Japanese Corporate Governance in Transition

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Japanese corporate governance is in transition. Such an institutional change can be an evolutionary and path-dependence process, since it may not necessarily follow the same paths taken in other countries, nor converge to existing models elsewhere. The paper deals with (1) a stylised model of Japanese corporate governance, (2) the current problems of existing mechanisms and some emerging new disciplines and players, and (3) some implications for the future of Japanese corporate governance. Throughout the paper, the two-tier and contingent mechanism will be stressed not only as a traditional Japanese model but also a more general model of corporate governance.

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I. Basic Concepts and a Stylized Model of Japanese Corporate Governance

A. Introduction

Japanese corporate governance is in transition. Such an institu-

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tional change can be an evolutionary and path-dependence process, since it may not necessarily follow the same paths taken in other countries, nor converge to existing models elsewhere (Bebchuk and Roe 1998).[1] Thus, it is inherently difficult to predict a definite direction in which Japanese corporate governance will head for. This paper is not aimed at providing a comprehensive survey of corporate governance in Japan,[2] but will address more conceptual arguments which may help crystallize the main issues in its transition.

This paper is divided into three sections. Section I mainly discusses the stylized model of Japanese corporate governance. Section II describes current problems of the existing mechanisms and some emerging new disciplines and players. The final section concludes this paper and presents some implications for the future of Japanese corporate governance. Throughout the paper, the two-tier and contingent mechanism will be stressed not only as the traditional Japanese model but also as a more general model of corporate governance.[3]

B. Definition of Corporate Governance

Before examining a prototype model of Japanese corporate governance, we present a brief discussion of several definitions of corporate governance. Indeed, the span of its meaning is rather large. The narrowest definition is the defence of the shareholder's interest, namely, a disciplinary mechanism, which induces managers to maximize the shareholder value. This view is implicitly based on the assumption of a simple neo-classical firm, which is financed solely by equity. A more realistic view on corporate financing patterns provide a broader definition, for example, "the ways in which the suppliers of finance to corporations assure themselves of getting a return on their investment," as defined by Shleifer and Vishny (1997).

[1] They argue that "even if corporate rules were to converge, path dependence might nevertheless lead corporate structures already in place to persist." Such a possibility is empirically studied by Deeg and Perez (1999) on European countries.

[2] See Tsuru (1996) and OECD (1996).

[3] Dewatripont and Tirole (1994) apply a contingent governance model to banking regulation.

However, some commentators have advocated that these definitions are still too narrow and should be widened to encompass other groups who also keep close relationships with a firm. This view supports that the defence of stakeholders' interest must be the most comprehensive definition, because managerial decisions are seen to influence not only investors but also other natural stakeholders, especially, by creating some "externalities" (Tirole 1999). For example, the closure of a large firm has a dramatic effect on the local economy, but such externalities are not incorporated in the shareholder's value.

C. Stakeholder Society?

We have no intention to stimulate further the philosophical debates on this issue, but we believe that stakeholder's interest might be too broad as a definition of corporate governance.

First, if you assume this definition, the following proposition hold: you could discuss any business issues in terms of "corporate governance." A self-evident corollary is that the most fundamental cause of the Asian crisis lies in their poor corporate governance system. However, such an argument for "crony capitalism" will mask the important mechanisms of successes and failures in these economies.

Second, in spite of the importance of stakeholders and their relationship with management, employment relationship and supplier relationship, for example, could be examined separately from corporate governance issues.[4]

Third, advocates of "stakeholder society" must admit some difficulties in providing high-powered incentives to managers as shown in multiprincipal and multitask agency models (*e.g.* effort substitutions (Holmstrom and Milgrom 1991),[5] conflicts between tasks

[4]Tsuru (1996) defines an economic system as "a nexus of organic connections among its constituent members such as firms, consumers and government." He places the firm at its center and divides the economic system into several sub-systems, each of which corresponds to the firm's relationship with a stakeholder. The sub-systems include corporate governance (shareholders), financial system (creditors), employment system (employees) and supplier system (suppliers). These sub-systems are complementary to each other and thus not independent from corporate governance.

