Corporate Governance in Japan: Institutional Change and Organizational Diversity

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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 peformance 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

		Transparency/Accountability	
		Limited	**High**
Organisational Resource Base	**Narrow**	*Quadrant 1* Small family businesses; Start-ups University spin-offs	*Quadrant 2* “Threshold firms” IPOs
	Extensive	*Quadrant 4* Declining organisations; Public-to-private Buy-outs	*Quadrant 3* Mature listed firms

Filatotchev, I., Wright, M.(Eds). “Corporate Governance Life-cycle”. Edward Elgar, 2005.

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
  - bifuration 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

	Divergence **'multiple equilibria'**	**Convergence** **'one best way'**
Higher Complementarity of Sub-systems	Path Dependence	Formal Convergence
Lower Complementarity of Sub-systems	Hybridization / Reconfiguration / Heterogeneity	Functional Convergence

Source: Adapted from Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference by William W. Bratton and Joseph A. McCahery 1999, Columbia Journal of Transnational Law, Vol. 38, No.2.

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

J-Type Hybrid	**J-Firm**	**A-Type Hybrid**
Toyota, *Mitsubishi Chemical,* *Asahi Brewing*	**..conservative** *Kikkoman* **or under stress…** *Construction, Real Estate* *"Zombie" Firms*	*Sony,* *Hitachi,* *Mazda*

Diversity of Firms

- Differential impact of internationalization and deregulation across groups of firms

- Bifuration 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

	cgi1	cgia	cgib	cgic	Stock Opti	Decentraliz	Foreign	Horizontal	Individual	Bond	Bank	Union
Total CGI	1											
Shareholder (cgiA)	**0.66**	1										
Board (cgiB)	**0.66**	**0.18**	1									
Disclosure (cgiC)	**0.83**	**0.41**	**0.26**	1								
Stock Options	**0.22**	**0.11**	**0.1**	**0.23**	1							
Decentralization	**0.12**	0.05	**0.09**	**0.11**	**-0.09**	1						
Foreign ratio	**0.44**	**0.23**	**0.18**	**0.48**	**0.15**	**0.08**	1					
Inter-firm ratio	**-0.28**	**-0.12**	**-0.1**	**0.33**	**-0.17**	-0.04	**-0.4**	1				
Individual ratio	**-0.23**	-0.06	**-0.14**	**0.25**	0.06	**-0.15**	**-0.43**	**-0.35**	1			
Bond Ratio	**0.34**	**0.21**	**0.19**	**0.32**	**0.08**	**0.08**	**0.17**	**-0.21**	**-0.16**	1		
Bank ratio	**-0.18**	**-0.1**	0	**-0.26**	**-0.15**	0.05	**-0.3**	**0.1**	**0.15**	-0.04	1	
Union	0.03	-0.04	**0.08**	0	**-0.18**	**0.12**	0.06	0.05	**-0.33**	**0.15**	0.06	1
LTE+Seniority (type1)	**-0.19**	**-0.16**	**-0.09**	**-0.16**	**-0.14**	0	**-0.11**	**0.08**	0	0	0	**0.09**
LTE+Merit (type2)	**0.18**	**0.12**	**0.1**	**0.17**	**0.07**	0.04	**0.1**	**-0.09**	-0.04	0.05	-0.03	0.01
No LTE + Merit (type3)	0.02	0.07	0	0	**0.11**	-0.06	0.027	0	0.05	-0.05	0.03	**-0.13**

