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Reforming Japan's Corporate Governance System: Will the Markets gain Control?

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1. Abstract

Issues of corporate governance have become a major center of attention worldwide both, in the academic world of economics, managerial and legal

science as well as in the "real" world of management, legislation and politics. The discussion encompasses a broad and complex spectrum of issues, starting with normative questions of ownership and control of modern corporations and ending with highly practical matters such as the enforcement of bankruptcy rules. The design and functioning of corporate governance systems have a strong impact on decisions of individual investors, and thereby the access to and the cost of financial funds for companies as well as the allocation of capital in an economy.

Based on the narrower perspective of the finance model of corporate governance and within the analytical framework of institutional economics, this paper attempts to analyze the characteristic features of Japan's system of corporate governance, its deficiencies and disfunctionalities which became apparent since the middle of the 1980s and the emerging directions and patterns of its reform. By giving a concise survey of the established literature on the Japanese governance system it is argued that the Japanese system operated for a long time under the economic logic of networks, combining effectively market forces of control with mechanisms of balancing power under the main bank regime. Changes in the regulatory framework, particularly in the patterns of corporate finance and in the functioning of capital markets have, however, caused a decline of network cohesion and led to a hollowing-out of the mechanisms of control. At the same time, growing pressures from product and capital markets to enhance corporate performance and shareholder value call for a fundamental reform of the Japanese corporate governance system. In this paper the argument is made that--within the general tendency towards a stronger voice by institutional investors--the prevailing network governance system is loosing its clout, while three distinct patterns of reform of the Japanese corporate governance system are emerging: Global, independent firms with direct access to global capital markets seek strong relations with institutional investors and open their internal control systems; in firms with high financial leverage and a strong dependence on indirect finance, banks are expected to seek an enhancement of their power base through stronger ties; in young growth industries the (slow) development of an active market for corporate control is expected. The discriminating factors which determine these patterns are the type and ratio of equity ownership concentration and the leverage of corporate debt. These arguments are still rather speculative and it is too early to draw conclusions on which pattern of reform will become the mainstream mode of future Japanese corporate governance, mainly because the direction of the legal reforms in the regulatory environment is yet unclear.

2. 2. Modes of corporate governance--An analytical framework

The objective of this chapter is to introduce a theoretical framework which guides the analysis of Japan's corporate governance system, its apparent deficiencies and the emerging directions and patterns of its reform. It also helps to put the features of Japan's corporate governance system into an international, comparative perspective.

First of all, the analysis proceeds from the normative perspective of the so-called "finance model of corporate governance". In contrast to the so-called "stakeholder model of corporate governance" the modern joint stock corporation is not viewed as a coalition of various groups such as shareholders, employees, creditors, consumers or communities holding stakes in a company which need to be enforced and balanced by means of a governance system, but as a legal entity which is managed by professional managers who use various forms of financial funds from suppliers of finance to operate the firm.[1[1]] As suppliers of equity finance, shareholders have a special position, because they--as the legal owners of the firm ("principals")--have formerly delegated management responsibilities to professional managers ("agents"), but bear a limited, yet final liability for the firm; this in turn entitles them to claim the right for residual control and profit of the firm.[2[2]] The key issue of corporate governance is, therefore, to design institutional, economic and legal mechanism which assure all suppliers of funds, and in particular shareholders, a return on their investment. This is a highly complex task due to three interrelated problems:[3[3]]

- - information asymmetries: Managers have better access to information about the firm than the suppliers of finance. As the private interests of suppliers of finance and managers are likely not to be the same, managers

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[1[1]] The "coalition or stakeholder model" has a strong tradition in the German managerial literature, e.g. Steinmann (1969) and Witte(1978), while the "finance or shareholder model" is firmly rooted in the Anglo-American management science, e.g. Berle and Means (1932), Jensen and Meckling (1976), Fama (1980). For an overview see Blair (1995), p. 1-17.

[2[2]] This so-called Berle-Means-Model is, of course, a highly simplicistic view of the modern corporation, which ignores essential elements such as the role of debt, ownership structure, institutional investors, limited liability etc.. While the separation of ownership from control can be considered to be the very root of governance problems, they also relate to other suppliers of finance, e.g. creditors. Despite certain conflicts of interests between equity owners and creditors, I will broadly use the term "suppliers of finance" instead of only speaking of "shareholders", because from the viewpoint of corporate governance debt in some circumstances plays a major role in the governance of a firm. For a detailed discussion see: Williamson (1988); Blair (1995), p. 17-121.

[3[3]] Jensen and Meckling (1976), p. 305-312; Shleifer and Vishny (1997), p. 737-748.

may be induced to misuse their information advantage for own benefits when using entrusted financial resources. Other than simple expropriation, typical examples for the misuse of funds by managers are the waste of free cash flow in projects with low returns[4[4]] or investments into projects which lead to management entrenchment.[5[5]]

- - incomplete contracts: Suppliers of finance may try to design contracts which bind the managers to their interests, but due to future uncertainty it is impossible to design complete contracts which cover all eventualities. This leads to a more or less significant degree of discretionary decision power in the hands of managers.

- - agency costs: Various types of costs arise when trying to align the interests of suppliers of finance and managers and to control management behavior. The lower the share at stake, the less is the motivation of the supplier of finance to bear these agency costs, and the higher the incentive to free ride on control efforts by others ("rational abstinency"). Typical agency costs are incentive contracts which align managers interests to the interests of the suppliers of finance ("signalling or bonding cost"), costs for ex-ante information gathering on investment projects ("screening costs") and cost for the supervision of the management ("monitoring costs"). In addition, the higher the financial stake of an investor, the higher are the opportunity costs due to non-diversification of funds.

In summary, governance problems arouse from the fact that--due to information asymmetries and incomplete contracts--managers have a substantial degree of discretionary power which they may misuse to the disadvantage of the suppliers of finance. Yet, efforts to design and enforce mechanisms of control to lower and/or limit these risks are costly and tiresome. The key issue of corporate governance is, at its heart, to develop regulatory and organizational modes which motivate suppliers of finance to provide financial resources to a firm despite the existence of certain costs of governance.

[4[4]] This is often the case when firms in mature industries diversify into unrelated industries. See Jensen (1986).

[5[5]] This refers to manager-specific investments where their return depends to a high degree on special skills, knowledge, etc. of the manager, making it costly to replace the manager or enabling him to extract higher benefits from the firm. See Shleifer and Vishny (1989).

In such a world of information asymmetries, incomplete contracts and various agency costs, the actual mode of a governance system--and thereby the mode of capital allocation--is largely influenced by the regulatory environment under which it has to operate. This is due to the fact that the regulatory environment, as it is institutionalized in the legal system, regulations for capital markets and the like, has a profound impact on the level of information asymmetries and the actual nature of agency costs. Furthermore, the history of a regulatory framework also matters, as former political decision determine the spectrum of choices and the "path of development" for a specific mode of governance.[6][6]

In a recent publication, Dietl develops and tests a theoretical model to explain the prevalence of different organizational modes of corporate governance and capital allocation in industrialized nations by arguing that differences in regulatory regimes, on the one hand, and specific characteristics of an investment relation, on the other hand, lead to inefficiences in capital markets; the existence of different modes of governance can be interpreted as different organizational responses to efficiently cope with these inefficiences.[7] [7] The regulatory regime characterizes the basic stance and regulatory focus which underly the design of a system of corporate governance. Dietl develops a dichotomy of regulatory regimes, the neo-classical regime and the relational regime.[8][8] The regulatory focus of the neoclassical regime which roots in the classic theory of efficient capital markets[9] [9] lies on the enhancement of the allocative efficiency of capital markets by assuring best access and availability of information and by seeking to reduce possible insider information and rents. The relational regime argues that market imperfections impede the efficient functioning of capital markets and, therefore, places the focus on enhancing the efficiency of market coordination and governance by reducing governance costs and by fostering investment into information-seeking. Both regimes mark the ends of a continuum and differ in practice in respect to accounting and disclosure rules,

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[6][6] The notion of "path dependency" plays an growingly important role in recent theories on corporate governance. See Roe (1997), Aoki (1993), p. 17-21.

[7][7] Dietl (1998), p. 4-110. The relation between a firm and its suppliers of finance constitutes an investment relation. In his model, the nature of this relation is determined by two variables: (1) the level of industry maturity which influences the stability and predictability of the investment environment; (2) the plasticity of an investment project which depends on the range of investment alternatives and the degree of complexity of information required for decision making. In conjunction, these variables determine the characteristics of the information of a specific investment project.

[8][8] Dietl (1998), p. 12-26.

[9][9] Fama (1970)

insider regulations, (anti-) takeover rules, regulations on market interference, diversification requirements of institutional investors and restrictions for bank activities. Based on this framework Dietl elaborates six main types (plus 6 subtypes) of organizational modes of corporate governance and capital allocation [10[10]] and analyzes each type in respect to its specific investment relation costs resulting from the generation and use of information/knowledge, the level of risk diversification and the level of agency problems. Dietl concludes that the cost efficiency of each mode of governance is not absolute, but relative depending on the specific characteristics of the regulatory environment and the nature of the investment relation.

My own analytical framework builds substantially on the model of Dietl, particularly on his elaborations on regulatory regimes and the essential role of information for an investment relation and its governance. However, while Dietl argues from a birdseye perspective by analyzing various modes of governance under differing regulatory regimes in respect to their relative efficiency for capital allocation and governance, I take the perspective of the supplier of finance. I argue that a specific mode of governance reflects an economic choice of the suppliers of finance, who seek to balance their governance efforts and costs with possible governance benefits or rents under a prevailing regulatory regime. A supplier of finance is the more willing to invest in governance, the more he can expect certain exclusive benefits such as insider rents. In turn, the higher the expected benefits, the higher will be the amount of funds a supplier of funds is willing to invest. As regulatory regimes differ in the acceptance or encouragement of exclusive information rents and the compensation for costs of governance and risks of non-diversification, differences in the mode of governance, in the extent of actual governance activity and in the concentration of ownership can be expected as a natural result.