[5]Dixit (1997) also argues that "all these groups (stakeholders) will become

(Dewatripont and Tirole 1999). Thus, "modern incentive theory provides some foundations for the narrow and a priori peculiar concept of shareholder value," as argued by Tirole (1999).[6] We do not deny the merits of "stakeholder society" or "low-powered" incentives, which can only balance incentives among activities within firms and in particular inspire co-operation and co-ordination as stressed by Holmstrom and Milgrom (1994). These merits and demerits, however, should be discussed in a different context. We return this issue in the conclusion.

Last, there is a good reason why shareholders are very special among stakeholders. They play a distinctive role in bearing the residual risks of the firms, letting managers concentrate on their management work. This implies that too much institutional protection of shareholders, jeopardizing their role of risk-taking, might be counter-productive. The fundamental role of corporate governance should be understood as a mechanism to improve the trade-off relationship between incentives and risks for managers, and consequently, enhancing the imperfectly protected shareholders' value.

It is also noted that governance[7] is a very basic concept in the areas of "Transaction Cost Economics" (TCE) (Williamson 1996) or Historical and Comparative Institutional Analysis (HCIA) (Aoki forthcoming). Governance is a mechanism to ensure that a transaction, a contract and a relationship between (or among) economic agents, could be enforced and maintained efficiently. This topic again should be further examined.[8]

principals, with firms as their common agents. Such "politicization" of firms will further lower the power of incentives, which is often already low for other reasons (p. 381)."

[6]Tirole (1999) discusses the merits of the shareholder value model, which could (1) offer plenty of "pledgeable income," (2) focus and sharpen incentives of managers, and (3) prevent foot-dragging and deadlock in decision-making (by undivided control).

[7]For example, trust, social norms, and self-enforcing contracts.

[8]Zingales (1998), applying the incomplete contracts approach (based on their idea that a firm is a "nexus of specific investments," defined corporate governance as "the complex set of constraints that shape the ex-post bargaining over the quasi-rents by a firm." He describes that "the objectives of a corporate governance system should be 1) to maximize the incentives for value enhancing investments, while minimizing inefficient power seeking, 2) to minimizing inefficiency in ex-post bargaining, and 3) to minimize any governance risk and allocate the residual risk to the least risk-averse parties."

D. Two-Tier and Contingent Governance Structure: A Carrot-and-Stick Mechanism

Thus, let us focus more on the mechanisms of corporate governance itself. Our question should be "how to disciple management" rather than "whose interest to protect." In this sense, there are many ways to facilitating corporate control. Holmstrom and Tirole (1989) classify these into internal and external discipline, and the latter is further divided according to their origins, (1) capital market discipline (*e.g.* takeovers, Manne 1965), (2) labour market discipline (*e.g.* career concerns, Fama 1980; and Holmstrom 1982), and (3) product market discipline (*e.g.* Hart 1983; and Sharfstein 1985). Their approach is more comprehensive than that of a popular survey by Shleifer and Vishny (1997), who mainly focus on legal protection and large investors.

The relative importance of each mechanism is quite different among nations. Every industrialized country has developed her own way to disciple managers, at least, among industrialized countries. Comparative corporate governance has been an intensive research area recently (Chow 1997; Hopt *et al.* 1998; and Roe 1998) and detected, for example, differences among the US, Japan and Germany as discussed in detail later.

Despite such diversity, Kaplan (1994, 1995) finds surprising similarities in the effectiveness of corporate governance among these three countries. He examines the relationship between firm performance and management turnover for Japanese, German and US large firms. Controlling for the age and the tenure of presidents, he finds that poor stock performance and earning losses increase the likelihood of top management turnover in Japan, the US and Germany. Thus, the relationship between performance and turnover does not differ among firms in these countries and show striking similarities given the large structural differences in the governance systems in three countries.

This result may lead us to consider some similarities among these different governance systems, which ensure their comparable effectiveness. Our hypothesis is that a good combination of several mechanisms is necessary for efficient corporate governance,[9] since

[9] Hirshleifer and Thakor (1998) stress the complementary relationship between internal control mechanism (board) and external mechanism (takeovers).

there is no single and universal governance mechanism. In particular, a "two-tier" governance structure or a "carrot-and-stick" approach might be useful and corporate governance systems in these three countries can be re-interpreted by this approach. The "carrot-and-stick" approach is a combination of two mechanisms. One is an internal discipline that gives managers positive incentives ("carrot"). The other is an external disciplinary pressure, which could credibly replace incumbent managers when they perform poorly and subsequently transfer control rights to new ones ("stick"). The most typical example is "markets for corporate control," namely, takeovers.

