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Thoughts on Evolving Corporate Governance in Japan

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Let me begin with some general comments about the large corporation, which after all is the focus of concerns regarding corporate governance.

As a general point, good corporate governance of private sector corporations requires good public governance, including the public policy environment, the governance of state owned enterprises, and especially the rule of law and its implementation. There are huge problems in almost all developing countries, where corruption is endemic. The problems are considerably less severe in Japan and the U.S., though we each have our own corporate scandals.

The first purpose of a good corporate governance system is to allocate resources efficiently so as best to utilize them. Ultimately all resources are owned by people, often mediated through the institutions that people and their societies have created. People are owners of four types of real resources: physical capital; land; labor services, which I subdivide into blue collar, clerical, and managerial; and fourth, idea services – creative new ideas, inventions, innovations. The corporation allocates all these resources by paying for them one way or another; and the financial system is the mechanism by which household and other saving is transferred to investors.

A second, related purpose of a good corporate governance system is to be effective. This means first of all aligning and promoting the incentives to get the owners of these resources to use them well, for the sake of the firm's objectives. Effectiveness also requires having internal governance mechanisms which prevent fraud and other misconduct, including tunneling of resources away from the company to selected powerful interests. Thus, effective corporate governance relies upon and builds upon a range of institutions to protect the owners of these various resources from exploitation by the company: labor unions and other representative mechanisms for worker rights; laws and social norms which protect consumers (the customers), minority shareholders, intellectual property rights, and others. Social norms which define the proper behavior of all stakeholders, including management, are very important in every country, and especially in Japan.

A third purpose of corporate governance is to enhance the role of the corporation in society in order to enhance social welfare. This is where the great debate about the proper role of the corporation is taking place. To what extent should the corporation as an economic institution be addressing broader social objectives – employee job protection, income distribution, helping the disadvantaged, protecting the environment? I do not intend to pursue that debate here. My perception is that, in practice, most large companies in most countries pursue a relatively narrow definition of their social responsibilities. Since corporations have to be founded on good profits, if not profit maximization, in order to survive, their social responsibility practices usually are motivated by branding objectives, to develop and maintain a reputation as a good, responsible, reliable company.

The control by management of the corporation is a major common feature of the Japanese and American economic systems. The key difference lies in the stated purpose of the company and hence of its corporate governance: primarily to protect and benefit the owners of the company and its physical and intangible resources – the stockholders in the U.S. model; or the owners of the labor services, including managerial services, i.e. the regular employees of the company in the Japanese model. In both countries management also has to take care of the other stakeholders – customers, suppliers, banks and other creditors – but when critical decisions have to be made, who comes first? It is the stockholders in the U.S., and the employees in Japan. Which corporate governance objective is more efficient, more effective, and more socially desirable? I do not think there is a clear cut answer at the theoretical level. Which is more important: cheap sources of finance; or loyal, committed employees? Or can a company have both?

At a practical level of actual business behavior in both countries, good corporate governance today seems to aim at raising minimum standards of governance and developing so-called best practices. These include corporate disclosure, transparency and accountability, overcoming the information asymmetry and agency problems of separation of ownership and control, and assuring the integrity and honesty of managers.

What is impressive to me is the extent to which Japanese corporations have developed a system of self-perpetuating, entrenched and quite autonomous management control. This is because in Japan, like the United States, the shares of most listed companies are quite widely distributed with no effective blockholders, so that ownership and control are separated.

The future depends upon the past. Path dependency is important; the current heritage of institutions, relationships, shared historical experience, and values are embodied in the specifics of each company's corporate culture. But path dependency is only one factor, not a sole determinant. Success breeds change; innovation forces change; the changing external environment creates new challenges and new opportunities. Given Japan's recent history, it is not surprising that corporate governance in Japan is in great flux. The postwar economic system is under attack, but what the new model or models will be are yet to be determined.