Furthermore, the various modes of governance described by Dietl can be interpreted as mechanism which differently combine market-based elements of governance and hierarchy-based elements of governance. The governance mode of unintermediated capital markets, for example, is largely built on the governing effects of the generation and utilization of highly transparent, objective and scattered information which are transmitted and digested

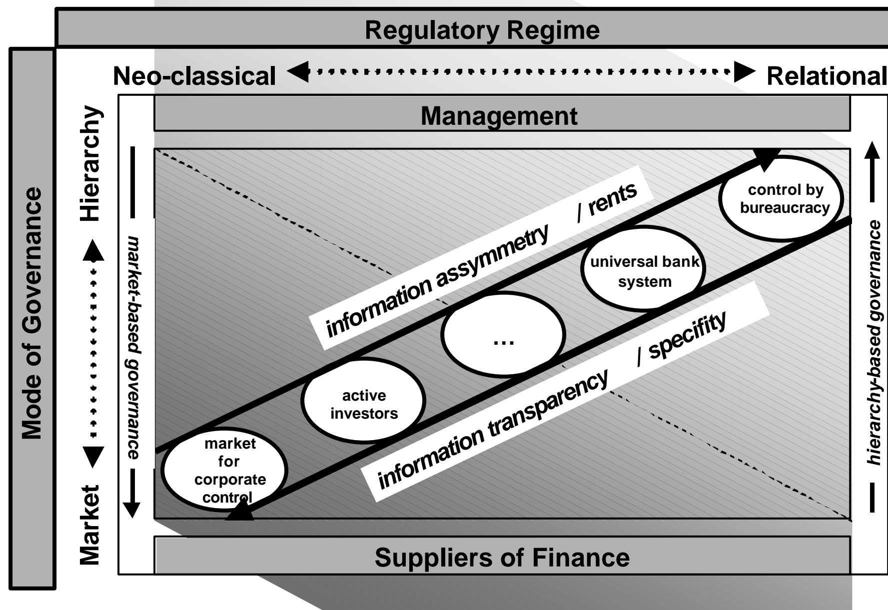
[10[10]] The main types are unintermediated capital markets, capital markets intermediated by investment trusts or banks, holding companies, multidivisional organization, leveraged buyout associations, financial *keiretsu*. See Dietl (1998), p. 26-92.

through the price mechanism of wide and deep stock markets. The governance mode of the universal bank, as another example, requires a few, highly exposed banks to become actively involved in governance affairs on various level of hierarchy and company processes, while market mechanisms of governance play a less significant role.
This distinction between market--and hierarchy-based modes of governance draws its basic notion from transaction cost theory by arguing that information can be treated like an asset. The higher the relevance of insider information and information asymmetries the higher is the degree of "information asset specificy". It is a standard argument in transaction cost economics that the coordination of projects or tasks which are characterized by a high degree of asset specificity is more efficiently achieved by means of a hierarchical organization, while projects or tasks with low asset specifity are best coordinated by means of the market price mechanism.[11[11]] In this sense, regulatory regime which foster a high degree of information asset specifity are likely to result in modes of governance which rely of hierarchy-based elements of governance, while market-based modes of governance flourish under a regime which constrains information asset specifity. A high degree of information asset specifity justifies investment into hierarchy-based modes of governance, because substantial exclusive rents can be expected. If such kind of rents diminish due to the prevailing regulatory regime, market-based modes of governance which assure access and transparency of information are better equipped to attract suppliers of finance.

Markets and hierarchy mark the two extreme ends of a continuum which describes possible mechanism or modes of governance. The purest form of governance is an unintermediated market for corporate control under a neoclassical regulatory regime. The more the regulatory environment is based on notions of the relational regime, the more important become information asymmetries, information asset specifity and possible information rents and, as a result, more and more elements of hierarchy-based governance are incorporated. Therefore, in reality modes of governance combine both, elements of markets and elements of hierarchy, though in varying proportions. These theoretical considerations are summarized in the following chart which serves as the basic analytical framework of this paper.

[11[11]] Williamson (1985); Kay (1997), p. 33-56.

Chart 1: Market- and Hierarchy-based Corporate Governance



This framework enables us to plot and compare different mode of corporate governance by applying a consistent set of criteria. For example, it seems plausible to describe the American model of active investors as a highly market-oriented mode of governance with limited information asset specifity. [12 [12]] Strict insider regulations and requirements for extensive disclosure of information serve as the base for a highly liquid, deep and transparent capital market where share price information function as the main means for governance. The board of directors, a hierarchical element, incorporates market mechanisms by assuring a dominant role of outside directors. Professional managers are tied to the shareholders interest by market-based incentives such as stock options. The emergence of active institutional investors, usually pension or mutual funds who engage in stable shareholding relations with a firm, reflects an increase in the importance of hierarchy-based mechanisms of governance. These investors invest heavily in thorough data research and field analysis, but expect direct access to the management and to company information. The continued concern of managers with investor relations such as road shows etc. can be regarded as addititional organizational (= hierarchical) attempts to provide exclusive and specific information to these type of investors.

[12[12]] For a comparative analysis of the US, German and Japanese system of corporate governance see Dietl (1998); Roe (1994)

The German universal bank system can be regarded as a predominantly hierarchy-based mode of governance developed under a highly relational regulatory regime. The German system employs high-powered organizational elements by clearly separating the functions of strategic decision making and management control from implementation responsibilities. The former rest with a strong supervisory board ("Aufsichtsrat") who controls the management board ("Vorstand") responsible for implementation. Banks play a central role as the dominant shareholders with significant powers in the supervisory board. It is widely assumed that German bank possess an intimate knowledge about company affairs and are involved in corporate decision at an early stage. [13] [13] Furthermore, the dominance of debt finance in Germany opens up new channels of proprietary information for the banks as the leading creditors.

These distinct differences in the mode of corporate governance in Germany and the United States are reflected in similarly distinct differences in the structure and concentration of ownership and the concentration of power in corporate institutions of governance.

Table 1: Structure of equity ownership

	Japan (1994)	Germany (1990)	USA (1992)
Households	23.5%	17%	***49.8%***
Financial Institutions	***40.6%***	***32%***	5.6%
Banks	22.2%	10%	0.3%
Insurances	17.0%	12%	5.0%
Security Brokers	1.4%		0.3%
Pensions Funds	1.6%	n.a.	***29.2%***
Investment Funds/Trusts	2.6%	n.a.	9.0%
Corpoations	***23.8%***	***42%***	n.a.
State	0.5%	5%	0.0%
Foreign Investors	7.4%	14%	6.3%

Source: Dietl (1998) S. 123

Table 2: Share in voting rights of top shareholder

Voting Share	Japan (1995)	Gerrmany (1994)	USA (1994)
0 % - < 10%	***61.1%***	3.2%	***66.0%***
10% - < 25%	21.3%	6.9%	17.4%
25% - < 50%	12.9%	16.7%	13.0%
50% - < 75%	4.7%	***31.9%***	2.1%
75% - < 100%	0.0%	***41.3%***	1.5%

Source: Dietl (1998) S. 124

[13][13] The recent biography of Edzard Reuter, former CEO at Daimler Benz (now Dainler Chrysler) draws a vivid picture about firm-bank-relations in Germany. See Reuter (1999)

In the United States, private households are the dominant group of shareholders, while in Germany financial institutions, mainly banks, and corporations hold the majority of shares. The concentration of ownership, reflected in the concentration of voting power in the hands of the top shareholder, reveals a high level of fragmentation of power for the United States, and a equally high level of concentration of power in Germany.

It is interesting to note that in terms of ownership structure Japan resembles Germany, with financial institutions as the main shareholder group, while in respect to the concentration of ownership, and thereby power for control, the situation is similar to the United States with a comparatively low level of ownership and voting power concentration. It is the subject of the next chapter to analyze this--at first sight--rather peculiar result.

3. 3. Japan's "network" mode of corporate governance

In this chapter I conclude that Japan's mode of corporate governance can be characterized as a governance mode following the logic of "networks" which mixes hierarchy-based and market-based elements of governance under the conditions of a hybrid regulatory regime.

In Japan, the mixture of mainly German and American legal tradition has resulted in a regulatory regime combining neoclassical and relational elements. The legal foundations for Japan's system of corporate governance are mainly laid down in the Commercial Code (*shoho*), the Securities and Exchange Law (*shoken torihiki ho*), the Accounting Report Amendment (*shoho tokurei ho*) -an amendment to the Commercial Code regulating special disclosure and auditing requirements for large joint stock corporations--as well as a number of ordinances by the Ministry of Finance.[14][14] Taken at face value, many of these regulations follow the ideals of the neoclassical regulatory regime. For instance, the segregation of banking and investment business has restricted the emergence of an universal banking system, diversification requirements for bank and

[14][14] Kawamoto (1994), p.58-144; Schaede and Baum (1994), p. 611-627.

institutional investors restrict a concentration of ownership at financial institutions, laws against market manipulation basically protect investors rights, and the auditing and disclosure requirements by the Security and Exchange Law increasingly adopt US standards of shareholder-oriented financial reporting.[15 [15]] And according to the Commercial Code, the corporate institutions of governance follow in general the model of the US board system. Shareholders enjoy important basic control rights and protection of minority rights, while the Board of Directors (*torishimariyakukai*) has strong powers to decide on the company's strategic direction, to ensure it's implementation and to control and monitor the management entrusted with the implementation of company policies. In addition, the auditor (*kansayaku*) or--in large companies--the auditing committee (*kansayakukai*) has significant formal powers to check the actions of the Board of Directors.

Yet, when looking closer, many regulations bear substantial elements of a relational regulatory regime. For instance, the auditing and disclosure requirements stipulated in the Commercial Code leave firms with substantial room for discretionary action, lead to ambiguity in Japan's financial statements and are an important cause for information asymmetries. Often cited examples are the widespread valuation of assets at book value which lead to substantial hidden reserves (*fukumi*), the limited disclosure of pension liabilities, or the underdeveloped refinement of consolidation rules which allow companies to shift profits or losses rather freely within a group.[16[16]] Also, the formulation of stricter laws against insider tradings are a rather recent development.

By far the most obvious examples for elements of a relational regulatory regime are, however, laws like the Banking Law (*ginkoho*) and the Foreign Exchange and Trade Control Law (*Gaikoku kawase oyobi boeki kanriho*), which -through their profound impact on the respective roles and functioning of Japan's credit and capital markets--have shaped the actual mode of Japan's corporate governance to a substantial degree. The classification of bank licences in terms of short--and long-term credit finance, regional coverage and along specific types of business or customers have led to a strict segmentation of credit markets. Combined with the

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[15[15]] Dietl (1998), p. 132-140.

