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Corporate Governance in Japan

Evolution, Policy Measures, and Future Issues

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Keio SFC Academic Society

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Abstract

Corporations are the driving force behind any market economy, and their proper behavior is crucial to economic security. Hence, this paper focuses on Japanese firms (companies or corporations) that played important roles in developing and forming the entire Japanese economy, and discusses various aspects from the viewpoint of corporate governance. The main arguments are as follows. First, the conditions, which maintained management discipline of corporations, have been gradually lost since the 1980s. Second, this loss led to a "vacuum of corporate governance", which contributed to the asset price bubble in the 1980s and the prolonged recession in the 1990s. Third, capital markets are becoming more influential due to increased ownership of Japanese corporations by foreign investors. Fourth, because Japanese corporations are adding Anglo-American elements into their governance, "hybrid" styles are increasing, and the style of governance is diversifying. Fifth, for Japanese companies to continue producing innovative products, two important tasks--improving the financial environment that underlies corporate governance and improving relevant laws and regulations-- must be completed.

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Introduction

How a business corporation is organized and how it behaves decisively affect the entire economy. From 1955-75, which was a super high-growth period of the Japanese economy, the average annual growth rate recorded double digit figures, and it was clear that Japanese firms with their active production and capital investments drove the economy. Similarly, during the "lost decade", or the long stagnation of the Japanese economy in the 1990s, one of the main causes for this depression was the inactive investments of Japanese firms.

This chapter considers the Japanese corporation,[1] which has historically played an important role in shaping the entire Japanese economy. Moreover, this chapter critically evaluates a series of relevant issues from the viewpoint of "corporate governance"; namely, how the behavior of a corporation emerges due to conflict and adjustment of various stakeholders' interest in a corporation. In particular, the chapter asks such questions as: (1) How is the traditional behavior of a Japanese corporation related to its unique structure? (2) When did the traditional Japanese corporate system stop functioning properly? (3) When did changes in the social and economic environment occur? (4) How has the nature of corporate governance changed with respect to relevant public policy and environmental changes? (5) What are current and prospective policy issues?

In the last twenty years or so, the environment surrounding the Japanese economy has undergone a dramatic change. Domestically, unprecedented changes have occurred in various spheres, including innovations in information and communication technologies (ICT), the rapidly aging population and subsequent decline in the household saving rates, business corporations retaining excess cash, the continuous decline of asset prices, de facto zero interest rates, and continuing deregulation. In addition, drastic changes such as financial globalization, the global transmission of the US sub-prime loan problems, and the rapid economic development of certain Asian and other economies, have occurred internationally. All these developments have definitely influenced Japanese corporate governance.

Section 1 outlines the characteristic structure and behavior of traditional Japanese corporations, and then presents two types of corporate governance schemes and their corresponding financial systems in order to better understand the above characteristics in a

[1] Although the terms corporation, firm, and company differ somewhat, they are used interchangeably in this chapter.

generalized framework. Section 2 considers two important elements, which characterize the traditional Japanese financial system and the corporate governance, namely the main bank system and the closely related phenomenon of cross-shareholdings. Furthermore, their functions with respect to corporate governance are explained. Section 3 describes the circumstances that necessitated traditional corporate governance to erode, as well as the subsequent effect of the emerging "vacuum of corporate governance", which eventually led to the growing bubble in asset prices and the ensuing long stagnation. In Section 4, we review and evaluate various policies and codes of good corporate governance, which strive to strengthen corporate governance and are provided by both the government and private organizations. Section 5 provides a summation of the changes that Japanese corporate governance has undergone in response to changes in both the environment and various policies. Then it focuses on M&A's (mergers and acquisitions) as an important phenomenon to demonstrate the increased pressure from capital markets as well as conducts econometric analysis to evaluate these effects. In Section 6, we explain how changes in the environment and the institutional framework have altered "external governance". Moreover, it examines how the "internal governance" of corporations has become increasingly diversified as well as discusses a desirable governance framework along with the requisite public policies. Finally, Section 7 summarizes the main conclusions. Appendix 1 explains the method and data for the econometric analyses of the M&A's presented in Section 5, while Appendix 2 presents an empirical study on the relationship between the corporate governance structure and the efficiency of corporations.

1. Uniqueness of the behavior and the structure of traditional Japanese corporations

Japanese corporations have greatly contributed to the long-term development of the Japanese economy by producing innovative products and expanding sales both at home and abroad. However, due to changes in the economic environment and public policies, the structure and the behavior of today's Japanese firms vastly differ from those of a few decades ago. Hence, to fully understand the nature of today's Japanese firms, it is necessary to first review the characteristics of traditional Japanese firms. Herein, we initially summarize the distinctive features of traditional Japanese firms, and then present a framework to understand today's firm in terms of an international comparative perspective. Finally, we explain how the corporate governance system is closely linked to the financial system.

1-1 Three characteristics of traditional Japanese firms and their relationships

What are the characteristics of a typical Japanese corporation relative to corporations in other countries? As discussed later, these characteristics have certainly been changing since the late 1990s. However, since after World War II until the 1980s, numerous researchers have documented that Japanese firms have three distinctive features compared to, for instance, American corporations.[2]

The first characteristic is called the "growth orientation of the Japanese firm". A traditional Japanese firm values corporate growth or expansion of the firm's size rather than the profit margin, which sharply contrasts the average American firm that emphasizes profit or the profit margin.

The second difference from an American firm is the "de facto dispersion of company ownership". A traditional Japanese firm does not consider shareholders as "owners" of the firm, and accordingly, does not pay much attention to its shareholders or share prices. The traditional perception has been that a company belongs not only to shareholders, but also to all the stakeholders, including managers and employees. This perception is due to two circumstances.

One is that financial institutions and non-bank business corporations held most of the company shares (roughly 70%) so that individual shareholders were insignificant. When a company's shares are held within the corporate sector, which is called cross or mutual shareholding, exercising control rights by one company as a shareholder over another company implies that the former company needs to admit reciprocally to the intervention by the latter. Accordingly, when cross shareholding is prevalent, corporate control and monitoring by the capital (stock) market are naturally weakened.

The other circumstance is that the members of the board of directors, who are legally expected to monitor the company's management on behalf of the shareholders, were not independent of the company managers, but rather the two were integrated. In a traditional Japanese firm, the majority of the board of directors are selected from senior managers of the company. Therefore, the board directors do not necessarily play the role of external shareholder agents, but rather the board of directors are regarded as representatives of all the company's employees. Under these circumstances, the perception that company

[2] For instance, Clark (1979) and Abegglen and Stalk (1985) are among the well-known books in the early years that introduced the Japanese firm to overseas audiences. The explanation below is based primarily on Okabe (1992).

ownership belongs not simply to the shareholders, but also to all the stakeholders, including managers and employees, is natural. Hence, this de facto dispersion of ownership severely limits the influence of shareholders, and enables managers to run the company without worrying about the share price.

Third, as it relates to the shareholding structure, traditional Japanese firms have a large number of domestic subsidiary firms and related firms, which they heavily rely for production and other business activities. This sharply contrasts American firms, which have far fewer related firms. In other words, the main body of a Japanese firm is engaged in rather limited business activities, but by actively integrating a whole array of subsidiaries, the entire group of firms can undertake a wide range of business activities. Therefore, the mutual relationship between organizationally independent firms is very close, which in effect, leads to a vague boundary of a firm. Moreover, transactions are continuous and of a long-term nature. For instance, the Toyota Motor Corporation, the largest automobile maker in the world, has 522 affiliated firms (as of March 2007), which are subjected to consolidated financial statements, and thus, form a large corporate group in production and distribution. Hence, traditional Japanese firms tend to form corporate groups.

As the above survey shows, traditional Japanese firms have three characteristic features; they (1) are strongly growth oriented, (2) do not consider shareholders and share pricing (or a de facto dispersion of company ownership), and (3) are group oriented (or opaque about the firm's boundary).

When company managers do not have to consider share prices, they tend to emphasize increasing their products' share in the market as well as the prestige of the associated companies rather than the profit margin. In addition, when long-term employment is presumed, the positions of both managers and board directors are secure so that the time horizon of the management is likely to extend further. Thus, the focus is on corporate growth rather than efficiency. Furthermore, when long-tem employment prevails with limited layoffs in accordance with short-term business fluctuations, wages become a fixed cost rather than a variable cost. Therefore, a firm tends to reduce the average wage cost per unit of a product and to increase its profit by expanding sales volume. This type of expansionary behavior of a traditional Japanese corporation can be understood as arising from both the long time-horizon of the management and the dispersion of de facto corporate ownership, which continuously oblige the management to escape the pressure of wage payment.

1-2 Two models for a system of corporate governance

Textbooks provide a basic understanding of the behavior of a firm. Their views are based on neoclassical economic theory, and are applicable to the behavior of typical American firms. Namely, the theory assumes that a firm strives to maximize its profits, or the share price (the sum of the discounted expected future dividends), which measures the wealth belonging to the shareholders. However, the behavior of the Japanese firm seems to deviate from this theory. In order to capture this phenomenon, it would not be wise to interpret the behavior of the Japanese firm as "abnormal", but it would be more meaningful and productive to establish a separate model of corporate governance.

Although the typical Japanese firm has undergone many changes in recent years, some fundamental aspects still survive and are in sharp contrast with firms in foreign countries, especially American firms. Accordingly, let us try to understand the nature of the firm by introducing two models. Although this two-model approach has conventionally been adopted (for instance OECD 1995; and Allen and Gale 2000), the novelty herein is that the models have been somewhat extended to cover corporate monitoring or corporate governance in addition to being linked to the financial system. By establishing two models, the American model (or Anglo-American model) and the Japanese model (or Japanese-German model), we can understand the characteristics of a Japanese firm more clearly.[3]

The American corporate governance model

The American corporate governance model, or the outsider model, is found not only in the United States and the United Kingdom, but also in many other English-speaking countries, including Canada and Australia. The outstanding feature of this model is that company management is subject to severe scrutiny by an outsider, called the capital market (especially by way of a corporate takeover through the acquisition of a company's shares). The strengths include a high degree of transparency because all transactions are conducted according to explicit contracts and legal provisions, and it is an efficient restructuring method for the economy because inefficient firms are subject to mergers and acquisitions

[3]These two types correspond roughly to a "shareholder's view" and "stakeholder's view" in understanding a corporation. The former is sometimes called the finance approach (because it focuses on the power of the provider of funds) or an agency view (because corporation managers are understood to be the agents who supervise the corporation on behalf of the shareholders). However, if we focus on the monitoring nature of a corporation, the American model is an "outsider" model because the stock market is the monitor, and it is closely related to a "market-based financial system". On the other hand, in the latter type, banks (especially the main banks in Japan), which collect and store a full range of corporate information, play important roles. Thus, it is an "insider" model linked to a "bank-based financial system".

(M&A's) or takeovers, which leads to a drastic restructuring of a corporation in a very short time.

On the other hand, there are three major shortcomings. The first is the time horizon of corporation management tends to be short because the performances of managers are assessed in the stock market by the current profit. The second is that society incurs a relatively large monitoring cost due to the inevitable large transaction cost for drafting formal contracts, as well as for utilizing both legal processes and stock market as they are overlapping monitors. The third is as a consequence of hostile takeover, drastic corporate restructuring may damage the interests of stakeholders, especially employees.

The Japanese corporate governance model

In contrast, the Japanese corporate governance model, or the insider model, is fairly extensive in OECD countries, except for those mentioned above. The most important feature of this model is that companies are not monitored by outsiders such as the capital market, but are monitored mainly by a bank, or a quasi-insider, which is usually both a creditor and shareholder. This model has three main strengths. The first is the long-term horizon of the management because managers generally work for the same company for a long time and represent the interests of future managers. The second is the relatively small transaction costs because in addition to corporate monitoring by a single entity, usually a bank, which can economize the cost of monitoring, many transactions happen based on mutual implicit understandings without written contracts or legal documents. The third is the relatively flexible restructuring of a corporation because the interests of various stakeholders can easily be taken into account.

On the other hand, shortcomings include the following. The lack of transparency, which is due to extensive implicit contracts in transactions, can lead to managers abusing their discretionary power. In addition, this lack of transparency may lead to trade friction with global international businesses. Finally, drastic and speedy corporate restructuring is difficult because various implicit contracts are likely to hinder the process.

These two types of corporate monitoring are closely related to the issue of how corporations raise the required funds, namely, the issue of corporate finance or more broadly the financial structure. In other words, the issue of corporate governance is basically reduced to an issue of corporate finance.

1-3 Correspondence of corporate governance to the financial system

There are two general ways to raise funds, which depend on the nature of the funds being raised: funding by issuing shares (equity) and funding by issuing debt (borrowing from a bank by issuing a loan certificate or issuing a debenture). In the former case, funds are provided by shareholders, whereas in the latter, they are provided by a creditor. Because the provider of equity bears a larger risk than a provider of debt, a shareholder, in accordance to the proportion of his shareholding, is entitled to own the right to control the company. Accordingly, shareholders greatly influence governance as well as the behavior of a company in one of two forms.[4] One is control by "voice", in which the managers are monitored by the shareholders exercising the right to speak and vote at shareholders' meetings. The other is control by "exit", which occurs when a shareholder sells his shares on the stock market when he feels the company's performance is unsatisfactory

On the other hand, when funds are raised by issuing debt, the borrower (company) must periodically pay the contracted rate of interest to the creditor. Thus, a company with high debt ratio needs to generate sufficient profits for the periodic interest payments and to repay the principal when the debt is due. This situation places pressure on the managers to operate the company efficiently. Moreover, the obligation of periodic interest payments contributes to efficient management because it pumps up excess cash flows in the company and thus, restricts unnecessary investments.

Therefore, each financing method exerts different effects toward efficient management of a company. Unlike in the United States, companies in Japan primarily raise funds by assuming debt, even in recent years. Hence, Japanese companies have traditionally been disciplined by debt, rather than by equity.

If we note the two types of disciplining mechanisms for a company's behavior, then the two types of corporate governance presented earlier, can be translated as two distinct corporate financing methods, and moreover, as two types of financial systems. One financial system is an "open-market type", in which funds are transferred by selling and buying standardized securities in the open market where a large number of anonymous participants conduct arms-length transactions. This may be called the "Anglo-American financial system". The other system is a "bilateral type" in which a financial institution continues a long-term customer relationship with its clients, and the provision of funds (lending) is conducted by bilateral negotiations. This may be called the "Japanese-German financial system". Exhibit 1 describes in detail these two financial systems.

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[4] These two types of disciplining mechanisms for a corporation, "voice" and "exit", were initially presented by Hirschman (1970).

Exhibit 1. Two types of financial systems and their functional properties: Anglo-American model and Japanese-German model

	Anglo-American model	Japanese-German model
Main financial transaction	In the open market	By bilateral transaction
Main funding instrument	Securities	Loan
Dependence on banks	Low	High
Nature of bank loan	Short-term	Short-term and long-term
Importance of internal funds	High	Low
Shareholding by banks	Not important	Important
Major shareholders	Households Institutional investors	Banks Intercorporate shareholding
Block share trading	Frequent	Infrequent
Corporate control	Stock market	Banks (main banks)
Information acquisition and processing	Market acquires and distributes diversity of opinion and risk; Information cost is low	By continuous transaction, banks can acquire and share information with client firms; economies of scale works in information acquisition
Allocation of risk	Risk is dispersed broadly to various economic units in financial markets	Risk is essentially concentrated in banks
Performance characteristics	More responsive to changes	Superior at implementing corporate policies that require agreements of various parties
Suitable economic activity	Developing new industries and new technologies (Product innovation)	Improving the efficiency of production processes of existing products (Process innovation)
Industry examples	Railways, computer, and biotechnology.	Automobiles and electronics

(Source) Okabe (2007) Table5.3.

