Spotlight

Japan
Corporate Governance: A System in Evolution

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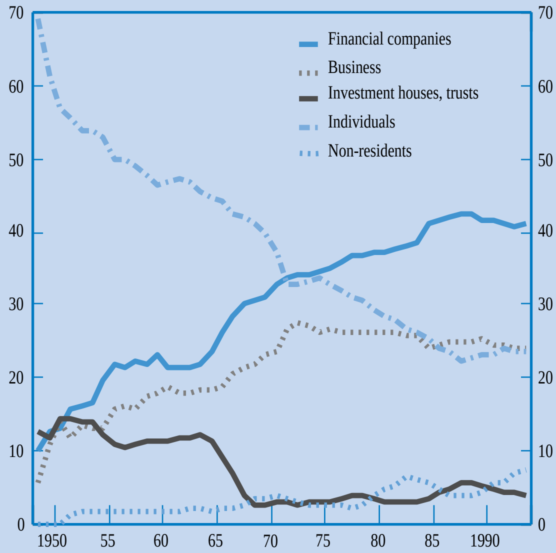
The divergence of interests between managers and share-holders which arises from the separation of ownership and control in modern joint-stock companies can adversely affect the performance of the corporate sector and thereby the economy at large.[1] Since the 1950s, Japan's approach to the problem of corporate governance has differed from that in other countries.[2]

There are broadly three mechanisms of corporate governance. The first is to motivate managers to carry out efficient management by linking their pay or promotion to the performance of the firm. In many countries, this approach has meant high managerial salaries and schemes such as share options for executives. In Japan, executive pay is on average lower than in other OECD countries and stock options have not generally been used because of restrictions on the ability of companies to buy back their own shares and because the income-tax treatment of such packages has been unfavourable. As a result, direct incentives for managers are lower in Japan.

The second method is to use indirect means of corporate control such as that provided through the discipline of the capital market. A take-over market is presumed to be the ultimate weapon against managerial misconduct. But in Japan take-overs are relatively rare compared with the United States and the United Kingdom, though not because of legal impediments. Rather, given the prevalence of stable shareholding, it is quite difficult for an external buyer to purchase a sizable portion of shares in a company through the Japanese market. Indirect control by take-overs is therefore limited.

Figure 1
Distribution of Share-holders by Category, 1949–94
%



Source: Annual Securities Statistics, Tokyo Stock Exchange

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The third mechanism, direct control, involves giving more power to shareholders, creditors or other interested parties, either by strengthening their ability to monitor the performance of the company or through their institutional rights, such as the power to replace management. The legal structures of corporate control in Japan are very similar to those in other countries. But the ownership structure, where nearly 70% of all stocks are owned by institutions and corporations (Figure 1), is rather different. Moreover, the concentration of ownership is much higher in Japan than in the United States and the United Kingdom,[3] reflecting both the fact that financial institutions are allowed to own stocks in Japan and the tendency for companies with business relationships to hold each other's stocks ('cross-shareholding').

The Main Bank

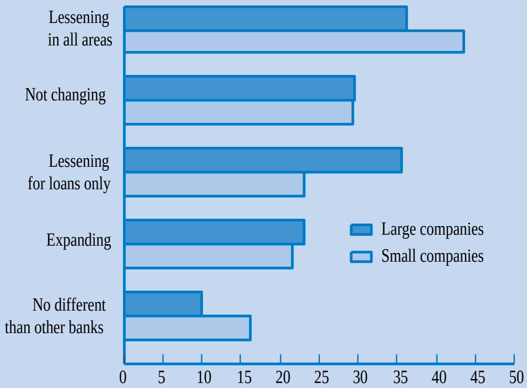
In Japan, a few important institutional shareholders exercise direct control, aided by stable and concentrated shareholding. Among them, the so-called 'main bank' plays an important role in corporate governance. Although a company usually does business with several banks, it often has a special relationship with one of them. This main bank performs five important functions: it makes loans, and is usually its major creditor; it helps place the bonds issued by the firm; it owns shares, often, indeed, as the main shareholder; it offers payment settlement facilities; and it supplies information and management personnel.

These functions enable the bank to integrate three types of monitoring: *ex ante* – basically, screening the company's applications for loans; interim – gathering information on the continuing performance of borrowers; and *ex post* – intervening in the affairs of firms in difficulties. It is not entirely clear why banks have an incentive to carry out such extensive monitoring on behalf of other bank lenders and shareholders. Nevertheless, it seems to have resulted in a number of advantages for other financial institutions.

Figure 2

The Perceived Role of the Main Bank

% of responses to a survey in 1991



Source: *Research Reports*, No. 75, Nihon Keizai Research Centre

One of the most important features of the Japanese main-bank system has been that it provides a type of contingent governance. When performance is good, corporate affairs are left to the incumbent management. When it deteriorates, the main bank, using its power as a lender and shareholder, intervenes in the management of companies to supervise downsizing and reorganisation where necessary.

Such interventions often occur through the appointment of bank directors to the board of the company. There is substantial evidence that the influence of directors placed by banks on client firms' boards is much stronger than their numbers would suggest, reflecting the important role of the main bank. Moreover, the probability that a bank will send additional directors to a board is directly related to poor performance, particularly in comparison with other companies in the same industry. Other large shareholders also exercise an important but subsidiary influence. In addition, business partners, such as suppliers and clients, also monitor the performance of companies.

The main-bank system worked well in the past, but strains are now beginning to emerge as a result of the impact of financial liberalisation in Japan. The demand for bank loans has fallen as companies have reduced their fixed capital formation and financial investment after four years of sluggish economic growth. In addition, financial deregulation has both eased access to capital markets and reduced bank profits. In the current environment, the banks may not be able to afford to undertake such extensive monitoring services (Figure 2). The severe bad-loan problems faced by the major banks have made them reluctant to take risks and have reduced their capital. These changed circumstances may impair their ability to provide aid when their clients face financial distress, which has hitherto been a key aspect of their *ex post* monitoring role.

Although the capital position of banks may recover in the current upturn, more financial institutions other than banks may have to become involved in corporate governance. In particular, stiffer competition in life insurance and in fund management could force these institutions to take a more active role. Deregulation of these two sectors should therefore be accelerated. The fund-management market could be further liberalised, and reform of the investment rules governing life insurance and pension funds pursued with new vigour. New accounting procedures, based on market prices, would be another welcome step.

Another way to encourage diversity in the provision of corporate governance would be to allow the creation of holding companies with financial stakes in a wide range of firms. Such companies could provide 'their' firms with central management skills. And a change in the tax disincentives and legal restrictions which limit stock options would tie the rewards to management more closely to the performance of the companies which they run.

These liberalising measures would allow the governance system to evolve in a manner appropriate to the structural changes in the economy, including a lower growth potential, an aging population,[4] deregulation and changes in other markets, such as labour. The strengths of the bank-based system of governance could be simultaneously reinforced by improving the banks' own disclosure and accountability, and by strengthening supervision of the banks. ■

*1. See also Peter Jarrett, 'The United States – Corporate Governance: The Market as Monitor', **The OECD Observer**, No. 203, December 1996/January 1997.*

*2. **OECD Economic Surveys: Japan**, OECD Publications, Paris, 1996.*

3. The top five share-holders own an average of a third of outstanding shares in a Japanese company, compared with about a quarter in the United States and a fifth in the United Kingdom.

*4. Peter Hicks, 'The Impact of Aging on Public Policy', **The OECD Observer**, No. 203, December 1996/January 1997.*

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