Japanese Corporate Governance in Comparative Perspective

By Dr. Paul Sheard

Recently, corporate governance has come into the spotlight of policy debate and public discussion in Japan. The experience of the bubble economy and its prolonged and painful aftermath has raised questions about the adequacy of Japan's system of corporate checks and balances. A string of scandals involving corporate payoffs to *sokaiya*, Japan's notorious stockholder meeting "fixers," the latest in a long series of post–bubble banking, securities and corporate scandals, has shaken confidence in the integrity of capital market controls on top management. As Japan embarks on a historic structural transformation of its postwar economic institutions, symbolized by "Big Bang" financial reform, it is fitting that the issue of corporate governance comes to center–stage.

The concept of corporate governance

"Corporate governance" refers to the process and mechanisms by which the capital market monitors the actions of corporate management and holds man-

agement accountable for its decisions. Corporate governance is integral to the operation of a well–functioning market economy. Households entrust their assets and hard–earned savings to corporations through the financial market, and provide their employment services to corporations via the labor market. It is vital to the nation's economic health that corporations are managed well. Because the stakes are so high, powerful incentives exist in any market economy to deliver sound corporate governance. If corporate governance is inadequate, mismanagement will be rife and misallocation of resources the order of the day. Competitive market economies have low tolerance for such systemic malfunctions.

While the imperative to produce sound corporate governance is universal, the legal, regulatory, institutional, and private arrangements that exist to produce this vary widely from country to country. The functions of corporate governance are, broadly speaking, the same across market economies: corporate management needs to be provided with proper incentives to work hard, to be honest, and, above all, to make "good" decisions, and the capital market needs to be able to monitor management ex ante and to take remedial action when problems arise ex post. One key function of corporate governance is to align managerial incentives with "social" goals (sometimes narrowly defined as those of shareholders); another is to equip the capital market with mechanisms to actively intervene in corporate management, to wrest control from incompetent or intransigent management and to restructure the assets of failing corporations. All corporate governance systems have these monitoring and control functions. However, the form that these functions take manifests a great deal of diversity, both within and between different systems.

Two kinds of governance system

To simplify discussion of a complex subject, it is useful to distinguish and contrast two kinds of corporate governance system: insider–oriented systems like the Japanese system and open market–oriented systems of the Anglo–American kind.

It is important to realize that both the Japanese and Anglo–American systems are just that, "systems," or collections of attributes that are internally consistent and complementary to one another. Taken in isolation, an aspect of one system, such as stable shareholding arrangements in Japan or golden parachutes in the United States, may appear arbitrary or even reprehensible, but it may serve a necessary and rational purpose as one cog in a more complex integrated machine. It is dangerous to judge a corporate governance system by its appearances, particularly in isolation.

The key difference between the two systems relates to where the locus of corporate monitoring and control resides and how circumscribed the rules of the game, and participation in it, are. In an insider–based system, corporate governance functions are carried out by a small number of readily identifiable economic agents, such as "main banks" or large parent firms, and corporate control events are subject to a high degree of internal regulation by the key parties concerned, including incumbent managements. In open market–oriented systems, a diverse set of monitoring and control mechanisms exist and which one prevails in a given set of circumstances is left to competitive market forces.

The distinction between the two systems is often made in terms of whether banks play a dominant role or whether the stock market is the main locus of monitoring and control. This in turn relates to whether an active takeover market exists or not. The takeover mechanism is at the heart of the Anglo–American open market model of corporate governance. Any party can bid for the control rights of a listed corporation by accumulating a large enough ownership stake; who ends up control-

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One after another: Sokaiya scandals keep public prosecutors busy with searches of head offices

ling a corporation ex post may bear no relation to who was in the driving seat ex ante.

In a bank–oriented system, banks, as large creditors, perform a similar function by directly intervening when things go wrong. This is a form of takeover but the system does not rely on an arena, or market, for the trading of control rights in order to operate. Instead, pre–designated "insiders" do the job, often banks but in many cases large parent firms.

Structure of the Japanese system

Two pivotal elements in the Japanese system of corporate governance are the important role played by "main banks" and large parent firms, and the high degree of interlocking shareholdings. These are the building blocks of the insider–based system of corporate governance.

Japanese corporations, including banks, typically maintain interlocking shareholding relations with key business transaction partners. Normally shares held under these ongoing "stable shareholding" arrangements constitute a majority of the firms shares. By building up corporate control coalitions among trusted business partners, Japanese corporations are able to suppress the operation of a competitive takeover market. Instead the top shareholders of the firm, which are also the key business partners, constitute a latent corporate control coalition. This does not mean that corporations are free from capital market discipline. Rather, suppressing the external takeover market merely provides the basis for main banks and parent firms to perform these functions as insider–based, as opposed to arms–length, monitors. The extensively documented behavior of main banks in intervening in corporate management in informal rescue operations is a direct manifestation of this internalized takeover role. Large parent firms perform a similar and complementary, if less eye–catching, role (one in four listed firms in Japan has a top shareholder holding a 20% or more stake and these parent firms provide senior executive personnel on a recurrent basis).