Anglo-American Model

The first type is the "Anglo-American model", or the "market-based financial system". In this, a financial transaction occurs, in principle, in an open market between the market participants, which are not related to the company, and each transaction is theoretically independent of previous and future transactions. Here, financing is in the form of transferable securities: selling them to procure funds and buying them to provide funds. It is due to this characteristic that this model is sometimes referred to as security-based finance, a market-based system, or an open-market model. In this system, firms procure long-term funds in capital markets, and depend on banks for only short-term funds, so that bank dependency is relatively low. Because the relationship between a firm and a bank remains relatively weak, it becomes necessary for firms to hold abundant internal funds to conduct daily business and select capital expenditures.

Furthermore, the pressure of a hostile takeover from the stock market, not the bank, monitors and controls the firm as well as secures the efficiency of the firm's operation. Accordingly, from the viewpoint of corporate governance, the Anglo-American model of the financial system is often called the 'outsider' model.

Japanese-German model

In contrast, the second model, the Japanese-German model,[5] financial transactions occur basically between banks (or other financial intermediaries) and a client firm in a bilateral manner with a continuous element due to maintaining close long-term relationships. In this case, the main financing method is bank lending (loans). Hence, this system is also known as loan-type finance, bank-based finance, an institution-based system, a bank-based system, or a bilateral model. Here, banks provide not only short-term, but also long-term funds, either through loans or by acquiring corporate bonds or equities issued by corporations. Thus, a firm's dependency on the bank is high. Banks may acquire stocks issued by the client firm, and hold that stock in a 'stable' manner. Accordingly, a bank is both the lender and shareholder for the client firm, so that the bank effectively participates in the management of the client firm in both these capacities. Thus, corporations are monitored

[5]We note that it may seem unreasonable to treat Japan and Germany with the same model. For instance, (1) the nature of business activities of a bank in the two countries differs substantially (Japanese banks have long been prohibited to engage in securities businesses, whereas German banks have traditionally dealt with these businesses in the name of universal banking), and (2) in Japan, the indirect or bank finance by the public sector is outstandingly large. However, the two typological approaches are useful and indispensable in order to precisely understand the components and the functions of the financial system.

and disciplined by banks (especially main banks) rather than controlled by the pressure from the stock market. Therefore, from the viewpoint of corporate governance, the Japanese-German model is called the 'insider' model or network-type model.

For a firm, maintaining a close and continuous relationship with a bank means that the firm can count on timely and flexible borrowing from the bank; thus, it is not necessary for the firm to maintain abundant internal funds or liquidity. Furthermore, if this kind of bank-firm relationship is maintained, the bank generates a large flow of information about the client firm (thus, reducing the information asymmetry), which may reduce the cost of funding for the firm because the risk premium in the borrowing rate becomes relatively smaller.

Japanese corporate governance as well as corporate finance can be characterized as above, which is in contrast with the Anglo-American system. However, it is important to understand that the Japanese system is supported by two important elements. Hence, Section 2 addresses these elements.

2. Two characteristic elements in Japanese corporate governance

Corporate governance in Japan has had two basic distinctive features. One is that a bank (especially the main bank as was extensively observed, as we explain later) has had an important role in monitoring and disciplining client firms. The other is that equity funding where shareholders are theoretically expected to discipline corporations has played a limited role in corporate governance because shares have been extensively cross-held between banks and corporations or between non-bank corporations. These two features have provided the uniqueness for Japan, and substantially limited the effectiveness of corporate governance. Herein we review these two features.

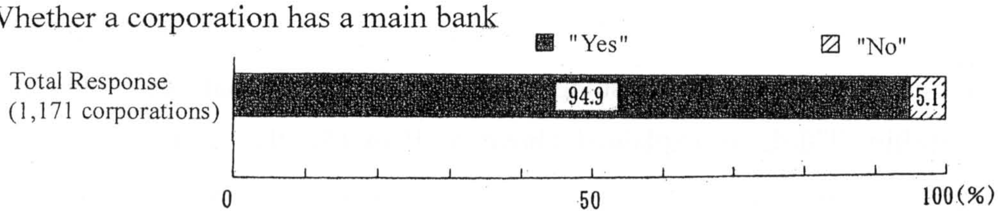
2-1 Definition and three functions of a main bank

Definition and conditions for a main bank

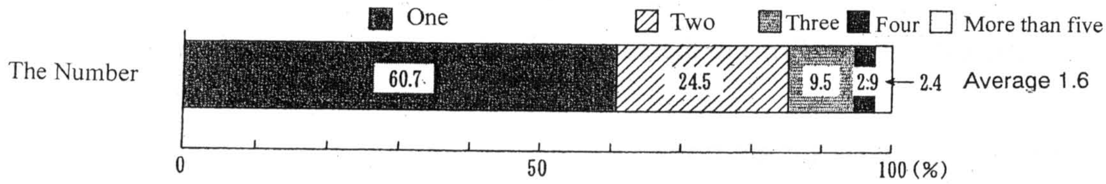
There are two classifications for the financing patterns of an economy: direct finance and indirect finance. In Japan, indirect or bank financing has dominated the financial system for more than 50 years (since World War II); and long-term close relationships between firms and banks have been extensively observed. For instance, according to a

Exhibit 2. The possession and the number of main banks: a survey in 1993

(1) Whether a corporation has a main bank



(2)The number of main banks



(Note)
1. Figure (1) shows the percentage of corporations responding to the question "Does your company have a main bank or main banks? (The definition of main bank is up to you.)" Figure (2) shows the percentage of corporations responding to the question "How many main bank(s) does your company have?" The average number is a weighted average where companies having no main bank are included.

2. The responding companies cover listed companies in both the first and the second sections of security exchanges, companies of over-the-counter trading, and companies of unquoted stocks.

(Source) Fuji Research Institute (1993).

survey conducted in 1993, when direct financing was gradually permeating the financing scene previously dominated by indirect financing, more than 90% of large listed corporations still had a "main bank" or two (on average, 1.6 main banks).

A main bank relationship, which is the relationship between a firm and a bank, is typically characterized as having all or most of the following elements: (1) the firm continuously has a large (or the largest) borrowing over a long period; (2) the bank is a main shareholder of the firm; (3) the bank carries out a variety of banking and other transactions with the firm, such as a foreign exchange business and trustee function of corporate bonds; (4) the bank maintains a close human relationship by dispatching executives to the client firm; and (5) although the bank does not intervene in the management of the client firm as long as the firm is making reasonable profits, the bank often rescues the client firm when the latter is in financial distress, provided that the firm is judged as eventually being viable.

In addition, three remarks are necessary to understand the nature of a main bank relationship. First, this relationship is an implicit contract between a bank and a firm, and is not written explicitly in a document. Second, it is not simply a relationship of banking and lending, but covers a wide range of both short- and long-term transactions, including direct financing (a trustee function when issuing corporate bonds), mutual shareholding, and a human relationship. Third, as explained above in item (5), the nature of a bank-firm relationship changes in accordance to the financial situation of the firm. This mutual relationship can be described as having state-contingent nature, which is an important aspect of Japanese corporate governance. However, this relationship has also created problems, including the skyrocketing of asset prices (the bubble) in the late 1980s as well as the insufficient effort of firms to increase productivity in subsequent years.

Three function of a main bank

A main bank has three functions in corporate finance and governance. In fact, substantial research has demonstrated that, when a set of conditions is satisfied (as typically was the case until the mid-1970s), the following three effects are evident.

First, the main bank is an efficient provider of funds to a client firm. The reason for this is that the main bank relationship ameliorates the informational asymmetry in bank lending because the bank can acquire pertinent information about the firm's financial position as well as the risk of the investment, which allows the bank to offer a loan at a lower lending rate compared to a case without a main bank relationship.[6]

Second is that main bank can monitor, discipline, and, when necessary, control the client firm. This is possible because the main bank serves both as a creditor and a shareholder of the client firm, and effectively is in a position to monitor and control a firm on behalf of all the other shareholders. This practice has been widely recognized to exist.

Third is the provision of 'insurance' against the client firm when the firm is in financial distress. It has been widely observed that the main bank of a firm often rescues the client firm, as long as the firm is deemed viable, by providing emergency loans or by arranging a rescue package involving all creditors.

2-2 Nature of corporate monitoring by a main bank

Corporate monitoring by a main bank, the third function in the above description, has some distinctive features. First, the monitoring function over a company exists in a

[6] Okabe (1999: chapter 1) provides a theoretical explanation.

concentrated way in a particular body (a main bank or a group of banks), and the monitor has the characteristics of a company "insider". This may be called "insider monitoring", and sharply contrasts monitoring in the United States where monitors are all participants in the capital markets (individual investors, investment banks, institutional investors, security analysts, credit rating agencies, and corporate raiders) and are company "outsiders".

Second, the same entity (a main bank) conducts corporate monitoring, regardless of the phase of investment activity by a company. This monitoring can be called sequential monitoring. That is, a company's investment activity is monitored by a main bank in all three stages:[7] *ex ante* monitoring when a company comes to a bank with an investment proposal, interim monitoring after the loan is made and the investment is expected to generate a profit, and *ex post* monitoring upon completion of the investment to assess whether the expected profit was made, and, if not, to pursue the responsibility of the management as well as ultimately to judge whether to liquidate or rescue the company.[8]

Third, the nature of monitoring, in terms of methods, enforceability, and involvement of a main bank, varies significantly, depending on whether a company is in an ordinary situation or a financially distressed situation.

Because this monitoring has a "state contingent" character, it is called "contingent governance".[9] That is, when a borrowing company maintains a reasonable level of profit, the main bank does not typically intervene in the management because the bank can expect stable interest and fee revenues. However, once a company falls into a financial distress, it is implicitly agreed that the responsibility to counter the situation rests on the main bank, meaning that the control rights of the company automatically transfer to the main bank. Thus, the main bank has an incentive to conduct *ex ante* monitoring as well as interim monitoring, in order to avoid a troublesome situation where the client company falls into financially distress.

Conditions for a main bank to perform corporate monitoring

For a main bank to effectively monitor a company, certain conditions must be met. First, the main bank must have the means to monitor a company. In fact, in the past, a main bank had not only provided a sufficiently large loan, but also held shares in the client firm.

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[7]Aoki (1994, 1995) has emphasized the distinction of these three monitoring phases.

[8]It is in this *ex post* monitoring, namely, restructuring or dissolution of a financially distressed company, that the main bank has demonstrated a high efficiency (Sheard 1994b; Kang and Shivdasani 1997).

[9]This characteristic has been emphasized as crucial for the main bank relationship by Aoki, Patrick, and Sheard (1994), Aoki (1994, 1995), and Sheard (1994b), and this name was coined by Aoki. Empirical evidence of this phenomenon has been presented by Hirota (1991).

Thus, a main bank could monitor the client company in the capacity of both a lender and a shareholder.

Second, there must be an incentive or reward for the main bank to pursue monitoring activities. In fact, there were many circumstances for a main bank to be profitable once it established a main bank relationship with a client firm because virtually all financial services, including foreign exchange transactions, and trustee and guarantee functions in issuing debentures, have traditionally been provided only by the main bank. Thus, the bank could exclusively receive fees for these services.

Third, corporate monitor (the main bank) of the client firm must also be monitored if the former is to effectively conduct its monitoring activities. In fact the regulatory authority, the former Ministry of Finance, was in a position to supervise banks, and actually could exercise the power to control the entry in banking as well as all aspects of bank activities (Aoki 1994). Thus, the presence of a monitor to oversee the corporate monitor ensured effective monitoring.

In summary, the main bank system (a) enabled corporations to efficiently obtain funding, which was favorable in both quantity and cost aspects, (b) assisted corporations to invest in relatively risky projects, and (c) contributed to maintaining efficient business operations by disciplining corporations. Thus, the system was a propelling force for the post-War high-growth of the Japanese economy. In fact, the main bank system attracted a great deal of international attention, especially in the late 1980s and early 1990s when the Japanese economy was booming due to soaring asset prices. For instance, the World Bank initiated a large-scale international research project on this in 1990, and it publicized not only the research results, but also recommendations for developing and emerging economies to introduce a similar system (for instance, Aoki and Patrick 1994). However, since the 1980s, the conditions necessary for a main bank to carry out corporate monitoring have gradually been lost, and as discussed later, Japanese corporations faced a "vacuum of governance".

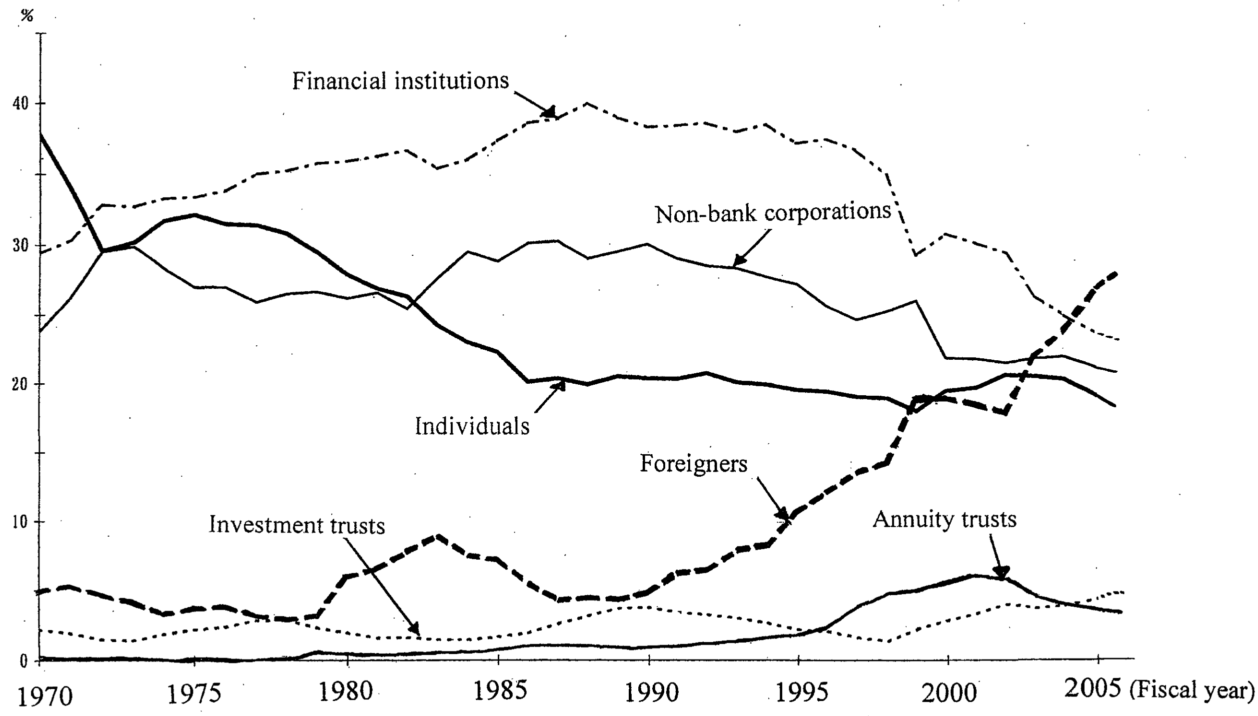
2-3 Cross shareholdings and their functions

The second important feature of Japanese corporate system, or in general, of the Japanese economic system is "cross shareholding", or the mutual holding of shares.

Cross shareholding: a distinctive feature of share ownership until the mid-1990s

In the ownership of Japanese corporations, two distinctive features can be noted.

Exhibit 3. Distribution of share ownership: fiscal year 1970-2005



(Note) The number of Financial Institutions excludes those of Investment Trusts and Annuity Trusts.

