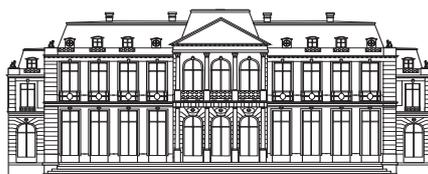


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CORPORATE GOVERNANCE IN ASIA: A COMPARATIVE PERSPECTIVE  
*Seoul, 3-5 March 1999*

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## I. Introduction

Today there are approximately 2.5 million corporations in Japan, most of which are limited liability companies. Among them, larger firms are usually organised as public-limited companies, which are required to have capital of JPY 10 million at the minimum, while a number of smaller enterprises are private-limited corporations. Out of 6,330 of the largest corporations that have sufficient capital for listing (JPY 1 billion or more), 6,249 or 98.7 per cent are public-limited companies, of which approximately 38 per cent are actually listed on the stock exchanges.<sup>1</sup> This note hereafter outlines Japanese corporate governance practices, focusing mainly upon the large, listed, public-limited corporations.

Section II will sketch the features of three major players in corporate governance: the board, shareholders and main banks. The board – the highest management body – is legally responsible to the shareholders, but in practice cares as much about employees in Japan. This is because the directors are mostly promoted from the middle management level of the company and are regarded as leaders of all the employees. This feature of the board is supported by a stable and concentrated ownership structure in which cross-shareholdings are particularly prevalent. Key shareholders are mostly important business partners, especially creditors such as banks and insurance companies, who value mutual business expansion rather than short-term returns on shares and generally refrain from intervening in management. Discipline for the board is in many cases provided by the main bank, which is usually the largest lender and a significant shareholder. The main bank continuously monitors management but intervenes effectively only when company performance deteriorates significantly. This governance structure of Japanese corporations is often described as “contingent governance” in which the board enjoys a relatively high degree of autonomy in usual business situations but is subject to external control by the main bank when the company is in distress.<sup>2</sup>

Section III will discuss the recent changes in Japanese corporate governance. Firstly, changes in the two key players – main banks and shareholders – will be pointed out. The intensive monitoring by main banks over management has been weakened as a consequence of Japanese firms becoming less dependent on bank finance. It is expected to become even less effective going forward because of the eroded rents for monitoring and the weakened capital base of the banks. In contrast, shareholders have increased their influence on management. This has resulted from the shift in the ownership structure of Japanese firms in which cross-shareholdings have been reduced and foreign investors have increased their holdings, and also from the shareholders becoming more active in exercising their rights. Secondly, the recent or forthcoming changes in some basic rules for management and their influence on corporate governance practices will be surveyed. These changes include the recent amendments to the Commercial Code regarding share buybacks and stock options, forthcoming accounting reforms, and the legal changes associated with a holding company. Lastly, the discussion will show the recent movements in the reform of the board structure. More companies carried out or planned reforms of their boards by introducing an executive officer system and thereby streamlining the board. Moreover, in order to improve supervision over management, reinforcement of the functioning of statutory auditors is under consideration.

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<sup>1</sup> The numbers of companies, except for that of listed ones, are as of 30 June 1998 (National Tax Administration, *Kaisha Hyouhon Chosa*). The number of companies listed on stock exchanges was 2,387 as of 7 December 1998.

<sup>2</sup> Aoki [1996]

Finally, Section IV will identify some future prospects for changes in the governance structure of Japanese corporations. Structural changes in the business environment, such as slow trend economic growth and more unstable ownership structures, will continue to pressure Japanese companies to reform their governance structures. Fundamental changes may take time, however, as corporate governance practices do not stand alone but interact with various economic and social systems and practices.

## ***II. Main features of Corporate Governance in Japan***

The governance structure of Japanese corporations is often characterised as “contingent governance” in which company insiders retain effective control of management as long as the firm performs well, but once performance deteriorates, the control is taken away and they are subject to severe sanctions such as the forced liquidation of the corporation. This contingent structure is supported by three major features of the main players in corporate governance: the board, the shareholders and the main banks. This section describes these features so as to explore how the governance of Japanese corporations has worked.

### **1. Role of the Board**

#### ***Board Structure***

In legal terms, company directors are independently responsible to shareholders for management of the company. They are elected by the majority of the shareholders at a general shareholder meeting, and must work faithfully for the company in accordance with the law and the decisions of the general shareholder meetings. In order to control the affairs of each director, a board of directors is formed. The board is expected to make important managerial decisions to be carried out by directors in charge, and to supervise the directors’ execution. This “unitary” board structure is similar to that of the UK and the USA, but different from the board structure of Germany, which has a “board of commissioners” to supervise the management, independent from a board of directors.

Though legal frameworks of boards of directors are similar in Japan and the USA, the actual functioning of the boards is quite different. While in the USA, the boards tend to focus upon appointment of the CEOs and other senior officers and supervision of their affairs, those of Japanese firms centre on strategic and management decision making.

This difference in the functioning of the boards is reflected in the contrast in the actual compositions of the boards in both countries. In the USA, many directors are appointed from outside of the company. They are required to have general expertise in corporate management in order to monitor the operation of the company on behalf of the shareholders. In Japanese companies, by comparison, the directors are usually promoted from the ranks of middle managers of the company and in many cases continue to be its employees. Having precise knowledge of how the company is operated, the directors are expected to make strategic decisions to guide the company. At the risk of oversimplification, it can be said that the directors of Japanese firms are typically leaders of the insiders, while those of U.S. companies are usually outsiders representing the shareholders.

This board structure of Japanese companies has been considered to have various advantages, especially in the context of the life-time employment. The potential for promotion to the board creates an important incentive for the company’s employees to be loyal and work hard for the company. The board, composed of the directors with good knowledge of a company, can choose the most appropriate strategies with which the company is likely to grow steadily.

However, such a board structure also has deficiencies. Firstly, it tends to create a hierarchical structure in the board, which can undermine the board's function to supervise the affairs of directors, especially the president. Promotion from within the company can establish seniority among directors, as in most cases such promotion is decided effectively by the chairman and the president as well as by a few other influential persons such as the ex-chairmen/presidents and the senior directors. The hierarchical structure is reinforced by the creation of vertical report lines between the president and the senior members and then between the senior and junior members, who are usually assigned the responsibility for certain parts of the company management. Secondly, under such board structures, the number of directors tends to increase over time in order to reward long-serving managers. As of July 1998, the average number of directors among listed companies was about 20, while 49 companies had 40 directors or more.<sup>3</sup> Because of this size of the boards, coupled with their hierarchical structure, it is common in large Japanese companies to form a committee consisting of the president and a small number of senior directors to make essential management decisions, which are almost automatically approved by the full board of directors afterwards. Thus, in spite of the legal responsibility, the role of the board of large Japanese corporations tends to be superficial as regards not only supervising the affairs of the directors but also directing the management of the company.

