

# **Foreign institutional investors and corporate governance in Japan**

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# Research questions

- What effect have foreign institutional investors had on corporate governance in Japan?
- To what extent have firms with higher levels of foreign ownership adopted “Anglo-American” forms of corporate governance?

# Corporate governance

- A set of ideologies, laws, and business practices that relate to the relationship between a firm and its various stakeholders.
- In this paper, specifically, corporate governance includes:
  - Board structure and function
  - Employment practices
  - Relationships between firms
  - Investor relations

# **Foreign institutional investors as a force for globalization**

- Researchers have generally been pessimistic about prospects of a “convergence” to single set of business practices around the world.
- Have looked at influence of global trade, global spread of ideas.
- Much less to say about institutional investors. Effect of foreign institutional investors on firm practices remains speculative.

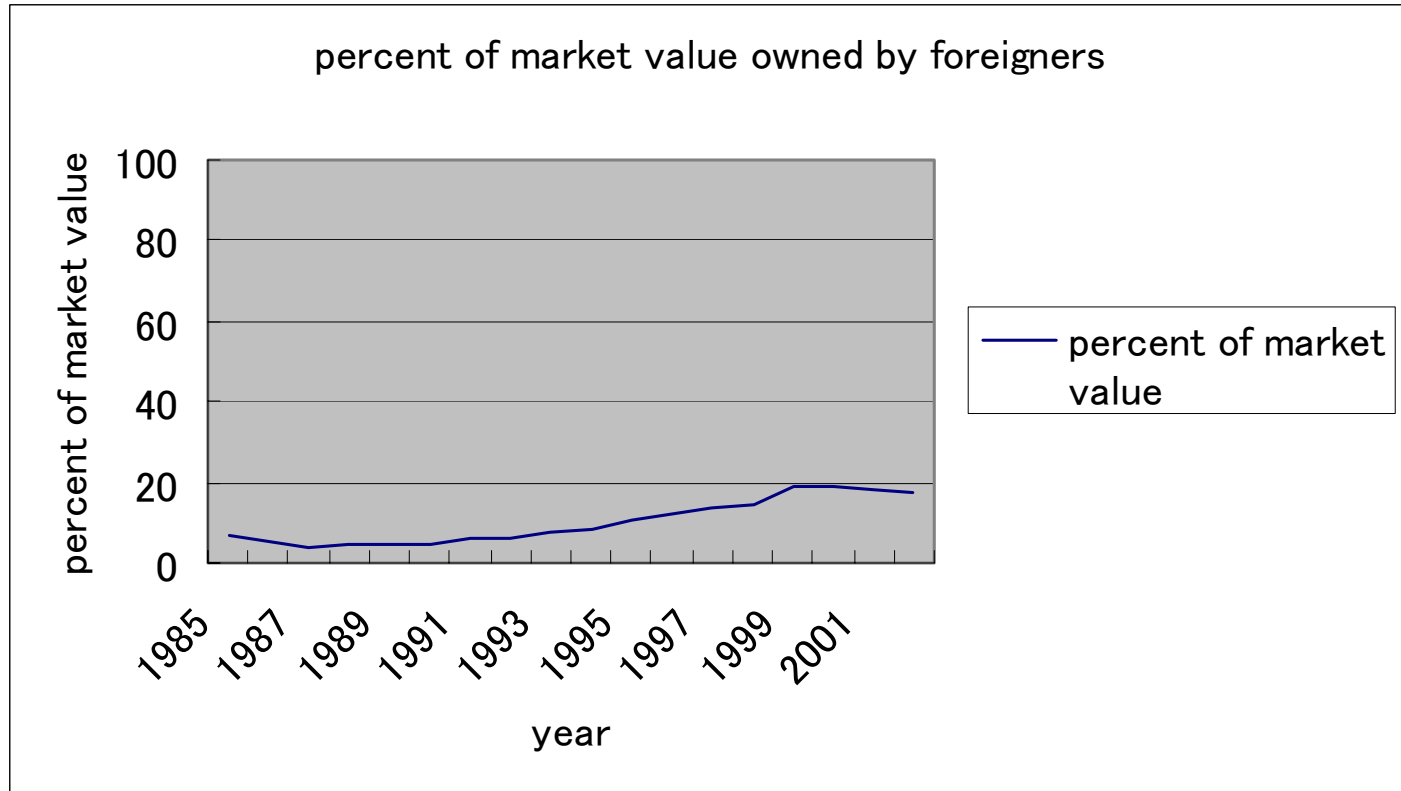
# How do foreign investors have influence?