My focus is on those 80 percent or so of Japanese listed companies in which management is entrenched and has quite autonomous control; I exclude companies controlled by founders or their families, listed foreign-controlled companies, and listed companies that in practice are subsidiaries of a parent company, such as Hitachi.

As in other countries, Japanese companies have been initially owned and controlled by their founders and successor family members. In pre-World War II Japan the system of family-controlled business groups (zaibatsu) developed as a major feature of Japanese big business organization in what was a quite fluid and competitive business environment.

The evolution from owner control to manager control was dramatically accelerated and reshaped both by early postwar company balance sheet destruction through real capital wartime destruction, government repudiation of its debts, and rampant inflation; and by the postwar U.S. Occupation reforms. Zaibatsu families and other major company owners essentially lost their shares in their companies, shares were initially widely redistributed to individuals, ownership and control were separated, and bank finance became very important. Management successfully preached the rhetoric that the status of capital should be reduced and that of labor raised, with management the mediator serving the public interest. There was a significant Marxist movement opposing "monopoly capitalism". Japanese management succeeded in creating the ideology – the belief system - that the company is a community which serves society, with responsibilities and reciprocal obligations, in particular to its employees and to its business and financial partners. This is in contrast to the perception that the American economy and society are run on Darwinian principles. I think many Japanese managers believe this ideology, even transcending its self-serving elements.

With separation of ownership and control, good corporate governance tackles information asymmetry and agency problems between management and the company's stakeholders. The integrity of the managers is essential. External monitoring, peer pressure, norms of ethical behavior are all designed to ensure first of all that managers behave honestly.

Even with separation of ownership and control, management is not completely autonomous. Its performance is monitored externally by its sources of finance – its banks, other creditors in the capital market – and by regulators; and internally by its labor force institutions. When performance is poor, these monitors intervene one way or another. For all companies everywhere, the ultimate monitors are its customers, who can always exit. The more competitive are the markets for a company's products, the greater the discipline on management behavior, as recent scandals in Japan have demonstrated.

The Japanese Management System

Japanese management has two fundamental, inter-related goals. The first is to ensure the survival of the firm forever. The second is to maintain management independence and autonomy in a self-selected, self-perpetuating management system. Bankruptcy and liquidation is the worst possible outcome;

selling the firm (usually termed merger) is the second worst. Japanese managers are not unique; managers everywhere want as much autonomous control and power as possible. What is unique was that the early postwar economic and political environment enabled Japanese managers to shape the evolving system to their great benefit, and to become so entrenched and free from external control. There are two basic reasons.

The first is that managers succeeded in having a majority of their company's shares held, each in relatively small amounts, by a large number of other friendly companies – banks, insurance companies, suppliers, customers. The extreme form of this stable shareholding is cross-shareholding, typically between banks and their large industrial clients. The implicit agreement of these tacit alliances – exemplified at the extreme by the horizontal business groups (keiretsu) – has been non-interference by one company's management in the management of the other company; and a tacit understanding that shares would not be sold without the agreement of the issuer, and then typically through private placement rather than the open market. So, relatively early on, company management made itself immune to the threat of hostile take-over bids. Moreover, in the postwar rapid growth environment, dividends were a very stable, ongoing commitment, easy to finance from profits; and share prices rose substantially. Until the 1980s, management recognized that good operating profits were essential to buy off all stakeholders.

The second potential challenge to management control was in fact internal - the highly politicized labor union movement that swept Occupation Japan. Strikes and other labor strife were common in what was initially a very difficult postwar economic environment. Management's two foremost problems were labor relations and obtaining finance in a policy environment which restricted capital market development and encouraged borrowing from banks. By the late

1950s a new group of labor leaders had emerged at the enterprise level who gave much higher priority to job security and wage increases, and were willing to forego strikes and accept the rapid technological changes that were taking place in exchange for job security and ongoing worker training and retraining. Firm-level labor-management relations became win-win. At the same time, unions developed substantial veto power over dramatic changes in their position, such as mergers, or sales of a division.