### *Statutory auditors*

In order to counterbalance the power of the directors being promoted from within, the Commercial Code requires statutory auditors to be appointed. Like directors, they have to be elected directly by shareholders, and are responsible for supervision of the affairs of the directors for the benefit of the shareholders. Statutory auditors have authority to demand reports on management from directors and employees, to examine the operational and financial situation of the company, to attend the board meetings, as well as to demand suspension of an action by a director when they believe it to be against the law or the articles of incorporation and likely to damage the firm seriously.

As statutory auditors are expected to provide supervision from outside the management and to reinforce the supervisory function of a board of directors, they cannot be the directors or the employees of the company concurrently. In addition, the large companies that have capital of JPY 500 million or more or debts of JPY 20 billion or more, are required to have at least three statutory auditors, in addition to a financial auditor, who compose a board of auditors. Moreover, at least one of them has to be an "independent" individual who has not been a director or employee for the past five years.

It should be noted that the Commercial Code does not ban directors from being executives or employees concurrently nor require any "independent" directors. It can be said, therefore, that the legal framework expects statutory auditors to play the major role in supervising management on behalf of the shareholders, which may support the practice to appoint directors from within the company.<sup>4</sup> In reality, however, "independent" auditors are approximately half of the statutory auditors,<sup>5</sup> and they are often ex-employees or individuals coming from the important business

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<sup>3</sup> The Weekly Toyo Keizai, 20 September 1997.

<sup>4</sup> In the past, a ban on directors being concurrently executives or employees of the company was discussed. It was not adopted due to the opposition of the business sector; instead, the supervisory function of statutory auditors was reinforced to cover not only financial reporting but also management of the company (Fukao [1997]).

<sup>5</sup> Life Insurance Association [1998]

partners such as the group companies and the main banks, who may not be so unbiased in supervising the affairs of the directors (Table 1).

### ***Interests of directors***

Despite the fact that the directors are legally responsible to the shareholders, they are not necessarily motivated to put much importance on maximising shareholder value. The simple way to induce directors to seek higher value for the shareholders is to associate their remuneration with the share price. The use of executive share options for this purpose is common in other OECD countries, especially in the USA. It is somehow common among Japanese companies to encourage the directors to buy and hold shares of the company, but granting executive share options has not been very popular thus far, perhaps partly because of the unfavourable tax treatment.

Another mechanism to link the remuneration of directors with the shareholder value, which is popular in the USA, is to set up the remuneration committee composed of “independent” directors. The committee is expected to determine the managerial salaries of corporate executives based on its assessment of the performance of the executives with regard to the enhancement of shareholder value. Very few Japanese companies have so far adopted this kind of mechanism. Although the salaries of directors are subject to the approvals of shareholders at the general meetings in Japan, the approvals are usually asked on an aggregate basis, not on the salaries of respective directors. Moreover, the widespread practice of paying both an employee salary and a director’s salary for a director who remains an employee may have eroded the supervision by shareholders.

It is also pointed out that that promotion from a middle manager to a director does not provide the person with significant changes in his remuneration and function salary to make him realise the qualitative change in the role and responsibility associated with the promotion. While directors are often entitled to various fringe benefits such as a large office space, a secretary and a company car, the managerial salaries of Japanese directors are lower, on average, than those of other OECD countries.<sup>6</sup> Especially junior directors are still located in the middle of the company’s hierarchy, though one step higher than middle managers, and may be discouraged to exercise fully their responsibility to the shareholders. The weak consciousness of directors on their duties for the shareholders may also be associated with the consensus building, bottom-up decision making process, which is common in Japanese organisations.

### ***Role of employees as stakeholders***

In some OECD countries such as Germany, stakes of employees in a company are institutionalised in the corporate governance structure by granting employees representation on a board of directors or of commissioners. In Japan, in contrast, there is no legal framework for corporate governance to require the board to consider the interests of the employees. The employees of Japanese corporations, however, have played a significant role in actual corporate governance practices.

The most evident function of employees in the governance structure is to provide candidates among themselves to be elected as director as well as to monitor the incumbent directors. As seen above, the directors of Japanese firms have usually been selected from the middle management level of the company, and generally expected to act as leaders of the employees. The selection itself is

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<sup>6</sup> OECD [1995-1996] contains the data on the international comparison of CEO compensations, originally provided by Abowd and Bognanno (1995), “International Differences in Executive and Managerial Compensation”, in Freedman and Katz (ed.), *Differences and Changes in Wage Structure*, Chicago, University of Chicago Press.

made by the top management level, but it should be acceptable, or at least not unacceptable, to the employees in general. The employees also monitor the affairs of the directors from their viewpoint. They have no legal power to dismiss the leaders deemed unsatisfactory, but their views could influence the other members of the board to take actions against such directors. The low level of managerial salaries of the directors possibly has resulted partly from the “peer” pressure of the employees on the “insider” directors. The influence of employees on management is obviously supported by the life employment system, in which management has to pay a significant attention to maintaining a co-operative relationship with the employees, and the bottom-up decision making process, which featured “Japanese management”.

In addition, employee stock ownership plans have been common in Japan. For some companies, their fund is one of the largest shareholders of the company. In reality, employee stock ownership plans are often prepared by the management in order to create another “stable” shareholder. It is also true, however, that they can provide the employees with the legal authority to influence management directly.

## **2. Role of Shareholders**

### *Shareholder rights*

The primary right of shareholders is the one to appoint and, when necessary, dismiss the directors at general shareholder meetings. It is accompanied by the right to require the directors and the statutory auditors to report on the management at the general meetings. Shareholders also have the right to be informed of and participate in decisions which will result in fundamental changes in corporate structure, such as amendments of the articles of incorporation and extraordinary transactions. In addition, the Commercial Code stipulates that the salaries of the directors and statutory auditors should be decided by the general shareholder meeting. Moreover, though the board is responsible for the formulation and implementation of corporate strategy, it is legally possible for shareholders to limit the authority of the board by amending the articles of incorporation.

The Code also provides protection for minority shareholders. For example, the “one share one vote” principle is rather strictly established. Minority shareholders have the right to call a general shareholder meeting and to claim an inspector to be appointed by the court for checking the procedure of general meetings. One of the most important rights of minority shareholders stipulated in the Code is the one for shareholder litigation against misconduct of the directors. Since its introduction in 1950, lawsuits had been rarely filed, as a shareholder was initially required to pay a significant petition fee in accordance with the claimed damage of the company. However, this process has been significantly facilitated by the amendment of the Code in 1993, which dramatically reduced the fee to a fixed amount of JPY 8,200.

### *Ownership structure*

The important merit of public-limited companies, especially those listed on the exchanges, is that they can acquire capital from a wide range of investors. As of March 1997, there were approximately 28.5 million shareholders for 2,339 listed companies, which means, on average, a listed company has more than 12,000 owners.<sup>7</sup> However, their distribution is not even, as shown by the fact that individual shareholders, amounting to more than 95 per cent of the total number of shareholders, hold less than a quarter of the outstanding shares (Figure 1).