- FDI—Ripplewood, Renault-Nissan, J-phone
  - Lots of publicity
  - But, relatively low (1/11<sup>th</sup> of US, as percentage of GDP)
- Foreign institutional investors
  - Less publicity
  - Relatively high levels of investment (17-18% of market capitalization)

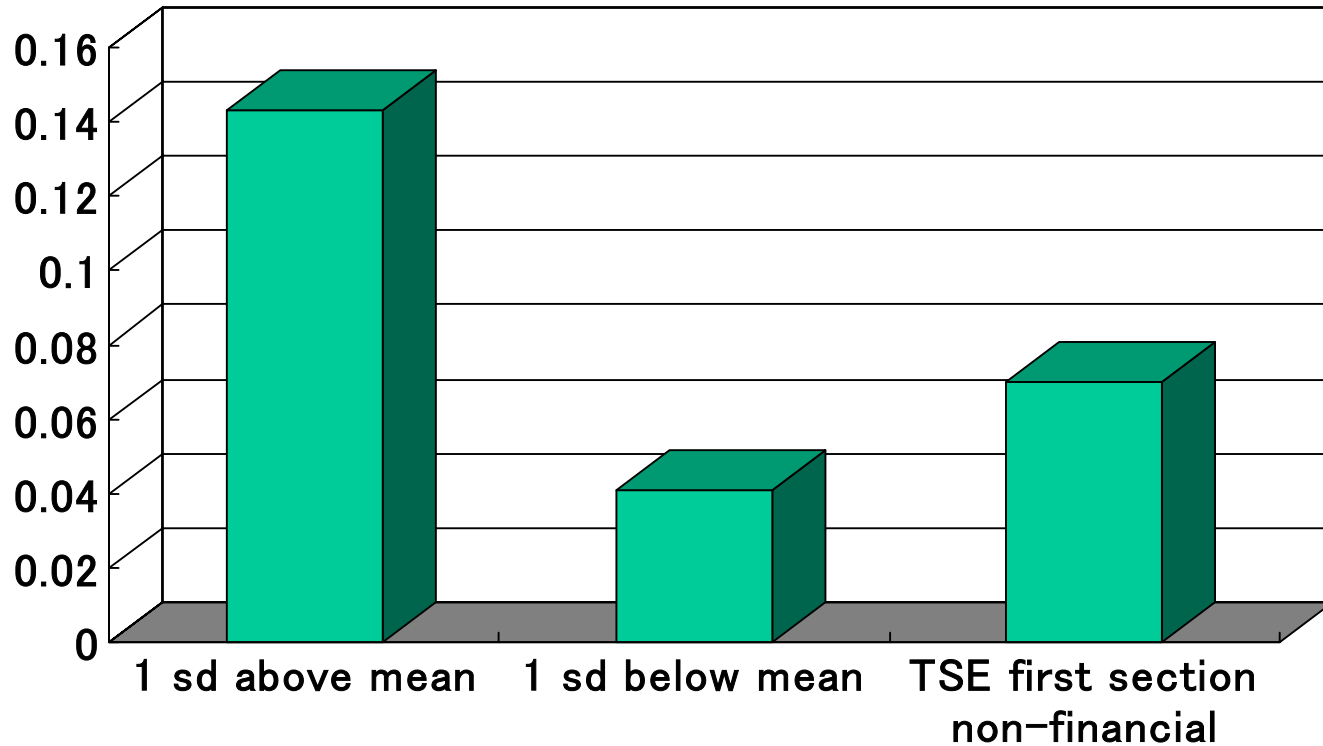
# Chapter outline

- Who are the foreign institutional investors?
- How do they influence firms?
- What are some of the outcomes of their influence?