(Source) Council of Japanese Stock Exchanges, A fiscal year 2006 survey of distribution of share ownership, 2007.

The first is that Japanese corporations (both financial institutions and non-financial firms or general business corporations) have a strong tendency to have their equity owned by a counterpart corporation, which the firm conducts business transactions. In fact, when we look at all stock owners, the portion owned by corporations (both financial institutions and non-financial firms or general business corporations) was overwhelming. As seen in Exhibit 3, at the end of March 1991, the shares owned by financial institutions (commercial banks, trust banks, and insurance companies) amounted to 43.0%, while the shares owned by general business corporations was 30.1%. In other words, nearly three quarters (73.1%) of all shares were held mutually within the corporate sector. However, this tendency has declined substantially, as discussed in Section 3(2).

The second feature is that shareholding by corporations, regardless of whether it is cross shareholding or unilateral shareholding, is generally not intended for a short-term gain in income, but is for long term or stable holding.

Thus, until the early 1990s, shareholdings in Japan were characterized by (1) mutual shareholdings within the corporate sector, and (2) generally were of a longer term or stable holding nature. This type of shareholding pattern is not only an issue of the ownership structure, but also relates to corporate governance and behavior as well as lays the general foundation of the Japanese economy, including the industrial structure, and the financial and employment systems.[10]

Stabilizing company management by cross shareholding

Traditional cross shareholdings in Japan are said to have had a stabilizing function on company management in three respects. First, in addition to preventing intervention or pressure from shareholders, this type of shareholding provided more discretion to company's managers by preventing hostile takeovers. Second, the expansion of managerial discretion helped extend the time horizon of company management, and brought about efficiency by "long-termism", in contrast to the alleged US companies' short-termism. Third, cross shareholding spread the business risk with other companies. That is, it functioned as a "mutual insurance" against business risk.

The above third function is supported by two different mechanisms. One is that the risk of profit fluctuation (sometimes recorded as deficits) is dispersed to counter parties or member companies in a corporate group by varying the payments of dividends (Nakatani 1984). The other is that mutual shareholding works as a buffer of funds. That is, mutual shareholding can be a form of "insurance" in case of financial distress because mutually held shares have a "reserve" characteristic, which can be "withdrawn" (shares can be sold in the market) when operating profit declines sharply, thereby decreasing the probability of bankruptcy. In fact, when a large corporation is brought to the brink of bankruptcy, a measure is generally taken to sell the holding shares (Sheard 1994a). This type of mutual insurance mechanism (or dispersion of risk within a corporate group) was one of the factors that contributed to enhanced investment activities and helped the Japanese economy modernize and develop after the World War (Japan Fair Trade Commission 2001).

Softening of management discipline

On the other hand, cross shareholding poses a serious problem for corporate governance because when companies mutually hold shares both parties assume (1) that they hold shares as friendly insiders, and (2) that the shares will not be sold to hostile takeover bidders (Sheard 1994b). This means that from the beginning both sides forgo the right to

[10]Detailed analysis of cross shareholding, including the reasons for, its effects, and the future outlook is presented in Okabe (2002a; 2002b).

exercise controlling power of counterpart corporations.

Hence, compared to capital markets, the disciplining pressure from cross shareholding is relatively weak on two grounds. First, because when shares are held mutually, managers of both corporations are likely to implicitly agree not to intervene in the management of the counterpart corporation. Second, the possibility of block share trading or a hostile takeover is substantially decreased. Therefore, cross shareholding decreases the disciplining pressure on corporate management, and is likely to prevent the efficiency of management, as measured by ROE (return on equity), to rise.

Cross shareholding has another problem. In addition to softening the management discipline of general business corporations, it weakens the management discipline of banks, which are important members of a corporate group. Thus, the banking behavior contributes to the inefficiency of general business corporations. In general, main banks, many of which held shares mutually with client firms, helped weaken corporate governance and ultimately brought about a "vacuum of corporate monitoring", as discussed in the next section.

3. Changes in the economic environment and the limitations of the traditional system

The main bank system, cross shareholding, and the related system of long-term employment are characteristic features of the traditional Japanese economy, and they all supported Japan's post-War economic development. In addition, this system worked well to overcome various turbulent events that the economy faced, including two oil crises in 1973 and 1978, and rapid yen appreciation in 1985.[11] However, beginning in the 1980s, the system began to cease to function properly due to significant alterations in the economic conditions surrounding the Japanese economy.

In this section, we first discuss how the surrounding conditions changed. Then we address how a vacuum of corporate monitoring emerged, and how it subsequently became an important factor in the prolonged recession of the Japanese economy.

3-1 Changes in conditions surrounding the Japanese economy and their effects

Let us briefly review the changes in the Japanese economy over the last 40-50 years.

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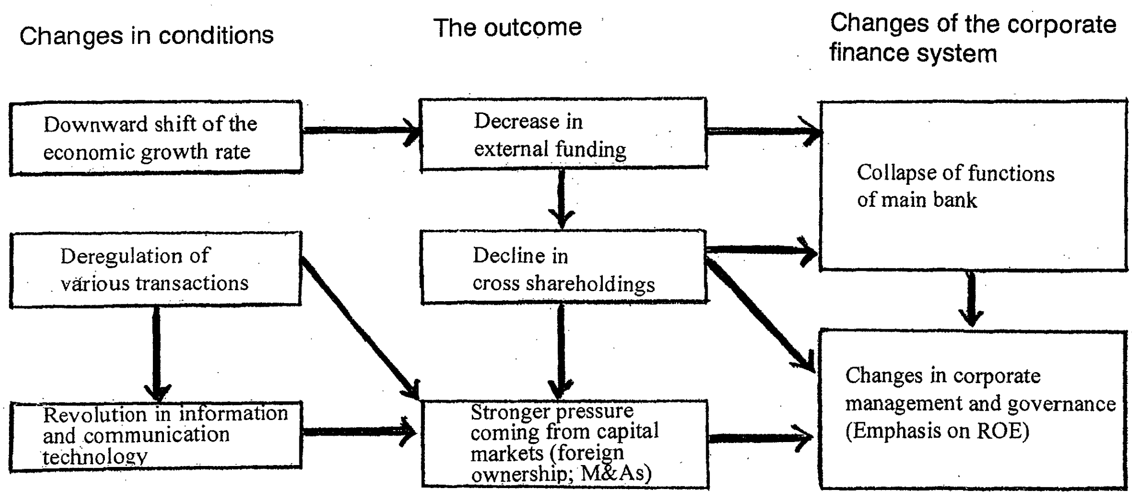
[11]If we emphasize the financial aspect of this system, it may be called "developmentalist financial system". Ikeo (2006) has described the function and limitations of this system quite accurately.

Exhibit 4. Changes in the surrounding conditions of the Japanese corporate finance and their effects



(Note) In order to avoid complexity of the diagram, only major channels are indicated, nor are the bidirectional (mutual) causalities indicated.

(Source) Okabe (2007) Exhibit 4-2.

The first change was the decline in the economic growth rate, and was most clearly felt by the decline in capital investment, which once drove the super-high growth rate of the economy. The level of private corporate investment, as percentage of GDP, remained high during the super-high growth period from 1955 to 1970s, but has markedly declined since the 1980s. This has led to drastic changes in how corporations raise investment funds, and subsequently in corporate governance.

Second, after the 1980s, various regulations and restrictions, which were implemented during the high growth period, were gradually relaxed or all together removed. For example, today all the regulations and restrictions in such areas as business, entry, interest rates, and international financial transactions have been removed.[12] Accordingly, market forces have permeated extensively into all types of transactions, and today, economic and financial transactions have become increasingly globalized. Moreover, many East Asian countries as well as India have achieved remarkable economic development, and in this new environment, the Japanese economy has increasingly competitive surroundings both at home and abroad.

Third, information and communication costs have dramatically declined due to

[12] An exception is the capital adequacy regulation (Basel Accord). This regulation needs to be treated differently from other regulations because it relates to the safety of the payment system, which is part of society's infrastructure.

innovations in information and communication technologies (ICT) and the simultaneous development of the Internet. Above all, financial transactions are strongly influenced because they depend heavily on information and communications. Nowadays a large amount of funds can be transmitted speedily, efficiently, and safely across national borders, which has led to financial globalization.

These changes have resulted in tremendous structural changes in financial markets and the corporate sector. Here, we focus on three important aspects: (1) dramatic changes in the pattern of corporate funding, (2) dissolution of cross shareholding, and (3) increased pressure on corporate management from capital markets. As shown in Exhibit 4, these aspects are mutually related.

(1) Dramatic change in the pattern of corporate financing

The first structural change is the finance pattern of corporations. Since 1994, corporations have experienced not a shortage of funds, but an excess, which reflects both the decline in the economic growth rate (the decline in the demand for investment funds) and the accumulation of internal funds. Exhibit 5 shows the statistics for 1990-2005, and clearly indicates the following: (1) the total amount of funds acquired has a clear downward trend throughout this period; (2) internal funds have had an overwhelming importance; (3) the acquisition of external funds has declined drastically (after 1998-2001 such acquisitions declined and the magnitude of this decline increased; that is, there was a net repayment of debt); and (4) for all external finance sources, bank borrowing has shown the most rapid decrease (as loans are being repaid).

Incidentally, domestic funding sources have undergone a dramatic structural change due to the unprecedented aging of the Japanese population. That is, the retiring and the aged people are using the savings they accumulated during their working years, and consequently the national saving rate, which was once very high relative to international comparison, is rapidly declining. Between 1985-89, the average household saving rate was 14.1%, but declined to 5.0% in 2000-2004. Accordingly, the role of the household sector, which was once an overwhelmingly important source of funds, has receded.

Decreased bank borrowing and the relative increase in equity funding have two important implications. One is that company managers must now strive for a higher ROE (return on equity) to satisfy shareholders. Therefore, companies have had to change their operating principles from sales volume expansion to a higher ROE. The other is that decreased bank borrowing means companies are less reliant on banks in financial and other

Exhibit 5. The sources of funds of private non-financial corporations, yearly average in trillion yen

	1990-93	1994-97	1998-2001	2002-05
Acquired funds total	86.2	53.0	37.7	46.5
Internal funds	52.5	48.1	43.6	73.5
External funds	33.7	4.9	-5.9	-27.0
New stock issue	2.7	2.4	2.1	-11.2
Debenture	2.7	-0.8	-0.7	-1.1
Bank borrowing	28.3	3.3	-7.3	-14.7

(Note) Calculated by the author using Financial Statements Statistics of Corporations, Ministry of Finance, various years.

business transactions, implying that the foundation for maintaining a main bank relationship has eroded. Furthermore, another supporting condition that the relationship has been lost is corporations have increased the selling shares of the main banks, which were once held for the purpose of maintaining a main bank relationship.

(2) Dissolution of cross shareholdings

The second change is the dissolution or rewinding of cross shareholdings. The implication of this dissolution is that one of the conditions supporting a main bank relationship has been lost. Moreover, the behavior and governance structure of Japanese corporations have been altered to reflect the intention of overseas investors because a substantial part of the stocks discharged from cross shareholding has been acquired by overseas investors.

This change has occurred in two respects. First, to satisfy the demands of overseas investors, Japanese corporations have been required to change their management styles, and have received increased pressure to emphasize their ROE (return on equity or efficiency of capital) instead of size expansion. This has been the case since typical overseas institutional investors, such as CalPERS (The California Public Employees' Retirement System),[13] acquired Japanese stocks as part of diversifying their portfolios in order to disperse risks and increase investment returns. Second, US institutional investors are now actively participating in managing the Japanese firms, especially since 1993. Hence, their "voices" are increasingly

[13] CalPERS is the largest pension fund in the United States, which provides benefits to 1.5 million California public employees, by investing in stocks, bonds, funds, and real estate both domestically and internationally.

reflected in Japanese management because in the US, exercising voting rights by institutional investors is required as a shareholder and as part of their fiduciary duty.[14]

Furthermore, the dissolution of cross-held shares is likely to have to mobilize the employment situation because the board directors of Japanese companies have traditionally been selected and promoted from the senior managers of the company, but because the voice of overseas investors inevitably needs to be reflected, directors are now being appointed from outside the company. Moreover, the dissolution of cross shareholding may reduce the degree of mutual commitments of long-term transactions of general business corporations, and may even weaken the cohesiveness of the corporate grouping.[15]

In summary, dissolution of cross shareholding will likely dilute the "long-term transaction" relationship of the Japanese economy, which is one of its most distinctive features. Thus, Japanese corporate governance must change.

(3) Increased pressure from capital markets

The third change is that along with the dissolution of cross shareholding, increased pressure from capital markets (stock markets) on various aspects of corporate governance has been inevitable. Traditionally major shareholders of Japanese corporation have been banks or general business (non-bank) corporations, who remained "silent owners". However, in recent years, participants in stock markets have diversified, and their motives and transaction patterns are varied. Thus, the nature of the corporate governance mechanism has changed.

To be specific, increased shareholding by overseas investors as well as domestic institutional investors, such as pension funds, investment trusts, and insurance companies, which have a fiduciary duty to invest funds efficiently, has necessitated that the Japanese firm emphasize efficiency rather than sales volume expansion. Hence, these new shareholders have affected business management, not only by actively selling and buying shares in the stock market ("exit"), but also by speaking up at shareholders' meetings ("voice"). The surge of M&A's of corporations by acquiring a large portion of corporate stocks since 1997 (see Exhibit 8) has strengthened the disciplining function of capital markets because it means that the market for corporate control has rapidly developed in Japan and that managers must manage their companies more efficiently to avoid a M&A.

[14]A fiduciary duty is an obligation to act honestly and in good faith for the best interests of another party (investor of funds).

[15]A caution is needed as there is a reverse (newly established) movement in cross shareholding, which aims to establish a strategic relationship with other relevant companies.

These are the factors, which gradually reinforce capital market governance or discipline by capital markets.

3-2 Incidence of the vacuum of corporate governance and the asset price bubble

The governance of Japanese corporations used to be administered by a main bank, and that mechanism, to some degree, guaranteed the efficiency of the management. Substantial theoretical and empirical research conducted since the late 1980s has supported this view.[16] Moreover, earlier studies, up until the mid-1990s, generally praised the monitoring function of main banks. That is, many reports presented a view that the main bank system replaced and performed one of the fundamental functions of a capital market, which was to monitor corporations, because capital markets were relatively less developed and subjected to various regulations in Japan. The point in this argument is two-fold. The first question is not whether monitoring actually occurred, but what was the effectiveness of the monitoring? Second is how has the monitoring function been altered in recent years?

In more recent years, an increasing number of researchers, for instance Weinstein and Yafeh (1998), have asserted that the monitoring function of a main bank has been overestimated. The logic behind this argument is that monitoring was "state-contingent governance", that is, the main bank intervened in the client company only when the latter was in financially distressed situations, but did not intervene as long as the company maintained a certain satisfactory level of profits. Thus, these researchers have argued that the effectiveness of the monitoring function, if it even existed, was limited.

(1) Disappearance of conditions necessary for corporate monitoring by a main bank

In recent years, presumably after the mid-1980s, the three conditions necessary for a main bank to serve as a corporate monitor have vanished; these conditions are namely the existence of (1) the means to monitor, (2) the incentives to monitor, and (3) the supervision of the monitor. Refer to Section 2 (2) for the details. Therefore, it is reasonable to speculate that the monitoring function of a main bank has gradually been lost, while a substituting governing mechanism has yet to emerge. Consequently, a situation emerged for Japanese corporations where an effective governance mechanism did not exist, or the incidence of a "vacuum" of corporate governance resulted.[17] Let us examine how the three conditions have

[16] One of the most comprehensive early studies is Aoki and Patrick (1994).