[16[16]] Since fiscal year 1999, and particularly from fiscal year 2000 on, substantial tigthening of accounting principles and disclosure requirements are likely to increase the validity and transparency of Japan's financial reports. See: The Diamond Weekly of 23.10.1999.

general segregation of bank and investment business, the strict control of foreign capital flows and interest regulation until the 1980s resulted in a credit-based, bank-dominated financial system which channeled private savings into the banking sector, instead of developing deep and liquid capital markets. While the liberation of capital markets since the early 1980s stimulated a significant growth of equity and bond markets in Japan, strict regulations to curb competition as well as discretionary interventions by the Ministry of Finance such as stock price keeping operations impeded the development of open and transparent capital markets in the neo-classical sense.
Yet another important feature of Japan's relational regulatory regime has been the strong cooperation between the government, the bureaucracy and big business. These cooperative relationships have -among others--fostered business structures characterized by extensive, horizontal and vertically-structured networks between companies. The role and economic weight of these networks, in particular in form of the large *keiretsu* groups, is a widely acknowledged, well documented and studied phenomenum of the Japanese economy and business system.[17][17] A key supporting element within these networks are capital ties between group members, which usually are small, but stable and quite often reciprocal. In aggregation, however, this leads to the fact that a large number of equity shares of Japanese companies are not traded on the market, but in the hands of stable, friendly shareholders such as business partners and group members. Although definitions and data vary in detail, it is safe to assume that--until very recently--cross-shareholdings (*mochiai*) amounted to 10-20% and stable shareholdings to 40-50% of all equity shares in Japan.[18][18] Stable and reciprocal equity ties rest upon an implicit, mutual understanding not to sell shares and are designed to cement tight, long-term commercial relationships between customers, suppliers and their business partners and to foster mutual trust.[19][19] While networks explicitly or implicitly are based on an economic rationale such as lowering transaction costs or allowing for flexible, implicit contracting, they also pose strong barriers against takeovers and impede the liquidity and transparency of capital markets.

Taking all these features of Japan's hybrid regulatory regime and the resulting nature of its business system together, it can be concluded that the existence of substantial information asymmetries and potential for insider

[17][17] For example: Aoki (1994), Fruin (1992), Gerlach (1989), Imai (1994), Nakatani (1984)
[18][18] Nissei Kiso Kenkyujo (1999), Hoshi (1994), p. 287-291.
[19][19] Kester (1991), 53-67.

rents characterize the investment relation between suppliers of finance and firms. This, in turn, deters individual investors like private households to invest in stock markets. At the same time, financial institutions and institutional investors like life insurances and trust banks with only limited stake in a firm have only limited incentive to engage in active governance, while banks through their extensive credit business enjoy significant insider knowledge which justify investment in goverance efforts. These features of investment relations in Japan find an expression in the above mentioned structure of ownership and concentration of voting rights. In a typical Japanese corporation, private households hold less than 20% of the equity, while financial institutions and--in some cases--companies form the dominant group of shareholders accounting for a 60% or more share of equity holdings. Most often, the top 10 shareholders are comprised by institutional investors like life insurances or trust banks with an average share of 5-10%, and banks with an average share of 2-5%. With the obvious exception of subsidiaries of industrial companies, there rarely exists a dominant shareholder, but a major share of equity is held in a few and stable hands of financial institutions, non of which commands a dominating vote. These features have a distinct influence on the actual mode and functioning of Japan's system of corporate governance, to which prominent authors on Japan's business system often refer to as the "main bank system of contingent governance". [20 [20]] Three core elements, often referred to as "stylized facts", constitute this mode of governance:

- a nexus of bank-firm-relationsships
- reciprocal delegation of monitoring functions between main banks
- discretionary interventions by the financial bureaucracy

A nexus of bank-firm-relationsships

[20[20]] Aoki/Patrick/Sheard (1994), p. 5-35; Sheard (1989), Sheard (1994), Hoshi (1994) There is also a strong argument that–under the conditions of an internal labor market- Japanese corporations are managed and controled in the interest of their employees to maintain employment security. Aoki speaks of a "dualistic" mode of governance by banks and employees. However, while in Japan considerations of employment security surely rank high among management objectives, employees do not have any formal and informal channels or mechanism of significant substance to exert actual control on management. There is no formal representation of employees in the decision-making bodies of a company (like in Germany) and weak labor unions, autocratic practices in human resource management, the social importance of seniority and the limitations for an "exit option" on a developed labor market seem to curb the power base for employees. On the contrary, these features rather represent mechanism with substantial force to align employee interests with the interests of the company. See Aoki (1994); Abegglen (1985); Miwa (1998).

Within the above mentioned networks the main-bank-relation plays a pivotal role. A firm and its main bank a tied together by a complex nexus of relations. The main bank ranks among the top shareholders and holds the largest share among other bank shareholders. A firm can usually look back on a longstanding credit relation with its main bank which most frequently acts also as the largest creditor of short-term funds. The main bank administers the deposit and cash settlement system (*kessai yokin/toza yokin*) of the firm, handles payments and promissionary notes, and provides various business services. In line with the liberalization of financial services, the main bank has developed a substantial fee-based business with its firm, for instance by acting as trustee for bond issues or as co-leader in case of foreign currency denominated bond emission and the like.

Reciprocal delegation of monitoring functions between main banks

Within these networks the shareholding members have explicitly or implicitly delegated the monitoring of the firm's management to the network's main bank(s). In the particular case of banks which have main bank function in one network, but not in others, the delegation of monitoring functions is reciprocal. The monitoring function refers to the responsibility of the main bank to intervene into a firm's management affairs, in case the firm faces serious problems. In this sense, the monitoring role of the main bank is "contingent" to the state of a firm's business. It is argued that the specific mechanisms of main bank governance include the ex-ante judgement on business plans and investment projects as well as their impact on a firm's creditworthiness, the interim monitoring of developments in the firm's financial position, and the ex-post responsibility to manage a bail-out or restructuring process of the firm and to serve as the last-resort supplier of finance in case of financial troubles. The main bank possesses a substantial power base, so the argument goes, to perform these functions effectively, by having a mandate as the network agent, by being a large creditor, by commanding an insider position with detailed insight in a firm's financial affairs, as well as by the threat of removal and takeover of a firm's management or by the withdrawal of funds leading to the firm's bankruptcy or liquidation. In this respect, the main bank is said to act like an insurer or quasi subordinate lender to a firm by taking over overproportional business risks.

These mechanisms are reinforced by forces of network discipline. While reciprocal shareholdings imply a mutual agreement of non-interference in

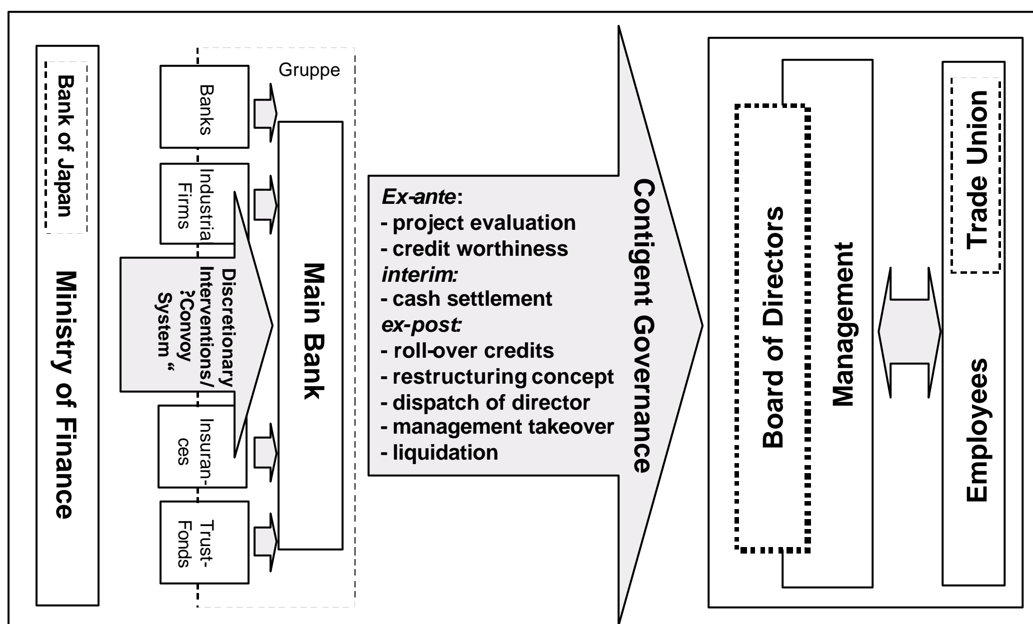
each others management, networks link the economic fortunes of its members, facilitate extensive sharing of information and produce long-term economic advantages for a network member.[21[21]] The firm's participation in these advantages depend, however, to a large extent on its trust and reputation within the network. These network-internal safeguards further strengthen the position and power of a main bank.

Discretionary interventions by the financial bureaucracy

The third element of the main bank governance system is the influence of the financial bureaucracy. Through formal intervention and informal guidance the financial bureaucracy enjoys substantial discretionary power over the banking industry which can be applied in two ways. On the one hand, the longstanding regulatory regime serves to protect the position, influence and benefits of main banks by discriminating against other potential suppliers of finance and by curbing competition. On the other hand, discretionary powers of the financial bureaucracy assure that a main bank lives up to its responsibilities. By doing so, the main bank can expect support and protection from the financial bureaucracy when engaging in bail-outs of troubled companies, even if it places a lot of financial and managerial strain upon a main bank. Esspecially in case of emergencies, a main bank could rely on the support of the financial bureaucracy which would orchestrate the support by other financial institutions or even arrange for the bail-out of a troubled bank itself, a system commonly refered to as the "convoy system".

[21[21]] Kester (1991), 67-75.