Three Broad Groups

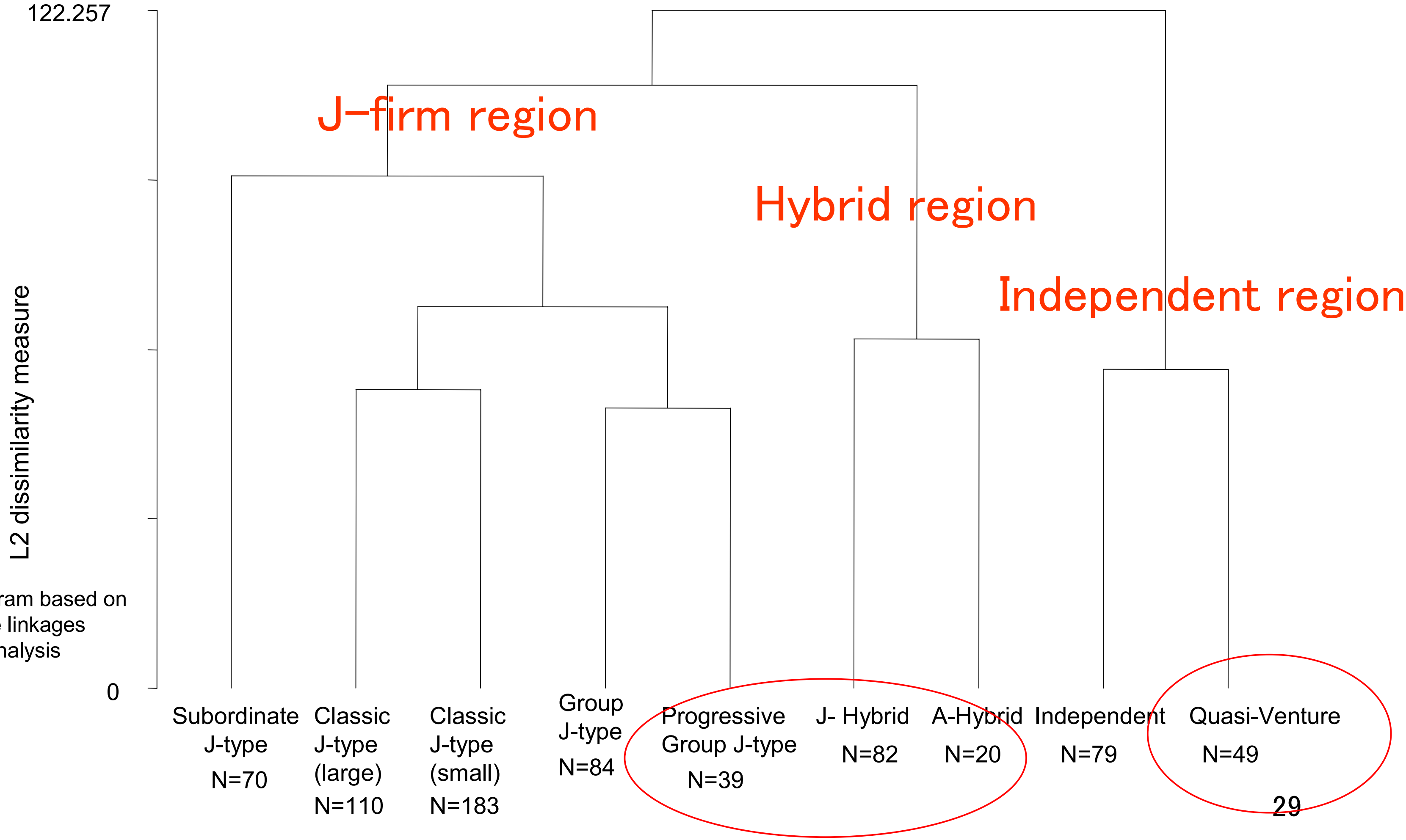
- J-Firm type (69% of firms, 41% of total employment)
  - *Keiretsu*-networks
  - Strong bank dependence
  - Low on CG reform
- Hybrid Type (14% firms, 48% employment)
  - Institutional investors
  - Bond dependent
  - High on CG reform
- Independent Firms (17% firms, 11% employment)
  - individual ownership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

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 <u>fit</u> between
  - company
  - sector
  - national constraints
  - international constraints
- No one best way!
  - different models have different trade-offs
  - who gets what?
- Degree of complementarities <u>depends</u> on organizational architecture / industry context

Issues of a Hybrid Model

- New recombinations of governance characteristics
  - Rejects economic determinism of single best model
  - Rejects societial 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

	Sub J	J-type 1	J-type 2	Group J	Progressive J	J-Hybrid	A-Hybrid	Independent	Quasi-Venture	TOTAL
Cluster Variables										
Total CGI	21.5	25.7	24.4	16.3	42.3	39.1	43.6	25.5	33.2	27.3
Shareholder (cgiA)	4.9	3.4	4.6	3.3	8.7	6.5	10.5	6.5	6.8	5.2
Board (cgiB)	10.0	10.9	10.6	7.7	15.2	13.6	11.9	8.4	13.9	10.9
Disclosure (cgiC)	6.6	11.5	9.2	5.3	18.3	19.1	21.2	10.6	12.6	11.2
Stock Options	9%	31%	27%	19%	41%	34%	35%	38%	31%	28%
Decentralization	2.7	2.9	2.5	2.5	3.2	3.0	2.7	2.4	3.1	2.7
Foreign ratio	1.6	5.7	1.7	2.0	7.2	18.4	37.6	2.7	6.7	6.0
Inter-firm ratio	66.5	19.9	28.9	46.6	43.2	11.4	7.0	11.4	9.8	28.2
Individual ratio	21.3	32.9	47.9	32.2	19.8	19.5	11.8	69.5	49.0	37.8
Bond Ratio	0.01	0.04	0.02	0.02	0.06	0.07	0.05	0.02	0.06	0.03
Bank ratio	0.19	0.16	0.17	0.20	0.12	0.09	0.03	0.20	0.19	0.16
LTE+Seniority (type1)	59%	63%	57%	65%	49%	44%	40%	48%	49%	55%
LTE+Merit (type2)	20%	25%	27%	18%	36%	43%	35%	29%	39%	28%
No LTE + Merit (type3)	21%	12%	16%	17%	15%	13%	25%	23%	12%	16%
Union (yes/no)	79%	80%	61%	83%	77%	87%	95%	47%	82%	73%
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										
eroa2	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