Three institutions developed that came to be called the Japanese postwar economic system: the main bank system of finance; the permanent employment system of job security, seniority-based promotions, and enterprise-level unionism; and the management system of entrenchment, with company boards of directors consisting of internally promoted members selected by an internally-promoted president. The main bank was supposed to monitor corporate performance and step in when their business clients were in trouble; and the Ministry of Finance was supposed to monitor the banks. It was an opaque, cozy, at times collusive system. Indeed, catch-up very rapid growth to the 1970s, and sustained good growth until 1991 both made the postwar economic system very effective, and over time validated it, but through its success eventually undermined it. Rapid growth makes inevitable mistakes less costly and often hides them; poor growth performance exposes past and current mistakes and raises their costs.

What is remarkable is that, as a quid pro quo, norms of managerial self-restraint developed and became very strong. CEO and top management salaries were only 10 to 20 times those of an average employee’s and the CEO in many cases came to limit his term to 6 or 8 years before choosing his successor and becoming the Chairman. Managers were well paid, particularly when expense accounts and post-retirement positions are included; but they did not become super multimillionaires. A major pay-off was in status and prestige; big business leaders more or less replaced the prewar nobility in Japan's social hierarchy.

By the late 1980s the Japanese managerial system came to be perceived as having many virtues: a long term time horizon; the efficiencies of sustained relationships in enhancing trust; the belief that only managers know their company well enough to make basic strategic decisions – a belief that self-servingly persists today among many Japanese companies. And with all this success came much hubris.

The Ending of the Postwar Economic System

Symbolically, this postwar economic system came to a crashing end with the bursting in 1990 and 1991 of the huge twin asset bubbles of stock prices and urban real estate prices, especially commercial real estate that served as the collateral for many bank loans. The ongoing policy responses by government officials, bankers, and businessmen alike of inertia, delay, procrastination and forbearance are major causes of Japan's mediocre economic performance since the early 1990s – only about 1.2% growth, substantially below potential, with all the well-known problems the Japanese economy faces today.

This poor performance of the Japanese economy has made much more evident the weaknesses of the postwar economic system and its corporate governance system. What were strengths in rapid growth became weaknesses in slow growth.

The fundamental problem is that the postwar system worked well in a rapid growth, catch-up economy, but does not work well in a mature economy whose growth rate potential at full employment of resources is no more than 2 percent or so. One key problem is the lack of flexibility to carry through quickly the sorts of major reallocations of resources that became necessary in a slow growth environment in which some firms and industries have lost competitiveness, and where technological and innovations drive necessary changes in efficient resource allocation.

In many respects the system was opaque and inflexible, unable or unwilling to change as the business environment changed. One consequence has been a loss of confidence and trust by the public in business leaders and government officials; the public had never thought particularly highly of politicians. It has come to be recognized that good economic performance and good corporate governance have to be founded on disclosure, transparency and competitive markets. Japan's economic and corporate governance systems are in a slow-moving process of quite fundamental transformation.

Before addressing the changes in the corporate governance system, first let me say something about the changes in the permanent employment system and the main bank system.

The negative side of the permanent employment system has been the lack of good markets for redundant workers in large firms, especially for those employees on the managerial track. The downside of very deep, firm-specific corporate cultures is that many of the management skills are developed for the purpose of internal and also external networking, and these skills and knowledge are not very useful to other, unaffiliated firms. In particular, the market for senior executives is virtually non-existent. It is not surprising that top management try desperately to protect their jobs until retirement; they have no place to go.

Given the difficult reality that, for many firms, downsizing is necessary for survival and that attrition and reduced hiring are not sufficient, a number of them have negotiated expensive buy-outs of their employees. Firm are reducing the importance of seniority and increasing that of meritorious performance in wage increases and promotion. Many young college graduates today may not believe that a company's permanent employment commitment is fully credible. I think the permanent employment system will persist in modified form, in part because the inevitable reductions in the labor force, a demographic given, will create labor shortages by the end of this decade if the economy succeeds in achieving sustained growth.