Chart 2: Corporate Governance under the Main Bank System



The following chart summerizes these "stylized facts" and mechanisms of the main bank governance system in Japan (see chart 2).
It is important to note that such a scheme offers various economic incentives for a main bank to perform these contingent responsibilities.[22[22]] On the one hand, the bank can expect substantial "main bank rents" in form of more or less exclusive, long-term business relation with the firm. Examples are access to profitable fee-based business, low cost deposits such as *ryodate koza* (compensatory deposits which bear no interest), and access to the management of salary accounts, deposits or loans of a firm's employees and group companies. The close relation with a firm leads to substantial insider information and an intimate knowledge about a firm's strategy, plans and financial needs. On the other hand, the main bank can expect certain administrative favors or benefits, if it follows instructions of the financial bureaucracy. And under the "convoy system" the bank can always rely on the support of the financial bureaucracy in times of troubles.

In theoretical terms this scheme of corporate governance can be described best as "network governance", mixing market-based elements with

[22[22]] Scher (1999), p. 26-36.

hierarchy-based elements of governance.[23][23] In institutional economics such hybrid modes of task coordination are often called "networks" which try to utilize the advantages of both, markets and hierarchies, for the management of transactional relations.[24][24] Membership in Japanese networks is--in principle--free, and transactions within networks are coordinated in a decentralized manner via markets, e.g. markets for products, services, credit and equity finance, thereby economizing on various costs for organizing hierarchies. The same can be said in regard to network governance. Just as there is no central network coordinator who orchestrates the entire network, the main bank cannot be considered to be an almighty network watchdog. A Japanese main bank is not as influential in governance affairs like, for instance, a German Hausbank, because equity ownership is rather fragmented and dispersed, thereby limiting the voting power and active participation of a main bank in a firm's governance institutions.[25][25] Compared to equity ownership, the mechanisms of the credit market appear to be the more effective mechanism for active governance considering the position of a main bank as an important creditor.[26][26] On the other hand, discretionary interventions by the financial bureaucracy as well as the formal and informal institutions and channels within a network and between a bank and a firm constitute elements of a hierarchy-based mode of governance. Furthermore, the possibility that the main bank supervises the restructuring process or even takes over a firm's management in case of financial emergency implies a replacement of market-based governance by hierarchy--a process which somewhat ressembles the functioning of a leveraged buy-out (LBO) where a public firm is taken private again and controlled directly by its creditors and owners.[27][27] Some authors refer to the main bank system as an internal market for corporate control which replaces the control mechanism of mergers and acquisition.[28][28] These kind of hierarchial elements are, however, contingent to the state of business of the firm governed. In this respect, a network mode of governances economizes on

[23][23] Uetake and Nakata (1999), p. 12-18.

[24][24] Williamson (1991); Powell (1990); Thorelli (1986).

[25][25] Although a main bank may dispatch a bank representative in the board of directors or the auditing committee in case of financial trouble, the actual number of bank representatives on Japanese boards is rather limited. Furthermore, it must be distinguished between the widespread practice of taking former bank representatives onto the board to strengthen a business relationship, and the limited role of bank representatives as outside directors. See Scher (1999), p. 36-42; Corbett (1998), p. 116-126.

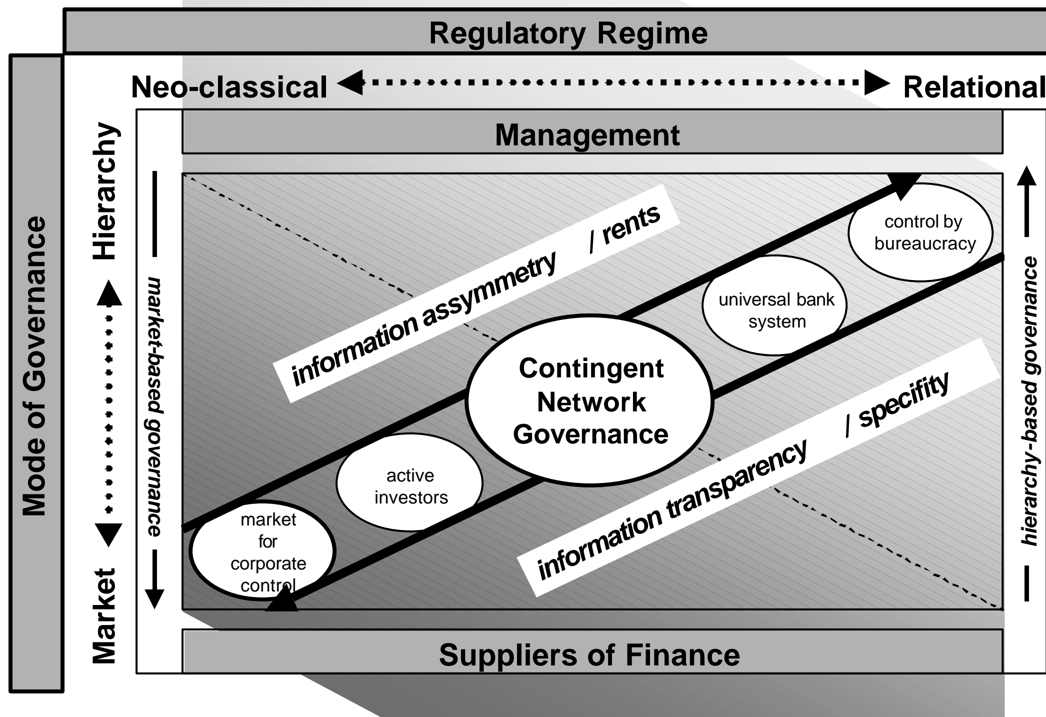
[26][26] The role of debt and large creditors as a governance mechanism has received growing attention in the theory of corporate governance. See Diamond (1984), Shleifer and Vishny (1997), p. 757-758.

[27][27] An LBO implies that the separation of ownership and control is reversed. The governance effects of LBO's have been stressed by Jensen (1989)

[28][28] Sheard (1989), p. 407.

various transaction costs (mainly related to production and communication of information) existing under a purely market-based mode of corporate governance.

Chart 3: Japan 's Mode of Contingent Network Governance



In summary, Japan's mode of governance has emerged as a hybrid form between market--and hierarchy-based governance within a hybrid regulatory regime and can be best described as contingent network governance (see chart 3).

Network governance economizes on important agency costs:[29[29]] bonding and signalling costs are reduced due to the importance and disciplinary function of mutual trust; groupwide sharing of information, the delegation of the monitoring function to the main bank and the insider position of the main bank lower the need and cost for monitoring, and finally the intimate knowledge of the main bank about a firm's business raises the efficiency of restructuring, thereby lowering the residual loss.

[29[29]] Kester (1997), p. 237-242; Hoshi (1994), p. 291-299; Kaplan (1997), p. 251-255.

Despite the fact that there are limits to test the validity of this complex model and effective functioning of Japan's network governance[30[30]] and that the rationality of the main bank's governance role has been questioned in theory[31 [31]], the above model of Japan's mode of contingent network governance is believed to have been in function at least until the liberalization of capital markets in the 1980s. In the following chapter, the apparent deficiencies and the structural causes for its declining effectiveness are analyzed.

4. The hollowing-out of Japan's "network governance system" in the 1990s

4.1.4.1. Evidence for the ineffectiveness of Japan's corporate governance system in the 1990s

During the last 10 years of economic stagnation in Japan following the steep decline in asset prices it has become obvious that Japanese companies failed to create value for their shareholders and that scarce economic resources were misallocated on a massive scale during this period. Furthermore, a series of financial scandals revealed that shareholders were deprived in a systematic manner by criminal practices of managers in quite a number of well-known Japanese companies. Taken these facts together, one can safely conclude that Japan's mode of corporate governance did not work effectively to prevent such misuse of management powers.[32[32]]

In comparison with US companies, Japanese profit ratios measured in terms of return–on-equity (ROE), return-on-assets (ROA) or earnings per share (EPS) have never been impressive, but the gap has widened significantly in the 1990s. Since 1990 the average ROE of all stock-listed companies in Japan declined from over 7% in 1990 to below 3% in 1998, while that of US companies surged well over 20%.[33[33]] Considering that 10-year government bonds had a yield of a little less than 2% in 1999, one dares to say that investment even in otherwise lackluster Japanese government bonds would have been the more rational choice for shareholders.

[30[30]] For empirical evidence see Sheard (1994); Hoshi/Kashyap/Scharfstein (1990); Kaplan and Minton (1994), Kang and Shivdasani (1997), Horiuchi and Okazaki (1992).

[31[31]] For instance, Ramseyer argues that the notion of implicit contracts by which a main bank takes on the default risks are irrational, because they cannot be enforced. Scher questions the identity of shareholders' and creditors' interests and points out risks of moral hazard by a main bank in case of a company's default. Scher (1999), p. 48-50; Ramseyer (1994), p. 241-252.

[32[32]] Sherman and Babcock (1997), p. 270-271.

[33[33]] Tokyo Shoken Torikihikijo (1999), p. 80-81; Ide (1998), p. 64-65.

At the same time, the persistently high level of excess production capacities and excess employment reflect a massive waste and misallocation of economic resources which--though declining--have not yet been corrected in a consequent manner. Estimates for the amount of excess production facilities vary between ¥57 trillion (Economic Planning Agency) to ¥95 trillion (Nikkei Needs) or between 10-20% of Japan's GDP.[34[34]] As a result, capital productivity has declined continously in the 1990s and has fallen below US level since 1994.[35[35]] In addition despite a record high of 3 million unemployed, Japanese companies are believed to employ another 2.5 to 5 million employees in excess. The other side of this coin is the lack of capital supply in growth industries. The severe credit crunch in Japan has hurt mainly small and medium-sized companies, regardless of their growth potential. And Japan's already underdeveloped market for venture capital and private equity even shrank further since 1996.[36[36]] In this sense, the misallocation of capital created significant macro-economic cost in form of lost opportunities for growth.

These developments can be interpreted as a massive misuse of free cash flow at the hands of Japanese managers which was not curbed effectively and corrected swiftly by means of a functioning governance system.[37[37]] The high growth of many Japanese companies in the 1970s and 1980s combined with the deceleration of growth in many maturing industries generated free cash flow of a large scale in many Japanese companies. In addition the extremely low cost of capital in Japan in the mid to late 1980s made it highly attractive for many companies to take on funds, either in form of debt and - more so--in form of equity and bonds. Alone the domestic emission of shares, convertible bonds and straight bonds by all listed Japanese companies amounted to about ¥50 trillion between 1987-1990, not considering the massive floating of Japanese bonds on Euromarkets.[38[38]] Awash with cash companies invested these funds in a massive built-up of capacities and personnel as well as in the diversification of their business, often into unrelated areas. Speculation on financial assets (*zaitech*), real estate or golf courses were a further favored investment by Japanese companies in the late 1980s.

