Corporate Governance in Japan: Institutional Change and Organizational Diversity

Gregory Jackson
(Kings College London, RIETI)

Hideaki Miyajima
(Waseda University, RIETI)

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I. The J-Firm

- Main bank relationship
- Stable shareholding
- Lifetime employment
- Enterprise unions
- ‘Insider’ management

→ Firm as ‘community’, commitment to long-term organization building
Understanding Change

• Several competing theories:
  - convergence theories stress change but toward single “best” model
  - path dependence stress continuity; change is a bounded process

• Three challenges
  - balance of continuity and change,
  - how do new combinations of governance factors fit within systemic context
  - determinants across firms
II. The 1990s

- Forces for change:
  - Internationalization
  - Consequences of Deregulation
  - Innovation/Technology Paradigms

- Route to high performance CG not straightforward
Internationalization

- Finance
- FDI
- International Norms and Practices of CG
- International Accounting Rules
- Extra-territorial Application of Rules
Internationalization

• Important, but not sufficient explanation
• the proportion of firms exposed to foreign investors, listing requirements and international bond ratings remains fairly small.
• these firms are among the largest in terms of market capitalization or employment, and so their needs cannot be ignored by business interest groups and policy makers.
• But the selective scope of such pressures makes a one-size-fits-all solution difficult.
Liberalization

- Financial Degulation in 1980s
- Competition for finance, banking crisis
- Monitoring capacity of MB eroded
- Other issues:
  - privatization
  - aging, pension reform
  - scandals
  - social closure of the large firm
  - generational change in management
Shifts in Organizational Life Cycles and Architecture

- **Shift in the life-cycle of firms**
  - Restructuring of older industries
  - Promotion of new industries

- **Knowledge and Information**
  - changed distribution of knowledge
  - Innovation systems

- **Different demands on governance**
  - capacities, resources, structures
## Corporate Governance and Firm Dynamics

<table>
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<tr>
<th>Organisational Resource Base</th>
<th>Transparency/Accountability</th>
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<tr>
<td>Narrow</td>
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<td></td>
<td><em>Quadrant 1</em></td>
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<td>Small family businesses; Start-ups University spin-offs</td>
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<td>Extensive</td>
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<td><em>Quadrant 4</em></td>
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<td>Declining organisations; Public-to-private Buy-outs</td>
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What has been the target of reform?

- Adapt to international pressure
- Banks and NPLs
- Corporate Restructuring
- Scandals at Japanese firms
  - Distinct from U.S. scandals?
  - Also contrasts to problem of large shareholders in Southern Europe or South Korea
The Politics of Corporate Governance Reform

- Lack of consensus in the business elites and among policy makers about nature of the problem

- Cautious approach through incremental amendments.

- Politics shape, rather than block, reforms
III. Summary of Recent Changes

- Ownership/Finance
- Employees as Stakeholders
- Role of the Board
- Other Long-term Changes
Ownership and Finance (1)

• Changing function of MB relation
  - bifurcation in 1990s, large vs. small firms
  - changed function -- contingent governance to evergreen policy
  - bank healthiness matters!
  - erosion, but not elimination, of MB

• Stable shareholding
  - Decline but not disappearance
  - Continued protection from hostile takeovers
  - Future of relational contracting?
Ownership and Finance (2)

• Foreign Investors
  - Strong association with changes in governance
  - CG reform, downsizing, divestment
  - Limited segment of firms

• Venture Capital
Corporate Restructuring and Financial Distress

- Japanese firms restructuring more than commonly perceived (Itoh et al.)
  - Diversification not the major governance problem, as in 1980s U.S.
  - High levels of entry/exit from business
  - Impact of governance characteristics?
- New role of bankruptcy in financial distress
- New role of private equity (Yanagawa)
Employees as Stakeholders (1)

- **Lifetime employment**
  - Modification, not abandonment
  - (benevolent) employment adjustment is happening!

- **Merit Pay**
  - Growing importance relative to seniority

- **Unions**
  - Strategies for changing boundaries of the firm (Sako)
  - Support some aspects of governance reform
  - Internal governance mechanism in their own right
Employees as stakeholders (2)

- Complementarities between employment and governance weaker than expected
  - Some evidence available, but...
  - No necessary relation
  - Further research needed
- ‘Good fit’ between different bundles of governance characteristics and particular market niches
The Role of the Board

- Legal changes
  - Enabling legislation
  - Limited mandatory impact, but some role of markets and outsiders

- Board Reform
  - Very diverse patterns across firms
  - Outside directors as monitor? Other roles too!

