CHANGES IN JAPANESE CORPORATE GOVERNANCE

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1. Introduction

Corporate governance systems vary around the world. These differences result from different legal systems, systems of corporate finance and corporate ownership as well as divergent norms around the firm's responsibilities to its various stakeholders. (Dore 2000). While much research has considered how these differences originated and why they persist (Hall and Soskice 2001, Jackson 2002), less research has considered what happens when different systems of corporate governance come into direct contact. These different systems of corporate governance came into direct contact in Japan. Perhaps the latest example would be the acquisition of the Lehman Brothers brokerage operations by Nomura in 2008.

Foreign ownership of shares of Japanese firms increased from about 10.5% in 1996 to 27.6% in 2008 (TSE 2009). This increase in foreign ownership came as shareholders, primarily banks and insurance companies – slowly sold their shares as a response to financial crisis and changing of accounting standards. While financial institutions held 41.1% of all shares in 1996, by 2008, their share ownership had dropped to 30.9% (TSE 2009).

This change in ownership brought two very different notions of corporate governance into direct conflict. In Japan, shareholders tend to be stakeholders with long term interest in the firm, in addition to the expected return on their equity investment. Banks, for example, held shares as part of a broader relationship of managing financial transactions and supplying loans. Corporations held shares of their suppliers and buyers. These interconnected and complementary sets of relationships supported the fundamental attributes of the corporate Japanese system.

Foreign portfolio investors, on the other hand, had very different interests. They stood apart from the Japanese corporate relational system and had less interest in ongoing business relationships with Japanese firms. These foreign portfolio investors were familiar with the shareholders movements from USA and Europe.

2. Trends in foreign investment in Japan

From 1996 to 2008, the percentage of publicly listed Japanese shares held by foreigners increased from 10.5% in 1996 to 27.6%. The increase in foreign share ownership in Japan reflected a larger worldwide trend. Foreign ownership of listed French firms increased from approximately 12% to 42.3%, while ownership of shares in the UK by foreigners increased from about 17.2% to 36.3% in the 2007. These numbers indicate that this increase in foreign investment was not limited to Japan, but was a worldwide phenomenon. One of the reasons could be the rise of the institutional investors, especially pensions funds. (P. Druker 1997). This trend accelerated as the money managed by institutions increased and as pensions became more willing to invest their funds in equity.

In the 1990s, US investors invested 94% of their assets domestically, while UK investors kept 82% of their assets in the UK (Useem 1998). Slowly moving into the 2000 years, institutional investors began to move their money abroad, as investors were looking to diversify their portfolios across currencies and economies.

The leading foreign investors in Japan were American and European, especially UK funds (Shirota 2002). Most foreigners were institutional investors. In 2008, only 0.5% of foreign investors in Japanese publicly listed equities were individual investors. (TSE 2008).

Foreign direct investment, where foreign investors take a large and strategic stake in a Japanese firm or set up their own operations, received much publicity. Among the one that received the most attention was the Renault's purchase of a controlling stake in Nissan. Signed in 1999, the Renault-Nissan Alliance has built a unique business model that has created significant value for both companies. These investments made by foreign funds had effect on corporate governance and other economic and financial reforms.

A study made by the American Chamber of Commerce in Japan indicated that foreign direct investment in Japan, defined as strategic investment with the intention of transferring management resources and know-how, was quite low in an international comparison. In 2006, foreign direct investment in Japan was 1.1% of GDP, while that in the UK was 32.4%, Germany was 22.4% and US 27.9%.

3. Composition of Ownership

To further explore the identities and objectives of foreign stockholders we examined the ownership of the Tokyo Stock Exchange First Section non-financial firms in 2008. In 11 firms, foreigners had controlling stakes of over 50%, while foreigners owned over 33.3% of an additional 34 firms (this is the level that allows for veto rights over board decisions). In a substantial number of firms, foreign ownership was over 10%. We indentified cases in which the purpose of the foreign shareholder could be classified as strategic. These were cases in which a foreign corporation (not a bank or investment fund) was one of the top 10 shareholder and the investment was for strategic, rather then portfolio purposes. Especially in auto and pharma sectors, foreign investors could be considered strategic. These leaves a substantial number of large and well-known firms of whose shares 30% or more were in the hands of foreign portfolio investors, including Sony or Canon, tabel 1.

Foreign investors had very different interest from the majority of Japanese investors. They had different set of obligations to their beneficiaries than Japanese funds. The US pensions had clear obligations of fiduciary duty mandated by law, as well as the UK funds. Furthermore, in most cases foreign investors were investing purely for return on investment, where Japanese investors were often wrapped in a web of other ties and obligations with the firms whose shares they held, and their own affiliated banks and corporations. Japanese institutional investors tended to be closely linked to banks or to corporations that had other interests in the firms that they were investing (Hiraki 2003).