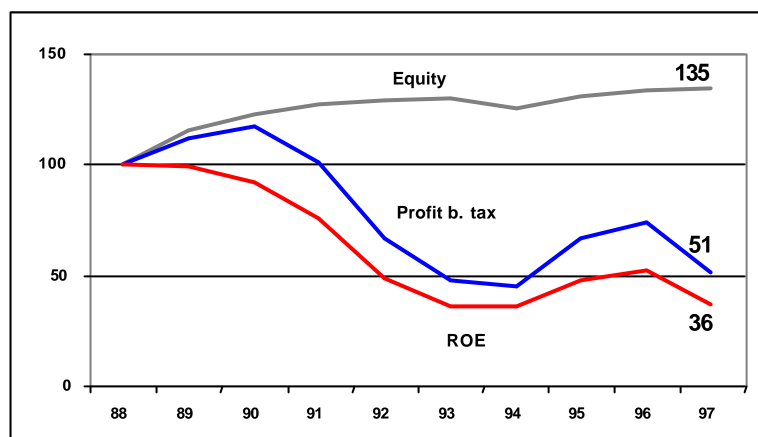
[34[34]] Nihon Keizai Shimbun, 29.3.1999; Nihon Keizai Shimbun, 7.5.1999, Nihon Keizai Shimbun, 11.1.2000.
[35[35]] OECD (1996), p. 171-172.
[36[36]] Hurwitz (1999).
[37[37]] Kester (1991), p. 219-235.
[38[38]] Tokyo Shoken Torikihikijo (1999), p. 138-139.

Ever since the collapse of stock and land prices which led Japan into a prolonged spirale of deflation these investments are haunting Japan's companies, and it seems legitimate to ask whether ever the decisions for these investment projects were based on a sound, economic analysis. Further analysis of company data show that companies not only blew up their balance sheets and cost structures, but that until very recently they made hardly any notable progress in cleaning up their balance sheets. Figures by the Japanese Ministry of Finance show that even after the burst of the "bubble", total assets increased (see chart 4).[39[39]]

While companies were able to reduce current assets and inventories in line with declining growth, fixed assets, particularly fixed tangible assets, continued to increase. At the same time, cost for personnel, administration overhead and depreciation kept growing reflecting the massive built-up of capacities and personnel. As a result, net profits and profit margins shrank rapidly, despite the fact that companies succeeded to reduce the cost-of-goods in line with the decline in sales turnover. Finally, the equity capital base ballooned due to the issue of vast amounts of new equity shares. The combined effect of a growing equity base with a sharp decline of net profits caused the free fall of the ROE (see chart 5).

[39[39]] Own calculations based on Okurasho (1999)

Chart 5: Development in Equity, ROE and Profits before Tax
(1988 - 1997; Index 1988 = 100)



Source : Own calculations based on Ministry of Finance (1999)

The fact itself that companies overinvested or invested into wrong projects with low returns should in my opinion not be overemphasized too much; after all, it is a known fact to investors that investments bear risks and that these risks can manifest themselves in form of a below-market returns or even the destruction of value. The astonishing fact, however, is that corrective actions and the adaption to a new, adverse environment apparently takes such a long time in Japan. This raises basic questions about the soundness and functioning of Japanese mode of corporate governance, and about possible causes for the apparent lack of effective control of management.[40[40]]

4.2. 4.2. Causes for declining network cohesion

4.2.1. 4.2.1. The hollowing-out of the legal institutions for corporate governance

The Japanese mode of network governance rests upon the contingent interference by the main bank. This, in turn, leaves the management of Japanese companies with substantial freedom and autonomy in strategic as well as operational matters – a development which has resulted in the almost complete hollowing-out of the legal institutions for corporate governance.

[40[40]] Jensen writes: "The Japanese economy...is currently suffering from enormous overcapacity caused in large part by what many view as the breakdown of its corporate control system." Jensen (1997), p. 26.

The shareholders' meeting, the board of directors and the auditing committee have practically lost their effectiveness in governance matters.
The practise of stable (cross-) shareholding and mutual non-interference in management affairs between corporate shareholders has reduced the annual shareholders' to a largely ceremonial affair.[41 [41]] When convening a shareholders' meeting most corporate shareholders refrain from exercising their formidable legal powers by sending back a blank proxy vote which empowers the incumbent board members to decide on the agenda, top personnel matters and other strategic issues unilaterally. Furthermore, hiring professional racketeers (*sokaiya*) by the management to scare off critical shareholders and to assure smooth shareholders' meetings has -despite legal countermeasures--been a firmly rooted business practise in Japan. As a result of these practises, Japanese shareholders' meetings are very short and usually lack any debate of substance or even controversy.[42[42]] Some insiders bluntly call the annual shareholders' meeting a mere formality, because usually a meeting of the largest shareholders is convened by the main bank prior to the "real" shareholders' meeting. At this meeting, the President and the Board of Directors are questioned by the main bank representative, while the other shareholders are expected to refrain from questions on their own, in order not to undermine the posture of the main bank.[43[43]]

This formally leaves the Board of Director with formidable powers. According to the Commercial Code, the Board of Directors is entrusted collectively with the power to decide basic personnel, financial and strategic matters of the company and to supervise the President and Representive Directors to whom the management of the company has been delegated. Yet, as a matter of fact, the real function of the Board of Directors of many Japanese companies has been reduced to acclaim decisions of the President and his management.[44[44]] One of the main reasons for this development is that the members of the Board are most frequently long-time company employees who have climbed up the internal hierarchy, while outside, independent directors are a rare exception. Although the board members are formally elected by the shareholders' meeting, they ascent to the Board due

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[41[41]] Sakamoto and Sakuma (1998), p. 98-104; Nihon Keizai Shimbun (1993), p. 28-30.
[42[42]] 80% of the 2,402 shareholders' meetings held between September 1997 and June 1998 lasted less than 35 minutes. Only 6% took more than one hour. As a matter of fact, as a result of measures to keep ,*sokaiya* away from the meetings most meetings are held on the same day, which at the same time makes it more difficult for individual shareholders to attend a meeting. See Shoji Homu No. 1510, 30.11.1998, p. 112-113.
[43[43]] Interview with a Senior Manager of Daiwa Institute of Research
[44[44]] Sakamoto and Sakuma (1998), p. 104-109

to the President's proposal and support. In this respect, board membership represents the top end of the internal career path and is dependent on the internal personnel evaluation system and the might of the President. As such, members of the Board consider themselves to be salaried employees rather than professional agents working on behalf of shareholders' interests. In addition, quite often board members are responsible for a specific business or function and try to push through the particular interests of their specific area of responsibility, rather than considering matters from a wholistic company perspective. This is also reinforeced by a corporate executive compensation system which in Japan mostly lacks incentives such as stock options tying compensation to shareholders' benefits.[45[45]]

The effective functioning of the Board is further hollowed out by its sheer size. In many Japanese companies, the Board consists of more than 30 members making debates on board level almost inoperable. In fact, real debate and decision-making is often conducted outside the Board in an executive management committee (*jomukai* or *keiei kaigi*) which consists of the President and a few senior board members. Although the Board formally has the final decision power, many important decisions are made outside its boundaries or without sufficient transparency, thereby blurring its true responsibilities and powers.

The third institution supposed to perform governance functions consists of auditors or, in large companies, an auditing committee.[46[46]] The institution of auditor is a remnant of the pre-war German influence on Japanese commercial law, but with the post-war reforms under US leadership its legal status has become quite ambiguous. According to the Commercial Code, auditors have the right and duty to audit a companies' operations and to check the legality and fiduciary duties of the management. Yet, in reality, the auditors are considered to be rather toothless, because they, like the board members, are often former long-term employees chosen by the President and have only limited access to internal information.[47[47]] The strengthening of the position and clout of auditors has been a topic of continued legal debate, but a series of legal reforms has not led to significant change so far. A major reason is that any attempt of reform so far has

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[45[45]] OECD (1996), 147-148.
[46[46]] Sakamoto and Sakuma (1998), p. 109-116.
[47[47]] Recent reforms of the Commercial Code focus on the strengthening of shareholders' rights, e.g. simplification of shareholders' law suits, and to enhance the position and independence of the auditors, e.g. increase in number of outside auditors and extension of period. See Nihon Keizai Shimbun (1993), p. 62-105.

refrained to vest the position of the auditors with any power in regard to personnel affairs --considered a key ingredient to governing power-- at the Board level. 48[48]

In summary it can be concluded that Japan has seen a gradual hollowing-out of its legal institutions of corporate governance leading to a widening gap between the legal mechanisms of control and the actual governing practise. This development is to a large extent due to the workings of the network governance mode. Under the conditions of stable (cross-) shareholdings and a mutual understanding of non-interference in each others management affairs, corporate shareholders consider shareholdings as a means to cement business relations and, therefore, refrain from the exercise of governance powers. As long-term employees board members and auditors tend to consider themselves rather as salaried employees than as agents of shareholders. Furthermore, the factual concentration of power in the hands of the President impede the exercise of control by the board. This leds to a high degree of factual autonomy of Japanese management to decide and implement company policy which--under the main bank scheme--is in fact subject only to contingent control by the main bank.

4.2.2. 4.2.2. The weakening power of the main bank

While the mechanisms of contingent governance by the main bank may have worked effectively during the high growth area under conditions of scarce financial resources and extensive financial regulation, the deregulation and liberalization of Japan's financial markets since the 1980s, however, have significantly weakened the institutional foundations of the main bank's governance power:49[49]

- \- Deregulation (e.g. interest rates, new financial products like commercial papers,etc.) and liberalization of Japan's financial markets (e.g. reduction of capital controls) resulted in growing competition among domestic and--increasingly important--with foreign financial institutions which reduced the level of main bank rents and, thereby, the incentives to perform governance functions. In fact, growing competition forced banks either to operate on lower margins and to engage in riskier, less transparent loan business with smaller companies, or to compete with innovative financial products on new, liberalised market segments.

