Ongoing Corporate Board Reforms: Their Causes and Results

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Introduction

- The boom of corporate governance reform in Japan
- Conventional J-type firms has been dramatically changed.
- The magnitude of this change is equivalent to the postwar reform period that marked to dissolve the prewar structures.

Three Issues

- What is the reality of current changes in corporate governance in Japanese companies?

- Whether the outstanding business performance has been enhanced or not, in the companies that have advanced corporate governance reforms?

- What kind of companies have implemented such governance reforms？ Is strong stake of corporate insiders really obstacles to board reforms?

Data and Methodology

- Combining the result of a questionnaire survey of companies regarding their recent governance structure reforms (876 companies with response rate 34.0%, October 2002, all listed firms, non financial firms) and their financial data (by FY2000-02).
- the Corporate Governance Score (CGS) based on the result of a questionnaire survey concerning governance structure reforms in the companies.

What Kind of Change is Occurring?

1. **From Emphasizing on Business Customers to the Market**
2. **Intensifying Reforms in the separation of management and monitoring (Executive officer system and Committee system)**
3. **Outside Directors**
4. **Stock Option**

Table 2. Trend in Corporate Governance Reforms (Unit: %)

	Exective officer system		Outside Directors		Stock Options	
	FY 2002 (846 firms)	FY 1999 (1145 firms)	FY 2002 (863 firms	FY 1999 (1138 firms	FY 2002 (864 firms	FY 1999 (1209 firms
Already introduced	33.0	12.8	35.8	30.1	28.1	9.5
Plan to intoduce	2.7	2.3	2.9	1.1	1.9	2.2
Considering to introduce	25.8	37.4	32.7	27.3	15.2	25.6
No intention to introduce	38.5	47.5	28.6	41.4	42.7	43.7

Source, MoF Surveys.

Corporate Governance Score (CGS)

- The CGS is comprised of three sub-indexes:
- **CGS_{sh}: General Meeting (Protection of the Right of Minority Shareholders) (10 Variables)**
- **CGS_{br}: Board of Directors (6 Variables)**
- **CGS_{ds}: Information Disclosure (10 Variables)**

Analysis 1: Comparison of Average Performance by CGS Quintile

Table 6. Analysis by the Average

Index	Quintile of CGS	High (1)	(2)	(3)	(4)	Low (5)	Testing the gap
1	Q	2.07	1.40	1.34	1.04	1.03	1.04***
2	Standardized Q	0.92	0.38	0.32	0.04	0.02	0.90***
3	ROA	5.01	4.17	3.38	3.15	2.75	2.26***
4	Standardized ROA	1.39	0.99	0.18	−0.05	−0.43	1.82***
5	Sale growth ratio	5.33	2.63	0.65	8.24	−1.11	6.45***
6	Growth ratio in the # of employees	5.78	1.27	1.79	1.14	−3.06	8.84***

Analysis 2: Estimate of Decision Fusion for Business Performance

$$P_i = F\ (CGS\ (CGS_{sh},\ CGS_{br},\ CGS_{ds})\ ,\ SIZE,\ DAR,\ LIST,\ GSALE)$$

- P_i indicates business performance, standardized Tobin's q (that includes the growth value in the future) and ROA (that eliminated peculiar characteristics by industry the company belongs to)
- ***SIZE*** : the size of the company (natural logarithm for the amount of asset),
- ***LIST*** : years of being listed,
- ***GSALE*** : the growth ratio in sales.

Main results

- Performance is positively sensitive to CGS,
- Performacce is less sensitive to CGS_{sh}, CGS_{br} nor Executive Officer System and Outside Board
- Performance is positively sensitive to CGS_{ds} .

Why Information disclosure enhance firms performance?

- Decreasing capital cost.
- Commitment effect of corporate manager

Why the US type board reforms did not enhance firm Performance?

- Formal make up and miss match to its business structure and organization forms.
- No independency of outside directors.

Determinates of Governance Reforms

***CGS* ＝ *F* (*SIZE*、*SHLD*、*CREDIT*、*EMP*)**

- ***SIZE*** : the logarithm of total asset.
- ***SHLD*** : the composition of ownership on governance structure reforms.

  STAB : the ratio of shares held by financial institutions

  FRG: the ratio of shares owned by foreigner.

Variables (continued)

- ***CREDIT*** : financing and a company-creditor relationship on the company’s choice in internal governance structure.

  BOR : the level of dependency on bank.

  BOND : the degree of dependence on capital market,

  CML : a dummy that is one if a firms set credit (commitment line)
- ***EMP*** : the extent of stake of employee based on questionnaire survey, i.e. the company-union negotiation, and negotiation/explanation items at labour-management council .

Main Result

- ***CGS*** is negatively sensitive to *STAB, BOR,* and positively sensitive to *FRG, BOND* and *CML.*

- ***CGS*** is not sensitive to *EMP*
- More Interestingly, *CGS* is positively sensitive *EMP*, if we divided sample firms into two types: firms facing financial discipline in capital market and firms not facing such discipline by getting bond rating.
- **It implies the high commitment of employee is not necessary to obstacles for governance reforms, but rather pushes its reforms if firms face the pressure of financial market.**

Employment/Wage System and Corporate Governance Reform

CGS＝ F (SIZE、SHLD、CREDIT、TYPED)

TYPEDUM

- Long term employment/seniority-based pay dummy : *TYPE I*,
- Long-term employment/merit based pay dummy: *TYPE II*,
- Part-time employment/merit-based pay dummy *: TYPE III*

Main Results

CGS is negatively sensitive to *TYPE I*, and positively sensitive to *TYPE III, which is no surprising.*

However, CGS is significantly positively sensitive to *TYPE II.*

It suggests that firms keeping long-term employment, but trying to introduce the merit based wage system is also positive to corporate governance reforms

Conclusion

- Corporate governance reform does matter, especially information disclosure is important
- There is no clear evidence that the introduction of US type system (executive officer system and outside directors) actually contributes to improve firm performance.
- Contradicting to common assumption, the degree of employees' involvement in management and governance structure reforms is not necessarily confrontational.

Implication

- Japanese listed firms are no more homogeneous. As a result of rational choice of corporate insiders, J-type firms diversified into two types.

US models

J-firm

Overhauls

-- Cross shareholding and main bank system have not played any value enhancing role

-- Real target of reforms is firms that maintained conventional J-type characteristics

-- This diversification is not stable, traditional J-type firms were not sustainable.

Implication II

- Firms that implement governance reforms are under the pressure of capital market (bond rating and foreign institutional investors)
- The complementarities among main bank, cross shareholding and long-term employment is no long working.
- Choice of board structure is fully contingent on technology, business portfolio, and internal organization (decentralization and modularization)
- US model oriented firms and J-type overhaul will coexist.