# Foreign ownership has increased over time



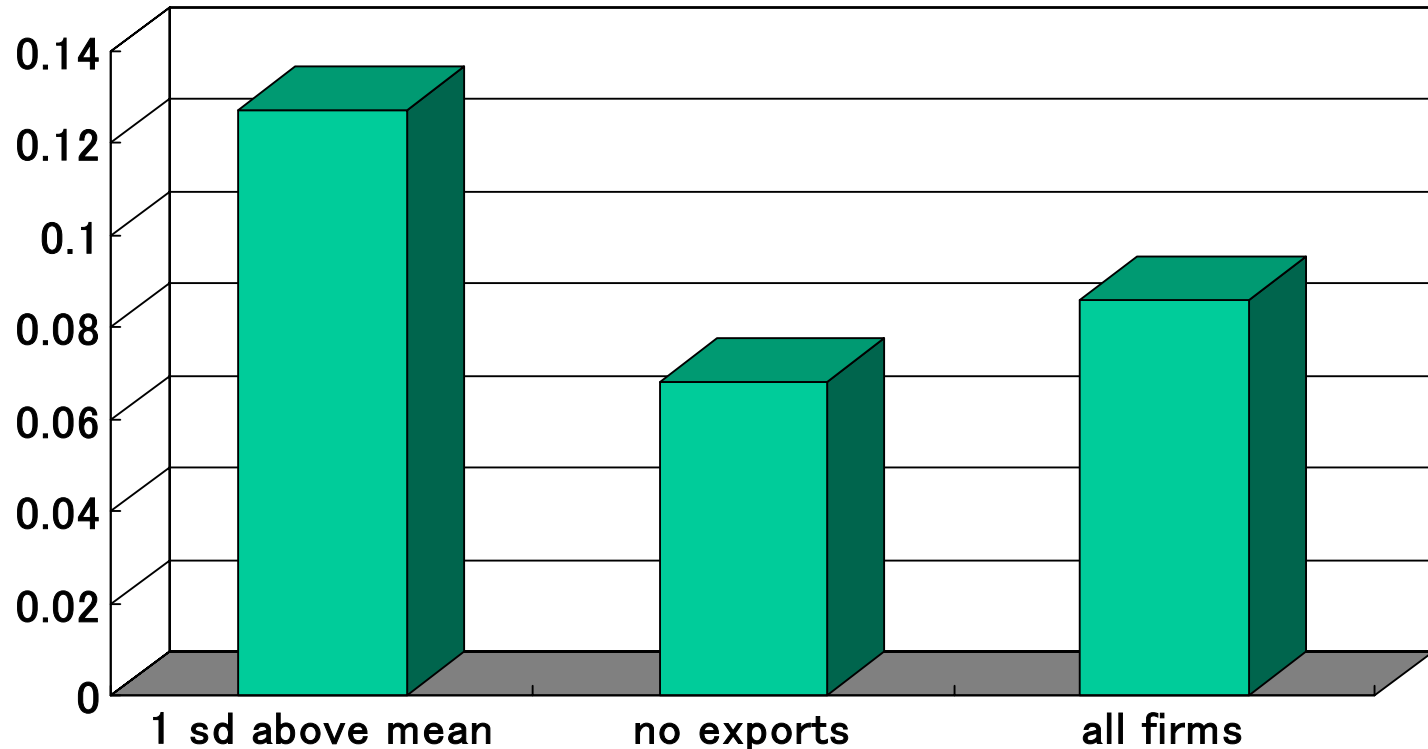
# Foreign ownership higher in larger firms



1363 TSE first section non-financial  
Firms, 2002



# Foreign ownership higher in exporting firms



1363 TSE first section non-financial  
Firms, 2002

# **Rough assessment of foreign shareholders**

- 869 TSE1 TSE2 firms in 1996
- Approx 150 recognizable foreign shareholders in top 10
- 20 industrial companies
- Financial institutions
  - Chase approx 20 times
  - Bermuda Bank and Bermuda Trust approx 10 times
  - Credit Suisse approx 6 times
  - Others: Bankers Trust, Royal Bank of Scotland, State Street

# **What do foreign investors want?**

- Less tied to system of cross-shareholding, reciprocal obligations and favors
- Fiduciary responsibility to shareholders
- Anglo-American conceptions of “appropriate” business behavior
- Less tied to reputation concerns about downsizing

# **How do foreigners exercise influence?**

- Exit
- Voice

# Foreigners drove share prices in 1990's

- Foreigners' share of transactions of shares increased from 30% in 1996 to 39% in 1999, and foreigners were net buyers in each year from 1991 to 1999, except for 1998 (Takahashi 2000).