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<sup>7</sup> Tokyo Stock Exchange [1998a]

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In other words, a large portion of shares are held by corporations, which distinguishes the ownership structure of Japanese corporations from that in most other OECD countries. Soon after the second world war, outstanding stocks were mainly held by domestic individuals, but their share has steadily declined to less than 25 per cent. On the contrary, domestic corporations have been increasing their share, which amounted to roughly 65 per cent in March 1998.

Among domestic corporations, financial institutions hold a relatively large amount. Approximately 40 per cent of the stocks belong to domestic financial institutions, while 24 per cent are held by non-financial corporations. Among the financial institutions, banks have about half, amounting to 22 per cent of all outstanding stocks, in aggregate (Figure 2). This implies that banks must keep the stocks of a wide range of companies, as they have been legally prohibited from owning more than 5 per cent of any given company. The second largest portion, about 10 per cent of all stocks, is owned by life insurance companies. Ownership shares of financial institutions are also high in the UK and the USA, but mutual funds and pension funds hold the major portion among them and banks have few, if any.

The significant holding of shares by domestic corporations has resulted from the prevalent cross-shareholding practices among Japanese corporations, which originated in the late 1940s or early 1950s with the aim of raising capital while preventing hostile take-overs.<sup>8</sup> Cross-shareholding became prevalent in the mid-1960s to mid-1970s (Figure 3). As stock prices soared in the late 1970s and early 1980s, the shares held by Japanese companies created considerable hidden profits for the companies, which strengthened their financial basis and contributed to the expansion of their business.

Cross-shareholding is arranged for strategic purposes. It is a symbol of long-lasting relationship between the two parties, and consequently the shares in this arrangement are normally not sold off without the agreement of the issuer. As a result, the prevalent practice of cross-shareholding has created a relatively concentrated and considerably stable ownership structure of Japanese corporations. The top 10 shareholders of the companies listed on the Tokyo Stock Exchange (TSE) First Board have, on average, 44 per cent of the outstanding stocks of a company.<sup>9</sup> These large shareholders are in most cases domestic banks and insurance companies as well as other group companies and important business partners. Research has shown that more than 90 per cent of the listed companies considered the majority of their stock to be held by “stable” shareholders.<sup>10</sup>

### ***Control by shareholders***

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<sup>8</sup> In the late 1940s, many large firms, especially *ex-zaibatsu* (the large financial holdings in pre-war period) affiliated companies, faced the pressing need to raise capital under the reorganisation plan after the second world war. However, the stock market collapsed in 1949 because of the serious recession induced by the severe anti-inflation policy implemented in 1949 as well as the excess supply of stocks resulting not only from rushing issues of stocks by the large companies, but also from market auctions of stocks of *ex-zaibatsu* affiliated companies, which began in 1948 in order to redistribute their ownership among the public and thereby “democratise” the Japanese economy. The market collapse brought two serious problems to the managements of the large companies: the difficulty in increasing capital and the real threat of hostile take-overs with high liquidity of shares and sharp declines in share prices. In order to survive this difficult circumstance, the companies asked their related firms, especially financial institutions, to hold their shares. As a result, cross-shareholding, especially among *ex-zaibatsu* companies, advanced significantly during 1949-55 (Miyajima [1995]).

<sup>9</sup> As of December 1998. The ratio includes holdings by the executives of the companies in addition to the 10 largest shareholders.

<sup>10</sup> Fukao [1997]

Shareholders can influence management in two ways: executing their rights as shareholders or trading the shares. As seen above, shareholder rights are well-protected in legal terms, but it has been rare to see shareholders in Japan influencing management directly by exercising their legal rights, except for the cases of the abuses by “greenmailers.” However, the concentrated ownership structure makes it possible for key shareholders to give considerable influence over management. As these shareholders are usually the affiliated companies in the same corporate group (so-called *keiretsu*) or the important business counterparts of the company, they have various occasions to communicate their demands to the management informally. Furthermore, they sometimes send their personnel to the board as directors or statutory auditors, which provides a means to control management directly.

In this regard, it should be noted that the interests of these key shareholders are not necessarily identical to those of minority shareholders with pure investment purposes. In addition, these large shareholders may generally refrain from intervening in management of the company, because they put more importance on maintaining or even expanding their business with the company rather than seeking the short-term returns on shares, and because the company in question is, in turn, often their large shareholder.

Shareholders may also have an influence on management indirectly through their trading of the shares. In principle, when they are not satisfied with management, they may sell the shares in the market, which could lower the share price and eventually increase the risk of a hostile take-over for the management. In practice, however, unlike in the USA, this mechanism to provide discipline for corporate managers through stock markets has not functioned well in Japan. This is not because of the legal framework, which is rather less restrictive than that of the USA as it does not provide the incumbent management with various anti-take-over measures, but mainly because of the stable ownership structure supported by cross-shareholdings. One may say that the legal restriction against hostile take-overs is not really necessary in Japan, as the ownership structure provides sufficient protection.

Moreover, the efficient functioning of the market for corporate control requires that share prices accurately reflect the performance of a company management, which does not seem to be the case of the Japanese capital market at least in the past years. It is also pointed out that in Japan hostile take-overs may not pay in the end, as they could undermine the incentives and loyalty of the employees and hence their performance, especially when followed by lay-offs and/or salary reductions.

### **3. Role of Main Banks**

#### ***Main bank system***

In Japan, external control over management of a company is often supplied by its creditors. Among them, the bank that has a close business relationship with the firm, monitors its operation carefully and provides external corporate control in lieu of the take-over market by intervening in the management of the firm, especially when the firm is in financial distress. This so-called main bank system is one of the major characteristics of the Japanese corporate governance structure.

There is no strict definition of a main bank, but it is typically the largest creditor of the company. The main bank relations imply that the concerned company will ask the bank for credit when the company needs external finance for its operation and/or investment, and the bank will arrange the needed credit on favourable terms either by itself or by organising a syndicate. At the same time, the main bank is usually one of the major shareholders, in many cases as a result of the

cross-shareholding arrangement, though it is not necessarily the largest one due to the regulation that prohibits banks from holding more than 5 per cent of the stock of any particular company.

Moreover, in most cases, the main bank is the principal supplier to the company of various financial services, which include not only loan extensions, but also payment and settlement operations and underwriting and management of bond issues. The main bank sometimes provides management resources as well, for example, by giving financial and investment advice and even sending its managers to the board of the company as directors or as statutory auditors (Table 2).

### ***Monitoring by main banks***

As the largest creditor and also a large shareholder, the main bank has a definite interest in assuring the sound management of the company. Through the functions mentioned above, the main bank can acquire considerable information on the financial and managerial situation of the company on a regular basis, which enables the bank to carry out effective monitoring of its management. According to Aoki [1996], the main bank can administer three types of monitoring: *ex-ante*, *interim*, and *ex-post*. *Ex-ante* monitoring is mainly related to investment decisions of the company. The main bank can monitor them by examining loan applications, as important investment normally requires external finance. *Interim* monitoring concerns performance of the on-going business and projects carried out by the company. The main bank is best situated to watch these by, for example, monitoring day-to-day cash flows at the company's settlement account. *Ex post* monitoring involves evaluating the financial performance of the company and, when the company is in difficulty, intervening in the management decisively to take necessary corrective measures. Having considerable information on the company, the main bank is well-positioned to decide effectively whether to rescue or liquidate and how to restructure the company. Moreover, as a significant creditor and shareholder, the main bank not only can have determining influence on the management, but also can co-ordinate appropriately the claims of various stakeholders, sometimes by accepting a disproportionately larger burden to rescue the company.

