below their ready bust-up value. Persistent stable shareholding is part of the reason. Another has been the ongoing predilection of domestic institutional investors to support incumbent management regardless of its performance. Further, the corporate bond market does not price risk adequately. Spreads are quite narrow, a high yield (junk) bond market is only nascent, and banks have not yet developed a loan market charging higher rates to riskier borrowers. Their dilemma is that, should they set interest rates realistically based on creditworthiness, many of their borrowers would go bankrupt. Neither the banks nor the politicians can afford that.

The Permanent Employment System

Poor economic growth and the need by firms to cut costs, downsize, and restructure have sharply reduced the demand for labor, while the supply has continued to increase. Unemployment has risen to an unprecedented 5.3 percent; but that is not the full story. Participation rates have fallen as potential workers have withdrawn from, or never entered, the labor force. Part-time workers have gone from 4.7 million in 1990 to 12 million today, some 23 percent of those employed. Firms have had to go beyond the traditional adjustments of overtime reduction, elimination of contract and temporary employees, and dispatch of workers to affiliated firms.

For many companies, downsizing requires more than attrition. For legal and reputational reasons, firms have not been able simply to lay off workers. Rather, they have pressured worker early retirement or “voluntary” separation by providing buy-outs. The specifics have been worked out in close consultation with the enterprise unions, and there has been virtually no overt labor strife, despite substantial discontent. This gradualist, expensive approach reflects management’s continuing commitment to its regular employees. Senior managers have been particularly concerned about their eventual successors – employees on the management track. This process of downsizing of employment is seen by some as the deinstitutionalization of the permanent employment system (Ahmadjian and Robinson). Others argue that the system is adjusting but has not fundamentally changed (Kato).

It is too early to determine what will happen to the permanent employment system. Wages and promotions will be based more on merit rather than seniority. Many of today's young college graduates do not believe that a company's permanent employment commitment is credible; they expect to shift from one company to another over time as opportunities emerge. I think the permanent employment system will persist in modified form, in part because the inevitable reductions in the number of Japanese of labor force age, a demographic given, will create labor shortages by the end of this decade if the economy succeeds in achieving sustained growth.

Outside Auditors

In addition to its statutory auditors, companies are required to use outside auditors to certify their financial statements. Auditing firms can no longer afford to be accommodating of management interests. The Enron and Arthur Andersen collapses shocked Japan's auditing profession. Closer to home, in early 2002 Ohta-Showa Audit Company had to pay a substantial fine to the FSA for its mishandling of Long-Term Credit Bank audits. Under revised rules, since March 2003 auditors are required to declare whether a client faces serious risk of going bankrupt within a year, and can be sued if they mislead shareholders.

The May 2003 decision of the auditors not to allow a full five years of Resona Bank deferred tax assets to count as capital was dramatic. It meant that Resona was below the 4 percent minimum capital requirement for domestic banks. Unable to raise further capital privately, Resona had to request a capital injection from the government, with all that entailed.

Suddenly auditors became major players in the governance of distressed banks and other companies.

<u>Corporate Management Responses</u>

Japanese management is on the defensive. Its leadership and corporate governance are under challenge due to sustained poor performance, exacerbated by some highly publicized scandals. What has emerged is a lively debate and a fascinating clash of views and policy proposals between a few business leaders who actively seek to change Japanese corporate governance to a much more market-based, American-type system and those leaders, skeptical of American corporate governance in practice, who want to improve the existing Japanese system. The debate centers on two issues: for whose interests does the company exist; and who should be responsible for monitoring the company's operations?