[17] This may be expressed as loss of the disciplining mechanism for corporate management. Horiuchi (1998, 1999) has emphasized the importance of this problem, which has occurred not only in general business (nonbank) corporations, but also in financial institutions.

been lost.[18]

First, the means or instruments of a main bank to monitor client corporations have been weakened or gradually lost. Specifically, this situation now prevails as bank lending and the holding shares of a client firm decrease. This means that a main bank, which once intervened in the management of the client firm as creditor and shareholder, no longer has the means to intervene.

Second, incentives on the part of a main bank to monitor a firm, in the capacity of a main bank that represents all the shareholders, have weakened. Traditionally the incentives to monitor a firm were consequences of and supported by economic rents resulting from various government regulations, including foreign exchange business, debenture issuing, and interest rates on deposits. The relaxation or abolishment of these regulations has erased the rents associated with these financial services, and banks have lost this source of revenue.

Third, the monitor (Ministry of Finance), which monitored the corporate monitor (private banks), and thereby completing the entire monitoring system, has completely lost the trust of, and in turn, its influencing power over, private banks. In the 1990s, the regulatory authorities, then Ministry of Finance, but currently the Treasury, was severely criticized due to the lack of transparency in handling administrative matters, the lack of international perspectives, the lack of consistency in policies and policy philosophy, as well as repeated mistakes in handling administrative matters. In response to these developments, the Ministry of Finance lost the authority to supervise banks, and a new agency, Financial Services Agency, which is independent of the Ministry, took charge. In terms of the method for bank supervision, there was a transition from the traditional command and control approach to a more transparent approach with less government discretion that relies on the disciplining power of markets. In this new arrangement, the direct discretionary power of the authority over private banks disappeared decisively since the mid-1990s.

Due to the above three changes, the top two tiers lost their functions in a "three-tiered" corporate governance system, which consisted of "government authority-private bank (main bank)-general business corporation". Unfortunately, another system (most preferably the well-functioning capital markets) was not ready to adequately replace the function of the traditional system. Hence, a vacuum of corporate governance resulted, and the Japanese economy faced numerous problems, which are examined in the next section.

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[18]The following discussion is based primarily on Okabe (1999: chapter 2). Sheard (1994a, 1997) and Nakatani (1996) have reported similar interpretations with more details.

(2) Vacuum of corporate governance and its consequences

The disappearance of a corporate governance mechanism, or an emerging vacuum of corporate governance, contributed to the asset price bubble in the 1980s. The reason is that neither general business companies nor banks were externally monitored. Moreover, their behaviors were unchecked. Consequently, the risk of investing in real estate was underestimated, which lead to heavy investments in the real estate market. Additionally, the vacuum of corporate governance contributed to the various fraudulent practices by senior management at general businesses and banks, which were disclosed beginning in 1997.

Furthermore, the lack of discipline at banks caused "forbearance lending" as well as the behavior of banks to refinance firms even in cases where there were little prospect of firms repaying the extended loans. Various statistics show that in the first half of the 1990s banks extended further loans to such "problem industries" as real estate and service industries, which had profitability margins hovering at low levels, rather than forcing them to repay. Consequently, banks assisted in the relaxation of business operations of these firms by less frequent and loose monitoring (Sekine, Kobayashi, and Saita 2003). This easing in corporate discipline is similar to "soft budget constraints" (Kornai, Maskin, and Roland 2003), a phenomenon occurred in former centrally planned economies. A similar circumstance prevented Japanese firms from improving efficiencies.

To summarize, a vacuum in corporate governance was observed not only in general businesses, but also in banks. Hence, banks contributed to the inefficiencies in various industries by relaxing management discipline instead of enhancing efficiencies. Thus, banks deterred, rather than accelerated, the restructuring of the entire Japanese economy, which led to an economy that saw a prolonged difficulty in changing domestic and international environments. The above understanding that the traditional function of the main bank was no longer working can be confirmed by an econometric study reported in Appendix 1. This study demonstrates that main banks were no longer performing a disciplinary function as early as 1989, the peak period of the asset price bubble.

Because the malfunctioning of the Japanese financial system was obvious, the government implemented various proposals to reform the financial system so that the system would function in the new environment of globalization and ICT innovation.

4. Policy responses to strengthen corporate governance

The Japanese corporate system fell into a difficult situation where it had to adapt to changes in social and economic conditions. Thus, beginning in the latter half of the 1990s, the government introduced and implemented various policies to strengthen Japanese corporate governance. To reflect these measures, Japanese companies, themselves, have tried to improve their own governance systems, while various associations have simultaneously explored and presented guidelines as well as new models of desirable governance systems.

The outcome of these environmental changes, particularly increased ownership by foreigners and the expansion of M&A's, can be understood due to the result of two aspects. One is a change in "external governance", which altered the behavioral mode of corporations due to disciplining pressure from outside of the company. In this respect, the government has revised and enacted laws and regulations. The other is a change in "internal governance" as outside pressure has led to the modification of the internal organizational structure of companies. In recent years, legal and regulatory arrangements have been made in these areas using the guidelines provided by various organizations. In this section, we review these policy developments.

4-1 Legal and other regulatory measures by the government

Three directions of institutional change

Government measures usually take the form of changes in relevant law, such as corporate law, commercial law, securities transaction law; or introducing various guidelines such as those on defensive measures against takeovers and institutional arrangements for corporate governance. A characteristic of Japan is to undertake these reform measures in an incremental fashion, rather than utilizing a "big bang" approach, which would be to set forth numerous drastic measures at once. Policy measures in recent years have had three basic directions (Kusakabe 2005), which are summarized in Exhibit 6 as they relate to the institutional aspects of corporate governance.

The first direction is policies aimed at allowing a more diversified system by legally increasing alternatives with respect to the internal organization of a company or the form of company mergers. These measures include (1) diversifying the organizational structure of a company, including lifting a ban on a pure holding company, (2) simplifying merger procedures, (3) modifying bankruptcy laws and introducing business reconstruction law, and (4) establishing a system to divide a corporation. Additionally, measures were taken to (1)

Exhibit 6. Government policies to strengthen the Japanese corporate governance

Strengthening the legal arrangements of corporate organizations	-Diversification of organizational structure of corporations including lifting ban on a pure holding company (Revision of Anti-monopoly Law) [1997] -Simplification of merger procedures (Revision of Commercial Law) [1997] -Modification of bankruptcy laws (Introduction of Business Reconstruction Law) [2000] -Establishing a system of dividing corporations (Revision of Commercial Law) [2001] -Strengthening the independence of certified public accountants (Revision of Certified Public Accountant Law) [2004] -Establishing a guideline of corporations' internal governance (Ministry of Economy and Industry) [2005] -Strengthening the auditing and corporations' internal governance systems (Introduction of the Japanese version of the US Sarbanes-Oxley Act) [2006] -Modification of governance related systems including information disclosure (Revised Corporate Law) [2006] -Revision of guidelines of merger regulations (Ministry of Economy and Industry) [2007]
Strengthening the functions of markets	-Introduction of consolidated financial statements system (New accounting standards) [1999-2001] - Opening of public utility works to private sector (Ministry of Economy and Industry) [2005] -Strengthening the regulation of cartels (Revision of Anti-monopoly Law) [2005] -Clarification of the nature of defensive measures against takeover (Ministry of Economy and Industry; Ministry of Justice) [2005] -Unification of the trading procedure of financial products (Introduction of Financial Products Trading Law) [2007]
Diversifying the governance structure of corporations	-Introduction of outside auditors (Revision of Commercial Law) [1993] -Expansion of outside auditors system (Revision of Commercial Law) [2001] -Introduction of an option to adopt the company with three committees, an Anglo-American corporate governance [2003] -Guidelines of defensive measures against takeover (Ministry of Economy and Industry; Ministry of Justice) [2005] -Completing legal framework to allow for diversified corporate governance structure (Revised of Corporate Law) [2006]

(Note) Compiled by the author using Kusakabe (2005), Tokyo Stock Exchange (2004), Lecof: Revisions of Laws and Regulations pertaining to Corporate M&As, and other sources.

strengthen the independence of certified public accountants, (2) strengthen the auditing and corporations' internal governance systems by introducing the Japanese version of the US Sarbanes-Oxley Act[19], and (3) modify governance related systems by fully revising corporate law. Furthermore, by integrating all these institutional changes, the government (Ministry of Economy, Trade and Industry) has provided guidelines for corporations' internal governance.

The second direction is policies aimed at strengthening the functions of markets, including among others, (1) opening public utility works to the private sector, (2) strengthening the regulation of cartels, and (3) clarifying the nature of defensive measures against takeover. Other measures included in this category are the unification of the trading procedure for financial products and the introduction of a consolidated financial statement system. All these measures have facilitated a more efficient market mechanism as well as induced the growth of M&A's in the market for corporate control.

The third direction is policies aimed at diversifying the structure of corporate governance. Enacted in 2006, the revised Corporate Law achieved all these tasks. Under this new Law, very flexible actions have been made possible by deregulating the establishment of a company, reorganization of a company structure by mergers, and introduction of defensive measures against company takeovers. As described below, a representative example is that Japanese businesses can now opt for a "company with committees" system, which is modeled on a US board or an Anglo-American governance system. Thus, as far as the legal arrangement is concerned, Japan has completed all the necessary steps, except in areas such as completing the details for a hostile takeover, by taking continuous actions for about the last 10 years (since 1997) (Kusakabe 2005).

Anglo-American system introduced as an option

Of all these legal modifications, one of the most important changes is that a company now has the option to adopt a "company with committees" system, an Anglo-American corporate governance system modeled on US boards. This was introduced in 2003 by amending the Commercial Law, but was solidified in 2006 by enacting the revised Corporate Law, which completes the diversification of the corporate governance structure in Japan.

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[19]Sarbanes-Oxley Act is a US law intended to strengthen the auditing system and the internal control of corporations, which was enacted in response to a number of major corporate and accounting scandals. In Japan a law of the same nature was introduced, and hence, usually called the "Japanese version". However, strictly speaking, it is not an independent law, but is a part of the Financial Products Trading Law enacted in 2007, which wholly replaced the former Securities Transaction Law.

This measure now enables a company to adopt one of two systems for its board of directors. One is the traditional board system where an audit committee monitors the board of directors. The other alternative, the new governance system, is the "company with committees" system. In the latter, the format of governance requires specifically that: (1) the board of directors specialize in monitoring the company management, while the actual managerial and operational matters are performed by executive officers, (2) auditors are replaced by three important committees (nominating, compensation, and audit committees), which consist of board members and are established within the board, and (3) more than half of the members of each committee must be outside directors.

In this newly established organizational form, the basic idea is that company management and monitors of the management are separate, and the role of outside directors in monitoring management is important. This is precisely the Anglo-American notion of governance, and this new legal framework has diversified Japanese corporate governance. Under this newly established legal framework, various regulations have been removed in a wide range of spheres, including establishing a company, reorganizing a company via mergers, and introducing defense measures against hostile takeovers. Consequently, a company now has more freedom to organize its structure.

Is the new format spreading? In June 2003, the number of companies that moved to adopt the new system is approximately 40. Thus, the system does not seem to be rapidly spreading.[20] However, it is clear that this legal amendment is an important factor in the diversification of Japanese corporate governance. In fact, a survey conducted in 2003, which included the 400 largest Japanese companies, revealed that differences in business areas, organizations, and the governance structure have already been widening in manufacturing since 1990.[21]

4-2 Guidelines for desirable corporate governance

Reflecting the above changes in the institutional arrangement, various associations in the private sector have designed and published guidelines or codes for "desirable corporate governance". These associations include the Tokyo Stock Exchange, Nippon

[20] According to a survey (Japan Corporate Auditors Association 2004) conducted two years after the introduction of the new system, the total of "already adopted", "decided to adopt in the future", and "contemplating to adopt" amounted to only 3.1% of all the listed companies, while 86.0% replied "no intention to adopt". Similarly, a survey by Life Insurance Companies Association conducted in 2003 found the total of "already adopted" and "plan to adopt in future" amounted to only 5.5%, and the majority of companies responded "no plan to adopt" (52.4%) or "undecided" (41.3%).
<http://www.seiho.or.jp/news/h15/pdf/kabu03/kigyouanke.pdf>

[21] Policy Research Institute of the Ministry of Finance (2003).

Exhibit 7. Guideline for good corporate governance: two examples

	Case 1	Case 2
Name	"Principles of Corporate Governance of Listed Companies"	"On the Desirable Corporate Governance System in Japan"
Prepared by	Tokyo Stock Exchange	Nippon Keidanren (Japan Business Federation)
Publication date	March 2004	June 2006
Aim of publication	To provide the basis for common understanding on corporate governance by all the parties concerned, including listed companies and shareholders	To provide the view of the Japanese business circle taking into account of its own survey and the reality of Japanese companies
Aim of strengthening corporate governance	To fix the environment for corporations to continuously increase their value	To lay foundations for both preventing dishonest behavior of companies and increasing profitability, and thereby lay improving the management structure of companies in order to increase their value in the long run
Basic proposition	1. The principles do not recommend a specific model or a system, but present basic checkpoints 2. In order to achieve effective results, it is better to let companies compete with each other for better governance rather than to enforce a specific governance system	1. Enforcing a specific governance system is inappropriate 2. For Japan it is desirable to fully take the history and the reality into consideration, and for each company to construct the effective framework reflecting its own vision
Main points	1. Respect for shareholders' rights (rights to vote and to receive dividends) 2. Securing equality among shareholders (minority shareholders and foreign shareholders) 3. Establishing smooth relationship among various stakeholders (improving internal organization) 4. Disclosure of information on company activities sufficiently and in a timely manner 5. Improving the monitoring system of company management (board of directors and auditors) and securing accountability to shareholders	1. Consideration for a variety of stakeholders, which results, in effect, in the increase of shareholders' value 2. Respect for a diversity of governance systems 3. Importance of effectiveness, not the form itself 4. Priority is to be placed on market evaluation rather than regulations 5. For the present, the effect of the newly introduced system (an optional system allowing to choose Anglo-American governance) should be watched carefully; also a system needs to be established to identify genuine shareholders (long-term shareholders) who should be involved in monitoring the management

(Note) Prepared by the author using Tokyo Stock Exchange (2004), and Nippon Keidanren (Japan Business Federation) (2006).

Keidanren (Japan Business Federation), the Japan Corporate Directors Association, and Japan Corporate Auditors Association. Of these, we consider the guidelines issued by two important organizations, which represent a large number of businesses and are likely to be the most influential. Namely, they are the "Principles of Corporate Governance for Listed Companies" (Tokyo Stock Exchange 2004), and "On Desirable Framework of Corporate Governance in Japan" (Nippon Keidanren 2000). Exhibit 7 summarizes content and characteristics of these two guidelines.

"Principles of Corporate Governance of Listed Companies" by the Tokyo Stock Exchange

"Principles" prepared by the Tokyo Stock Exchange was released in 2004, and aimed to provide the basis for a common understanding on corporate governance by all the parties concerned, including listed companies and shareholders. "Principles" considers that the goal of strengthening corporate governance is to fix the environment so that corporations can continuously increase their value. In addition, "Principles" does not recommend a specific model or a system, but presents basic checkpoints and asserts that, to achieve effective results, it is better to let companies compete with each other for better governance rather than to enforce a specific governance system.

More concretely, "Principles" notes the importance of (1) respect for shareholders' rights (rights to vote and receive dividends), (2) equality among shareholders (minority shareholders and foreign shareholders), (3) smooth relationships with various stakeholders (improving internal organization), (4) sufficient disclosure of information about company activities and in a timely manner, and (5) improving the monitoring system of company management (board of directors and auditors) to secure accountability to the shareholders.