# Exit

- Foreigners tend to direct the market. The level of the market is determined by foreigners (US I-Bank).
- Japanese pension funds follow US investors and US analysts. Much of the holdings of Japanese pension funds stable shareholdings--but the part that is more liquid--follows US capital into Japanese firms (IR executive).

# **Exercising voice: Little activism**

- Foreigners remain slow to exercise voting rights
- No targeting of poorly governed firms (a la CalPERS)
- Foreign/Murakami coalition shows no results so far

# **But, firms hear foreign investors**

- Investor relations activities focused towards foreigners
- Foreigners get time with senior management
- Foreigners as “gaiatsu”



# Senior executives see little shareholder activism

- We have foreign investors besides [the foreign investor with a controlling stake] But we don't hear much from them, and they don't come to the kabunushi sokai.
- There is no direct influence of foreigner investors, though we have to expect that this will increase in the future.
- 25 or 26% of our shares are owned by foreigners--and I'm sure CALPERS is in there. The foreigners have not applied direct pressure, at the sokai for example. They approve of what we are doing. If they didn't I'm sure they would start pressuring us.

# **But, firms listen to foreign shareholders**

- We've had foreign pressure. For example, a well known fund is a 5% shareholder. We can't turn down when this fund asks our shacho to breakfast. This state of affairs started from around 1998. (IR person).
- From my point of view, I particularly like to meet with foreign investors, since they are always raising new questions and waking me up. I am excited to see foreign investors and get new ideas. Such communication is important...Japanese investors often seem to be trying to get us to reveal insider information. We would like to teach them ethics. (IR head).
- We visit US and Europe twice a year. This is because we have a bit more than 30% foreign investors--and we've been doing this for about 10 years.



# Foreign investors have a louder “voice”

- We can learn from our investors. Japanese investors are becoming more vocal, but have become hesitant to speak out. Calpers is vocal generally, but we have never wrote us a letter. But their publicity is a very good thing--it prepares us. We are ready for what investors ask. We listen to investors.
- I wish I could go back in time and be a shacho in the old days. One big part of the shacho function these days is investor relations. In the old days, no one wanted to say anything that rocked the boat--but now, we need to address questions from fund managers

# Foreign investors apply pressure through voice

- Japanese investors are not able to ask the sorts of questions that we do. They are unwilling to speak up to senior people at companies. They are happy to see the IR department--but the IR department is weak and knows little about strategy--you might as well just read the newspaper. Japanese investors are also not as respected by companies as the foreigners, and thus are unable to get in to senior management.

# Foreigners as gaiatsu

- I go to talk to a CEO. And the CEO talks about a 3-5 year plan that is very ambitious, and not terribly realistic. After the CEO leaves, IR guy admits that the plan has lots of problems. I agree and the response of the IR guy is "Next time you meet the CEO, please tell him what you just told me" (paraphrased, US I-bank).