The negative side of the main bank system is that gradually the banks weakened their independent monitoring capability, and came to trust their large borrowers too much. Relationships replace careful credit analysis.

Eventually, the roots of the cozy, at times collusive, non-transparent relationship among regulators, banks, and to some extent big businesses came to be increasingly exposed by a series of scandals and other events. The Ministry of Finance was very slow to shift from the convoy system of regulation to prudential regulation. Yakuza had infiltrated some borrowing companies to an unprecedented extent. The costs and inefficiencies of cross-shareholding became all too obvious as share prices collapsed, hidden unrealized capital gains disappeared, and dividend payouts remained low. The weaknesses of the entrenched management system came to be more and more exposed.

Thus, corporate governance and monitoring of companies by banks is no longer effective, while the capital markets have not yet adequately taken over the corporate monitoring function. There is not yet an adequate market for corporate control. The establishment of the FSA was a major step forward, but it inherited a system of forbearance of a weak bank system, into which the political leadership has not been willing to inject sufficient government capital to make the banks strong again. The government should have used 20 trillion yen not to buy dollars but to bail out the banking system, or even better it could have done both.

Changes in Corporate Governance

Accordingly, Japan's system of internally based, opaque corporate governance is under attack, and at least formally has been changing significantly. In practice, most changes so far have been led by the government – changes in the rules of how the game is to be played, with the market gradually adjusting to these changes. These can be divided into major legal and institutional changes enhancing firm flexibility – stock options, M&A rules, holding companies, share buy-backs and so forth – and changes which enhance external monitoring – mark-to-market, tougher accounting and auditing rules, stockholder derivative suits, capital market liberalization, and the new opportunity to replace the Japanese board system of inside directors and statutory auditors with a U.S.-style committee board structure. And outside auditors, now facing the possibility of shareholder suits if they certify misleading financial statements, have suddenly become potentially important corporate governance players, as the Resona Bank bailout case last spring demonstrates.

In a recent study, Ronald Gilson and Curtis Milhaupt have analyzed the 71 firms, 45 of which are listed, that have adopted the new committee board system in its first year. Of the total, more than half (36) were Hitachi and some 21 subsidiaries, of which 18 are listed, and Nomura and some 13 privately held subsidiaries. "Outside" directors elected to their boards were from the parent company. In contrast, a majority of the outside directors for the remaining 35 firms were drawn from unaffiliated firms or were lawyers, and more independent (or less dependent). In only 19 of these firms were outside directors half or more of the board. These companies were classified into the following types: global market players such as Sony; firms with large foreign institutional shareholders such as Columbia Music Entertainment and Orix; distressed firms such as Resona Holdings and Manulife; and foreign controlled firms such as Vodaphone and Seiyu. In contrast, no core firms in bank-centered keiretsu have shifted yet to the committee-based board system. All the committee board companies are required to have at least two outside directors, and many have more than that. In contrast, only a quarter (500) of 2102 Tokyo Stock Exchange companies surveyed in fall 2003 have any outside directors, and only about half of those (263 firms) have just one outside director. The Japanese definition of outside directors is weak, so the difference between outside directors and independent directors (defined in U.S. law but not Japanese law) is even greater. In practice, achieving a system of truly independent directors is a problem in all countries.

Another significant change has been in stock ownership: bank and life insurance company sales of their holdings of corporate shares on the one hand, and the rising share of foreign ownership on the other hand. Based on the Nippon Life Insurance Research Institute estimates, at the end of March 1991 stable shareholding comprised 45.6 percent of all listed company shares; by March 2003 it was down to 27.1 percent. Cross shareholding, 18.0 percent in 1991, declined to 7.4 percent in 2003. On the other hand, foreign shareholding, 4.7 percent in 1991, increased to 17.7 percent. Nonetheless, many shares remain held by stable shareholders, especially those of larger, keiretsu-member companies. Interestingly, there does not appear to have been any significant decline in corporate shareholding in banks, and has actually risen in each other, which I assume are parent company purchases of the shares of subsidiaries being sold by banks and insurance companies.