- Insider Governance (R. Dore)
  - Importance of career patterns and incentives
  - Corporate change as social change in norms and values
Long-term Changes

• Organizational architectures (Aoki)
  - Complementarities between corporate governance and organizational architectures
  - Information sharing
  - Continued importance of diverse organizational architectures

• Changes in Bureau-Pluralism (Aoki)
IV. A New Paradigm?

- Increasing Diversity of Firms

- Hybridization
  - Not convergence on single “best” model
  - Not path dependence of past model
  - Mix of continuity and change
  - Incremental changes as institutional layering and conversion

- Incremental forms of change
Assumptions about change

- Convergence vs. divergence
  - ‘one best way’
  - Multiple equilibrium
- Complementarities
  - Strong
  - Weak
Patterns of Institutional Change of National Corporate Governance Systems

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<th>Divergence</th>
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<td>‘multiple equilibria’</td>
<td>‘one best way’</td>
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<td>Higher Complementarity of Sub-systems</td>
<td>Path Dependence</td>
<td>Formal Convergence</td>
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<td>Lower Complementarity of Sub-systems</td>
<td>Hybridization / Reconfiguration / Heterogeneity</td>
<td>Functional Convergence</td>
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Different Processes of Change Lead to Increasing Heterogeneity of Corporate Governance in Japan

### Traditional J-Type Firm

- Strategic adaptation, institutional conversion
- Path dependence, lock-in
- quasi-convergence

<table>
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<tr>
<th>J-Type Hybrid</th>
<th>J-Firm</th>
<th>A-Type Hybrid</th>
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<tbody>
<tr>
<td><em>Toyota, Mitsubishi Chemical, Asahi Brewing</em></td>
<td>..conservative Kikkoman or under stress… Construction, Real Estate “Zombie” Firms</td>
<td><em>Sony, Hitachi, Mazda</em></td>
</tr>
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</table>
Diversity of Firms

- Differential impact of internationalization and deregulation across groups of firms

- Bifurcation of ownership characteristics: MB ties, keiretsu groupings, foreign ownership, VC

- Differential adoption of CG reforms:
  - outside directors, stock options, executive officers, committees, etc.
  - transparency, disclosure
  - organizational restructuring
  - employment downsizing, pay systems
Cluster Analysis

- Cluster analysis using complete linkages among 723 firms
- MoF Survey Data, plus supplemental financial data
- 14 variables measuring various CG characteristics:
  - corporate governance rating
    - shareholders rights, board reform and disclosure
    - stock options
  - corporate structure
  - ownership
    - ratios of foreign, personal and inter-firm holdings
    - centralization/decentralization
  - financial dependence
    - bond ratio, bank borrowing ratio
  - employment patterns
    - lifetime employment,
    - seniority-based vs. merit-based pay
    - union
## Correlation Matrix:
### Governance Characteristics

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<th></th>
<th>cgi'1</th>
<th>cgia</th>
<th>cglb</th>
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Three Broad Groups

- **J-Firm type (69% of firms, 41% of total employment)**
  - *Keiretsu*-networks
  - Strong bank dependence
  - Low on CG reform
- **Hybrid Type (14% firms, 48% employment)**
  - Institutional investors
  - Bond dependent
  - High on CG reform
- **Independent Firms (17% firms, 11% employment)**
  - Individual ownership
  - SME finance
  - Low on CG reform
But several important subtypes...

- due to imperfect correlations between governance traits.....
- and relative independence of employment variables from ownership/finance variables

- We identify 9 distinct patterns!
How many models of the Japanese Firm?
A typology of governance characteristics

Dendrogram based on complete linkages cluster analysis

L2 dissimilarity measure

J-firm region

Hybrid region

Independent region

Subordinate J-type N=70
Classic J-type (large) N=110
Classic J-type (small) N=183
Group J-type N=84
Progressive Group J-type N=39
J-Hybrid N=82
A-Hybrid N=20
Independent N=79
Quasi-Venture N=49
Some Emerging Hybrid Models

• Progressive J-firm
  - Group company, but uses bond and bank finance
  - Board reform to strengthen control (more outsiders!), but less shareholder rights and disclosure
  - LTE+merit

• J-Hybrid
  - Foreign pressure, bonds and banks
  - Disclosure-oriented CG
  - LTE+merit

• A-Hybrid
  - Extreme foreign pressure, bonds only, high self-financing
  - Shareholder and disclosure oriented
  - Some abandon LTE
Other Patterns?