E. Stylized Model of Japan

In the case of Japan, especially, during the 1960s to 1980s, there might be at least an academic consensus that main banks had played a leading role in Japanese corporate governance. Aoki (1994) stresses that the governing structure of top management is "two-tier" (or "dualistic") and "contingent," in the sense that it is controlled by both the main bank and internal labour markets. The controlling power of both parties is, however, contingent on the financial state of the firm.

In normal circumstances, the main bank does not exercise explicit control over corporate policy or management selection despite its position as a major stockholder. Thus, discipline from internal labour markets plays a major role affecting the incentive mechanism in these situations. However, in critical conditions, the main bank involves itself in corporate restructuring. Thus, internal (managerial) labour markets and main bank functions are "complementary."

F. A Discipline from Internal Labour Markets in Japan

We now consider the governance role of managerial labour markets. The more likelihood of internal promotion in Japanese companies implies that managerial labour markets should be a part of the internal promotion system. Existing literature has presented several stylized facts of Japanese internal labour markets (in large companies during the post war period), especially in comparison to the US (for example, Tsuru 1996). Among them, (1) longer job tenure (internal promotion), and (2) less use of performance-based

pay scheme have an important implication for managerial labour markets.

Without a performance-based pay scheme, the selection process of candidates for top mangers sometimes looks like an "elimination tournament" or an "up or out" scheme. A worker who is not good enough to be promoted may keep staying at his job level until his retirement or is induced to leave "voluntarily" and move to another affiliated firm. Better-qualified and motivated workers can stay longer in the firm and climb up its hierarchy. They will consequently move to the posts of top managers.

Thus, the quality and effort level of a candidate for top managers may be screened and monitored from multiple dimensions for a long period. Peer pressure from internal labour markets may serve as a discipline to a candidate for top managers in Japan. However, such peer pressure can work even when they become top managers. Ex-CEOs of large Japanese companies usually do not retire. They keep higher-ranking positions as president or counsellor, having implicit but significant control rights over younger top managers.

G. Intervention by a Main Bank

The active involvement of banks in corporate restructuring was also very important in Japan. For financial distressed firms, control rights of management were transferred to the main bank (*e.g.* Aghion and Bolton 1992).[10] Who will take over as management in the event of financial distress is clearly agreed upon *ex-ante* and explicit intervention by a main bank occurs only in such cases. On the other hand, in the normal or favourable financial states, the controlling power of investors is not visible, while implicit pressure by monitoring is always on management. Thus, a main bank is characterized as "neither attached to nor detached from a firm."

[10]They focus on debt contracts as mechanisms for transferring property controls between two parties (a lender and a borrower). Debt contracts leave managers in control in high earning states but switch control to creditors in low earning states. If financial performance is indicative of where transfers of control from managers to creditors should occur, the debt contracts are superior to contracts that leave either managers or creditors in control in all states. Contingent governance mechanism could derive from more general settings, see Aghion and Tirole (1997) and Burkart, Gromb and Panunzi (1997).

H. A Mechanism Involved in "Markets for Corporate Control"

It has been sometimes argued that the lack of strong and explicit pressure from shareholders indicates a fundamental defection in corporate governance in Japan. However, the contingent governance mechanism by a main bank, with facilitater *the transfer of control rights*, has played a similar role of "markets for corporate control," which had existed typically in the US and the UK. The other way round, if a country has no mechanism like "markets for corporate control," her corporate governance mechanism could not be effective.

This brings us to a question whether Japanese corporate governance has worked well or not in an empirical sense. Some evidence clearly shows that there existed, at least during the 1980s, a successful and efficient governance system whose main actors were the main banks and large shareholders, which penalized poorly performing manager and ensured efficient management, despite the absence of external markets for corporate control in Japan.

For example, Kaplan and Minton (1994) investigate the determinants of appointment of outside directors previously employed by banks or by other non-financial firms to the boards of large non-financial Japanese firms (119 firms; from 1980 to 1988). They find that appointments of both bank and corporate directors increase significantly with poor stock performance. They also show that bank directors are appointed in companies that are contracting or are in financial distress, while corporate directors are appointed in companies that have temporary problems. Turnover increases substantially in periods when outsiders are appointed even when we control for company performance. Company performance stabilizes and improves modestly after both types of appointments.