Yoshihiko Miyauchi, chairman and CEO of Orix, epitomizes those pushing for a major transformation of Japanese corporate governance. In 1999 he stated: "We aim at a stockholder's capitalism that brings long-run benefits to stockholders, not short-term ones as in the United States" (Takahashi). He has arranged programs to train Japanese in their proper roles and responsibilities as potential outside directors. Not surprisingly, the leaders of some of the blue chip companies in which foreign shareholding is highest are among the most outspoken proponents of change. At the same time, some of Japan's most successful companies are headed by defenders of the current system. Thus, Hiroshi Okuda, chairman of Nippon Keidanren (the Japanese Business Federation) and former president of Toyota Motor Corporation, and Fujio Cho, current president of Toyota, affirm that a company's primary commitment is to its employees. Toyota, however, is such an exceptionally successful company that some argue it cannot be a role model. Nonetheless, other business leaders such as Fujio Mitarai, president of highly successful Canon Inc., also defend the current system.

One test will be the number of companies that choose to shift to the new option, as of April 2003, of a committee-based board embodying a significant role for outside directors. In their first opportunity (in most cases the June 2003 shareholder annual meetings), 36 firms adopted the committee-style system; 5 have more outside than internal directors, and in another 5 the numbers are equal. Some companies indicated they switched in order to enhance transparency and attract foreign investors. Others, such as Hitachi, did so to reinforce control over group firms; current or former executives from the parent company are being made as outside directors of 18 listed group companies. Several of the companies have come under foreign control (Nikkei net Interactive).

Some business leaders suggest the number of companies adopting the committee-based system will be about 125 by 2005. That will still be small relative to the total of some 2500 listed companies. About 24 percent of Japanese listed companies surveyed now have at least one outside director and that number will increase; nonetheless managers continue to be very reluctant to share much power with outsiders. And, as in all countries, an ongoing issue is how independent outside directors really are.

The trend to reduce board size sharply and create an executive officer system is accelerating. Even Toyota reduced its board by more than half in 2003. As of early 2003, 34.2 percent of listed companies have adopted the executive officer system (Michael Solomon Associates). However, establishing this system is motivated predominantly by efforts to increase management oversight efficiency; it has a limited effect on corporate governance. Many firms and their peak organization Nippon Keidanren are focusing on improvements in internal auditing, control, and ethical behavior, which are termed internal corporate governance (Ito).

Overall, corporate governance reform seems to have been driven primarily by legal and institutional reforms rather than a fundamental change in management mind set, at least so far. So, whether it wants to or not, management has to be much more responsive to shareholder interests due to greater disclosure and auditing requirements, the threat of being sued, and the embarrassment of a hostile proxy fight.

In fiscal 2002, 783 firms announced plans to buy back up to ¥9.7 trillion ($88.2 billion at ¥110/dollar) of their shares and actually repurchased ¥2.8 trillion. Close to 800 firms have announced repurchases during fiscal 2003 of ¥7.3 trillion. Nippon Life, Japan's largest insurance company, has taken an activist position, pressing firms with cash surpluses to carry out buy-back programs and to increase dividends, threatening to raise the issue at the 2004 shareholder meetings. Some firms are beginning to use stock options to align managerial and shareholder interests; however, given unattractive American experience, they are cautious. It will be some time before stock options become important in aligning management and shareholder interests.

Aside from those companies and financial institutions in severe financial distress, Japanese management remains firmly entrenched. Firms going through re-structuring or work-outs will see some management personnel changed. Their corporate governance will surely improve. But, unless the firms become foreign-controlled, it is not likely their fundamental commitments to regular employees and internal directors will change substantially.

The moral hazards of the Japanese corporate governance system are quite different from those common in the U.S. Thus, for example, Japanese firms do not pay extravagant compensation to top management. While American managers may steal from the company, Japanese managers steal *for* the company. One form of moral hazard in Japan is that middle management expends considerable effort to protect the CEO and senior management from exposure of company mistakes or personal scandal. This opaqueness has its costs, as gangster blackmail has demonstrated. There are two fundamentally more important moral hazards. First, management has had a proclivity to invest surplus cash in new projects, seemingly regardless of profitability. Second, managers of firms in serious difficulty keep current employees far too long, thereby significantly eroding the value of the company, the firm's future, and the prospects for both current and future employees. And, as the company deteriorates, they do not replace themselves with managers who are given a mandate to carry out the needed reforms.