"On the Desirable Corporate Governance System in Japan" by Nippon Keidanren

Second, the guideline, "On the Desirable Corporate Governance System in Japan", prepared in 2006 by Nippon Keidanren aimed to provide the viewpoint of the Japanese business circle by considering its own survey and the reality of Japanese companies. The guideline considers that the goal of strengthening corporate governance is to lay a foundation that prevents dishonest company behavior while simultaneously increasing profitability, and thereby improving the management structure to increase the value of companies in the long run. The report emphasizes that enforcing a specific governance system is inappropriate, and that it is desirable to fully consider the history and reality of Japan. Hence, it recommends that each company construct an effective framework, which reflects its own vision.

More concretely, the guideline points out: (1) the need to consider the various stakeholders, which, in effect, results in increased shareholders' value, (2) respect for diverse governance systems, (3) the importance of effectiveness, instead of the form itself, (4) priority should be placed on market evaluation rather than regulations, (5) for now, the effect of the newly introduced system (an optional system allowing a company to choose Anglo-American governance) should be watched carefully, and (6) a system needs to be established to identify genuine shareholders (long-term shareholders) who should be involved in monitoring the management.

Evaluation of various codes of good governance

The two types of aforementioned governance have subtle differences in the logic and what is emphasized because they were prepared by organizations, which differ in nature. That is, in "Principles" emphasis is placed on the view of shareholders and participants in the stock market, whereas in "On the Desirable Corporate Governance System", which was drafted by a business federation, practical things, including examining actual business practices and effectiveness over formality, are emphasized.

However, it is important to note that these two codes have more similarities than differences.[22] First, they both consider that the goal of strengthening corporate governance is to continually increase the value of a company. Thus, it is not surprising that the activity of a firm is usually evaluated by the value of a corporation (total share price), which can be interpreted as the international standard.

Second, when referring to an increase in corporate value, the importance of a strong foundation is fundamental to establish solid relationships with various stakeholders and to meet their needs.

Third, although good governance has common elements, it is recognized that there is not a single form or model which universally provides all nations the best governance (OECD 2004b; Japan Corporate Governance Forum 2006). It is acknowledged that a desirable governance system for a nation must be decided by considering its culture,

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[22] Besides these two guidelines, there are other reports, including a similar report, "Best Governance Research Report", based on a field study of 21 corporations (Japan Association of Corporate Directors 2007). This report has emphasized that the best governance system differs, depending on the stage of corporate development. However, all these reports have reached the same conclusions, which are discussed below. Also, the guideline on internal governance presented by the government (Ministry of Economy, Trade and Industry 2005) has the same characteristics, especially in that it is a "guideline" and not an absolute.

traditions, social situation, and business practices. This understanding implies that there should be an optimum Japanese system.

Fourth, which is the most striking characteristic, both "Principles" and "On the Desirable Corporate Governance System", as well as all the similar proposals, are merely "guidelines", and present a general direction in rather abstract terms, and do not include enforceable rules or provisions with penalties. This characteristic substantially differs from the case in other countries. For instance, the New York Stock Exchange includes minimum standards, while the London Stock Exchange shows the "best practice". Both cases refer to many concrete aspects. In contrast, the Japanese case does not have a single binding item so that companies have a far greater freedom to adjust.

The Japanese approach may be considered "inducement by soft law", or the application of traditional *"gyosei shido"* or administrative guidance. Therefore, these guidelines work indirectly, and the effectiveness is naturally limited. However, it should be noted that the input from various experts was considered when drafting the Japanese guidelines. In the case of "Principles" by the Tokyo Stock Exchange, opinions were collected from business executives, academics, journalists, and officers of various associations, whereas in Nippon Keidanren's "On the Desirable Corporate Governance System", detailed opinions of 16 large representative Japanese corporations were surveyed and analyzed (Nippon 2000). Therefore, the indirect effect of this process should be appreciated because the process itself helped share information about other companies and the best practices.

4-3 Factors changing corporate governance

Some have argued that changes or diversification of corporate governance should not be interpreted as a consequence of government policy actions. Proponents of this view see these new government policies not as the major independent source of change, but view them as public policies in response to social and economic pressures. This perception may be called an "endogeneity" of public policies. According to this view, guidelines of corporate governance issued by various associations, including the Tokyo Stock Exchange and Nippon Keidanren, have had only limited effects, and that the effect on the governance system is the actual pressure from markets.

Certainly, public policies and guidelines have such elements.[23] However, a more

[23]A good example in this respect is the major deregulation of Japanese financial markets in 1984, in response to the recommendation of the US-Japan Yen-Dollar Committee. The deregulation policy was inevitable because market forces to override and nullify regulations were so strong that traditional regulations could no longer be

accurate view is that market forces and government policy influence to each other (bi-directional causality) and mutually work together to direct the future path, and that the government can act on its own initiative in deciding the content of its policy. For instance, when introducing a system, a government chooses whether to impose one particular system on all companies or to provide alternative systems that companies may choose. Thus, in constructing the fundamental structure of a nation, which includes the corporate governance system, it is clear that public policy has definite role to play.

An example of the effectiveness of public policy: changes in accounting standards

One example of a public policy that greatly influenced Japanese corporate governance is the introduction of new accounting standards in 1999-2001, as these standards hastened the sale of cross-held shares and eventually changed the nature of corporate governance.

These new accounting standards aimed to make the Japanese financial reporting system more compatible with international standards by establishing a more transparent and precise evaluation system. These standards consist of two pillars. One is emphasis has shifted from traditional financial reporting based on individual corporations to that of a consolidated basis. The other has reformed the evaluation of financial assets (securities, financial derivatives) by replacing the practice of historical cost valuation with the market valuation method.

These changes in accounting standards obliged financial institutions and business firms to reassess the meaning and profitability of cross-held shares, whose implied costs had not been carefully assessed. This necessitated that cross-held stocks be sold, and the proceeds allocated to other types of investments or to repay debt. Thus, the dissolution of cross shareholding necessitated a change in the Japanese corporate governance by eroding the main bank system and by the increased acquisition of shares by foreign investors.

5. Evolution of Japanese corporate governance

The Japanese financial system, which basically defines the Japanese corporate governance system, has been continuously evolving in recent years to reflect the shift in corporate funding pattern, dissolution of cross shareholding, the increased role of

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maintained.

institutional investors, and the revolution in information and communication technology (ICT). These changes, coupled with new public policies, have been transforming Japanese corporate governance.

However, it is worthwhile to note that the governance system as well as any new social system cannot be molded in a short period. Generally the formation of a new system is the accumulation of incremental changes of a previous system. In other words, any social change is subject to "path dependency".[24] In addition, it should be noted that both market forces and public policy contribute to the transformation process. Hence, viewed in this manner, Japanese corporate governance is in the midst of this type of evolution.

In Section 5-1, we explain the consequences of the main bank system and cross shareholdings, both of which once characterized Japanese governance. In Section 5-2, we consider the aspect of capital markets, which are increasingly influencing corporate governance; in particular, we analyze the effects of the increasing number of M&A's. In Section 5-3, we describe changes in the internal governance of corporations. Finally in Section 5-4, we clarify where the Japanese corporate governance currently stands in the continuously evolving process.

5-1 Changes in two factors that once characterized the Japanese financial system

Two distinctive features of the Japanese financial system that generated many characteristics of traditional Japanese corporate governance, namely the main bank system and cross shareholding, have changed quite substantially.

The first evidence for the decline of the main bank relationship is that the role of a main bank as an important lender has been receding due to both an excess of funds on the part of corporations and the increased availability of various funding methods. Second is that this decreased dependency on banks has weakened the power of banks over client corporations, thereby, decreasing the monitoring function of banks. However, it should be noted that for those corporations (especially small and medium-sized enterprises), which

[24]Path dependency is the tendency in which a current institution (Z_t) is inevitably formed based on the past (Z_{t-1}). This tendency appears due to many factors, including the way that people think. It is important in public policy discussion because it relates to the feasibility of the policy. However, caution must be taken not to over-emphasize this aspect because it might lead to defeatism. In general, path-dependency can be expressed as follows (Okabe 2002:Chapter 6):

$$Z_t = \alpha + \beta Z_{t-1} \qquad (0 < \beta < 1)$$

where Z_t is a function of Z_{t-1}. The value of parameter β may be regarded as the nature of public policy in structural reform; in the case of a gradual policy, β is near 1, whereas with drastic structural reform, β will be closer to zero.

have difficulty accessing capital markets or acquiring overseas funding, the importance of maintaining a main bank relationship has not changed. For these types of companies, a main bank relationship is likely to be maintained.

To summarize, the main bank system (1) is expected to weaken on the whole due to the decline in the lending-borrowing relationship, but (2) is likely to persist in the case of small and medium-sized enterprises. Accordingly, due to the decline in the monitoring function, we can conclude that, as a whole, the nature and traditional functions of a main bank have changed.

In regards to cross shareholding, the trend of dissolution has been observed since the latter half of the 1990s. Surely some factors work to retain or enforce cross shareholding, rather than dissolve it because some business firms utilize cross shareholding as a means to strengthen business partnerships when establishing a transaction with a new business partner or when restructuring existing business relationships. However, there are more and stronger factors to dissolve cross shareholding. These factors are (1) the rate of return of cross-held shares has been quite low, while companies have increasingly been obliged to increase the rate of return, ROE, or ROA, (2) companies have learned that shareholding involves more risks than previously thought, and (3) for business firms, there is less of a need for mutual shareholding with financial institutions (less need to maintain a main bank relationship) because companies can now raise funds relatively easily from domestic and international capital markets. These factors have contributed to the dissolution of mutual shareholdings.

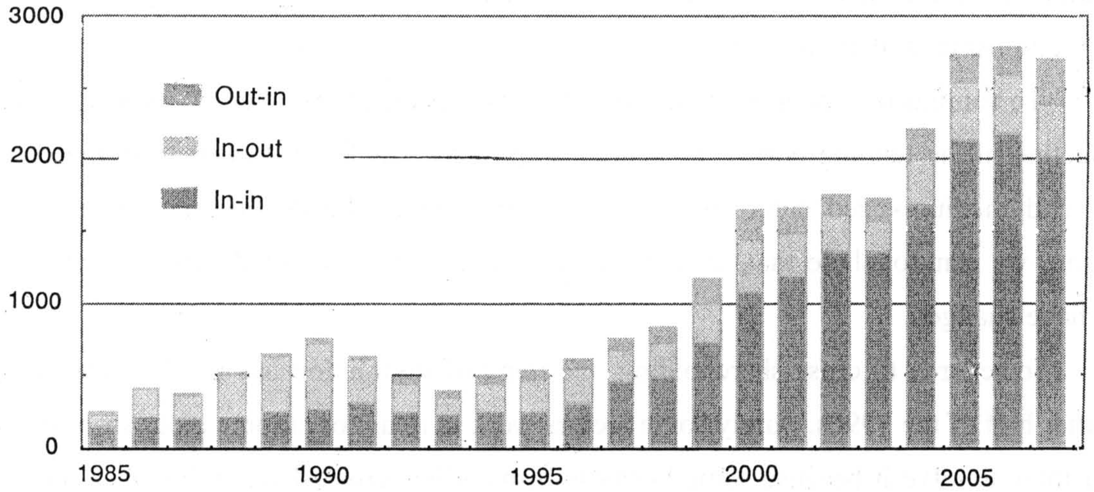
Thus, both the main bank system and cross shareholding are disappearing. Consequently, Japanese corporate governance, which was originally based on these two features, has been forced to change. A small, but important remark should be made here. That is, the change in the Japanese financial system should be understood not as transition from bank finance (indirect finance) to market finance (direct finance), but rather a transition from bank finance to "market-intermediated financing system".[25] In the latter system, institutional investors, which offer such financial products as investment trusts by collecting small-size funds and investing them in capital markets, are expected to have larger roles. Therefore, increased shareholding by institutional investors is likely to exhort greater influence on the stock market, and accordingly on corporate governance.

5-2 Changes in external governance: increased effects of M&A's

There are two clear aspects of corporate governance. One is "external governance",

[25] For details, see Ikeo and the Policy Research Institute of the Ministry of Finance (2006).

Exhibit 8. The number of M&A's in Japan, 1985-2007



(Note) Out-in: M&A of Japanese firms by foreign firms
In-out: M&A of foreign firms by Japanese firms
In-in: M&A of Japanese firms by Japanese firms

(Source) Statistics and data in MARR: M&A Journal.
<http://www.recofdata.co.jp/mag_marr/details/graphe/>

which relates to the various pressures from outside a company and how these change a company's behavior. The other is "internal governance", which focuses on a corporation's internal organization and how it is changing. In Sections 5-2 and 5-3, we look at the developments of each of these aspects in turn.

First thing to note is that the most powerful pressure working on external governance is M&A's (mergers and acquisitions). In fact, the annual number of M&A's in Japan increased five-fold from 500 a year in the first half of the 1990s to 2,725 in 2006. As shown in Exhibit 8, the drastic increase is quite astonishing.

The reasons for this rapid increase are as follows. First, Japanese companies have been forced to urgently and efficiently rationalize their corporate structure or to reorganize business groupings in order to survive the changing environment surrounding the Japanese economy, that is, a prolonged recession and increased competition of NIEs (newly industrialized economies). This aspect may be called a "passive reaction" to environmental changes. Second, some companies, which have both large potential for growth and financial strength (with low debt ratio), are actively engaged in M&A's. This aspect may be called "active or strategic use" of M&A's. Third, as seen in Section 4, the legal environment has been adjusted to facilitate reorganization of the corporate structure and M&A's.

M&A is an action of a company to participate in another company's management or to control another company completely through a merger in order to acquire voting rights at shareholders' meetings of a target company. Thus, M&A's severely influence corporate governance of the acquiring companies and acquired companies. One approach to M&A's, which has been used by numerous finance researchers, is to examine the changes in the value of corporations as expressed by the share prices of the acquiring companies. However, this approach seems to be too narrow to understand all the processes related to a M&A, and thus, has limitations. Therefore, we investigated the effects of M&A's not on the share price, but on corporate performance, which underlies the share price of a corporation.