Kang and Shivdasani (1995), by using a sample of top executive turnover in Japanese corporations (270 non-financial firms from 1985 to 1990), find that the likelihood of non-routine turnover is significantly negatively related to firm performance, particularly when performance is measured relative to other firms in the industry. In addition, firms with ties to a main bank are more likely to remove top executives for poor earnings performance than are firms without a main bank. They also find that some evidence of a marginally stronger relation between stock-price performance and non-routine turnover for firms with high levels of block ownership. Conditional on turnover, they find that a successor is

more likely to be appointed from outside the firm when ownership by the top ten shareholders is high or there exists a main bank relation. It is less likely for firms with keiretsu membership.[11] Thus, Japanese managers can never be insulated from turnover in the case when their performance is bad. In this sense, we cast doubt on claims that Japanese managers can ignore or pay little attention to short-term measures of corporate performance or shareholder value.

The overall effect of main banks on firm's performance is, however, empirically ambiguous. Lichtenberg and Pushner (1994) show evidence on the relationship between ownership structure and corporate performance measured by productivity (total factor productivity) and profitability (the return on assets) for Japanese manufacturing firms (1241 firms: from 1976 to 1989). They find a significant positive relationship between the ownership by financial institutions and the level of productivity or profitability. In contrast, Weinstein and Yafeh (1998) conclude that a firm with a main bank relationship has a slightly lower return or slower real sales growth even in the high growth era as well as in the 1980s. However, the problem of the latter paper lies in their definition of a main bank relation, which is judged by whether a firm can be grouped in financial corporate groups or not. In reality, non-group firms also have main banks and the strength of relations with main banks is variable even among group firms.

I. The German Case

As is well known, German corporate law prescribes a two-tiered board system for joint-stock companies ("AG") and a strict division of responsibilities in a company's management between the management board and the supervisory board. The management board is responsible for the day-to-day operations of the company and for

[11]Such an insulating effect is also found in Morck and Nakamura (1999). By using 383 Japanese manufacturing large firms from 1981 to 1987, they find that the appointment of bank directors is also followed by the firm's poor performance, but there is a marked difference in the process and effect of their appointments between bank-affiliated firms and independent firms. For example, poor current liquidity is a much more important factor to spur bank appointment in independent firms, where subsequent downsizing and cutbacks in entertainment spending is more prevailant than in bank-affiliated firms.

strategic decision-making. The supervisory board appoints the management board and carries out a governance role, by monitoring and controlling it. It is strictly prohibited for the supervisory board to assume any management tasks. Thus, executive directors have some discretionary power on their management decision, insulated from direct pressures from shareholders in normal circumstances ("carrot"), but would be dismissed by the supervisory board when they perform poorly ("stick"). Franks and Mayer (1998) find that there is a clear relation between management board turnover and corporate performance for more than four hundreds German quoted corporations.

J. The US Case

A traditional model of US corporate governance, which had been typically relevant until the end of the 1980s, could also be described as a "two-tier" system. In normal circumstances, managerial compensation plans such as stock options have served as internal discipline to managers ("carrot"). External discipline ("stick") had been provided by the so-called "Wall Street rule."[12] In critical conditions, takeovers had played a central role to replace poorly performing American managers. In the 1990s, the US mechanisms have been drastically transformed, but still keep a two-tier structure. "Institutional investors' activism" has replaced "the Wall Street rule" and the role of outside directors might have been much more dominant recently, with taking the place of takeovers, which have been legally constrained over the past decade.