The main bank system has been beneficial to Japanese banks, as it has enabled them to diversify their credit portfolios, while economising on the cost of information gathering by sharing the monitoring roles on corporate management among them. The banks could also earn sufficient rents through long-term relationships with the client companies, which often provided fees to the main banks in the forms of excessive deposits, monopolistic handling of employee's salary accounts, high interest rates, etc., in the hope of getting help from the main bank when necessary (Table 3, 4).

### ***Role of the government***

The government has played an important role in supporting the main bank system. Firstly, regulation had contributed to protecting the rents earned by main banks. Until the deregulation in the 1980s, there was stringent regulation on deposit rates, which had been kept at sufficiently low levels so that the banks could gain a fair amount of profits by extending loans. Competition among the banks had been therefore mainly related to lending volumes. In this context, being a main bank was quite profitable, as it assured the bank of the largest share of the lending to a client company on a long-term basis. The regulation that effectively restricted new entry to the banking industry had contributed as well to protecting the rents for the existing banks.

Secondly, the government has provided discipline to main banks. Through its regulatory and supervisory powers over banks, the government has played the monitoring role of a main bank for the banks. Once the government discovers that a bank is in difficulty, the government is expected to take appropriate corrective actions, including merging the bank with a healthy bank which operates its business soundly.

***Contingent governance mechanism***

The corporate governance structure with contingent control by main banks worked well in Japan in past years. The main bank system was quite efficient not only for the banks, but also the other stakeholders, who could free-ride the intensive monitoring by a main bank. It was particularly important when financial experts were scarce in the society. Moreover, the monitoring by a main bank on corporate management, especially the *ex post* monitoring, reduced the risk associated with the bankruptcy of the company, so that Japanese firms could get considerable finance from the main bank as well as other lending institutions. It enabled Japanese firms to be highly indebted, compared with those of the UK and the USA, which had contributed to lowering their cost of capital and thereby encouraged them to invest in longer-term projects.<sup>11</sup>

It should also be pointed out that the contingent governance mechanism, heavily dependent on the monitoring role of main banks, has limitations. Firstly, the monitoring should be inevitably biased by the interest of main banks which are typically the largest creditor of their client companies. As suggested above, the agency problem between lenders and shareholders could be lessened by a main bank being a large shareholder concurrently. However, considering that shifts in effective corporate control were often triggered by the financial distress of the firms, the contingent governance mechanism functioned to protect the interests of the lenders rather than to lead to the maximisation of shareholder returns.

Secondly, the mechanism has the inherent tendency to lead to a lack of proper risk assessment by banks and by companies. The competition among banks for their lending volumes, supported by the rents protected by regulation, would induce banks to increase lending without sufficient risk assessment by free-riding on the main bank monitoring; the bank, in turn, is inclined to expand further its credit to the client company in order to protect the merits of being a main bank. As seen above, the higher the leverage of a company, the lower the cost of capital for the company becomes. The volume competition among banks could keep the interest rates for their lending at low levels, which encourages the company to invest in projects with lower expected returns. The lack of effective monitoring from the viewpoint of shareholders is likely to result in poor profitability of a firm and lower returns on equity.

Lastly, the monitoring role of a main bank has to be effectively supported, on the one hand, by the sufficient rents to be earned by the bank in association with the role, and on the other hand, by the sufficient capacity of the bank to exercise the effective monitoring, especially to bear a disproportionately large burden when the client company gets in distress.

It nevertheless worked well in Japan for many years. It is probably because the key shareholders of a given company were mostly its affiliates or business partners, as seen above, which were more interested in continuing the business relationship with the company than in boosting returns on equity, and also because the returns were not excessively low, given the generally strong performance of Japanese firms in the growing economy. The economic expansion in the 1980s also helped to reduce the costs of main banks, as the risks of their clients being in trouble was relatively low and asset price increases created considerable hidden profits for the banks to strengthen their financial base.

***III. Recent Trends***

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<sup>11</sup> More detailed analysis was provided by Fukao [1997] and OECD [1996].

Since the economic bubble in the latter half of the 1980s ended, Japanese economy has been stagnated. In this economic climate in which the performance of Japanese firms has also been disappointing, the traditional corporate governance practices as well as other characteristics of “Japanese management” have come under question. In response, various changes and reforms have recently been observed in the corporate governance structure. This section outlines these changes and reforms. Firstly, it discusses a weakening of monitoring by main banks which played key role in the traditional “contingent” governance structure. Secondly, increasing pressure from shareholders on management is described. The pressure has been intensified because of the shift in ownership structure as well as the change in the attitudes of shareholders. Thirdly, the section looks over the recent or forthcoming changes in some basic rules for corporate management and their influence on corporate governance practices. Lastly, the recent efforts of Japanese firms to reform their boards are illustrated.

## **1. Weakening of Control by Banks**

### *Shift in corporate finance*

High economic growth during 1960-74 created significant cashflows for Japanese companies. As a result, in the following relatively slow growth period, their need for external funding decreased and internal sources of funding became more important in their financing for investment, making the firms less dependent on bank finance. Official statistics show that, in the aggregate balance sheet of listed companies, the ratio of capital to total assets has continuously increased for the last 20 years, while the ratio of fixed liability has stayed unchanged or even slightly decreased (Figure 4).

In addition, deregulation of the financial markets in the 1980s paved the way for Japanese corporations to raise funds in the market. Thanks to their strong financial positions in those days, many Japanese firms could earn high credit ratings, which enabled them to get finance in the markets at more favourable rates than banks offered. This further weakened their dependence on bank finance. This trend has continued in the 1990s (Figure 5).

Decreasing dependence on bank finance does not necessarily mean a weakening of the relationship with the main banks. Research has shown that more than 80 per cent of large Japanese firms do not plan to decrease their borrowing from the main banks (Table 5). However, another survey indicates that approximately 60 per cent of the companies expect the role of the main banks in corporate governance to lessen in the next five years.<sup>12</sup>

### *Less incentive and capability of banks*

By the 1990s, due to increased competition among banks and between banks and financial markets, the rents banks can earn by being “main” banks have considerably diminished. Firstly, financial market deregulation in the 1980s increased competition between banks and securities markets, which reduced dependence on bank finance of Japanese firms, as discussed above. Secondly, competition among banks for expansion of lending volumes had resulted in strengthening bargaining power of the firms in the loan negotiations. This eroded the profitability of the main banks which are expected to supply credit at the most favourable conditions to their client companies. Thirdly, the regulation on deposit rates, which had effectively protected the rents of banks in

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<sup>12</sup> EPA [1997]

increased lending, was gradually eased in the 1980s. It had also contributed considerably to deterioration of the banks' profitability.