Table 1: Share ownership by Market Value (All Listed Companies)

Year	Govt.	Financial Institutions								Business Corp.	Securities Corp.	Individuals	Foreigners
		Financial Institutions **Total**	City & Regional banks	Trust Banks			Life Insurance Co.	Non-life Insurance Co.	Other Fin. Institutions				
				Trust Banks **Total**	Investm. Trusts	Annuity Trusts							
1996	0.3	41.1	15.1	10.3	2.2	1.8	11.1	3.6	1.0	27.2	1.4	19.5	10.5
1997	0.2	41.9	15.1	11.2	2.0	2.4	11.1	3.6	0.9	25.6	1.0	19.4	11.9
1998	0.2	42.1	14.8	12.4	1.6	3.8	10.6	3.5	0.9	24.6	0.7	19.0	13.4
1999	0.2	41.0	13.7	13.5	1.4	4.7	9.9	3.2	0.8	25.2	0.6	18.9	14.1
2000	0.1	36.5	11.3	13.6	2.2	5.0	8.1	2.6	0.9	26.0	0.8	18.0	18.6
2001	0.2	39.1	10.1	17.4	2.8	5.5	8.2	2.7	0.7	21.8	0.7	19.4	18.8
2002	0.2	39.4	8.7	19.9	3.3	6.0	7.5	2.7	0.7	21.8	0.7	19.7	18.3
2003	0.2	39.1	7.7	21.4	4.0	5.8	6.7	2.6	0.7	21.5	0.9	20.6	17.7
2004	0.2	34.5	5.9	19.6	3.7	4.5	5.7	2.4	0.9	21.8	1.2	20.5	21.8
2005	0.2	32.7	5.3	18.8	3.9	4.0	5.4	2.2	1.0	21.9	1.2	20.3	23.7
2006	0.2	31.6	4.7	18.4	4.4	3.6	5.3	2.1	1.0	21.1	1.4	19.1	26.7
2007	0.3	31.1	4.6	17.9	4.7	3.5	5.4	2.2	1.0	20.7	1.8	18.1	28.0
2008	0.4	30.9	4.7	17.5	4.9	3.5	5.5	2.2	1.0	21.3	1.6	18.2	27.6

Source: TSE 2009 Statistical Highlights

Institutional investors, such as trust banks, tended to have close equity relationships with banks, and would vote according to the interest of its affiliated bank, which was likely to have close lending relationship with the firm. A corporate pension fund might hold shares in an important business partner of the corporation and would not dare to press too hard as a shareholder. Thus, Japanese domestic institutional investors were part of a system of close relationships that went beyond shareholding stakes and thus were unlikely to demand the same level of returns, as an investor that was looking only at the return on investment, tabel 2.

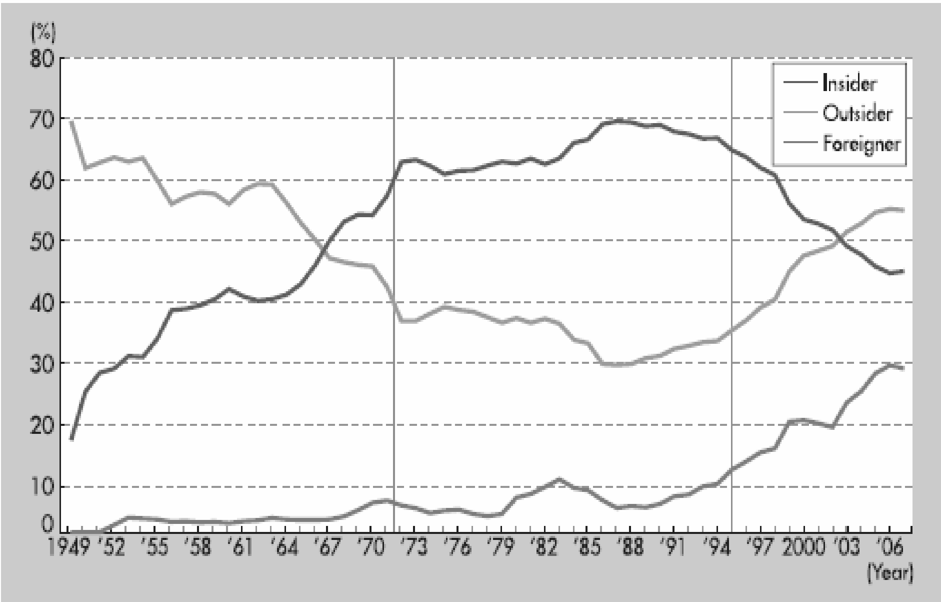
Tabel 2. Share ownership by type of investor

