National Diversity of Corporate Governance and the Global Standard

This is a transcript of the opening remarks by Professor Aoki Masahiko at the Fifth International Conference Europe–Japan held in Spain, December 1997.

By Aoki Masahiko

Corporate governance structure was traditionally discussed by lawyers from the viewpoint of how to control managers in the interests of stockholders. However, in the last decade or so, corporate governance has become an important subject matter in economics as well. From an economist's point of view, I conceptualize corporate governance more broadly as an institutional structure governing managerial decision–making in the corporate firm. There is a remarkable diversity in this institution across national economies, say between American, British, German, Latin, and Japanese corporate governance structures, among others. However, in the last decade or two, the integration and globalization of capital markets have proceeded at remarkable speed. Now, operations of Continental European financial institutions, including mighty German banks and French state–controlled banks, are tightly knit with the City, while Japanese banks and companies cannot escape the scrutiny of American rating agencies. Thus the following question is being frequently asked: *Will the national diversity of corporate governance disappear because of the globalization of capital markets and will national corporate governance systems all tend to converge to the Anglo–American type?*

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This question is related to the topic we discussed in the first session of this conference. That is, will the global standard be set according to the American model? This is the first question I would like to address in my opening remarks. My answer to this question will be as follows: although there are some important elements in the American system that other economies can learn, there will still remain national differences in corporate governance structure. More generally, I would like to argue that the global standardization should be applied only to interfaces across national or organizational modules, but national or organizational modules are likely to keep some unique features from each other in their contents. In the sphere of corporate governance, global standards may be applied to disclosure rules, accounting principles, etc., but there is no point in harmonizing internal governance structure, especially through statutory means.

In arguing so, I rely on a new view of economics into this subject. By a new view of economics, I refer to the method of Comparative Institutional Analysis which is developing at Stanford, The University of Tokyo, etc., which applies game theory to institutional analysis. According to this view, various institutions, such as corporate governance, financial institutions, employment systems and government, rely on each other or complement each other to form a coherent system in each national economy. Therefore, in order to see how an institution can evolve over time in one economy, it is necessary to look into the inter–relationships among institutions. It is wrong to take a look at one institution in isolation and regard it changeable by the law or by borrowing a foreign practice arbitrarily. Thus, generally speaking, institutional change is likely to assume path–dependent, national characteristics. In another words, history matters.

In the continental European and Japanese corporate governance structure, banks have played prominent roles, although there are differences among them too. Since many people argue that those bank–dominated systems will be forced to be transformed into market–oriented system à la Anglo–American, I would like first to discuss a few important points regarding the so–called

Anglo–American type, or more precisely, the American system. In passing I may note, the British corporate governance structure has evolved from common law tradition regulating partnerships, while the American governance structure originates in the statutory law regulating public corporations. Thus, there are subtle legal and practical differences between the two that many people overlook.

The first point I would like to make is that it is necessary to make a distinction between growing corporate financing through markets, particularly bond markets, and corporate governance through markets for corporate control, i.e., take–over through equity markets. The mere fact that a large corporation shifts its financing sources more and more to securities–markets rather than bank loans does not necessarily mean the automatic arrival of a market–based corporate governance structure. It is the second feature, i.e., active markets for corporate control, that is the unique element of American corporate governance. In spite of the increasing importance of bond market financing, this second feature has not evolved as an important institutional element in Japan and also in Germany. Why is this distinction important?

Among all characteristics defining corporate governance structure, I consider that the crucial defining factor is the question of who decides what to do when the corporate firm is in financial trouble. In the bank–oriented system, banks used to play a crucial role in deciding whether to rescue the troubled firm or terminate its life through liquidation, acquisition, etc. Even in the event of rescue, however, failed managers were expected to be replaced by the banks. In the market–oriented American system, there is a legal principle called the principle of equitable subordination, according to which any investor or creditor who plays important roles in corporate decision–making loses priority of its claims in the event of insolvency. Thus, commercial banks have traditionally been inhibited from involving themselves in troubled firms. Instead, through equity markets, unspecified outsiders may come to acquire firms whose stocks are undervalued because of incompetence, misjudgment on the part of the incumbent management. Both in bank–oriented and market–based structures, there were thus credible expectations among managers that, if they did not perform well, they would be punished by takeover or bank control. Such general expectations were able to discipline the behavior of managers in the normal course of affairs as well. If there were no such expectations, and if managers expected they would be certainly rescued or protected by banks or the state in the event of trouble, there would be no discipline on managers and employees. In this regard, the fundamental problem that Continental Europe and Japan are currently facing seems to be that the bank–oriented punishment mechanism has eroded, but an alternative mechanism of discipline has not been clearly formed yet. I predict that at least in Japan, the importance of cross stockholding among corporations will not disappear drastically to the extent that free markets for corporate control are to evolve. This means that the role of banks in corporate governance in the traditional sense has receded, but what can be an alternative mechanism is not self–evident. I think that people who talked about the convergence of corporate governance structure to the U.S. system are rather naive in perceiving that the development of two types of markets, bond markets and markets for corporate control, are concomitant.