Pros and cons of the Japanese system

The Japanese system of corporate governance has both strong and weak points. Three strong points deserve special mention. The first is that the Japanese system, by shutting out direct external capital market influences, provides a high degree of managerial stability and autonomy; this facilitates the creation and maintenance of valuable long–term relationships with employees, suppliers and customers. Successful Japanese firms have been able to build up dedicated, skilful workforces and sophisticated, efficient parts supply systems partly because the corporate governance system has given the parties concerned confidence they will be able to transact over a long time horizon without unexpected interference from the capital market in the form of withdrawal of capital (bankruptcy) or a change in control rights (takeover).

A second benefit is that the Japanese system helps to economize on various forms of monitoring and intervention costs. Because shareholders are often transaction partners, there is an economy of scope—shareholders do not have to expend inordinate resources collecting information; a certain amount is already generated in the course of doing business. The system of interlocking shareholdings among firms maintaining continuous business relationships with one another results in a diffuse mutual monitoring system with inherent, if low–key, checks and balances. A firm will have the majority of its shares held by "friendly" upstream suppliers of inputs of goods and services and downstream consumers of the outputs; these firms form a silent corporate governance coalition capable of thwarting any hostile takeover attempts but the self–same set of firms have both the information to judge management and the incentive and means to do effect changes when necessary.

Not all shareholders monitor actively however. Typically there will be one shareholder, a main bank or a large parent firm, who will be expected, and, because of the larger actual or implied exposure will have the incentive, to monitor more intensively and take the initiative in implementing remedial actions when things go wrong. This means that "stable shareholders" can delegate monitoring responsibilities to a single or small number of key players, thus assuring that a requisite amount of monitoring gets done but that unnecessary duplication is eliminated.

A third merit of the Japanese system is that it allows certain social costs, such as training costs and unemployment costs, to be internalized or borne by firms. This may lead to the overall level of such costs being lowered. In cyclical downturns or periods of structural adjustment, Japanese firms are known to tolerate higher levels of "intra–firm unemployment," and this has been an important factor in keeping recorded unemployment levels below 4 percent at their peak. To subsidize a given level of unemployment, the government can disburse unemployment benefits, which households pay for in higher taxes either now or in the future, or corporations can be asked (or given incentives) to carry excess labor, which households pay for in higher product prices or lower financial returns. Given the imperfect nature of labor markets, both solutions are second–best ones, but the second alternative, which seems close to the Japanese model, has some obvious benefits (not least that it is usually more efficient for the private sector rather than the government to disburse social welfare).

What about the weaknesses of the Japanese governance system? Three in particular warrant mention. One is that the system is inherently non–transparent and discriminatory between insiders and outsiders. It tends to lack external accountability and, lacking a diverse mix of competing subsystems and mechanisms, to be susceptible to system–wide failure (the bubble and its aftermath being a poignant case in point). Even if the system has an appealing internal logic, it has difficulty in meshing with the emerging international norm of an open, accountable market system.

A second weakness is that, while the system served Japan well in the high–growth period, when a clearly defined technology gap existed, when

firms faced abundant investment opportunities, and macro and micro economic goals were closely aligned, it does not appear to be as functional when uncertainty at both the economy–wide and individual firm level about whether, where, and how to invest is high.

A third problem with the Japanese system is that it tolerates too low a level of corporate restructuring. Because the system is geared to providing a high level of managerial autonomy and suppressing an active takeover market, positive incentives and means to effect restructuring are lacking. It is a system that is better at growing the productive assets of firms than dismantling and recombining them. Main banks and parent firms do intervene in borrower and affiliate firms with a view to restructuring them but usually only when the firm is in dire straits.

Pros and cons of the Anglo–American system

What about the Anglo–American open–market–oriented system? Two strengths stand out. One is that the market mechanism provides high–powered incentives to corporate managers to deliver shareholder value. Unfettered competition in the market for corporate control—the stock market arena in which rival management teams compete for the right to manage corporate assets—keeps top managers on their toes, and compensation schemes closely linked to stock price performance help to align managerial incentives with those of arms–length shareholders. Management teams that make poor decisions or lack focus are likely to see the market's displeasure reflected in a declining stock price (at least relative to competitors); this will not only hit the personal wealth of managers but will also provide signals and incentives to competing management teams to launch a bid for the firm. Even if this does not occur in practice, the prospect that it might is always present and has a salutary effect on managerial attitudes and effort levels.

A second strength is that the active takeover and M&A (mergers and acquisitions) markets of the Anglo–American system are conducive to corporate restructuring. Businesses, and pieces of businesses, can be taken apart, reassembled and scaled up or down with relative ease; this facilitates macro–level resource allocation, as M&A activity helps to free up and reallocate productive capital and labor resources, allowing a quick transfer from lower to higher yielding social uses. An active M&A mechanism not only helps to sharpen managerial incentives, it allows the capital market to maintain a high metabolic rate, resulting in a high degree of economic dynamism.