Share ownership (100 mil Yen)					
		Year 2007		Year 2008	
		Value	%	Value	%
Total		5.686.052	100.0	4.002.313	100.0
Govt & Local Govt.		18.634	0.3	15.646	0.4
Financial Institutions		1.768.762	31.1	1.237.432	30.9
	City & Regional Banks	263.395	4.6	189.341	4.7
	Trust Banks	1.017.036	17.9	702372	17.5
	(Investment Trust)	264.979	4.7	195.035	4.9
	(Annuity Trust)	200.547	3.5	140.545	3.5
	Life Insurance Co	308.280	5.4	219.017	5.5
	Non-life Insurance Co	124.536	2.2	88.531	2.2
	Other Financial Inst.	55.513	1.0	38.168	1.0
Business Corporations		1.175.278	20.7	851.372	21.3
Securities Companies		102.178	1.8	62.214	1.6
Individuals & Others		1.028.338	18.1	729.476	18.2
Foreigners		1.592.860	28.0	1.106.171	27.6

Source: TSE 2009 Statistical Highlights

Foreign investors in Japan could influence firms to adopt their desired corporate governance practices through exit – the threat of selling their shares – and through formal and informal exercise of voice – exercising voting rights and making their opinions known through less formal channels. The threat of exit, as well as more informal channels, exercise of voice, provided more effective ways of influence. Foreigners were less likely to wield influence through exercising voting rights, though this had begun to change in the 2000s (figure 1).

Figure 1. Long term trend of ownership structure



Source: TSE: Long term trend of ownership structure

Insider: Aggregate shareholdings by banks, insurance firms and other businesses

Outsider: Aggregate shareholdings by individuals, mutual/pension funds and foreigners

4. Corporate governance practices

For the past 7 years, the Japan Corporate Governance Index Research Institute surveyed Tokyo Stock Exchange First Section firms in their corporate governance practices. Based on these surveys, the JCGIndex measures how close a firm's governance adheres to Anglo-American standards. Practices evaluated include how a firm sets it performance objectives, accountability of the CEO, structure of the board of directors (size, independence, responsibilities), compensation system, management of subsidiaries, internal audit and control, and disclosure and transparency.

The JCGIndex ranges from 0 to 100. A firm that would receive 100 points, would have a significant number of independent directors on its board, and a board that had adopted a committee structure (of audit, compensation, and nominating committees dominated by independent directors). The firm would set its performance goals based on matrices valued by shareholder (return on invested capital) and the CEO would be accountable for achieving these goals, tabel 3.

Firms that scored higher on the JCGIndex tended to have larger percentages of foreign ownership. Another important aspect would be that firms that scored high in board structure and function, had higher levels of foreign ownership than low scoring firms. Firms that received high scores on this component had relatively high levels of board independence as measured by presence of independent directors, criteria for board appointments and the ability and authority of the board to monitor de CEO.

Table 3. JCGIndex Japan 2008

Category	Mean/Total possible points	Achievement rate (mean/total possible points)
Corporate objectives and CEO responsibility	10.6/28	37.9% (36.9%)
Structure and function of the board of directors	10.7/25	42.8% (36.9%)
Management system	17.2/27	63.7% (61.7%)
Transparency and communication with shareholders	13.4/20	67.0% (67.3%)

Source: JCGR Corporate Governance Survey 2008 Final Report

These correlations between the JCGindex and its various subcomponents and foreign ownership demonstrate an association, but not causation. In other words, it is not clear from these results whether foreign investors gravitated to firms that were closer to an Anglo-American ideal of governance. We can only presume that corporate governance issues were a key focus of questions by foreign investors, suggesting that at least some of the causation was due to foreign investors pressuring firms to change.

5. Conclusion

We examined the foreign portfolio investors and their effect on corporate governance in Japanese firms and observed that:

- Foreign portfolio ownership of Japanese equity increased significantly
- Foreign investors were advocates of Anglo-American style corporate governance
- Foreign investors influenced Japanese firms both through exit and voice. Their propensity to buy and sell shares gave them strong influence over share price in general and made exit a particular threat to firms.
- There has been a clear relationship between foreign investors and practices related to corporate governance

Though it is impossible to establish a definitive direction of causation between foreign ownership and corporate governance practices, it is clear that the increase in foreign ownership was linked to the transformation of corporate governance practices in Japan since the early 1990s. Whether foreigners actually influenced firms to change their governance practices or firms changed their governance practices to attract more foreign investors, increased board independence, disclosure and transparency, downsizing and asset divestiture occurred in response to an increase in foreign portfolio investment in Japan.

While the research presented suggested that foreign investors are associated with a shift towards Anglo-American governance practices in Japan, this does not mean that there is likely to be wholesale convergence and that Japan is on course to be exactly like the US. How much is Japanese corporate governance going to change is hard to tell, there are several scenarios, but for sure we will see changes in the years to come.

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