48[48] Shoji Homu No. 1526 of 25.5.1999.

49[49] Aoki/Patrick/Sheard (1994), p. 26-33/47-48; Hoshi (1994), p. 299-305.

Scher, for instance, argues that the main function of a bank's customer team is sales-oriented, while its monitoring capacity is limited. Furthermore, the dispatch of bank personnel--besides being rather limited in scale--serves mainly as a means of cementing business relationships or as a mechanism for outplacement of elderly bank employees, but not as a mechanism of corporate control. [50[50]]

- - The high growth of Japanese companies and the access of companies to forms of direct finance and to international capital markets (e.g. Euro-Bonds) resulted in a growing financial autonomy of Japanese companies and changed the balance of power between suppliers of finance and companies. Investments were increasingly financed by the company's operating cash flow or directly via capital markets, and companies strategically diversified their credit portfolio among several banks to enhance independence.

- - The growing integration of global financial markets and the emergence of new, innovative financial products have gradually reduced the supervisory powers of Japan's financal authorities and opened ways for financial institutions to circumvent administrative interventions. Despite regulatory efforts by the bureaucracy to maintain control, financial institutions have gradually gained independence. The "Big Bang" reforms, initiated under the former Prime Minister Hashimoto, are gradually taking effect by subsequently tearing down the barriers that segregated financial markets and by stimulating free market competition.[51[51]]

The effects of these interrelated developments on corporate governance became most obvious after the burst of the Japanese "bubble". The enormous amounts of uncollectable debt -by themselves a symbol for the massive misallocation of financial resources--not only eroded the equity base of many Japanese banks to a degree that led Japan into a dangerous deflationary process and brought Japan's entire financial system to the edge of collapse. [52 [52]] It also revealed an astonishing lack of sound banking

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[50[50]] Scher (1999), p. 36-42.

[51[51]] Recent events suggest that the Ministry of Finance itself may have changed its stance in regard to administrative guidance. The fact that the MoF did not prevent the bankruptcies of major financial institutions like Yamaichi Securities or The Long-Term Credit Bank and accepted their breakdown and sell-off to foreign investor groups has clearly sent the message to the Japanese financial industry that the "convoy system" is a thing of the past.

[52[52]] Uekusa (1999)

practices and mechanisms of risk management at the level of individual banks as well as on the level of the financial bureaucracy. Instead of performing their functions as delegated monitors and key agents for corporate governance, the governance of Japan's banking system itself has come into question.

The following statement by a senior Japanese bank official symbolizes the extent to which Japanese banks underestimated (or intentionally played down and maybe even concealed) the sheer size and economic effects of the bad loan problem:

> "...assuming that the total of bad loans at city banks is 14 to 20 trillion yen and that about 30 per cent discounting of collateral may be inevitable, the amount may be yet reasonably manageable in the current market when matched against unrealized profits on other assets. At worst, some financial institutions may have to be taken over by others. This is a good lesson for such institutions at this phase of financial development."[53[53]]

The actual amount of bad loans is estimated to be up to 100 trillion yen - equal to 20% of Japan's GDP and 5 –7 times larger as stated above. As a matter of fact, according to the Financial Supervisory Agency the leading 17 Japanese banks, which account for about two-thirds of the bad loans, disposed off 42 trillion yen of bad loans between 1992 and 1999 and made provisions for another 8 trillion yen.[54[54]] In addition, the disposal of bad loans, mainly through sales of the underlying collateral, often commands discounts of up to 90%.[55[55]] This example of the degree of misperception of the bad loan problem by Japan's banking industry is just one indication for the ineffectiveness of the banks' monitoring and governance function, but it is a crucial one as credits are at the heart of the firm-bank relation and the Japan's mode of contingent network governance.

While the system of contingent network governance under the main bank regime has been slowly eroding since the mid 1980's due to financial deregulation and growing financial independence of companies, the restructuring of Japan's financial industry after the burst of the "bubble" has accelerated the the ongoing process of unwinding networks and sell-off of

[53[53]] Sunamura (1994), p. 315
[54[54]] Nihon Keizai Shimbun, 20.2.2000
[55[55]] Nihon Keizai Shimbun, 29.2.2000

stable (cross-) shareholdings. The massive efforts of the Obuchi administration since the end of 1998 to stabilize Japan's financial system, to regain international trust and to re-capitalize Japan's banks with public money are a further indication for the immense burden of the bad loan problem on Japan's economy and on the health of Japan's financial industry. In combination with financial deregulation these measures have triggered a grand-scale reshuffle and overhaul of Japan's financial industry, and are forcing banks to redefine their role in matters of corporate governance.

In summary, it can be concluded that the institutional foundations for effective network governance under the main bank system have been weakened to an extent that resulted in the hollowing-out of Japan's mode of corporate governance. Applying our analytical framework, it can be argued that key hierarchical mechanisms of governance were weakened, while market-based elements of governance failed to serve as an effective replacement. As a result, Japan's management is left in a governance vacuum.

5. 5. Reforming Japan's corporate governance system: Emerging patterns for renewal

5.1. 5.1. Market pressures for reform

The ineffectiveness of Japan's prevailing mode of governance and the resulting costs of wasted capital and loss of corporate value have become widely acknowledged, and the need for reform is undisputed. In addition, the prolonged, deep recession combined with the opening and deregulation of Japan's economy and capital markets has freed formidable forces pressuring for the reform of Japan's corporate governance system.

First of all, growing competitive pressures on many product markets force Japanese companies to enhance their profitability. In various industries under deregulation such as energy, telecommunication or trade, competition by new market entrants (including foreign competitors) has eroded margins. Other industries like finance, telecommunication, life sciences or automotives require strong cash flows and earnings to finance the huge investments needed for R&D, information technologies or new environmental technologies. As a result many Japanese companies which formerly placed top priority on sales growth and market share, are emphasizing earnings, cash flow, ROE etc. as the most important corporate

targets.[56] [56] They engage in strong efforts to streamline their business portfolio, to refocus their operations and to close down or sell-off plants, product lines, business units and even total companies.

A second set of forces pressuring for higher profitability comes from capital markets. Since at least 1995, there is a clear tendencies towards the dissolution of group networks and stable (cross-) shareholdings as corporate shareholders and financial institutions sell-off non-performing or non-strategic shareholdings. The sell-off of shares by companies is a part of their general restructuring efforts.[57][57] In the case of banks, international equity standards by the Bank of International Settlement call for a clean-up of the balance sheets of Japanese banks. And Japanese institutional investors like life insurances are faced with record low interest rates and portfolio returns which are too low to serve the commitments to their policy holders, causing them to realize capital gains by a sell-off of shareholdings.

These developments have a profound impact on the ownership structure of Japanese companies. According to the NLI Research Institute, the ratio of stable shareholdings had been rather stable at around 47-48% until 1995, but since then declined by 6-7% to 41% in 1998. Cross-shareholdings, which had been stable at about 20-22% declined to 16% in the same period (see chart 6).[58][58]

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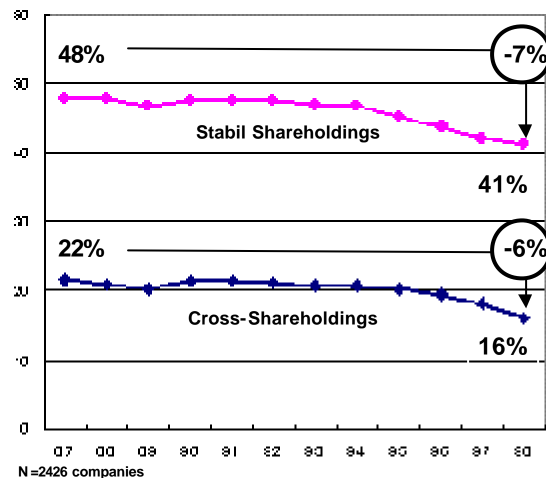
[56][56] Keizai Doyukai (1996), p. 106-107.

[57][57] Furthermore, new accounting rules emphasizing consolidated statements and demanding (from FY2001) market-based evaluation of certain financial assets cause companies to streamline their balance sheets. See: The Diamond Weekly of 23.10.1999.

[58][58] Nissei Kiso Kenkyujo (1999).

Chart 6: Equity Share of Stable (Cross-) Shareholdings



Source: Nissei Kis? Kenky?jo (1999)

This trend has accelerated during 1999 with foreign (institutional) investors and individuals emerging as clear net buyers and financial institutions and corporations as net sellers.[59][59] It is also reflected in a significant change in the ownership structure of Japanese companies. According to the Tokyo Stock Exchange, the average share of non-Japanese shareholders of all listed Japanese companies has increased by almost 6% from 4.2% to 10% between 1990 and 1998. Individuals increased their share by more than 2% from 23.1% to 25.4%, while during the same period the share of financial institutions shrank by almost 6% from 45.2% to 39.3% and that of corporations from 25.2% to 24.1%.[60][60] Considering the fact that ownership structure had been rather stable in the past, these changes in the last 8 years are significant and lead to the assumption that the voice of shareholders demanding higher returns will increase in the near future. In particular, the voice of institutional investors can be expected to increase significantly, when considering that also the reform of Japan's pension system (e.g. introduction of 401(k) pension plans) and the reform of Japan's postal savings and Fiscal Investment and Loan Program (FILP) may well lead to a substantial diversion of national savings away from deposits and insurance policies to securities such as stocks or mutual funds managed by institutional investors. The growing voice of institutional investors, in turn, has the

[59][59] Nihon Keizai Shimbun, 3.9.1999; Nihon Keizai Shimbun, 28.12.1999.
[60][60] Nihon Keizai Shimbun, 6.7.1999

potential to become a massive force pressuring for reform Japan's system of corporate governance.