Foreign institutional shareholding has become a significant factor in those companies deemed most attractive. Many are in companies performing well, developing good corporate practices, and newly engaging in activist investor relations programs. Even so, foreign investors are primarily driven by their expectations of stock price increases. Certainly the sharply rising foreign holdings of the shares of major banks since summer 2003 has not been due to improved bank corporate performance. Rather it is because the Resona case signaled that the shareholders of other major banks would also be bailed out if a crisis should occur.

As already noted, capital market institutions – such as securities analysts and credit rating agencies – have improved; and stock prices now serve as signals to investors and managers far better than earlier. Institutional investors, led by CalPERS, have been promoting good corporate governance, but not yet with great effect. The Japan Pension Fund Association may become a significant player; it has recently announced it will exercise pro-actively its substantial voting rights at general shareholders meetings.

The power of shareholders to exercise control over management rests fundamentally on there being a strong, deep market for corporate control, making the threat of take-over bids credible. A <u>Financial Times</u> article in April states: "At the start of this year (2004) there were 2,600 companies whose market capitalization was less than the value of the cash and securities on the books, according to a list compiled by HSBC." (Elizabeth Wing, "Japanese market revival sets off hunt for bargain stocks," April 5, 2004). The number of undervalued companies has decreased with the rise in stock prices this year and with the threat of hostile take-over actions, epitomized by the case of Steel Partners and its bid for Sotoh Corporation. While the bid failed, management was forced to make a major dividend pay-out, and the share price rose sharply. This triggered higher dividend payments and share price rises by a number of other smaller, cash-rich, listed companies. While these have been important first steps, they seem reminiscent of earlier greenmail attempts in Japan rather than engendering a significant improvement in Sotoh's corporate governance. Sotoh and similar companies may have less excess financial assets, but management remains entrenched and probably its behavior has not changed significantly.

The last-minute cancellation of ailing Kanebo's sale of its cosmetic business to Kao appears to me to be a prototypical case of the complex difficulties of restructuring major firms which are representative of the postwar economic system. My knowledge is not deep, so I trust you will correct my interpretation.

Anyway, as I understand it, Kanebo had a traditional management, a negative equity, a huge debt, some 513.6 billion yen of non-performing loans, and many unprofitable divisions being internally subsidized by the successful and profitable cosmetics division. Kao is successful: profit-oriented and profitable, sensitive to financial market signals, with an effective management. One division of the merged Mitsui Sumitomo Bank was a main bank for Kanebo, another division a main bank for Kao. The bank proposed Kanebo sell its cosmetics division to Kao, which made good business sense and which would enable Kanebo to pay off 400 billion yen of its non-performing loans to the bank. The reason given by Kanebo for the cancellation of the sale was the opposition of its union. I am sure that the union was not happy about the proposed sale. However, I have the impression that many senior managers also opposed the sale, fearing they would lose their jobs. Then Mitsui Sumitomo Bank took Kanebo to the IRCJ. Despite initial media inaccurate reporting, IRCJ evidently took an even tougher position, providing less funding and forcing senior management out, and appointing Kunihiko Yogo, one of its executive officers, as CEO. How the Kanebo restructuring works out remains to be seen. This case does provide insights into the behavior of major players: the main bank, top management, the union, the government – and not the Kanebo shareholders.