There is a downside, however. One problematic issue with the Anglo–American system is that there are substantial costs associated with operating an open market. Because the market is decentralized and entry and exit is free, there tends to be a large degree of duplication in monitoring costs. Because the price mechanism plays such a crucial role as a signalling and incentive mechanism, and prices evolve in real time, inordinate amounts of resources are expended in forecasting the future course of prices, much of which may have limited social value judged from a longer term perspective. Costs can get very high in times of financial distress. While the Japanese system has, in the form of the extra–legal main bank corporate rescue operation, a mechanism for sorting out corporate ill health at low cost and with minimal conflict, corporate failure in the Anglo–American system can be a costly and drawn–out affair, which often sees a substantial portion of the residual value of the enterprise eaten up in the bargaining process surrounding its distribution among competing claimants.

A second drawback of the open–market system is that rent–seeking activities have a tendency to proliferate; this is another kind of hidden cost of operating the system. For instance, because managerial compensation is so tied to stock price performance and the stock market's evaluation, managers have incentives to "play to the gallery," taking actions and expending resources to improve their standing in the stock market, to the detriment of longer term shareholder wealth creation. The high–powered incentives of the stock market can create a tread–mill that traps management in activities that boost short–term appearances rather than building a solid platform for long–term results. Another example concerns takeovers and M&A activities. While these have positive incentive and resource allocation effects, as articulated above, they also have distorting effects on managers, who do not take their discomforting effects lying down. While Japanese management have carefully crafted stable shareholding arrangements to thwart the takeover market, U.S. managers resort to a variety of contractual and legal means to counter the negative impact of takeover pressures (golden parachutes, poison pills, giving in to green–mailing).

Need for a comparative perspective

The above analysis suggests the value of a comparative approach to assessing corporate governance. The corporate governance systems of different countries reflect differences in regulatory regimes, legal frameworks, and institutional settings, differences in stages of economic development and historical background, and social, political, and cultural preferences. Corporate governance systems do not exist in institutional or historical vacuums, and there is no such thing as a "perfect" or the "best" system. While all corporate governance systems are ultimately aiming for the same thing—to produce good corporate management and efficient resource allocation—different systems possess very different architecture and ways of delivering those results. Corporate governance, because it inherently involves "second best" outcomes, involves various tradeoffs between competing goals. Different governance systems can be expected to exhibit differing relative strengths and weaknesses.

While the discussion above has been couched in static terms, it needs to borne in mind also that systems evolve through time, both through internal dynamics and changes in external parameters. What constitutes a strength of a system may prove to be a weakness as circumstances

change, and vice versa. A system that appears successful and functional in one period may cease to be so, if the internal and external conditions change. Systems need to be adaptable, and to be adapted. This observation is apposite to the current Japanese system, which, despite its underlying strengths, appears to have become increasingly dysfunctional in recent years and to have exhibited mounting symptoms of institutional fatigue.

Re-engineering and re-inventing the Japanese system

A prominent view is that the Japanese corporate governance system has outlived its usefulness and that "big bang" financial reform and the move towards a global standard in financial market rules and architecture will spell its death knell. The rhetoric of "big bang" and "global standards" suggests that the insider-based system is about to fall apart and be replaced by an open-market oriented system in the Anglo-American mould. While this cannot be ruled out as a long-term point of convergence, as a prognosis for the immediate to mid-term future it is too pessimistic and simplistic.

It is more likely that "big bang", and related policy initiatives, will result in a re-modeling and revitalization of the Japanese system of corporate governance as it evolves to a new stage of historical development. The system is clearly in need of re-design and institutional innovation. One problem is that the system currently lacks effective mechanisms and incentives for corporations to return surplus cash flow to the capital market. The introduction of share buybacks, stock options, and holding companies, and deregulation leading to a greater capital market appetite for generating higher rates of return, in what is likely to be a secularly low interest rate environment, should help to rectify this deficiency. Japan would also benefit from the development of a more active M&A market, but one that preserves cooperative management-labor relations. This also appears to be on the cards, with the introduction of holding companies and consolidate taxation (assuming it occurs) providing the likely trigger.

Key players: Main banks perform corporate governance functions in Japan

As deregulation proceeds, arms-length investors will play an increasingly important role in the stock market, but a scaled-down, more focused and pro-active cross-holdings and main bank system, augmented by the emergence of holding companies as a new and key locus of active corporate governance, will likely remain at the core of the governance system. In this scenario, "big bang" financial reform, rather than leading to the demise of the current system, by injecting a healthy dose of competition at all levels, will help to transform and revitalize it. Ultimately, in improving governance in Japan and keeping the Japanese model alive, this should be of benefit not just to Japan but to the international economic community as a whole.

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