The second point I would like to make regarding the U.S. structure is about the role of the board of directors. Although I have singled out the market mechanism of corporate control as a primary characteristic of the American system, in the last decade or so the actual implementation of takeover has become less conspicuous. Credible threat of take–over or acquisition is important as a institutional device for disciplining managers, but if its threat is to be actually implemented, tremendous costs may be involved. It is desirable to have a good mechanism to perceive possible financial trouble beforehand and to remedy such situations. In this regard, the American system seems to have introduced an innovation. In the last 20 years or so, the proportion of outsiders in the board of directors of large listed corporations has increased from one–third to two–thirds. Not only has their proportion increased, but their role has been enhanced in the area of appointment/replacement of top management and the setting of remuneration. Their active role is believed to have contributed to improved corporate efficiency. Some legal scholars in the U.S. started to redefine the nature of the board of directors in terms of "trustee" of the corporate body rather than as a mere agent of the stockholders, where the beneficiaries of a corporate body may not be limited to stockholders, but also workers and other stakeholders. This view is suggestive. The boards of directors of Japanese firms have been dominated by inside managers who have been promoted through the rank of hierarchies of permanent employees. Thus, the board functions rather as a trustee of the body of employees. As far as there is a credible expectation of outside discipline, such as bank control, in the event of failure, the insider control of the board of directors may not be a big problem, because the board has to take into account the corporation's financial viability. But once such a threat is gone, insider control of the board may create problems. I think that the recent series of corporate scandals in Japan is indicative of this emergent problem.

The third point I would like to make about the U.S. system is the emergence of a new type of relational financing and associated governance structure observed in Silicon Valley. The start–up entrepreneurial firms are financed by venture capitalists who exercises very strong control rights.

Venture capitalists finance multiple start–up firms engaged in similar project lines, expecting that only a few will be successfully brought to initial public offering (IPO). Venture capitalists closely monitor the progress of development projects conducted by start–up firms and finance by a step by step method as projects proceed, while retaining rights to terminate projects or firing entrepreneurs if projects do not proceed well. Such a mechanism may provide an effective governance structure where uncertainty involved in product development are so high that multiple projects should be simultaneously initiated on an experimental basis, but as technological uncertainty resolves a fewer projects are selected while others are weeded out.

Now having observed situations in the U.S., I will focus on Japanese situations. As I indicated at the beginning of this talk, I do not intend to argue that the Japanese should emulate the American method in order to resolve its own problems without any regard to the traditional way of organizing firms. But I would like to discuss some recent developments in the U.S. that may be suggestive for corporate governance reform in Japan.

I will start out asking why the traditional Japanese corporate governance worked well in the past in order to understand what the current problem is. Using academic jargon, the traditional Japanese corporate governance system is referred to as the contingent insider control: meaning that insider managers control management decisions as far as the financial state of the firm is sound, while as the financial state deteriorates, control rights shift to the main bank. The location of control right is thus contingent on the financial state of the firm. It was a good governance structure for the Japanese organization in which knowledge sharing and cooperation among workers are important, while it provides external sanction in the event of failure.

However, this structure does not work well any more. For one thing, corporate firms do not rely on bank loans any more to a significant degree. In anticipation of Big–Bang, better Japanese banks are redefining their relationships with large corporate clients in terms of investment banking. It is questionable, however, whether banks yet retain their ability and incentives to control their client firms in the event of financial troubles. Secondly, a problem also arises internally to the corporate organization. As financial and product markets are ever–more globalized and technological progress speeds up, environments of Japanese firms are becoming more uncertain. As a result, the size of the Japanese firm may be becoming simply too large for information sharing. Decision–making takes too long a time, and the location of responsibility for decision–making becomes ambiguous even to insiders. Because of information sharing, if a mistake in judgement is made, everybody tends to be susceptible to the same mistake. If we recall that one of the most important characteristics of the Silicon Valley phenomena from the corporate governance point of view was to allow for multiple projects to coexist based on different judgments and interpretations of information, this characteristic of the Japanese firm may be disadvantageous in the fields of product development and in other uncertain business environments.