The moral hazards of the Japanese corporate governance system do not lie in extravagant compensation of top management, or in an excessive focus on the short-run. And, in isolated cases, while American managers may steal from the company, Japanese managers steal *for* the company. One form of moral hazard is that middle management expends considerable effort to protect the CEOs and senior management from exposure of company mistakes or personal scandal; opaqueness has its costs, as *sokaiya* blackmail earlier demonstrated. There are two fundamentally more important moral hazards. First, management has had a proclivity to invest surplus cash in company new projects, seemingly regardless of their profitability. At the macro level, the ratio of business investment to GDP is too high. At the micro level, the return on assets at the company level is too low. This is particularly true of companies that promoted diversification at the expense of focus, as the problems of Japanese large electronics companies well demonstrate. Companies gave greater priority to sales growth and market share than to the profitability of investment.

A second form of moral hazard is that managers of Japanese firms in serious difficulty have delayed restructuring far too long, thereby significantly eroding the value of the company, its future, and thereby the prospects for both current and potential future employees. However, one criticism of this view is that using surplus funds for diversification or holding large amounts of cash, or delaying restructuring, were not due to the bad behavior of management but to their mistaken optimistic assumption about the future. Either way, those decisions have been very costly for firms.

An important corporate governance debate is under way in Japan. A few major business leaders seek a more U.S., market-based system geared to the long-term interests of stockholders, while criticizing U.S. short-run orientations and incentives. Most business leaders, however, seek to improve the existing Japanese system with greater disclosure and transparency and an outside director or two, or an outside advisory committee. One key issue persists: is the company's primary commitment to its employees or to its shareholders? Management support of employees of course is to a substantial degree support of themselves and those in the management hierarchy, beginning when college graduates enter the company. So far as I can tell, this mindset of most Japanese managers has not fundamentally changed.

My conclusions are as follows.

First, Japanese managers have relearned the lesson that profitability is important, in order to obtain finance and to keep all stakeholders reasonably happy. This is not a commitment to profit maximization but does mean that the weight assigned to shareholder interests will increase, even though the greater weight for regular employees will probably persist. It also means sales growth and market share will be less important independent objectives.

Second, while most companies will come to have a few outside directors, they will not dominate, and only a small number of firms will adopt the U.S.-style committee board system.

Third, the main bank system is unlikely to be resurrected as an effective monitor for most listed companies. Bank monitoring will shift to mid-sized private companies, like banks in other countries.

Fourth, gradually capital market institutions, instruments and prices will come to play a significant monitoring role, but they have a long way to go.

Fifth, a market for corporate control will emerge, and when it does it will have a significant impact. However, rather than a plethora of hostile take-over bids, I anticipate that concerned parties will negotiate arrangements to improve company performance and governance. It will be important to separate out instances of greenmail from those resulting in improved corporate governance.

Sixth, the postwar economic institutions of the main bank system, the permanent employment system, and the management-controlled corporate governance system will be weakened and transformed but will not disappear.

Seventh, firms will place primary emphasis, at least rhetorically, upon internal governance reforms, stressing ethical behavior and more effective internal communications, controls, and processes. The fundamental mindset of senior managers will be to maintain its commitment to regular employees, especially those in the management track, and not to the stockholders.

Eighth, a hybrid set of corporate governance objectives, institutions and practices will evolve out of the postwar system, with greater heterogeneity among firms, but few approaching the Anglo-American model.

A clever Japanese management today is engaging in corporate governance reforms that do not fundamentally reduce its entrenchment, while enabling the firm to be more successful in the long run. These include greater disclosure, transparency, the executive officer system, improved internal governance, the limited use of knowledgeable outside directors, buyback of shares, and enhanced reliance on the capital market. But few firms will shift to the board committee system or to a majority of directors who are truly independent outsiders. So long as firms can be profitable enough to buy off all stakeholders, Japanese management will be able to remain in control.

In Japan, good corporate governance often seems to simply mean good corporate performance. To the extent that industries and firms are facing an increasingly competitive environment, market pressures to improve performance are likely to be linked with measures to improve corporate governance. While there is not proof that good corporate governance causes good corporate performance, companies that score well on the Japanese Corporate Governance Index do have superior performance as measured by return on assets, return on equity, stock returns, and employment creation. Corporate governance is one element in a business strategy package that generates superior performance.