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 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

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<tr>
<th>Organisational Resource Base</th>
<th>Transparency/Accountability</th>
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<td>Narrow</td>
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<td>Quadrant 1</td>
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<td>Small family businesses;</td>
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<td>Public-to-private Buy-outs</td>
<td>Mature listed firms</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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Different Processes of Change Lead to Increasing Heterogeneity of Corporate Governance in Japan

Traditional J-Type Firm

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

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>
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<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>
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<td>Exits / Total Employment</td>
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<td>64%</td>
<td>40%</td>
<td>40%</td>
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<td>31%</td>
<td>10%</td>
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<td>50%</td>
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<tr>
<td>Cross-shareholding (yes/no)</td>
<td>54%</td>
<td>80%</td>
<td>77%</td>
<td>77%</td>
<td>76%</td>
<td>84%</td>
<td>60%</td>
<td>59%</td>
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<td>Self-Financing Ratio</td>
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<td>5.0</td>
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<td>Year Established (higher=older)</td>
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<td>2.2</td>
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<td>1680</td>
<td>846</td>
<td>1110</td>
<td>3927</td>
<td>6956</td>
<td>10301</td>
<td>750</td>
<td>2569</td>
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## Performance Indicators

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| Percent of Firms | 10% | 15% | 26% | 12% | 5% | 11% | 3% | 11% | 7% |

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