In the economic slowdown in the 1990s, the capacity of banks to perform the monitoring functions as main banks over their client firms has been weakened significantly. As a result of the collapse of the "bubble" economy in the 1980s, Japanese banks have suffered from accumulated problem assets, which have eroded their capital base significantly. Responding to such distressed capital situations, the banks have recently been squeezing their balance sheets while trying to increase capital. They have become much more cautious in extending new loans and reluctant to renew existing ones, which has created a serious credit crunch in the economy. The weakened capital base of the banks, coupled with the eroded rents, has discouraged them from performing the *ex post* monitoring function. This has been attested to by some of the recent bankruptcy cases, in which, against the general expectation, the main banks did not save the troubled companies by providing liquidity, nor did they agree to bear disproportionately large burdens in the liquidation of the companies.

The deterioration of their capital base also made it more difficult for the banks to keep a substantial amount of corporate shares, as discussed below. It is likely, therefore, that in the near future, main banks will be obliged to decrease their holdings of the shares of their client companies, possibly weakening the relationship between the client companies and the main banks. The monitoring roles of the main banks would thus become less effective as there would be less insider information. Moreover, an agency problem between the main banks and the other shareholders of the client companies could emerge, which would result in the outside shareholders having to take actions by themselves to monitor the corporations.

## **2. Increasing Pressure of Shareholders**

### ***Dilution of cross-shareholding***

Research shows that the ratio of cross-shareholdings (including holdings by life insurance companies) declined from the peak of 55.8 per cent in 1986 to 45.7 per cent in 1997. More recently, this trend has clearly accelerated from 0.5 percentage points annually between 1987 and 1992 to 1.4 percentage points annually between 1993 and 1997 (Figure 2).

The dilution of cross-shareholding has been induced by the successive deterioration in share prices and profits of Japanese companies since the bursting of the financial bubble towards the end of the 1980s (Figure 6). In contrast to various benefits when Japanese firms showed strong performance in general, such as creating hidden assets to strengthen their financial base, once economic performance worsened the negative effects of cross-shareholding on corporate management have become apparent. Firstly, long-term holdings of such shares deteriorate efficiency in asset management, as the shares pay low dividends and yield little or even negative capital gains. Secondly, the total asset value of a company as well as its profits are exposed significantly to share price volatility, which is intensified by low liquidity in the market resulting from relatively stable holdings of a large portion of the shares. These costs of cross-shareholding did not surface when a company made high profits in its own business and had sufficient hidden assets to cushion the volatility. The costs are now considered to be significant by many Japanese firms, as their own performance has weakened in the economic slowdown and their hidden assets have become eroded after a prolonged period of deterioration in share and land prices.

Fukao [1998] argued that this problem is particularly severe for banks, as well as domestic institutional investors such as life insurance companies, which currently hold a considerable amount

of corporate shares. As a result of writing off huge problem assets accumulated in the aftermath of the financial “bubble”, capital of many banks has been severely damaged so that the costs of holding such stock portfolios have become excessive. It is highly likely, therefore, that the banks will cut their shareholding to more appropriate levels, which will lead to a substantial unwinding of cross-shareholding.

### *Increasing share of foreign investors*

The reduction of cross-shareholding inevitably results in a relative increase in shareholdings by investors other than non-financial corporations, banks and insurance companies. Among such investors, foreign investors have increased their share remarkably. They now hold approximately 10 per cent of total stocks of listed companies (Figure 1). For approximately 12 per cent of the companies listed on the TSE, foreign shareholders own more than 15 per cent of the outstanding shares.<sup>13</sup>

The influence of foreign investors is much more significant in the market, as the liquidity of the market is thin as a result of a large portion of stocks held by “stable” shareholders. The share of foreign investors in the market turnover has increased constantly, reaching almost a third in 1998 (Figure 7).<sup>14</sup> The investment strategies of foreign investors have a substantial influence on the stock prices of the large, reputable companies in particular.

Domestic institutional investors could have played a much more important role in absorbing the shares placed to the market by strategic corporate shareholders, but the reality is that life insurance companies, the largest institutional investors in Japan, as well as non-life insurance companies and investment trusts, have been decreasing their portions in the ownership structure. Only pension funds have increased their share, but it was only 3.3 per cent in 1997, as private pensions play only a limited role in the Japanese pension system.

This is likely owing to the disappointing performance of corporate stocks, but also because, like banks, such institutional investors have lost their capacity to cushion the risk of price volatility of stocks from their clients whose risk profiles are very risk-averse. Fukao [1998] argued that Japanese institutional investors have essentially provided fixed-income financial assets for the household sector while investing in risky assets such as shares and long-term bonds. This risk mismatch was absorbed by their own capital and the unrealised profits on their stock and land portfolios, but these cushions have been eroded significantly by the sustained deterioration of stock and land prices as well as by the poor performance of their other investments after asset price bubbles burst towards the end of the 1980s.

### *Intensified demand of shareholders*

In addition to the shift in ownership structure mentioned above, changes can also be observed in the attitudes of shareholders in two respects: firstly, more shareholders tend to demand higher returns on equity, and secondly, shareholders have started to influence the management directly in seeking higher returns.

The first is the direct consequence of the recent shift in the ownership structure described above. The higher the ratio of “outside” shareholders who seek pure economic returns on their

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<sup>13</sup> As of December 1998

<sup>14</sup> It is the share to the market turnover excluding the transactions conducted by securities houses for their own sakes. The share to the total turnover including these transactions is 18.6 per cent.

investment in shares is, the more the directors have to pay attention to their interests. Moreover, the extremely low levels of the current returns on equity should urge the traditional “insider” shareholders, who stress the importance of the long-term business relationship, to press the directors to deliver higher returns, before disposing of them.

The second aspect is related to the recent tendency of institutional investors to become more active in using their legal rights in order to enhance the returns on shares, rather than simply selling the shares outright when they are not satisfied with low short-term returns. CalPERS (California Public Employees’ Retirement System) which is active in executing its shareholder rights to require more effective corporate governance from the viewpoint of investors, has invested more than JPY 4 billion in Japanese firms, and proposed in March 1998 some concrete actions for Japanese corporations to strengthen their governance. Domestic institutional investors such as life insurance companies and pension funds also have come to voice their interests as investors. In 1998, reportedly, a pension fund managed by a trust bank decided to execute its voting rights against the proposals of the managements at the general shareholder meetings of the particular companies.<sup>15</sup> Other domestic institutional investors are likely to follow this movement, which would lead to strengthening in the control shareholders have over managements.