Effects of M&A's on stability and efficiency of a corporation

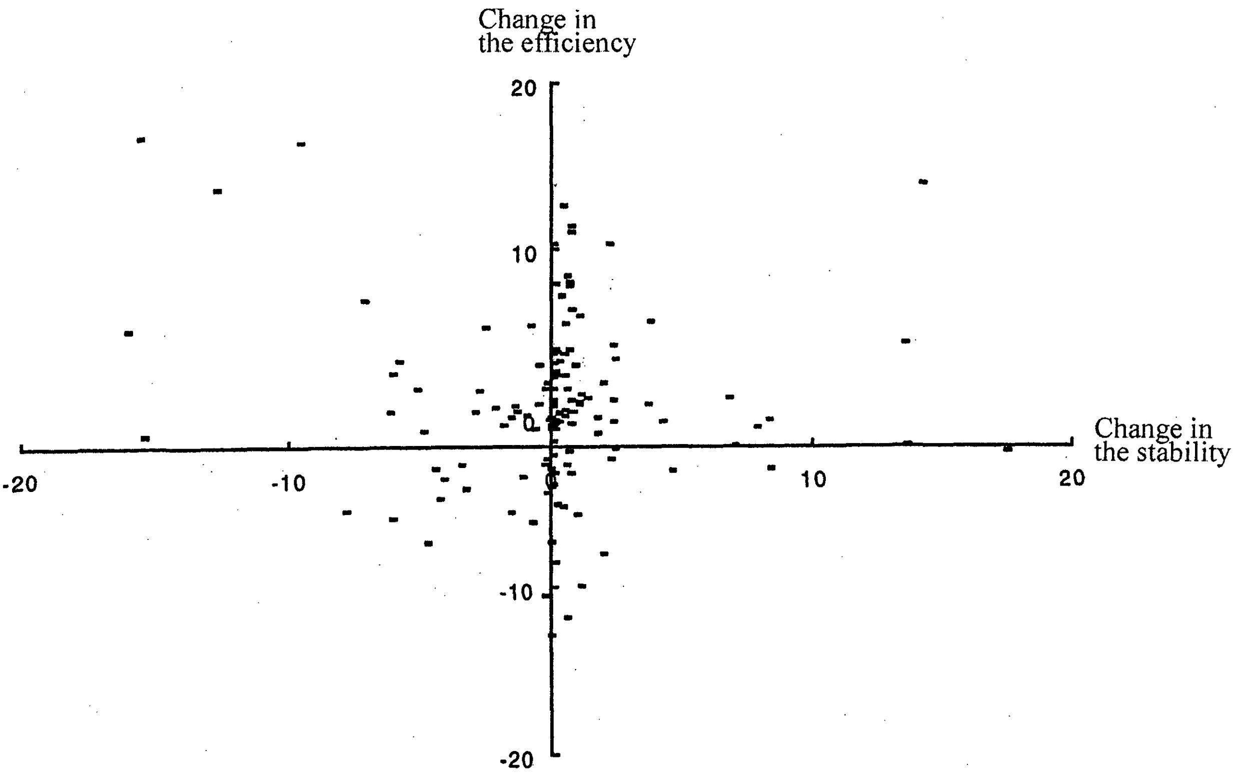
There are numerous empirical studies on the effects of M&A's in the US or the UK where M&A's were well-established before they began appearing in Japan. However, it is difficult to find a full-fledged empirical study in Japan. One reason is that a solid database regarding M&A's has yet to be established because M&A's have only begun to receive attention in recent years. In light of this situation, we collected relevant information and built a database for our research and conducted statistical analyses. Appendix 1 describes the data and the method of our statistical analyses.

To be specific, this research intends to determine how the performance of a merging company changes after a M&A. That is, this research evaluates corporate performance to answer two questions statistically: (1) what extent does a M&A contribute the "stability" of corporate performance?, and (2) what extent does a M&A contribute to the "efficiency"? An increase in corporate stability may be regarded as an increase in credibility or a decrease in credit risk perceived by the market. Thus, stability can be judged by the change in the probability of bankruptcy (default risk) after a M&A. On the other hand, an increase in efficiency may be defined as increase in the value of various resources (not only physical and human resources, but also technological and intangible assets) over which a corporation has control. Thus, the typical measure, the change in the ROE (return of equity), is used to measure the efficiency after a M&A.

Exhibit 9(1) shows the results of the analyses. The vertical axis (x-axis) measures the degree of stability of a company. A positive value indicates that the probability of bankruptcy of a company in 2004 became smaller than that in 2001. In other words, the stability of a company increased after the M&A. Conversely, a negative value means the probability of bankruptcy increased in 2004, three years after the M&A; that is, the stability of the company declined after the M&A. On the other hand, the vertical axis (y-axis)

Exhibit 9. The effects of M&A's on corporate efficiency and stability: an empirical study

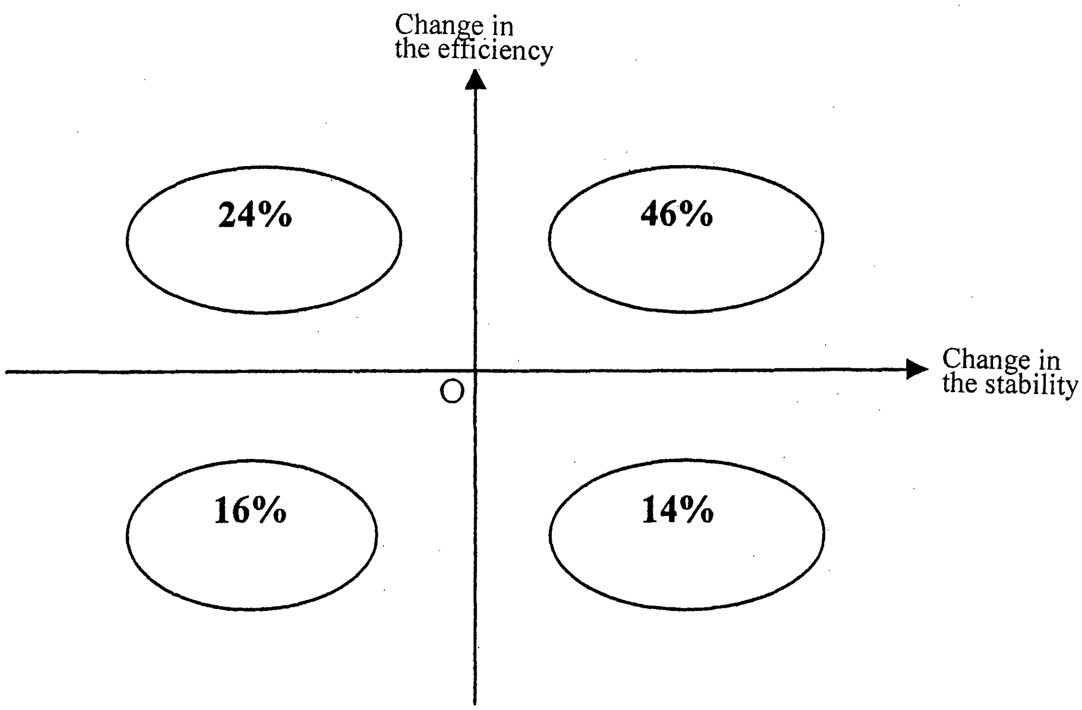
(1)



(Note) 1. Change in the stability: Percentage change in (Probability of bankruptcy in 2004 - Probability of bankruptcy in 2001) multiplied by -1.

2. Change in the efficiency: (ROE in 2004 - ROE in 2001) multiplied by 100.

(2)



(Note) The numbers indicate the composition of firms (in per cent) that belongs to each of the four quadrants.
(Source) Okabe (2007) , Figures 9-11(b) and 19-12(b).

measures the degree of efficiency of a company.[26] A positive value shows that the ROE was higher in 2004 than in 2001, indicating an increased efficiency after the M&A. Conversely, a negative value means that the ROE of a company declined; that is, the efficiency of a company decreased after the M&A. Each point (dot) in this diagram shows the 2004 situation of a company, which implemented a M&A in 2001 (157 companies). Exhibit 9(2) provides the same information collectively and more precisely as the number in each quadrant indicates the percentage of firms located in that quadrant (the four quadrants total is 100%).

These Exhibits show that out of the 157 companies implementing M&A's, (1) 73 companies (46%) successfully raising both stability and efficiency, (2) 21 companies (14%), successfully improved stability, but failed to increase efficiency, (3) 38 companies (24%) increased efficiency, but failed to improve stability, and (4) 25 companies (16%) failed to raise stability or improve efficiency.

What do these results mean? Result (1) shows that nearly half of all companies that implemented M&A's actually improved both stability and efficiency (or obtained an ideal result). Thus, M&A's are desirable for the Japanese economy on the whole.

Moreover, the results show that M&A's are a management tool with "high risk and high return" because for a little more than half of the companies, the M&A improved only one of the two criteria. In fact, about 20% of all the companies actually experienced a worse situation as both the stability and efficiency declined three years after the M&A. Broadly speaking traditional Japanese companies have been in a "low risk-low return" environment (a typical phenomenon is cross shareholding), but M&A's may be interpreted as a means to escape from such a situation as well as a diversified approach to company management.

Furthermore, the analysis revealed that M&A's are more likely to improve efficiency than stability and that (although not shown as an exhibit) a larger efficiency can be brought about for the company initially with less efficiency. Accordingly, M&A's can be appraised as an effective mean, or a mean to "purchase time" to propel structural reforms efficiently and swiftly. In this respect, M&A's not only play a role in improving the governance of Japanese corporations, but also have a significant meaning in restructuring the entire Japanese economy.

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[26]Japan was in a deep recession during the period covered in this study (2001-2004). Hence, the profit margins of companies generally declined; the average ROE of all companies declined 1.67%. Therefore, the horizontal axes in the Exhibits have been lowered by 1.67 percentage points because the results of M&A's should be judged in comparison with the average pattern of profits.

5-3 Changes in internal governance: comparatively slow progress

Next, let us examine the changes in the internal governance of corporations. Similar to external governance, changes in internal governance are inevitable. Change in internal governance is influenced strongly by legal provisions and various regulations. Broadly speaking, recent changes can be summarized as the addition of Anglo-American elements into the traditional Japanese internal governance system. These additions include strengthening the role of external auditors, introducing an executive officer system and outside directors.

Let us see some important aspects in detail. First, the structure of the board of directors, responsible for monitoring company management, has been changing since 1997 as the number of board members has been decreasing. A study (Abe and Shimizutani 2005) has shown that the average number of board directors for a company decreased from 17.4 persons in 1990-1996 to 14.7 in 2001. Next, in terms of board composition, although the basic structure of a traditional Japanese corporation still prevails in that the board is dominated by internally promoted directors, more companies are appointing outside directors. The above-mentioned study showed that the percentage of internally promoted directors decreased from 70.0% in 1990 to 63.2% in 2001, while the number of corporations appointing outside directors has been steadily increasing. In 2004, one in three listed corporations had an outside board member.[27]

Additionally, the stock option system introduced in Japan in 1997,[28] which provides work incentives to managers and employees, has steadily been adopted. In 2005, approximately 40% of listed companies had introduced this system.[29]

On the other hand, only a limited number of companies have introduced the "company with committees" system, an Anglo-American system of separation between company management and monitoring.[30] Thus, with respect to internal governance, Japanese corporations still maintain the traditional Japanese characteristic, which starkly contrasts the external governance style.

In summary, internal governance of recent Japanese corporations (1) has changed

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[27]A survey covering 2,108 listed companies revealed that 630 had already introduced outside director(s) (Nikkei, Japan Economic Journal, August 22, 2004).

[28]The stock option system is an arrangement in which a company gives board members or employees the right to acquire the company's stock at a predetermined price (strike price). Board members or employees can obtain profits, if they acquire stock, when the share price increases and they sell the stock at the same time. Because this reward is connected with an increased share price, which reflects an improved company performance, it is understood that the system provides incentives for employees to improve company performance.

[29]A survey by Nikko Cordial Securities Company.<http://www.nikko.co.jp/news/2005/pdf/050617.pdf>

[30] Refer to footnote 20.

Exhibit 10. Emerging Diversity of Corporate Governance in Japan

		Traditional Japanese firm	Hybrid-type firm	Newly emerging firms*
Sample firms (its share)		398 (55%)	173 (24%)	152 (21%)
Average number of employees		967	6,293	1,030
Share of employees (%)		23	67	10
Average ROA (%)		-0.10	0.96	1.45
Financial characteristics (%)	Bond ratio	1	9	3
	Bank loan ratio	19	11	17
Ownership characteristics (%)	Institutions	21.8	43.7	22.1
	Other firms	33.0	17.6	28.0
	Foreigners	2.7	14.5	4.6
	Individuals	41.7	23.3	44.6
Board and management Characteristics **	Transparency	8.2	18.2	11.0
	Board reform	9.7	13.7	10.6
	Shareholder protection	4.2	7.2	5.7
Employment characteristics (%)	Long-time employment	100	94	29
	Merit-based pay	24	45	100
	Stock options	13	39	56
	Union	70	99	51

* This includes, in particular, IT and other high-technology service firms.
** Higher numbers mean more positive in reforming each item. Maximum point of each item is 33, and the total is 100.
(Notes) Jackson and Miyajima (2007: Table 1.4), and Miyajima (2008) which rearranges some items.

slowly toward an Anglo-American type in terms of board structure, management incentives, and separation between management and monitoring, (2) but on the whole, these changes are rather slow and small in magnitude. The reasons for the slow or little changes are: firstly path dependency,[31] which slows any change; and secondly, more importantly, the Japanese legal system, which allows Japanese corporations to select alternative governance systems.

5-4 Present stage of governance transformation: a trend toward diversification

Where does the Japanese corporation stand on the stage of evolution of corporate governance? A recent comprehensive study conducted by Jackson and Miyajima (2007) has vividly described the present stage. They have shown that governance style has been

[31] Refer to footnote 24.

diversified in recent years, and that governance style can broadly be classified into three categories (Exhibit 10).

Traditional Japanese firms

The first group can be called "traditional Japanese firms" because these are characterized by (1) cross shareholding, (2) close relationships with banks (main bank relationship), and (3) long-term employment practices. This group still retains the basic characteristics of traditional Japanese firms in the sense that close relationships among companies, banks, and employees exist. Hence, these firms (1) rely more on banks and less on capital markets, (2) show a low ratio of share ownership by institutional investors, (3) are reluctant to reform the internal governance or employment systems, and (4) have comparatively low profit margins. These firms can be generally characterized as firms that have postponed reforms in the governance structure or in the restructuring of business lines. Companies in this category tend to be well established and have been in business for many years. This category represents 23% of Japanese companies based on the number of employees, but represents more than half (55%) based on the actual number of firms.

Hybrid firms

The second group can be called "hybrid firms" because this group has characteristics of both traditional Japanese firms and Anglo-American firms. These firms generally have increased market-based finance with reduced bank borrowing; and their stocks are held increasingly by foreign investors or Japanese institutional investors due to the dissolution of mutually held shares. Hence, their financing and ownership has Anglo-American character, but they have retained an internal organization structure with traditional Japanese character. That is, firms in this group still maintain (1) long-term employment; and (2) a traditional board structure, which consists mainly of internally promoted directors.

However, the external governance is Anglo-Americanized, while the internal governance retains the traditional Japanese characteristic, hence the name "hybrid". Although this category accounts for only 24% of all Japanese companies based on the actual number of firms, it consists of 67% based on the number of employees. However, it is important to note with regard to internal governance, these firms have been introducing various reforms, including (1) defining and carefully treating core employees, (2) introducing merit-based pay or a stock option system, (3) actively disclosing information, and (4) undergoing effective board reform to meet their specific conditions. Hence, these firms have begun to reform internal governance, and experience far less problems in corporate governance.

Moreover, although this group has a Japanese type of internal governance, this aspect differs significantly from the first group ("traditional Japanese firms"). These hybrid firms enjoy comparatively high profit rates because their dependence on overseas markets is high and is subjected to stronger disciplining due to severe international competition.

Newly emerged firms

The third category is "newly emerged" companies. With regard to employment, similar to the "hybrid" category, this group has a system that is market-oriented (Anglo-American) in nature. However, the financing sphere maintains traditional (Japanese type) finance. That is, firms in this category have fixed term (rather than long term) employment, merit-based pay, and a stock option system, but are highly dependent on banks, and the ratio of stocks held by institutional investors remains low. Thus, this type of firms has a Japanese type sphere of financing and ownership, and has yet to improve their internal governance to include such items as protection of minority stockholders.

This category represents on 10% of all companies based on the number of employees, but represents 21% based on the actual number of firms. This type of firms is found mainly in knowledge-intensive or ICT related industries or the retail industry. In many cases, these firms are founded by an individual and have been managed by him, and are relatively young corporations. The performance record of these newly emerged companies is that the average profit margin is relatively high, although this margin is widely dispersed.

Characteristic features of governance reform

In summary, changes in the Japanese corporate governance, viewed from both the external and internal governance structures, can be characterized by the following two statements (Miyajima 2005). First, the importance of outside stakeholders (shareholders and debt holders), a typical characteristic seen in market-based or American-type governance, has surely increased, and the influence of capital markets on corporate disciplining has been increasing. Second, in terms of internal governance reform, including the board structure and the management incentive system, many companies still maintain traditional Japanese characteristics.