Conclusion

The answer to all the questions posed at the start of the chapter is "to some extent, and in quite Japanese ways." This is because there is no monolithic Japanese corporate governance system today and there will not be in the future. Different firms will have different corporate governance systems, depending on their histories, ownership patterns, and leaders. This chapter is about the large subset of listed firms in which ownership and control are separated. Within this group, the variance of corporate governance arrangements will be substantially wider than in the past.

First, one major lesson of the past decade for Japanese management is that it is essential to restore the early postwar understanding that profitability is very important. Often better corporate governance is a code phrase for better corporate profitability. Only by earning profits can management buy off employees, shareholders, and other stakeholders, and thereby stay in power. All firms will come to give substantially greater weight to shareholder interests, but only a few firms will make maximization of shareholder value a primary objective. The important weight given to the interests of regular employees will persist. This will be reinforced by the return to labor market tightness as the economy achieves its growth potential and as labor force numbers decline absolutely.

Second, one or even several outside directors will come to serve on most corporate boards, but in only a few companies will they constitute a majority. The value of outside directors will continue to be founded on their independent views and judgment based on their own career experiences and their relationships, aside from the token symbolism for good corporate governance. I doubt that more than a modest minority of Japanese companies will adopt the U.S.-style committee-board system, since it bestows far greater power on outside directors.

Third, the main bank system has been found wanting in the severe stress test it has undergone from the early 1990s, and it is unlikely to play a major monitoring role again for most listed companies. Of course, some companies with traditional relationship affiliations, symbolized by the keiretsu, will continue to rely significantly on bank finance, though the degree of bank monitoring power and capability is uncertain. Regulatory forbearance and expanded safety nets not only for depositors but apparently shareholders have exacerbated and lengthened the duration of financial system weakness.

Fourth, a market for corporate control will emerge, and that will have important psychological effects. What is needed is the first success. There are a number of potential prospects. Hostile bids will have to be led by Japanese; behavior by the creditor banks will be one key. However, rather than a plethora of overt hostile take-over bids, I anticipate that concerned parties will negotiate arrangements to improve corporate performance and governance.

Fifth, financial market discipline has never been strong, kept weak first by successful growth and now by Japan's persistent lack of aggregate demand and poor economic performance. Nonetheless, there have been and will continue to be significant improvement in capital market institutions and investments, and prices are coming to play a significant monitoring role. Most directly benefiting will be the overlapping group of companies with large foreign institutional shareholding, subject to international competition, and adopting the committee board system.

The greatest improvements in Japanese corporate governance thus far have been substantially enhanced disclosure and transparency. These have been mandated by legal reforms. Capital markets still have a long way to go to have significant monitoring impact on most companies.

I do not expect the institutions of the postwar economic system to collapse or disappear. My judgment as to what will happen includes the following. The permanent employment system will rely less on seniority, more on merit, but the corporate commitment to permanent employment (to age 60) will endure. Employees may feel less committed to the firm than before, but commitment will increase with years of service; labor markets for middle-aged and older employees are not likely to become a great deal more flexible. Good relations between management and worker representatives will continue to be important, pragmatic, and relatively harmonious. Companies will still want to maintain good relationships with banks and vice versa; bank provision of financial services will increase even as their loans decrease. Unless a company does so poorly that it is taken over, its self-perpetuating management system will continue to be entrenched.

Japan is not going to embrace the Anglo-American governance model: after all, it is under attack at home and how the reformed system will work is not clear. Rather, I think Japanese firms will, slowly, continue to adopt (adapt) market-oriented approaches while seeking to retain the goals, if not the practices, of the postwar economic system. In short, the wise Japanese management today is engaging in corporate government reforms that do not fundamentally reduce its entrenchment, while enabling the firm – and thus *all* its stakeholders – to be more successful in the long run.

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