Activism of shareholders in using their legal rights can be also seen in the increasing number of shareholder litigations against management misconduct, especially after the amendment of the Commercial Code in 1993 to reduce the burden to initiate such actions. This has created considerable pressure on the members of the boards who personally face the risk of enormous financial liability in the result of such litigation. Shareholder litigation clearly distinguishes the board members from the employees, which has a dramatic impact on the recent reform of the board discussed below. It is argued, however, that shareholder litigation may put excessive pressure on directors so as to impede them from making material management decisions promptly, as unlike in the USA, the rule to safeguard directors from lawsuits against their business judgements has not been established yet in Japan.

### **3. Changes in Basic Rules for Management**

#### *Changes in practices and framework of management*

The recent intensification of the activism of shareholders has pushed the managements of Japanese corporations to modify their conduct so as to reflect more closely the interest of the shareholders to maximise their value. An increasing number of the firms have launched measures to improve the efficiency and transparency of management from the investors’ viewpoint. These measures include the more efficient use of funds with share buybacks, introduction of incentive schemes to link compensations of corporate executives to their performance, improvement of disclosure and adoption of the holding company structure.

These measures are supported, or sometimes induced, by various changes in the basic rules for corporate management which have been recently implemented or are expected to be implemented shortly. For example, the amendments of the Commercial Code to lift the restrictions on share buybacks and stock options were initiated by the desire of the companies, while the forthcoming reforms of corporate accounting practices encourage them to improve their disclosure.

#### *Efficient use of funds*

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<sup>15</sup> Nikkei Shinbun, 24 June 1998

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In the traditional governance framework, the managers of Japanese firms tended to pay more attention to their employees and lenders and to pour available funds into the expansion of the business. This use of funds became quite inefficient, however, as the economy slowed and investment opportunities lessened. The increased influence of shareholders has recently forced managements to revise such strategies and to seek more efficient use of funds from the viewpoint of the current and potential shareholders.

One remarkable response is the increasing implementation of share buybacks for redemption. When sufficiently profitable investment projects are scarce, to repurchase and redeem its own shares is an efficient use of funds for a company to meet the interest of its shareholders, as it reduces the number of shares outstanding and possibly leads to higher future returns on equity. Share buybacks had been legally prohibited in Japan, but the amendment of the Commercial Code in 1995 lifted the ban in response to the strong request of the business sector. Since then, the number of companies which have implemented share buybacks for redemption has rapidly increased. The legal amendment in March 1998 to expand the funds available for buybacks has facilitated their usage further. By September 1998, approximately 45 per cent of publicly traded corporations had announced plans for share buybacks for redemption, though the companies which actually implemented it remains 20 per cent of those that announced it (Table 6).

### *Incentive scheme*

Linking the personal interest of directors and employees to their performance is an effective way to increase the efficiency of management and operations. Traditionally the salary of a Japanese worker was connected to his seniority in the life-time employment practices, and reflected the performance of the industry and to lesser extent that of the company. In recent years, however, responding to their disappointing performance, Japanese firms are increasingly setting out the introduction of incentive schemes, especially for company executives, that link compensation to the performance of the company, or when applicable, the specific parts of the company the executives are responsible for.

In this context, some companies have adopted returns on equity or share prices as criteria to measure performance, so as to make clear the desire to maximise shareholder value. This movement was encouraged by the amendment of the Commercial Code in May 1997, which removed the legal impediments to stock options. The amendment was strongly urged by the business sector, and was accomplished quite quickly in the hope of having a favourable influence on the weak stock market. By January 1999, 165 firms, of which 96 are listed, had decided to introduce stock option programs.<sup>16</sup> Modification of the current unfavourable tax treatment, which is now under discussion, would further accelerate the use of stock options.

### *Reforms of corporate accounting practices*

Investors put importance not only on actual economic return but also on transparency in management, as the latter enables them to assess returns and risks associated with their investment appropriately. Especially in the current stagnated economic situation in which remarkable business performance is generally difficult, Japanese firms are obliged to put more emphasis on disclosure. Increasing importance of credit agencies in the market adds to the pressure on the firms, as credit agencies are ready to downgrade a company lacking sufficient transparency, which usually leads to a decline in the share price and an increase in the interest rates paid for borrowing. Many companies

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<sup>16</sup> The numbers of companies are available at the web site of Daiwa Securities Co., Ltd (<http://dvl.daiwa.co.jp/KOKAI/Stock/stock.html>).

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have reinforced their activities for investor relations, and some of them, which have significant ratios of foreign ownership, have begun to hold investors meetings overseas.

In association with this trend, major reforms of corporate accounting standards are about to be implemented. Among various changes, those that should have a significant impact on corporate governance practices are the emphasis on consolidated accounting and the introduction of mark-to-market accounting on financial products. Even though these new practices have been already introduced partly, this reform was not necessarily driven by the business sector but rather by market forces. The recent bankruptcy cases of large corporations raised a question as to the effectiveness of the traditional accounting practices. The reforms also reflect intensified demand from foreign investors and the credit agencies which operate internationally for harmonising Japanese accounting practices with the internationally accepted ones. The new standards are mostly in line with the principles which the International Accounting Standard Committee expects to establish shortly.

Firstly, in June 1997 the Business Accounting Council, a government advisory committee on corporate accounting standards, submitted its recommendation to reform the disclosure required by the Securities and Exchange Act, so that corporate information is provided principally on a consolidated basis. Consolidated financial statements were introduced in 1977, and the number of companies that provide such reports has gradually increased, accounting for more than 60 per cent (2,300 companies) of the domestic companies that submit financial reports to the authority.<sup>17</sup> However, consolidated accounting has had relatively minor roles in corporate disclosure, in which major accounting standards are still built on an individual company basis according to the principle of the Commercial Code. This reform intends to give the major role to consolidated accounting for the disclosure of the companies whose securities are traded in a market, so as to respond the demand of investors for improvement of transparency in management. The new practices will be enforced in April this year.<sup>18</sup>

Emphasis on consolidated accounting not only prevents large, listed companies from dressing up their financial statements by conducting transactions with the unlisted group firms, but also allows the executives to view their companies as a portfolio of businesses. This shift in the view induces changes in corporate structure and moreover corporate governance practices of Japanese firms, as discussed below.

Secondly, the Council also published its recommendation on the introduction of market-based valuation of financial products in January 1999. Asset valuation has traditionally followed the lower-of-cost-or-market method in principle, reflecting the conservatism of the Commercial Code in corporate accounting. This practice resulted in accumulation of unrealised profits for Japanese companies, especially in the early 1980s, and allowed them to expand their balance sheets aggressively, which led to difficulties afterward. Drawing a lesson from this harsh experience, and also seeking harmonisation with international standards so as to appease foreign investors, it has been decided to introduce mark-to-market accounting on financial products in 2000.<sup>19</sup>

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<sup>17</sup> Business Accounting Council, *Draft Recommendation concerning Review of Consolidated Financial Reporting*, 7 February 1997

<sup>18</sup> More precisely, it will be applied to the business year of respective companies starting on and after April 1999.