5.2. Emerging patterns of reform

These developments have just recently gained momentum. However, as companies are starting to reform their governance systems, it is possible to speculate on possible directions of reform. I argue that within the general trend towards a growing influence of institutional investors three distinct patterns of reform are presently emerging which may replace the long-established network mode of corporate governance:

- - Active investor-dominated governance
- - Bank-dominated governance
- - Market for corporate control

The discriminating factors that determine which of these patterns is followed by a single company are the type of shareholders, the ratio of shareholder concentration and the level of corporate debt in relation to equity. Generally spoken, the higher the number of institutional and foreign investors, the lower the level of shareholder concentration and the lower the debt-equity-ratio, the more a company's mode of corporate governance will inherit market-based elements of governance. In contrast to this pattern, the higher the number of corporate shareholders, the higher the ratio of shareholder concentration and the higher the debt-equity ratio, the more hierarchy-based elements will determine a company's mode of governance. In total, however, network-based forms of governance are likely to become weaker. Specifically, I perceive the following developments:

Active investor-dominated governance

A large number of globally active Japanese companies like Sony are at the forefront of reforming their system of corporate governance.[61[61]] These companies directly access global capital markets and have a high ratio of institutional and foreign investors among their shareholders. Already these companies engage in strong investor-relation efforts to cultivate good, stable relations with their institutional investors by adopting international standards for accounting and disclosure, and by pursuing shareholder value as a

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[61[61]] Uetake and Nakata (1999), p. 54-62.

dominant corporate goal. A growing number of companies undertake strong efforts to enhance the effectiveness of corporate governance by integrating market-based elements of governance. Key measures in this endeavour are:

- - the substantial reduction of the number of members of the Board of Directors
- - the increase of outside directors as members of the Board
- - the separation of the functions of strategic decision-making and control from implementation by adapting a system of Chief Operating Officers (COO)
- - the establishment of holding structures

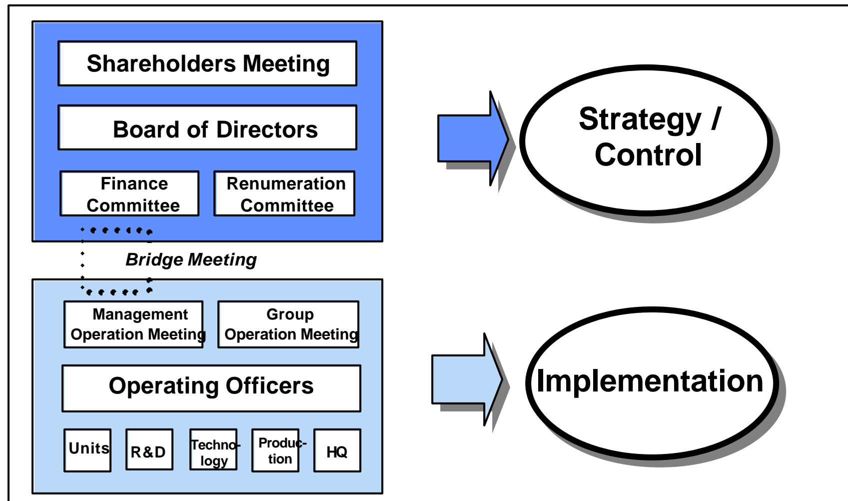
The reduction in the number of board members and the participation of outside directors aim to foster open discussion, speedy decision-making and a focus on strategic matters. The integration of outside directors intends to improve the monitoring and check functions of the board by adding independent, outside judgement and scrutiny. As recent examples, Fuji Xerox reduced its board size from 34 to 14 directors, 10 of which are outside directors. Importantly, Fuji Xerox has established two sub-committees for finance and enumeration, which are headed by outside directors (see chart 7). Sumitomo Bank reduced its board size from 39 to 18 directors, including 3 external members.[62[62]]

The introduction of a Chief Operating Officer (COO) system aims to enhance the accountability of managers and board members by seperating the operational or functional responsibilities from strategic decision-making and control. Accordingly the boards can focus on corporate policies and supervision, while the COO's have the full managerial competence and responsibility to implement policies. According to a survey by the Nikkei Business magazine, 179 companies or 7% of Japan's listed companies have decided to introduce a COO system.[63[63]] Sony, Takeda Chemical, Fuji Xerox, Mitsubishi Chemical and Nissan are leading examples of this trend. Despite the fact that in many companies which have introduced a COO system quite a number of board members still have double responsibilities also as a COO, thereby undermining the basic principle of the COO system, the COO system is slowly taking roots in Japan's system of corporate governance. At Fuji Xerox, like Sony a leader in corporate governance

[62[62]] Nikkei Business of 13.9.1999, p. 52-54.
[63[63]] Nikkei Business of 13.9.1999, p. 52

matters, only 2 of the 14 board members have also a chief operating function, while a bridge meeting between board members and COOs serves as an organizational means to facilitate smooth communication (see chart 7).

Chart 7: Management Organization at Fuji Xerox



Source: Nikkei Business of 13.9.1999, p. 53

The establishment of holding companies has become a new mode of top management organization for Japanese companies since the ban on holding companies was lifted in 1997 with the reform of Japan's anti-trust legislation. The establishment of holding structures aims to seperate financial control and business operations, thereby increasing the financial accountability of operating companies, while the holding company actively engages in corporate governance like an agent for its investors and suppliers of finance. The Daiwa group, Softbank, and NTT are recent examples for companies which have established holding structures as a means to improve corporate governance and financial accountability.

Bank-dominated governance

Another important, though less discernable pattern is the strengthening of bank-dominated governance in the direction of a universal bank mode of governance. Realizing the limits of contingent network governance, banks become increasingly selective about their business ties with Japanese companies. While dissolving ties with companies with limited business potential and strategic importance, banks are expected to forge stronger ties

and to exert stricter governance with important business partners.[64[64]] The restructuring of Japan's financial institutions, most notably the recent mega-mergers such as IBJ-DKB-Fuji Bank or Sakura Bank and Sumitomo Bank, are likely to accelerate the selection process in Japan's financial industry and create a few groups of universal banks which cover a wide range of financial services like retail banking, investment banking, trust banking, asset management, insurances and the like. Most likely the top 3 banks, Mizuho Financial Services (IBJ-DKB-Fuji Bank), the Sakura-Sumitomo Bank and the Tokyo-Mitsubishi Bank will form an oligopoly which dominates the industry. According to estimates by the Nihon Keizai Shimbun, these three banks will together command a 72% share of total assets, a 69% share in loans, and a 60% share of retail outlets (see chart 8).[65[65]]

Equally important, they will have strong shareholding positions in several industries (see chart 9). If aggregated, the Mizuho Bank holds significant shares in the steel industry (Kobe Steel, Kawasaki Steel, NKK), in the pharmaceutical and chemical industry (Showa Denko, Eisai, Daiichi Pharmaceuticals), and trade (Marubeni, Seiyu).[66[66]] The Sakura-Sumitomo Bank has strong aggregated shareholding positions in electronics (Casio, Yamatake, Olympus, Alps Electric), transportation (Mitsui OSK Lines) and construction (Kajima).[67[67]]

[64[64]] Nikkei Business of 30.8.1999.
[65[65]] Nihon Keizai Shimbun, 19.10.1999
[66[66]] Nihon Keizai Shimbun, 27.8.1999.
[67[67]] Nihon Keizai Shimbun, 15.10.1999. The Anti-Monopoly-Act forbids banks to hold more than 5% of the equity of a company. However, because the Mizuho bank is formed under a holding this rule does not apply. In case of the Sakura-Sumitomo Bank, it remains to be seen how the aggregated shareholdings are dealt with.

Chart 8: Future Concentration of Japan ‘s Banking Industry

	Total Assets (\ Bil)	Share %	Loans (\ Bil)	Share %	Retail Outlets	Share %
IBJ/DKB/Fuji Bank	\1,410	33%	\ 858	31%	705	23%
Sakura/Sumitomo Bank	\987	23%	\ 660	24%	800	26%
Tokyo Mitsubishi Bank	\698	16%	\ 389	14%	332	11%
Sanwa Bank	\476	11%	\ 319	12%	332	11%
Tokai/Asahi Bank	\590	14%	\ 395	14%	659	22%
Daiwa Bank	\155	4%	\ 105	4%	195	6%
Total (Top 10 banks)	*\4,316*	*100%*	*\2,726*	*100%*	*3023*	*100%*

Source: Nihon Keizai Shimbun of 19.10.1999

Chart 9: Shareholdings by new Japanese Mega-Banks

Industry	IBJ/DKB/Fuji Bank		Sakura/Sumitomo	
Heavy industry	Kobe Steel	8.56%	Tokyo Kikai	9.40%
	Kawasaki Steel	7.21%	Nikki	8.00%
	NKK	6.72%		
	Komatsu	5.10%		
Oil / Refinery	Cosmos Oil	4.80%		
	Japan Energy	3.62%		
Chemical / Pharmaceutical	Showa Denko	8.21%	Chugai	7.30%
	Eisai	8.60%		
	Daiichi Pharmaceuticals	8.00%		
	Yokohama Gum	7.44%		
Automobitive	Nissan	8.84%	Stanley Electric	7.10%
	Nissan Diesel	6.51%		
	Isuzu Motors	3.99%		
Elektronics	Oki Electric	8.18%	Casio	10.10%
	Pioneer	6.40%	Yamatake	9.30%
			Olympus	7.70%
			Alps Electric	7.40%
Constructiont	Hazama	4.80%	Kajima	8.10%
	Sato Kogyo	4.20%		
Food	Sapporo Beer	11.58%		
	Snow Brand	9.70%		
Trade / Transportation	Marubeni	9.24%	Izumiya	10.50%
	Seiyu	8.18%	Sankyo Seiko	8.90%
	Sogo	4.99%	Mitsui OSK Lines	7.50%
	C.Itoh	4.31%		

Source: Nikkei Business of 30.8.1999 / Nihon Keizai Shimbun of 15.10.1999

While these arguments are still highly speculative as it remains to be seen how the banks will handle their shareholding positions, it can be imagined that they will engage in strong governance efforts in industries and companies where they maintain large shares and which are highly indebted.

In particular the Mizuho Bank, by means of its holding structure, is in a position to further strengthen its capital ties without interfering with anti-trust regulations. But there are other means to exert stronger control by banks over its creditors, for instance by dispatching "real" outside directors or auditors. The ongoing restructuring of highly indebted companies in industries like trade (e.g. general trading companies like Tomen or Kanematsu, retail companies like Sogo department stores, Daiei or Saison), real estate, construction, steel or automotive will provide important clues for this argument. The general trend in the financial industry, driven by mega-mergers in the banking sector and followed by the insurance sector, is to form new financial service companies which--like universal banks--encompass a wide range of financial services. Companies which are highly dependent on external finance are likely to find themselves confronted with a highly oligopolized financial service industry which is eager to govern actively.