• Independents
  - Some small family ventures...
  - also some relatively progressive CG among group of former utilities firms and younger quasi-venture capital firms

• Among J-type..
  - Different degrees of horizontal and vertical dependence upon groups
  - Traditional employment relations
continued importance of diversity...

• Performance depends on fit between
  - company
  - sector
  - national constraints
  - international constraints

• No one best way!
  - different models have different trade-offs
  - who gets what?

• Degree of complementarities depends on organizational architecture / industry context
Issues of a Hybrid Model

• New recombinations of governance characteristics
  - Rejects economic determinism of single best model
  - Rejects societal determinism where practices can never be transferred across social contexts

• Tensions
  - LTE plus merit?
  - Stakeholders plus shareholders?
  - Transparency plus insiders?

• Can Japan get the right balance of external control and internal self-monitoring?
Transformation through incremental institutional change

- Institutional Exhaustion
  - depletion due to limits of growth supported by the institution and decreasing returns (e.g. MB)

- Institutional Conversion
  - old institutions take on new functions (e.g. employment)

- Institutional Layering
  - A merging of old institutions and rules with new ones, followed by differential growth (e.g. venture capital, board reforms)

Real change, but not change through institutional breakdown and convergence to a new system!
But an incomplete mix...

- Weakness of external controls
  - Need to revitalize banks through private equity funds
  - Institutional investor activism still in its infancy
  - Barriers to and dangers of hostile takeovers

- Much effort needed to strengthen capacity of independent outsiders
  - Two faces of outside directors
  - NGOs, unions
  - Professionalism
  - New role of the state, welfare state, public agencies
The future?

- As international markets expand, the cross-national diversity of CG will shrink but not disappear
  - stakeholders may effectively adapt to capital market pressures
  - need to widen definition of enterprise communities

- Positive-sum view of corporate accountability

- Changing role of the large corporation in Japanese society
Policy Implications

• Reform target = traditional J-type?
  - which direction of change?
  - how to overcome lock-in of negative traits?

• Regulatory measures

• Bank Healthiness

• Market pressures
  - Institutional investors
  - Bright and dark sides of M&A
## Data Appendix: Cluster Groupings

<table>
<thead>
<tr>
<th>Cluster Variables</th>
<th>Sub J</th>
<th>J-type 1</th>
<th>J-type 2</th>
<th>Group J</th>
<th>Progressive J</th>
<th>J-Hybrid</th>
<th>A-Hybrid</th>
<th>Independent</th>
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<td>57%</td>
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<td>95%</td>
<td>47%</td>
<td>82%</td>
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### Other Descriptives

| Exits / Total Employment | 10%  | 7%   | 11% | 13% | 6% | 7% | 6% | 14% | 7% | 10% |
| Outside Directors       | 54%  | 28%  | 33% | 39% | 64% | 40% | 40% | 11% | 41% | 36% |
| Executive Officer System | 16%  | 35%  | 31% | 10% | 49% | 48% | 50% | 24% | 47% | 31% |
| Cross-shareholding (yes/no) | 54% | 80%  | 77% | 77% | 76% | 84% | 60% | 59% | 64% | 72% |
| Self-Financing Ratio    | 4.6  | 5.0  | 5.0 | 4.7  | 5.1 | 5.6 | 6.4 | 5.0 | 4.6 | 5.0 |
| Year Established (higher=older) | 2.9 | 2.0  | 2.5 | 2.2  | 3.0 | 1.9 | 2.4 | 3.6 | 2.2 | 2.5 |
| Total Employees          | 1108 | 1680 | 846 | 1110 | 3927 | 6956 | 10301 | 750 | 2569 | 2270 |

### Performance Indicators

| eeroa2 | 0.3 | 0.4 | 0.0 | -0.8 | 1.2 | 0.9 | 2.4 | 2.0 | 0.8 | 0.5 |
| q      | 1.1 | 1.3 | 1.0 | 1.1  | 2.2 | 1.7 | 2.4 | 1.6 | 1.6 | 1.4 |
| risk   | 11.6| 11.6| 12.7| 11.5 | 16.4| 11.9| 11.8| 14.8| 13.8| 12.7|
| N      | 70  | 110 | 183 | 84   | 39 | 82  | 20 | 79  | 49  | 716 |

### Percent of Firms

| 10%  | 15%  | 26%  | 12%  | 5%   | 11%  | 3%  | 11%  | 7%  |      |

Source: MoF Survey based on G.Jackson & H.Miyajima