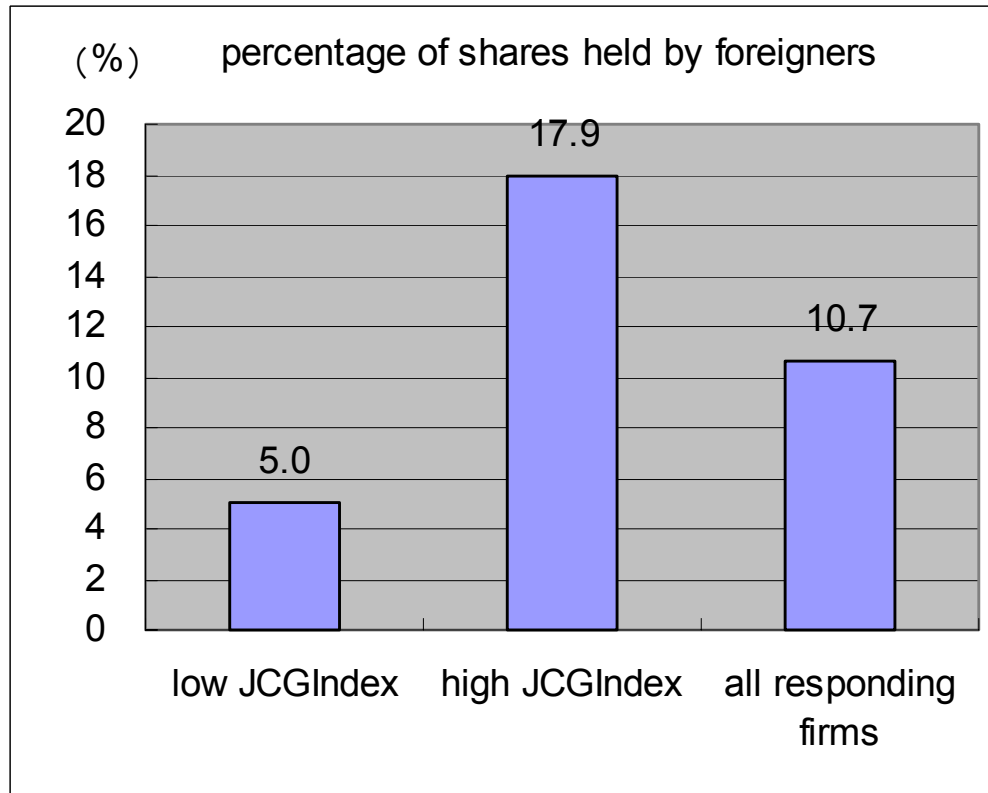
# Study 1: JCGIndex

- Survey sent to 1500 TSE first section firms, in 2002, 2003
- Collected responses from 300 firms over the two years
- Index of corporate governance practices
  - Corporate goal-setting and CEO accountability, board structure and function, management system, communication to shareholders
- Compare firms 1 sd over mean with those 1 sd below mean.

# **Foreign ownership associated with “Anglo-American” corporate governance**

- Results from 2003 JCGR study
- Results from 2002 show similar pattern
- Foreign ownership associated with overall corporate governance, use of equity-based measures of firm performance, structure and function of board, internal control systems, and communication with shareholders.

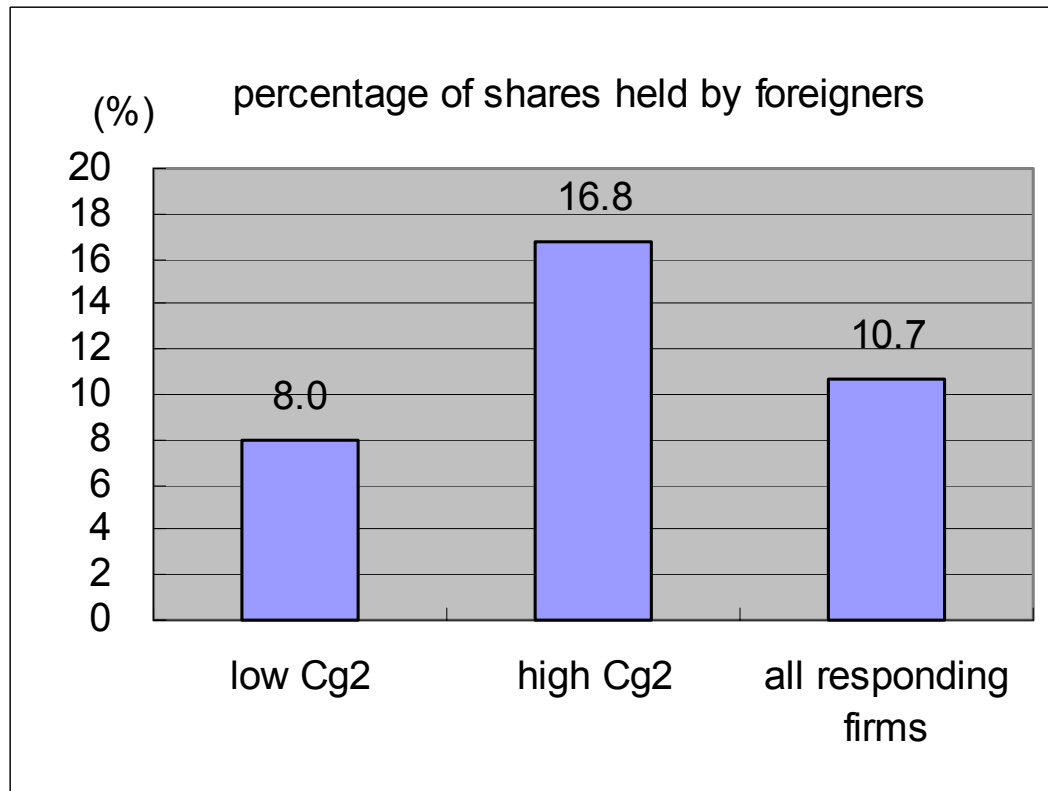
# High and low CG firms and foreign ownership