Market for corporate control

Typical mechanisms characterizing an active market for corporate control such as mergers and acquisitions (M&A), hostile takeover bids (TOB), leveraged-buy-outs (LBO), or mangement-buy-outs (MBO) are still applied only very rarely in Japan's business environment, although a significant surge in such kind of activities can be observed in recent years. [68][68] Japan is still an underdeveloped country in this respect and for the time being it is hard to imagine that an active market for corporate control with a similar impact on business culture like in the United States will emerge. [69] [69] Nevertheless, very recent developments in Japan's venture capital industry may lay the foundations for an US-style market for corporate control. The main protagonists, however, are not the large, established companies, but fast growing, venture-style firms like Softbank, Hikari Tsushin or Goodwill, on the one hand, and key suppliers of venture capital such as private equity funds and investment partnerships. Many of these companies are managed by young, American-style entrepreneurs like Masayoshi Son (42, Softbank) or Yasumitsu Shigeta (34, Hikari Tsushin) who seek to grow also via M&A and are actively buying and selling companies based on financial targets. The main target of venture capital funds is to invest in young companies with high growth potential to later realize capital gains through an "exit" via an initial public offering (IPO). With the (planned) establishment of new

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[68][68] Daiwa Securities (1999), Roland Berger & Partner (1999)
[69][69] Kester (1991), p. 83-107; Raupach-Sumiya (2000)

stock exchanges targeting venture firms such as the Mothers Section at the Tokyo Stock Exchange or NASDAQ Japan, the infrastructure for active trading of companies unhampered by stable (cross) shareholding is getting in place, creating a platform for a strongly market-based mode of corporate governance.

The above arguments are based on observations of activities by individual companies. Which of these patterns will in the end develop into the dominant mode of a reformed Japanese system of corporate governance depends largely on developments in the regulatory environment. After all, the legal institutions of governance and their underlying spirit shape the mechanisms and practices of corporate governance. However, at the moment it is impossible to discern a clear policy despite the on-going debate about legal reforms of Japan's Commercial Code.

The ruling Liberal Democratic Party (LDP) has presented in spring 1999 a proposal on minor changes of the Commercial Code, but concedes that a comprehensive reform of Japan's corporate governance system would require a fundamental debate considered too time-consuming in times of severe economic difficulties and international loss of confidence.[70[70]] The key element of the LDP is to further strengthen the position and independence of auditors by requiring that the majority of the members of the auditing committee of large companies are independent outsiders, by extending their tenure from 3 to 4 years, and by obliging the Board of Director to give quarterly explanations on the state of business to the auditing committee. Another element of the proposal is to further ease the process for shareholder lawsuits, while at the same time creating possibilities to limit the liabilities of Board members in case of shareholder lawsuits. Not only has the reform proposal been severely criticised as being a piecemeal approach without real substance, but the Japanese business community itself is split about the required direction for reform.

The Keidanren basically backs the LDP proposal,[71[71]] but an influential group of private businessmen who in 1994 formed the Corporate Governance Forum of Japan call for a two-step reform with the objective to establish a system similar to the US Board system based on independent

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[70[70]] www.jimin.or.jp/jimin/saishin/seisaku-51.html; Shoji Homu of 25.5.1999.
[71[71]] www.keidanren.or.jp/japanese/policy/pol144.html.

outside directors and an open market for top managers.[72[72]] In their final report the Forum has formulated a set of basic Corporate Governance Principles to be developed into a Code of Best Covernance Practices. The Forum differs between two set of principles, so-called A-Principles to be implemented immediately, and B-principles to be implemented in the nearer future. The A-principles call for the adoption of semi-annual account statements based on the International Accounting Standards (IAS), additional reports for important stakeholders, and for the introduction of outside directors and the seperation of strategic decision making/control from implementation. The far-reaching B-principles request fundamental changes of the Commercial Code, such as the abolishment of the auditor system and the integration of the audit functions in an auditing committee within the board, the obligation to have a majority of outside directors as board members, the ban of a personnel union of the President and the Chairman of the Board, the establishment of sub-committees for personnel, renumeration and auditing within the board, and some limitations to the powers of the shareholders meeting. The influential California-based pension fund CalPERS has endorsed the Principles and recommended their adoption as a benchmark for legal reform. As seen above, this initiative is not reflected yet in the government proposals and the reform process appears to be stuck.

The direction of the future Japanese corporate governance system depends, however, not only on the legal reform of Japan's Commercial Code. As important are reforms of Japan's financial system. The "Big Bang" reform generally aim for an enhancement of capital market mechanisms, but many details are yet unclear. But, as many boundaries between the various financial businesses are torn down, the emergence of powerful Japanese universal banks and a hierarchy-based mode of governance is a likely scenario. However, with anti-trust legislation still curbing the shareholding positions of banks, a major element of the universal bank mode of governance is not in place. On the other hand, it is still questionable whether institutional investors and individuals really can develop into the main driving forces of Japanese capital markets. This depends largely on the details of the rules and regulations which guide the behavior of these groups of shareholders. In particular, the details of the reforms of Japan's pension system (e.g. 401(k) pension plan) and the postal saving and FILP can be

[72[72]] Nihon Ko-pore-to Gabanansu Fo-ramu (1998). The group is made up from influential leaders of top Japanese companies like The Industrial Bank of Japan, Nippon Life Insurance, Nippon Steel, Fuji Xerox, Nissan, Orix.

expected to have a profound impact on the future role of institutional investors and individuals as key shareholders.

6. Conclusions

This paper analyzed the characteristic features of Japan's system of corporate governance, its deficiencies and the emerging directions of its reform. The Japanese system operated for a long time under the logic of networks, combining effectively market forces of control with mechanisms of balancing power under the main bank regime. Changes in the regulatory framework, however, have led to a hollowing-out of the mechanisms of control, while growing market pressures call for a fundamental reform of the Japanese corporate governance system. Within the general tendency towards a stronger voice by institutional investors, three distinct patterns of reform corporate are emerging: global, independent firms with direct access to global capital markets seek strong relations with institutional investors and open their internal control systems; in firms with high financial leverage and a strong dependence on indirect finance, banks are expected to seek an enhancement of their power base through stronger ties; in young growth industries the (slow) development of an active market for corporate control is expected. The factors which determine these patterns are the type and ratio of equity ownership concentration and the leverage of corporate debt.

These arguments are still rather speculative and it is too early to draw conclusions on which pattern of reform will become the mainstream mode of future Japanese corporate governance, mainly because the direction of the legal reforms in the regulatory environment is yet unclear. LDP attempts to reform of the Commercial Code are half-hearted, but aim for a strengthening of hierarchy-based elements, in particularly the auditor position. Strong forces in the Japanese industry, however, call for the adoption of a US-style board system based on market-based elements like outside directors and a seperation of board functions from operations. The reform of Japan’s financial markets will exert a strong influence on Japan’s future mode of corporate governance. However, clear trends are not yet perceivable. The "Big Bang" reforms may lead to the emergence of strong, universal-bank-like financial institutions and a highly concentrated financial service industry, laying the foundations for a hierarchy-based, German-type mode of corporate governance. At the same time, deregulation of capital markets may lead to a stronger role of institutional investors in governance affairs.

In this respect, it is too early to make predictions which pattern of reform, the market-based or the hierarchy-based mode of governance, will in the end dominate and replace Japan's network governance. The trend towards the dissolution of company networks and the weakening of the institutional foundations for Japan's mode of contingent network governance, however, seems to be irreversible.

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1 Trends in corporate governance reform among Japanese companies 14 2 Board evaluation to achieve continuous improvements in board function 18. â…£. Dialoguewithinvestorsandapproachesto corporate disclosure.Â Slump in the stock market and the marketâ€™s short-termism. As pointed out by the so-called Ito Review,* the prolonged low profitability of Japanese companies impeded the crea-tion of corporate value and, as a result, the Japanese stock market was in a slump for a long time.Â Since the establishment of Japanâ€™s Stewardship Code and Corporate Governance Code, dialogue between companies and investors has gained momentum, and more companies are aware of cost of capital. The Corporate Governance Model of Japan: Shareholders are not Rulers. Franklin Allen University of Pennsylvania. and Mengxin Zhao Bentley College.Â The third way in which the market for corporate control can operate is through hostile takeovers. These occur when there is conflict between the acquirors and acquirees over the price that should be paid, the effectiveness of the policies that will be implemented and so forth. Hostile tender offers allow the acquirors to go over the heads.Â In Japan, this system of monitoring is known as the main bank system. The characteristics of this system are the long-term relationship between a bank and its client firm, the holding of both debt and equity by the bank, and the active intervention of the bank should its client become financially distressed. Four options for controlling corporate dominance over global governance.Â is undertaking engagement with the UN to gain market dominance or market share, particularly in developing countries. Whether these specific criteria are appropriate or comprehensive should be decided by an intergovernmental process.Â A third option to constrain the engagement of the MNCs with the UN system is to create a quite different governance arrangement. If one considers that governments in the international system are not now able on their own to control the engagement of MNCs in global governance, a reconfigured international governance structure that brought civil society into the formal process could serve as a counterweight to MNC intrusions. A mechanism of corporate governance that enables management to make prompt and sound management decisions under appropriate and effective supervision is indispensable to the Nihon Unisys Groupâ€™s continuous growth and increase in medium-to-long-term corporate value. The Company shall create, maintain, and ceaselessly improve this mechanism. Furthermore, Nihon Unisys believes that a companyâ€™s raison dâ€™etre lies in its ability to contribute to society.Â Given the decision-making speed required in light of the changing market environment, the Company aims to make decisions that combine a broader perspective with objectivity and transparency as well as to ensure the effectiveness of supervisory functions related to the execution of duties. A reform project of corporate governance first must determine which measures will work. And the essence of making dramatic reform work is to ask, â€œCui bono?â€ Societies differ in their collective goals and priorities, and in the moral valence they assign them, so it is conceivable that improved welfare of stakeholders may not always have priority, for better or worse, over other collective goals.Â Cultural tendencies or â€œmentalitiesâ€ cannot be conceived apart from the existing political and market opportunities and incentives. Even Weber, who spoke disparagingly of the kinship organization in China. 138.