The effects of outside stakeholders on corporate governance and performance can be confirmed by the empirical study shown in Appendix 2. The main conclusion of this study is that the corporate disciplining function of capital markets has become increasingly clear; for instance, corporations with high foreign ownership show better performance.

Studies incorporating internal governance reform (Miyajima, Haramura, and Inagaki 2003; Miyajima and Kuroki 2007) have revealed that better performing corporations (as measured by Tobin's q) typically have such characters as (1) market-based finance, (2) a high shareholding ratio by foreign investors or institutional investors, and (3) good progress in board reform. On the contrary, poor performing corporations have features in common such as (1) bank-based finance, (2) maintenance of cross shareholding, and (3) delayed board reform. The mixture of these two types of corporations is currently the reality of Japanese corporate governance.

These facts clearly show the desirable directions of company management and of internal governance structure. So, let us turn to issues in the future.

6. Future prospect and the policy issues

In this section, we initially define a desirable financial system for Japan given the current domestic and international conditions in order to find a desirable system of Japanese corporate governance. Then, we explore the necessary public policy or guidelines for Japanese firms to guide them toward this desirable direction.

6-1 Desirable financial system for Japan

When a desirable financial system for Japan is considered, the two contrasting financial systems must be evaluated from the viewpoint of information processing. This is shown in the lower part of Exhibit 1, as earlier presented.[32]

Two models of the financial system and their functional properties

When the financial system is viewed as a vast information processing system, the Anglo-American system has the characteristics that (1) the acquisition and distribution of various information are conducted via markets and (2) well-developed financial and capital markets exist where transactions are conducted, reflecting various information. Accordingly, the information costs for a society are comparatively small. In contrast, in the

[32] The following explanations are based on Allen and Gale (2000: chapter 13).

Japanese-German system, the finance process is concentrated in financial intermediaries (banks) so that it excels in acquiring a set of existing information ("economies of scale" in information acquisition at work) rather than in collecting and digesting new information.

Thus, the Anglo-American system widely distributes project risks to various economic units, and the system is capable of responding to new developments in society and economy. Therefore, it is well suited to finance the development of new industries, which involve a relatively large risk, or to develop new technology. Examples of such industries and technologies include railways, computers, and biotechnology. In fact, these businesses were first achieved either in the UK or the US. Thus, this financial system is tailored for "product innovation".

On the other hand, the Japanese-German system excels in financing the needs of borrowers by coordinating interests among various stakeholders by maintaining long-term relationships. Accordingly, this system is suited for financing on-going business enterprises, when the firm's goal is to accelerate capital investment or to accumulate firm-specific labor skills, which are both crucial for mass-scale production of existing products. Thus, this system is well suited to finance existing products or industries where improving technological and production efficiencies are more important than innovation, and the risk is relatively low. The competitive edges of Japan and Germany in industries such as automotive and electronics validates this interpretation. Thus, the Japanese-German system is tailored for "process innovation".

Desirable financial system and corporate governance for Japan

What is the desirable financial system for Japan?[33] By applying the above analyses and considering the development stage and historical conditions of the Japanese economy, the answer is a system that more or less has characteristics of a market-based system rather than the traditional bank-based system. Alternatively, it can be said that Japan needs an innovation-inducing financial system.

The reason why Japan needs an innovation-inducing system is that East Asian

[33]Regarding the financial system, numerous interesting questions have been posed, including, (1) Which of these two systems is superior? (2) Is there one "best" system that can be implemented in any country? (3) Does financial globalization cause the financial systems in all countries to converge to one model? Recent research has generally concluded (1) that there is not a single universally optimal system (one size does not fit all, nor does it even fit all the time), and (2) that an optimum financial system for a given country depends on various economic and other conditions, such as the stage of economic development, effectiveness of regulation, degree of openness of the economy or of financial globalization, information and communication technology, the degree of development of the social infrastructure, and policy implementing ability of the government (Aoki, Patrick, and Sheard 1994; Beck and Levine 2002 ; Levine 2002 ; Levine 2004). This understanding also applies to corporate governance (Becht, Jenkinson, and Mayer 2005).

countries have developed rapidly and have caught up with Japan in industries (automobiles, electric appliances, and electronics) where Japan once had a comparative advantage. Hence, Japan now needs to develop new industries or to reform the economic environment so that new industries and businesses can start up easily. Put simply, Japan must transform the financial system, which has traditionally been suited for "process innovation", to one that is tailored toward "product innovation." This is because the latter system not only excels in widely allocating risk, but also functions more efficiently in acquiring, evaluating, and utilizing information about new technology and products.

Transformation of Japanese corporate governance

The Japanese financial system has been transforming from, roughly speaking, a bank-based to a market-based system due to the decline in the main bank relationship and the dissolution of cross shareholding. These changes in the financial system affect corporate governance. Concretely speaking, the changes can be summarized as moving toward the following three directions.

First, on the whole, traditional bank-driven corporate governance is changing toward capital market-driven governance; that is, discipline of corporations by main banks monitoring or possessing debt is changing to corporate discipline due to pressure from capital markets (stock and corporate bond markets).

Second, simultaneous diversification of governance styles is occurring because corporate governance style is determined by numerous factors and a single universally optimal governance model does not exist (see 4-2 and footnote 33). In the case of many excellent companies in Japan, it has been found that only few companies place top priority on increasing shareholders' value per se, but that almost all of them attach great importance in sincerely providing goods and services that the society needs as well as providing a sense of satisfaction to all their employees (Niihara 2003a, 2003b). Moreover, the Revised Corporation Laws of 2003 and 2006 stipulate the option of selecting from two alternative styles for the board of directors, thus, legally supporting the diversification.

Third, although Japanese corporate governance has been adding Anglo-American or market-based governance elements, it is not likely that it will converge with Anglo-American governance due to the reasons mentioned in footnote 33. Alternatively, it can be said that two types of factors determine the structure of corporate governance: those that can easily converge (i.e., the nature of financial markets, financial data, accounting rules) and those that cannot (i.e., corporate law or commercial law, which reflect each society's social system and customs), and thus, prevent corporate governance from converging.

Institutional complementarity: changes in corporate governance induce changes in the employment system

Hence, it appears that Japanese corporate governance has left the "vacuum", and a new disciplining mechanism seems to have emerged. This new circumstance where ROE is likely to have a high priority in corporate management is expected to induce a substantial change in employment because this new management style requires not only efficient utilization of capital, but also that wages are consistent with labor productivity, even in the short run. That is, pressure from the market may require that the wage level be rational (equal to labor productivity) at any point in time. Therefore, the seniority element (the number of years of continuous service in a company), which was once an important factor in determining the wage level, is likely to be weakened in this new wage system. If this trend continues, then the incentive for an employee to work years for the same company will be gone. Hence, it is probable that long-term employment practices will cease.

Changes in corporate governance influence the employment system because all the elements that used to make Japanese corporate governance (cross shareholding, main bank system, and long-term employment system) contributed jointly and collectively to form the system. Thus, it is important to recognize "institutional complementarity", which has been emphasized by Aoki (1995) and Aoki and Okuno (1996), meaning that an economic system should be viewed as a number of sub-systems that complement each other.

In this light, it is quite difficult to change only a specific system. Furthermore, path-dependency means that a system change takes time. Therefore, even if some sub-systems begin to change, the initial speed of change cannot be rapid because other related system must also change. Conversely speaking, if a change crosses a certain threshold, the speed of the change may rapidly accelerate, and all the related systems may change drastically and irreversibly. Currently, change is slowly underway as evidenced by (1) the increased pressure from capital markets by way of M&A's, (2) the legal option to adopt an Anglo-American governance system, (3) the increase of foreign ownership, and (4) the breakdown of the main bank system. This change is likely to transform the traditional characteristics of the Japanese economy, and create a new Japanese characteristic of a hybrid type system, which combines traditional Japanese and Anglo-American elements.

In this process, there is an important role of public policy, which must not only recognize the institutional complementarity of various areas but also be internally consistent. Thus, in the next section, we focus on public policy.

6-2 Public policy issues

Initially this section presents important remarks, and then discusses policy issues in constructing desirable corporate governance.

(1) Important remarks for public policy

Public policy on corporate governance should give high priority to enhancing innovation as well as other traditional policy objectives such as efficiency, fairness, and global harmony. Additionally, we would like to emphasize the following two points.

First, a historical perspective should be kept in mind. Traditional Japanese firms had competitive edges in the international arena until the latter half of the 1980s by forming devices (such as the main bank, cross shareholding, long-term employment) to assure continuous and long-term transactions and thereby, mutually sharing information and ultimately correcting the problem of information asymmetry.[34] However, the effectiveness of this system was lost due to the emergence of a vacuum of corporate governance, low efficiency of capital, the rapid increase of imports from China, and a drastic decline of information costs due to the ICT revolution. These developments clearly demonstrate that the optimum corporate system depends on the time as well as current conditions.

Second, cultural and geographical conditions must be considered. That is, an optimal system must be defined not simply by considering historical conditions, but also by considering the basic conditions of society and culture.[35] For instance, according to the two corporation model, Anglo-American companies presume that liquidity (mobility) of markets and society are comparatively large, whereas Japanese-German companies are characterized by mutual long-term commitments between stakeholders (employees and banks) and thus, a change in these relationships requires time and a relatively large cost. In other words, the Japanese-German system presumes that the liquidity of markets and society are comparatively small. As these two cases imply, the liquidity or mobility of markets and society are deeply rooted in each country's history and social values. Thus, when designing and implementing public policy on corporate governance this aspect should be remembered.

Given above arguments, there are two important issues in order for public policy to

[34] The nature, function, and evaluation of these devices are briefly described in Okabe (2007), and details are found in Okabe (1999:chapter 1; 2002a, 2002b) and Sheard (1995).
[35] This point has been emphasized by Dore (2006), a sociologist.

Exhibit 11. Employee participation in corporate governance: an international comparison

	Employees appoint some board members	Works councils mandated by law	Constitutional reference to employee participation in the management of the company
Austria	○	○	×
Denmark	○	○	×
Germany	○	○	×
Norway	○	×	○
Sweden	○	○	×
Spain	×	○	×
France	×	×	○
Italy	×	×	○
Japan	×	×	×
Australia	×	×	×
Switzerland	×	×	×
United Kingdom	×	×	×
United States	×	×	×

○=Yes ×=No

(Source) OECD (2004a), Table 3-1-A. Countries are selected and the order is rearranged by the author. Original table includes 28 countries in alphabetical order.

improve Japanese corporate governance: legal clarification of employees' interests, and improvement of the financial environment.

(2) Legal clarification of employees' interests

The first task is to legally establish employees' interests so that they can participate in company management and the distribution of company profits. As long as employees remain committed to a company, and in Japan, employees are very important stakeholders, it is reasonable that their position be represented and reflected in corporate decisions.

Specifically, a legal arrangement should be made for employees to participate in company management. Exhibit 11, which is based on OECD (2004a) survey, shows what type of legal rights employees have to participate in company management in various countries. It is evident that in Japan, employee participation in company management is not legally stipulated, even though they are very important stakeholders in Japanese companies. Then, it is desirable and rational to vest employees in Japanese companies with the legal authority to participate company management. If a legal measure is taken, it would be a fair arrangement and the morale of employees should increase, which, in turn, should lead to overall better corporate governance.

Second, the implicit rights of employees to the company should clearly be stated in a contract or another form, and be distributed more evenly during the years of the employees' working life. For instance, currently, an employee is entitled to receive a pension as a lump sum only at retirement, but this should be dispersed more evenly with time. If an employees' stock ownership program is introduced for this purpose, then employees can explicitly own this right in the form of a security. In the United States, for instance, a program called ESOP (Employment Stock Ownership Plan) has become commonplace. Similarly, the stock option system[36] was introduced in Japan in 2002, and is expected to spread widely.

(3) Improving the financial environment

The second task is to improve the financial environment so that companies can strengthen their governance and attain their ultimate objectives. Important tasks include (1) improving the institutional framework with regard to institutional investors, (2) assisting risk-taking businesses, and (3) improving M&A rules and regulations.

First, it is important to improve the institutional framework regarding institutional investors.[37] In recent years, due in part to the dissolution of cross shareholdings, institutional investors have become increasingly important shareholders. Thus, the legal and other frameworks as well as customs by which institutional investors participate in corporate governance as shareholders must be improved. Institutional investors naturally tend to invest in stocks of companies that generate high ROE. Consequently, it is likely that this pressure from the stock market contributes to the efficient management of listed companies. In Japan, where the population is rapidly aging, the role of institutional investors, in particular, pension fund investors, has increased. However, in the present legal framework, fiduciary duty[38] of institutional investors is not clearly defined, and thus, clarification and improvement of relevant laws and regulations remain issues (Kawakita 2003).

It should be noted that the above argument is for the case of general (nonfinancial) business companies. However, for financial institutions (not only banks, but also

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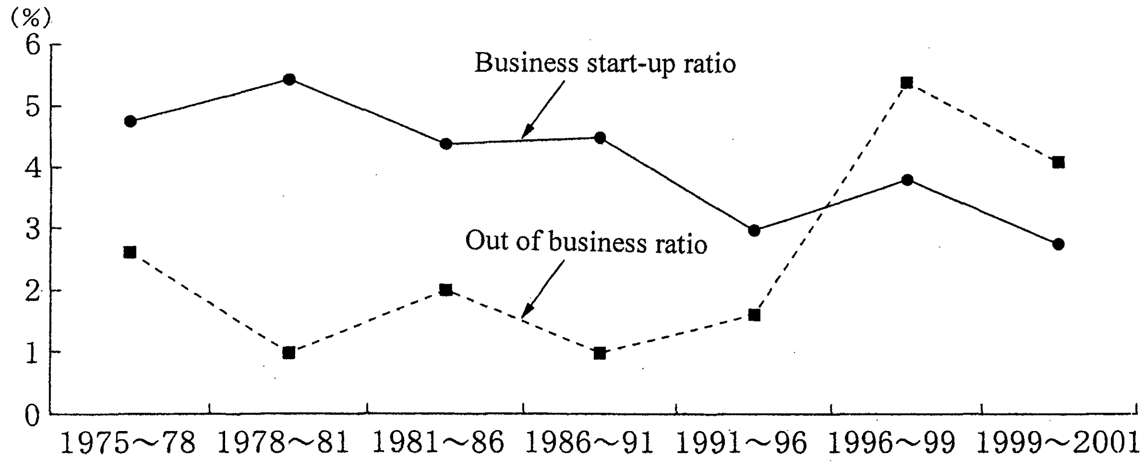
[36] The system allows a company gives a worker or manager the right to purchase the company's stock at a predetermined price (stock option) during a specified period of time. If the stock price increases, then the difference between the market price of the stock at the time of exercising the option and the pre-determined stock option price is the net gain.

[37] Institutional investors are financial intermediaries, such as pension funds, investment trusts, and insurance companies specializing in collecting small-sized funds from individuals and investing the collected funds in various financial and other assets on behalf of the individuals, so that individuals can be satisfied in terms of the rate of return, risk, and maturity.

[38] The obligation of agents such as insurance companies and pension funds is to seek the realization of maximum profit by investing the entrusted funds by individuals.

Exhibit 12. Business start-up ratio and out of business ratio in Japan, 1975-2001



(Note)

1. Based on the number of companies, excluding primary industries.

2. Business start-up ratio = The number of started-up companies (yearly average) / The total number of companies (in the previous survey).

Out of business ratio = The number of companies that went out of business (yearly average) / The total number of companies (in the previous survey).

(Source) Ministry of Economy, Trade and Industry, White Paper on Small- and Medium-sized Businesses 2003, Figure 2-2-4.

institutional investors such as investment trusts), there are similar issues of improving corporate governance and the legal framework (Nikami 2004; Anderson and Campbell 2004).