Significant at 1% level

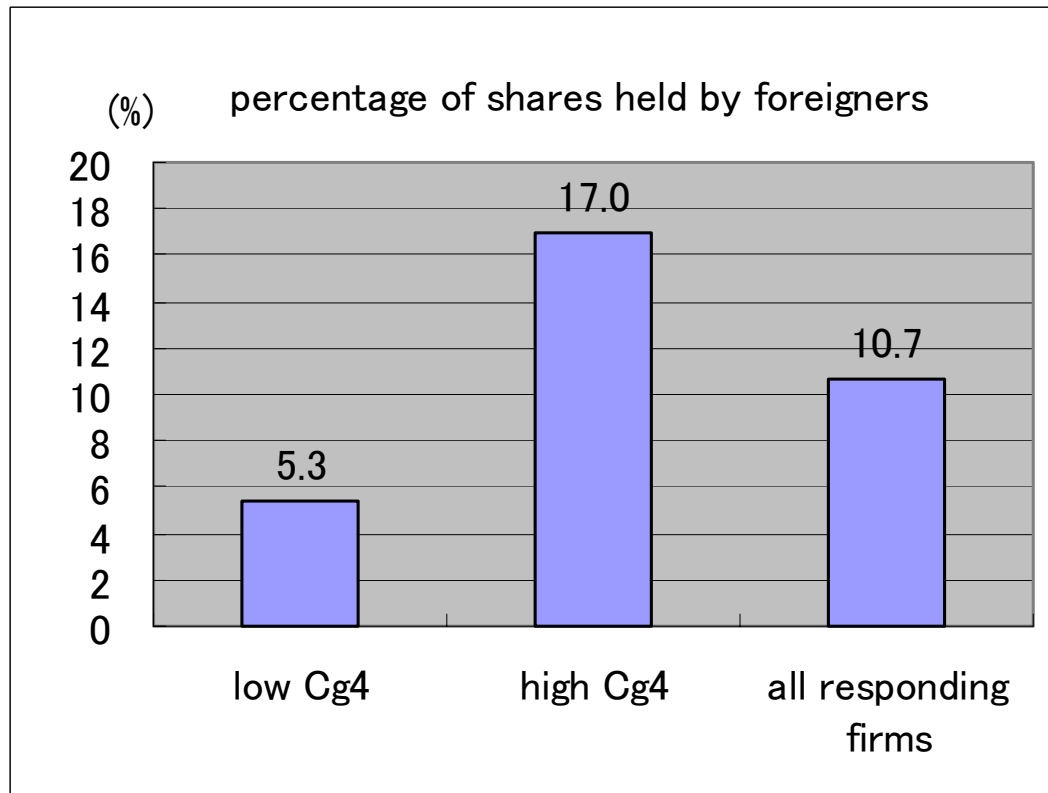


# Board structure and function and foreign ownership



Significant at 5% level

# Communication with shareholders and foreign ownership

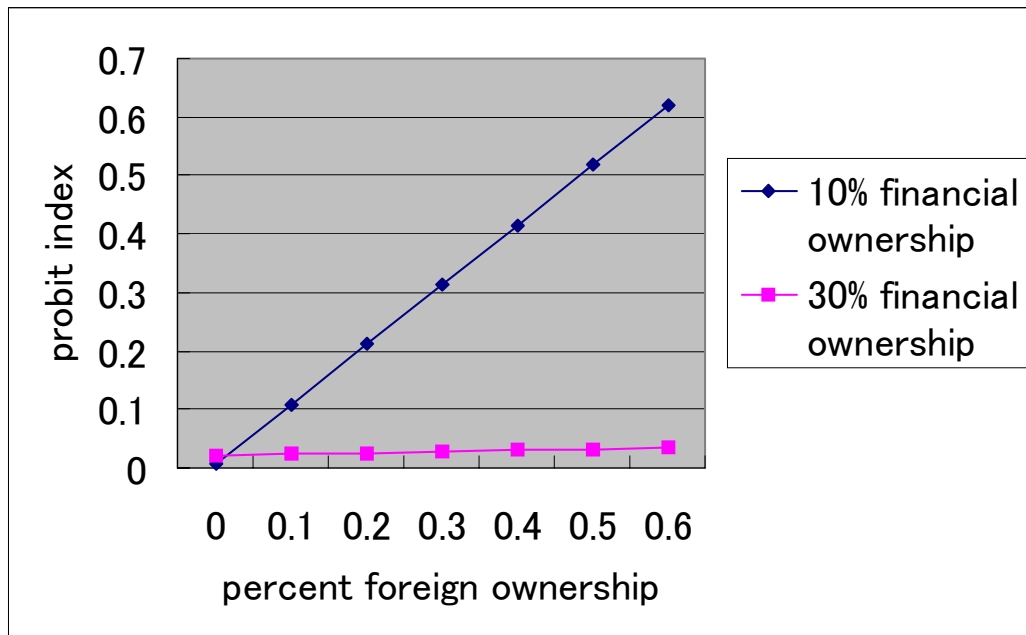


Significance level 1%

# **Study 2: A clash of capitalisms**

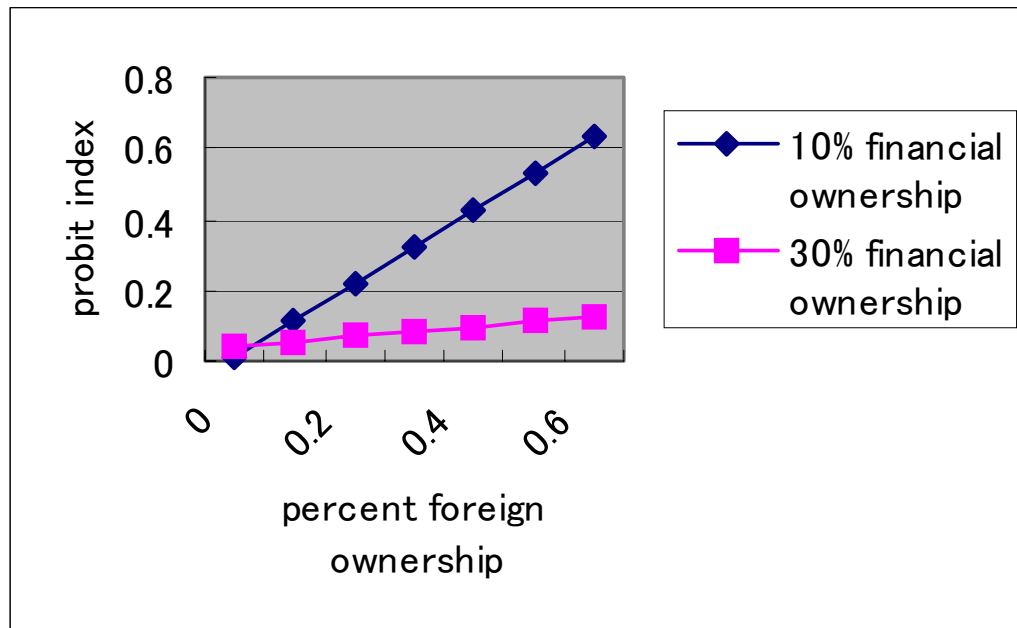
- Analysis of 1100 TSE first section firms, 1991-2000
- Look at downsizings and asset divestitures of 5% or more

# Foreign ownership associated with greater propensity to downsize in firms with low financial ownership



1100 firms 1991-2000

# Foreign ownership associated with greater propensity to divest assets in firms with low financial ownership



1100 firms 1991-2000

# **Is foreign investment case or effect?**

- Sony governance innovations and restructurings
  - Comes after foreign ownership levels are extremely high
- Research on downsizing and divestiture
  - Finds no significant increase in foreign investment after firms downsize or divest

# **Foreigners as cause and effect**

- Influence goes both ways
- But, foreigners as causal factor should not be underestimated
- Regardless of direction of causality—changed governance practices and foreign investment go hand in hand

# Conclusions

- Foreign institutional investment associated with changing corporate governance practices
- Foreigners use exit and voice, though formal shareholder activism remains rare