<sup>19</sup> Applied to the business year starting on and after April 2000, except for valuation on the securities whose holdings are not evident either for trading purpose or for holding until maturity purpose. The mark-to-market valuation of these securities which are considered to include the majority of stocks held by corporations with cross-shareholding arrangements, will be enforced for the business year starting on and after April 2001.

This accounting reform will sweep out unrealised profits and make firms that have a large amount of financial assets more exposed to price volatility in the markets. It will obviously increase the cost of keeping inefficient financial assets, which will inevitably accelerate the recent tendency of liquidating cross-shareholdings described above.

### ***Introduction of a holding company structure***

After years of operation and occasional business expansion, the corporate structure of large Japanese companies has become huge and complicated, with a number of divisions, subsidiaries and related companies. The deteriorated performance of Japanese companies, coupled with the intensified competition with other international firms, has urged them to set out to streamline and reform their organisation by introducing a holding company structure. This movement induced the legal change to lift the ban on creation of a pure holding company in December 1997, which in turn, accelerated the movement toward reform. The first case after the legal change is Daiwa Securities Co., Ltd which decided in its extraordinary general meeting of shareholders on 5 February 1999 to create a pure holding company. Other large companies are also moving in this direction either by establishing a similar holding company or by building a quasi-holding company structure through the creation of independent profit centres in the company, which together with the subsidiary companies, are supervised by the central management.

This movement eventually will be supported by expected legal changes. An amendment of the Commercial Code is expected to result in the introduction of a new method of exchanging shares which would enable existing companies to create a holding company smoothly and economically. The introduction of corporate taxation on a consolidated basis, which would facilitate considerably the creation of holding companies, is also under serious discussion. Moreover, though not a legal change, the forthcoming accounting reform for emphasising consolidated accounting will reinforce this momentum by changing the view of the managements of large companies, as described above.

The holding company structure will make it easier for management to trade its business units with other companies, and thereby facilitate mergers and acquisitions. It will possibly create a market for corporate control in Japan, which would enhance the disciplining of management by market force.

## **4. Reform of the Board**

### ***Board restructuring***

More recently, efforts of Japanese firms to improve efficiency and transparency in corporate management tend to accompany the reform of the board of directors. Various measures have been carried out or discussed in order to strengthen the effective functioning of the boards which are legally responsible for management, and to increase their accountability for the existing and potential shareholders.

The leading company in this respect is Sony Corporation. After introducing a quasi-holding company structure within the company in 1994, Sony decided in June 1997 to downsize the board from 38 directors to 10 by transforming most of the directors in charge of actual management of the "subsidiary companies" into executive officers. It also increased the number of independent directors from two to three, while the remaining 7 directors are concurrently the executives. An increasing number of companies have recently announced plans to downsize their boards by introducing the executive officer system, which usually accompanies the comprehensive streamlining and reorganising of the company with the introduction of a holding company structure.

One may distinguish two factors in this reform, which are in many cases interrelated closely. The first factor is downsizing of the board. It usually intends to improve the efficiency of the board functioning which has been criticised to be superficial because of their size. The second relates to changes in the practical function of directors. The demand from investors for effective disclosure and the eventual reform of accounting standards urge the board to focus more upon overall strategy and supervision of a group of companies than on management of individual companies. Creation of a holding company structure should clarify this change of the function of the board. More importantly, the recently increasing cases of shareholder litigation highlight the legal responsibility of individual board members for managerial decisions by the board. These factors require each director to be competent and fully accountable for management and supervision of the company and its subsidiaries. Obviously this change of the actual role of directors accelerates the significant downsizing of the traditional board structure in which many directors do not actually participate materially in managerial decision making.

### ***Improvement of supervision***

As explained, one of the deficiencies of the traditional board structure is its weak supervisory function over the affairs of directors. In the context of reforming the board to be more accountable for the shareholders, various measures to improve the supervisory function of the board are under implementation or consideration. Roughly speaking, there are two types of such measures: those to strengthen the existing mechanism and those to adopt new a mechanism which is widely used in the USA.

The first type mainly focuses upon enhancements to the functioning of statutory auditors, who are legally expected to conduct supervision over management from outside of the management on behalf of the shareholders. Three elements can be pointed out to reinforce their supervisory function in governance practice. Firstly, their independence from the management can be improved. The concrete measures proposed and seriously discussed include: to increase the number of “independent” auditors required in a board of auditors, to stipulate more stringent definition of the “independence”, and to lengthen the term of service for statutory auditors. Secondly, the actions that statutory auditors can take against the management can be strengthened. Granting to statutory auditors the authority to suspend or dismiss directors would increase the auditors’ power significantly, but little discussion has been made for this kind of drastic action. Finally, the capacity of statutory auditors regarding gathering information on management can be reinforced. In this context, such measures as increase in the budget and staff for the auditors, and closer co-operation of statutory auditors with internal audit and legal section and/or outside professionals, are implemented or planned in some companies.

The measures to reinforce the functioning of statutory auditors, *inter alia* those to enhance their independence from management, seem to focus upon the current discussion on the measures to improve the supervision of the board. A committee in the ruling Liberal Democratic Party published in September 1997 its proposal to amend the Commercial Code, which contains the measures to improve the independence of statutory auditors enumerated above, as well as the review of the framework for shareholder litigation. Japan Federation of Economic Organizations (Keidanren) has also issued a similar proposition.

The second type of measures to improve the supervisory function of the board are based on the introduction of new mechanisms for that purpose, which are popular in the USA. These measures include the appointment of “independent” directors and the establishment of remuneration and appointment committees.

Referring to the U.S. corporations which strengthened the supervisory function of their board by increasing “independent” or “outside” directors who are not executives and who focus upon supervision of the affairs of the executives, some suggest that Japanese companies should also raise the number of such independent directors to a majority in their boards. Recent research shows that independent directors are approximately a third of the directors for large, listed companies on average, but few companies plan to increase the number of such directors in their boards even though they recognise the important role of the independent directors.<sup>20</sup> This is possibly because the supervision from outside of management seems to be regarded as the principal role of statutory auditors, but not as the primary function of directors, who are themselves responsible for managing the company.

Establishment of remuneration and/or appointment committees has not been so popular among Japanese firms, either. There are some companies which have recently established a remuneration committee to determine the compensation of the respective directors and/or an appointment committee to select the candidates for the directors, like the U.S. companies. However, these committees may be different from those of U.S. firms, as they are sometimes composed of “independent” individuals who are not directors nor statutory auditors elected by shareholder general meetings and therefore have no legal responsibilities to the shareholders. One may argue that the committees are necessary in the USA to rationalise high managerial salaries and to choose the competent candidates for director objectively from both within and outside the company, but these issues are not real in Japan.

#### *IV. Future Prospects*

Recently, one can observe a remarkable shift in the corporate governance structure of Japanese corporations, as mentioned above. Research shows that the number of listed companies that have implemented or plan to implement concrete measures to strengthen governance are rather limited (Table 7). This trend seems accelerating nowadays. For example, a half of 17 major banks in Japan have recently introduced or determined to introduce the executive officer system coupled with downsizing the board.<sup>21</sup>

The shift looks heading for governance system of the Anglo-Saxon model. This is not surprising, as the shift is at least partly induced by increasing influence of foreign shareholders, especially those in the Anglo-Saxon countries. Indeed, such a shift becomes common among for the large listed companies that expand their business internationally, but less so among a number of the relatively small corporations to date.