Second, it is important to assist risk-taking firms. Public policy needs to improve the legal and other environments so that innovative firms can easily be started and grown, while such firms and industries that are unfit for the environmental changes are weeded out. The business "start-up" and "out of business" ratios relative to the total number of businesses (Exhibit 12) show a new trend after 1991, the year that the bubble burst. The out of business ratio increased sharply, while the start-up ratio kept declining, until the out of business ratio became larger than the start-up ratio, indicating that the total number of companies declined in the latter half of the 1990s. Due to this situation, it is imperative to raise the business start-up ratio by encouraging risk-taking venture businesses and by improving the financial environment so that risk capital for these businesses is easier to raise. Among other measures, public policy should assist to enlarge the channel of risk-bearing funds to high-tech industries.

Third, it is important to rapidly improve the legal and other environments for the increasing number of M&A's. In particular, legal measures are still incomplete and the environment for M&A's remains immature; for instance, there are an inadequate number of M&A advisors and M&A assisting organizations, and the market for managers is not yet well-developed. Improvements in these respects are necessary.[39]

What is important in designing policy is that the essential nature of a company be regarded as a collection of people who are committed to the organization for a relatively long period, and are not pooled funds, which are perfectly mobile in an instant. This is particularly true when considering the social and cultural conditions of Japan. Thus, if the situation arises where companies are sold and bought like merchandise, and the intention of the current shareholders decides the fate of all the employees, it is undesirable for the employees, who are important stakeholders. Moreover, a M&A is likely to damage the value of a firm due to the risk of damaging the value of various firm-specific skills, which employees have acquired and accumulated. Therefore, full use of the efficiency-enhancing function of a M&A should be made, but it should be simultaneously remembered that the short-sighted aspect of M&A should not hurt the value of the firm. In this context, the appropriate legal framework for defense measures against a hostile takeover[40] remains to be clarified, and it is this framework which will establish Japan as a good M&A market.

7. Conclusions

The main arguments of this paper can be summarized as follows.

(1) Compared to Anglo-American corporations, traditional Japanese firms, which greatly contributed to Japan's economic development during the post-World War period, had distinctive features in behavior and the structure, including (a) more importance was attached to size expansion than to increase the profit margin, (b) little attention was paid to

[39]In legal issues relating to M&A's, it has been said that there are situations where corporate laws and other laws (especially tax laws) are often not consistent, and that companies have occasionally been hindered from initiating M&A's to diversify risk. For instance, if the process is to be implemented smoothly to divide a company (by spinning off a part of a company) or for a TOB (takeover bid), then Commercial Law and Securities Transaction Law must be revised, respectively. However, it is generally understood that revisions have been insufficient due to the conflict with tax laws. Although the recently enacted Revised Corporate Law (in 2006) did unify many similar aspects, further actions are expected if conflicts remain among various laws.

[40]An example of a defense measure against hostile takeover is the "poison pill", which weakens the controlling power of the buyer over the buying company. This can be made possible by allotting the right (equity warrant) to existing shareholders to acquire the stocks of the company for a price less than the market price.

the shareholders or share price, and (c) long and continuous transactional relationships were maintained by mutually holding company shares. These phenomena can be understood as reasonable if we introduce two types of models for corporate governance: Anglo-American and Japanese models. These two models of corporate governance correspond roughly to two financial system models: Anglo-American and Japanese-German financial systems.

(2) Traditional Japanese corporate governance was characterized by two key elements. One is a firm had one (or a few) main bank with which the firm had a long-term and many-sided relationship. The other is that company stocks were held mutually (cross shareholding) between a firm and a bank, or between nonbank firms. These two phenomena performed various functions, including reducing informational asymmetry by way of maintaining close transactional relationships. On the other hand, they had some negative aspects like weakening corporate monitoring and discipline.

(3) Since the 1980s, the environment surrounding the Japanese economy changed drastically. These changes included a sharp decline in the economic growth rate, which led to a decline in the borrowing needs of firms, dissolution of cross shareholding due to increased sensitivity of the risk of holding shares, and the general trend of deregulations. Consequently, the conditions that supported the Japanese corporate monitoring were lost. Certainly the disciplining pressure on corporations from capital markets increased due to increased ownership of Japanese corporations by overseas investors, whose priority was higher ROE (return on equity). However, this pressure was insufficient to discipline Japanese corporate management. Hence, a "vacuum of corporate governance" occurred, which was a contributing factor to both the skyrocketing of asset prices (the bubble) in the late 1980s and the unusually long recession, the so-called "lost decade" of the Japanese economy.

(4) To reform the Japanese economic system, which had become incapable of adapting to the new environment, the Japanese government continuously put forward various policies, especially after the last half of the 1990s. These policies broadly point in three directions. One is to improve laws and regulations pertaining to corporate organizations and corporate mergers, including the enactment of Revised Corporate Law and Revised Certified Public Accountant Law as well as the publication of guidelines for internal governance of a company. Two is to strengthen the market mechanism, including the facilitation of M&A's and the unified treatment of transactions of various financial products. Three is to diversify the corporate governance structure in Japan by changing laws and regulations, and the most important of which was the introduction of an optional system to choose a "company with committees", an Anglo-American governance system. In addition, a few organizations in the

private sector, including the Tokyo Stock Exchange and Nippon Keidanren (Japan Business Federation), have drafted and publicly offered guidelines for the purpose of providing concrete measures to improve corporate governance. Each of these guidelines offered a somewhat unified picture of good governance, and the drafting process itself was useful as the participants learned desirable governance. However, it should be noted that these guidelines have had only limited influence on reforming Japanese corporate governance because they were merely guidelines, and hence, lacked a compulsory clause or penalty.

(5) Japanese corporate governance has been changing, and a new form is emerging due to the changes in the financial system and public policy. In external governance, pressure from capital markets (the rapid increase in M&A's, in particular) has played an important role since the decline in the main bank system and the dissolution of cross shareholding. This pressure has assisted in the restructuring of business organizations and spheres as well as contributed to increased efficiency. Although the changes in internal governance have been relatively slow, some companies are adopting an Anglo-American governance structure, a system in which the execution of the business and its monitoring are clearly divided. Consequently, the present state of corporate governance in Japan is clearly diversifying, and broadly speaking, Japanese firms can be classified into three types of firms: "traditional Japanese firms"; "hybrid firms", which have both a traditional structure for internal governance and Anglo-American structure for external governance; and "newly emerged" companies, which retain traditional character in external governance (reliance on banks), but adopt an Anglo-American employment system and internal governance. Comparing the performance of these three types of firms demonstrates that companies with superior performance are those with Anglo-American external governance (market-based finance and high ownership by foreigners) and are undergoing reforms in internal governance (the board structure).

(6) Given the historical conditions, as well as the present domestic and international conditions of the Japanese economy, it is desirable that the traditional financial system, which is suited for "process innovation", transforms so that it becomes well suited for "product innovation", which is found typically in the Anglo-American system. This change is now occurring as the governance format is being diversified. Thus, the role of public policy is to enforce and accelerate these changes. In deliberating policies, it is important to remember that (a) the Japanese corporate governance structure is not expected to converge on the Anglo-American model even with financial globalization and (b) that changes in one area (financial market, employment, inter-corporate relationship) will trigger changes in

other areas, which is known as institutional complementarity. Therefore, public policies in different areas must be consistent. Policies to improve and strengthen corporate governance include (a) legalization of rights and duties of employees, who are important stakeholders in the company and (b) improvements in the financial environment by reforming institutional framework pertaining to institutional investors and to M&A's as well as assisting start-ups of risk-taking businesses.

Appendix A1. Methods and data of statistical analyses of the effects of M&A's (Section 5-2)

This paper evaluated the effects of M&A's using two criteria--- (a) whether corporate stability has increased by a M&A, and (2) whether corporate efficiency has been enhanced. An increased corporate stability was captured by a decrease in the default risk of a company (the risk of bankruptcy). The default risk was calculated by combining such financial indexes as the ratio of retained profits to the total capital, and the interest coverage ratio. On the other hand, an increase in efficiency was captured by an increase in ROE or the ratio of current profit to paid-in capital.

Logit models were utilized to estimate the changes in the default risk. To assess the stabilizing effects of M&A's, we compared the bankruptcy probability of a company three years after a M&A occurred; if the probability of bankruptcy declined after three years, we judged that the M&A had a stabilizing effect on the company. On the other hand, to assess the efficiency effects of M&A's, we compared changes in ROEs for two cases, the change in ROE for companies that underwent M&A's (sample firms) to that of the average ROE for companies that did not conduct M&A's.

Sample firms were selected as follows: we initially identified all companies that carried out M&A's in 2001. Then from these companies, we selected 157 companies, which represented 15 industries and had sufficient financial data available for the present analyses. It should be noted that industries whose financial data showed unusually erratic movements were excluded. The reason why we compared the status of a company three years after a M&A is that typically after three years the full effects of the M&A are realized (in terms of financial statements). Thus, data from 2001 was compared to that from 2004.

Appendix A2. Corporate governance structure and company performance in Japan: an empirical study

How does the governance structure affect a company's performance? An empirical study of the effect of company ownership and financing patterns on the efficiency of company management (as measured by the value of the company) is presented.[41]

How company behavior is disciplined, and accordingly, how the efficiency is maintained, closely relates to the way a company finances necessary funds. The effect is conceptually due to: (1) discipline by debt finance, (2) discipline by equity finance, and (3) discipline by a main bank (by maintaining a relationship with a main bank).

The novelty of the analysis in this appendix is two-fold. First, three disciplining factors or "governance variables" (debt, equity, and main bank) are simultaneously considered. Second, the effects are compared using the same framework for two contrasting time periods (1989 and 1999).

(1) Equation to be estimated and the data

The regression equation to be estimated is as follows. The value of the firm or the overall corporate performance (Tobin's q) is to be regressed on (1) the debt ratio, (2) the intensity of its main bank relationship, and (3) the ownership structure. Exhibit A1 shows the basic premise of this regression.

$$\begin{aligned} TOBIN = {} & \alpha_1 DEBT + \alpha_2 MB + \alpha_3 OFFICIAL + \alpha_4 FOREIGN \\ & + \alpha_5 INDIVIDUAL + \alpha_6 FI + \varepsilon \end{aligned}$$

where

TOBIN: Tobin's q = (Total market value of issued shares + Interest-bearing debt) / (Owned equity + interest-bearing debt).

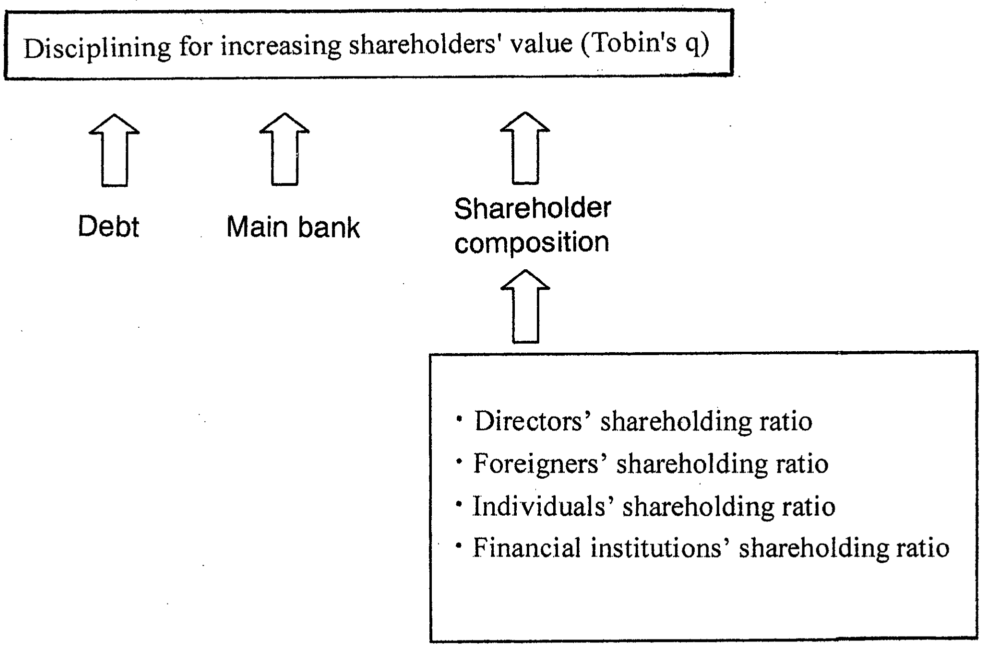
DEBT: Debt to asset ratio = Total debt / Total assets.

MB: Dependency on the main bank = Amount of lending by the top lending bank /total debt.

OFFICIAL: Board directors' shareholding ratio

[41] Below is a summary of Okabe (2007: Chapter 6).

Exhibit A1. The way of capturing the pressure on corporate governance in this study



FOREIGN: Foreigners' shareholding ratio

INDIVIDUAL: Individuals' shareholding ratio

FI: Financial institutions' shareholding ratio[42]

ε: Error term

Cross-section accounting data of large (listed) companies were estimated for two years, 1989 (for 501 companies) and 1999 (for 499 companies). The peak of the "bubble economy" was 1989, whereas 1999 was the most recent year for which consistent statistical data was available at the time of this research.

(2) Estimated results and the implications

The GLS (generalized least squares) method was used to estimate the equations. The estimated results, shown in Table A2, were generally satisfactory, and all the variables were highly significant. Hence, we can draw the following conclusions:

First, these factors, (a) issuing debt (debt finance), (b) block shareholding by foreigners and financial institutions, (c) foreign investors, and (d) pressure from financial

[42] Excludes investment trusts and pension funds.

Exhibit A2. GLS regression: influence of various factors on corporate governance, 1989 and 1999

	1989		1999	
Debt ratio	0.0330	***	0.0084	***
	(73.75)		(95.62)	
Main bank	-1.5790	***	-0.4202	***
	(-10.31)		(-10.98)	
Directors' shareholding ratio	0.0231	***	0.0024	***
	(8.89)		(7.79)	
Foreigners' shareholding ratio	0.0445	***	0.0263	***
	(21.98)		(63.40)	
Individuals' shareholding ratio	0.0017		-0.0034	***
	(1.56)		(-31.54)	
Financial institutions' shareholding ratio	-0.0026	***	0.0011	***
	(-6.21)		(14.25)	
Adjusted-R^2	0.9987		0.9999	
The number of samples (N)	501		499	

(Note) 1. The dependent variable is Tobin's q.
2. t-values in parentheses; asterisks *** indicate the significance at 1% level.
(Source) Okabe (2007), Table 6-8.

institutions and foreign investors, all play important roles in the value of a company. As anticipated, debt finance had a steady function of disciplining corporate managers in both 1989 and 1999, whereas block shareholdings by foreigners and financial institutions positively affected a company's performance, presumably due to the shareholders' motives to obtain high investment returns as well as to occasionally discipline the company with their "voice". Especially, the significance of foreign investors, as well as financial institutions, has increased importance in recent years in influencing a firm's value. Thus, all in all, the disciplining role of capital markets is becoming more evident in recent years.

Second, as evidenced by excessive lending or forbearance lending during and after the asset price bubble, the main bank had a negative effect on company performance for both years, which implies that the monitoring and disciplining function of a main bank had disappeared as early as 1989. This result is broadly consistent with other recent research. Hence, we interpret this result to imply that one of the causes for the asset price bubble in the late 1980s was the vacuum of bank corporate governance.

Third, if we recall that cross shareholding between financial institutions and general business corporations weakens the disciplining function, the above results demonstrate that the two traditional factors, a main bank relationship and cross shareholdings, hinder the discipline of Japanese corporations. Therefore, improving institutional arrangements in capital markets as well as corporate governance is necessary.

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