Then, should Japan emulate the American method of venture capital? I do not think so. I rather think that Japan should attempt its own corporate governance reform in a manner consistent with positive elements of tradition. I said that the Japanese firm is becoming too big for information–sharing, but did not deny that information–sharing within organizations is sometimes more efficient than rigid functional and informational specialization. How then can the Japanese firm adapt its traditional organizational principle of information sharing with a new environment where the role of the bank as a disciplinary device is being weakened and where the increasing technological uncertainty makes competition among smaller organization units more fitting.

In my opinion, impending deregulation of the pure holding company may have significant implications for restructuring Japanese firms. The current Anti–Monopoly Law illegalizes the pure holding company. It allows for business corporations to spin–off subsidiaries, while holding major business units internally. Why then does deregulation of the pure holding company matter, when Japanese firms have been allowed to be business holding companies. In my opinion, there is a critical difference between the two. Traditionally, the Japanese firm runs a unilateral personnel management, offering identical homogenous employment contracts to its permanent employees. Such a personnel management system has been conducive to the accumulation of shared information by providing incentives for cooperation to the employees. However, it deters the introduction of a diversity of employment contracts and thus a diversity of information and skill development.

Once the pure holding company is legalized, large multi–divisional firms can spin–off even major business units as relatively autonomous subsidiaries as needed. Each subsidiary then can run a separate incentive scheme, fitting the skill types required for its organizational objective. It can encapsulate the merits of information sharing within a smaller organizational units, while facilitating a diversity across sub–units. Further, the pure holding company can credibly commit to punish badly performing subsidiaries, while it may aid them in the event of temporary "financial distress." It may also be capable of nurturing start–up subsidiaries with its corporate resources (financial, informational and technological), which is analogous to the function of venture capitalists in the U.S. In other words, important elements of the contingent governance that used to be played by the main banks, as well as those of venture capital governance, may become *internalized* under the

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framework of a pure holding company.

The question then remains regarding who will monitor the monitor. As we have discussed, the ability and resources of banks to play an important role in the corporate governance structure have declined and we cannot possibly expect of them too much in this regard in the future either, although they will redefine their roles as investment banks. On the other hand, the emergence of competitive markets for corporate control has the least likelihood of success in Japan. In spite of the recent publicity regarding the undoing of the cross-holding of shares, sales of stocks of related companies have actually been limited to peripheral ones by financially pressed financial institutions and companies—and for good reason. Cross stockholding among major corporations has been serving as an effective device for mutually insulating inside management from hostile-takeovers, and there is no reason why its utility for inside management should have diminished. Insurance companies which manage a growing bulk of pension and related funds will certainly be concerned with the stock performance of client firms. They will, however, be likely to exercise the "voice" option, rather than "exit" from the financial *keiretsu* nexus, to control possible mismanagement of portfolio companies.

Strengthening stockholders' role statutorily, as proposed by some LDP politicians, may not be a solution either. The Japanese Commercial Code has already afforded relatively stronger rights to minority stockholders (e.g., the right of nominating candidates for directors in the stockholder meeting, liberal procedures for derivative suits) than in any other countries, but this has had a paradoxical result. The liberal statute makes the threat of professional trouble-makers in stockholders' meetings, known as *Sokaiya*, more effective. As a defense, the inside management-cum-directors of large companies have developed a practice of holding stockholders meetings on the same day (the last day of a common accounting year) with the excessive precaution of containing any "disorder"—sometimes by disguised bribery.

I thus consider that one remaining locus of reform ought to be found in the area of the board of directors, even if such reform may take time as well as be painful for the incumbent managers and employees. I consider such reform cannot be accomplished overnight by the stroke of a pen by legislators. Rather, competition among companies to reform the board structure by itself is crucial. In that respect, it may be pointed out that the world class Japanese corporations, such as Toyota and Sony, have already introduced some organizational devices for absorbing outsider's managerial advice and monitoring, if not in the form of a board of directors. The best solution toward modifying exclusive insider control can only be evolutionarily selected from such experiments. Those firms that cannot reform themselves by sticking to the traditional insider controlled governance structure immune from external monitoring will only lag behind in receiving and responding to messages sent from financial and product markets and be unable to survive ever intensifying global competition. JJTI

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