It is not likely, however, that the governance practices of Japanese corporations become identical to the Anglo-Saxon model in the near future. Corporate governance practices are not standing alone, but rather are closely interrelated with various economic and social systems and practices, for example, legal and regulatory systems, financial market systems, employment practices, etc. These systems and practices cannot be completely converged with those in the Anglo-Saxon countries, even though they may move in that direction in the period of mega-competition. In response to the significant changes in business environments, Japanese corporations are now seeking for their own model of corporate governance that is suitable for them in their particular environments.

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<sup>20</sup> Life Insurance Association [1998]

<sup>21</sup> Nikkei Shinbun, 27 May 1999

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**Table 1**  
**Origins of Independent Auditors**

<i>Origins</i>	<i>Number</i>	<i>Share</i>
Group companies	1,509	30.3 %
Professionals	784	15.7
Banks, insurance companies	622	12.5
Ex-employees	584	11.7
Other large shareholders	557	11.2
Other business partners	246	4.9
Public sector	175	3.5
Others	506	10.2
<b>Total</b>	<b>4,983</b>	<b>100.0 %</b>

Source: Toyo Keizai, *Kigyo Keiretsu Souran* [1995] quoted by Fukao [1997]

Note: responses from 2,632 large companies having capital of JPY 0.5 billion or more or debts of JPY 20 billion or more.

**Table 2**  
**The Roles of Main Banks**

	<i>First Section listed</i>	<i>Second Section listed</i>	<i>OTC registere d</i>	<i>Private</i>
Underwriting of bond issues	100.0	100.0	96.9	76.6
Providing guaranty in bond issues in abroad	88.9	96.6	100.0	88.9
Being the largest creditor	87.2	75.8	80.9	81.5
Having the largest deposits of the company	70.1	80.9	83.6	72.2
Having the longest history of transaction with the company	71.7	64.3	70.9	67.6
Holding a large amount of stock of the company	91.6	72.0	70.9	14.1
Having the largest share in handling the employee accounts for salary receipts	59.2	63.7	66.4	55.0
Acceptance of personnel as the board member	45.2	35.0	28.2	16.8
Acceptance of personnel as employees	10.3	12.7	17.3	10.0

(%)

Source: Fuji Research Institute [1993] quoted by Fukao [1998]

Note: The result of the questionnaire research conducted in January 1993. The valid responses came from 321 firms listed on First Section, 157 on Second Section, 110 of OTC registered, and 518 not publicly traded firms, except for the first and second items for which the responses were 239, 69, 65 and 128 concerning the first item and 162, 29, 6 and 9 for the second one.

**Table 3**  
**Expectations by Companies for Main Bank Support in times of Crises**

	<i>First Section listed</i>	<i>Second Section listed</i>	<i>OTC registered</i>	<i>Private</i>
Will obviously help.	63.0	52.9	39.4	41.9
May not help depending on our situation, but we hope they will.	30.1	37.4	50.5	42.9
We used to think they would, but do not any more.	5.4	7.1	6.4	4.9
We have never expected them to.	1.6	2.6	3.7	10.2
	100.0	100.0	100.0	100.0

(%)

Source: Fuji Research Institute [1993] quoted by Fukao [1998]

Note: Percentage of respondents choosing responses to the question, "Do you think you main bank will provide financial support and loans if you are in crisis?" The valid responses came from 315 firms listed on First Section, 115 on Second Section, 109 of OTC registered, and 508 not publicly traded firms.

**Table 4**  
**Contribution to the Main Banks**

	<i>First Section listed</i>	<i>Second Section listed</i>	<i>OTC registered</i>	<i>Private</i>
Contribution to deposits	27.9	22.2	21.8	21.0
Intensive orders for payments and employees-related transactions	21.3	15.8	13.6	14.9
Addition to interest rates	8.8	4.4	1.8	6.4
Purchase of bank stock	7.5	5.1	5.5	5.6
Borrowing of more than needed amounts	2.8	4.4	2.7	4.1
Payment of high bond underwriting fees	8.8	1.9	0.9	1.4
Acceptance of personnel	5.6	3.8	0.9	1.4
Others	0.3	1.3	0.0	0.4

(%)

Source: Fuji Research Institute [1993] quoted by Fukao [1998]

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Note: Percentage of respondents choosing responses to the question, “If you pay costs for your main bank, in what way(s) do you do so?” The valid responses came from 319 firms listed on First Section, 158 on Second Section, 110 of OTC registered, and 618 not publicly traded firms.

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**Table 5**  
**Projection of Financing by Sources**  
(159 firms with more than JPY 10 billion sales)

<i>Financing sources</i>	<i>Current Ratio</i>	<i>Increase</i>	<i>No change</i>	<i>Decrease</i>
Borrowing from main banks	14.5%	21.5%	65.1%	15.6%
Borrowing from other banks	33.4%	12.4%	57.0%	30.6%
Borrowing from group companies	0.4%	1.1%	97.7%	1.1%
Borrowing from business counterparts	1.2%	4.7%	88.4%	7.0%
Other borrowing	7.2%	9.7%	75.3%	15.1%
Domestic bond issue	24.1%	33.7%	51.5%	14.9%
Overseas bond issue	7.1%	20.9%	62.6%	16.5%
Domestic equity issue	7.0%	7.1%	87.1%	5.9%
Overseas equity issue	0.5%	4.9%	92.6%	2.5%

Source: Mitsubishi Research Institute, *Research on Japanese corporate system*

**Table 6**  
**Share Buybacks by Japanese Firms**

	<i>Companies announced</i>	<i>Companies implemented</i>
1995	5	5
1996	16	16
1997	262	78
1998	1,179	186
<b>Total</b>	<b>1,462</b>	<b>285</b>

Source: Life Insurance Association [1998]

**Table 7**  
**Measures to Improve Corporate Governance\***

	<i>Taken</i>	<i>Will Take</i>	<i>Will Not</i>	<i>Not Know**</i>
appointing independent directors***	35.6	4.0	37.9	22.5
appointing executive officers	3.5	10.6	54.9	31.0
downsizing the board of directors	28.6	9.9	31.9	29.6
setting a remuneration committee	0.4	2.0	74.6	23.0
setting an appointment committee	0.6	2.0	74.3	23.1
setting a body for legal compliance	25.8	10.0	38.8	25.4
setting an advisory body of outsiders	3.8	2.6	71.3	22.3

Source: Tokyo Stock Exchange [1998b]

Note\* : Percentages of 1,137 responding companies out of 1,822 companies listed on the Tokyo Stock Exchange.

\*\* : including "plan to take other measures for the same purpose".

\*\*\* : directors who have not been director or employee of the company and its subsidiaries for the last 5 years.