The two-tier approach to the US corporate governance could shed light on some puzzling empirical results on the effects of institutional investors and outside directors. Despite plenty of anecdotal evidence on their important roles, some comprehensive surveys

[12]In the US, institutional investors have been legally restricted to have a large enough block of shares, which allows them to control an individual company. Even pension funds, which are subject to relatively weak restrictions, are required to diversify their stock portfolio. As a background, American public mistrusts increases in the controlling power of large financial institutions. Consequently, institutional investors were reluctant to monitor management and had simply sold their stocks whenever they mistrusted management (a "Wall Street rule"). This type of behavior of institutional investors had been often blamed for shortsighted management in their investment in the 1980s.

conclude that "institutional investor activism does not importantly affect firm performance" (Black 1998) and that "there is no convincing evidence that firms with majority-independent boards perform better than firms without such boards" (Bhagat and Black 1998). It seems to be clear that under the two-tier structure, only one mechanism is not sufficient to ensure effective governance and good firm performance. The main role of outside directors should be understood as replacing poor performing managers, and this function is consistent with several episodes (*e.g.* GM, IBM, Kodak, and others) and the empirical analysis by Weisbach (1988).[13] We will return to this point later.

II. Japanese Corporate Governance in Transition

The bubble crash and long-lasting stagnation of the Japanese economy in the 1990s have spurred severe arguments against the effectiveness of the existing Japanese corporate governance system, especially the main bank functions. Indeed, several changes in the economic situations surrounding banks have weakened the governance role of the main bank.

A. The Main Bank Mechanism in Trouble

First, the monitoring incentives of the main bank has been lessened by a long-term decline in quasi-rents ("franchise values") in the banking sector due to financial liberalization. Second, ever-increasing non-performing loans and a decline in net worth of banks over the past several years have caused significant changes in lending behaviour. The growth of total bank loans has remained weak[14] and scarce funds have been increasingly allocated to "high-quality" borrowers ("a flight to quality"). More importantly, some main banks can no longer play a role as "a lender of the last resort" and gave up rescuing or rushed to withdraw their funds

[13]Weisbach (1988) shows, by using the dismissal cases of CEOs at 495 NYSE-listed companies, that as the number of outside directors increases, the relationship between corporate performance and the dismissal of CEOs becomes stronger after controlling for the influences of ownership structure, size, and industrial category.

[14]It is noted that the ratio of bank loans to GDP is still higher than that when a "bubble" started.

earlier from financial distressed client firms, who have maintained a long-term relationship with them.[15]

The change in the behaviour of a main bank might be a "rational" response to its deteriorated asset quality, but this may also create negative externalities. Because, a borrower and other banks would reasonably understand this as a "breach of trust," and once "reputation" as a main bank has been lost, it isn't easily recovered. Thus, a long-term relationship between a main bank and a borrower, which gave a strong basis for the main bank governance, might have been weakened significantly. The recent rapid dissolution of cross-shareholding between banks and business firms may well explain such a possibility.[16]

There has been some empirical evidence that hints to the declining role of bank-borrower relationships in the 1990s. Kang and Stulz (2000), by using a sample of 1,380 firms on the TSE from 1986 to 1993, show that firms whose debt had a higher fraction of bank loans in 1989, performed better during the bubble period (1986-9) but worse in the early 1990s (1990-3) in terms of returns. They also find that firms that were more bank-dependent cut more investment than other firms did during the period of 1990-3. In addition, Kang and Shivdasani (1999) compare the corporate governance structure of 177 independent firms that do

[15]A main bank as a leading creditor was often said to co-ordinate with other creditors to provide management support to the financial distressed firm in the form of rescheduling, forgiveness of debt, emergency loans ("a lender of the last resort"). However, it should be noted that the commitment by main banks was neither be rescue uniformly nor punish unequivocally the financial distressed firms. Another point is how we can explain the fact that in several cases, main banks bore a disproportionate share of the costs of associated financial rescue, since a main bank could exert an opportunistic behaviour of withdrawing its funds earlier by sensing the beginning of financial distress sooner than other banks can. This kind of moral hazard, however, had been significantly mitigated by the trust as a "delegated monitor" by other banks. A main bank might be different in the case of other borrowers and that relationship of trust reverses itself. Thus, banks are monitoring one another's main bank functions ("reciprocal delegated monitoring", Sheard 1994). Consequently, if a firm being monitored by a main bank experiences financial distress, the trust of other banks in the main bank is betrayed. Thus, by increasing the penalty associated with the breach of trust, reputation for a main bank has been secured.

[16]The recent volatility of stock prices and increasing risks on their assets give another incentive for banks to dissolute cross-shareholding.

not rely on bank debts, and 177 bank-affiliated firms in 1992. Independent firms, which are significantly more profitable than bank-affiliated ones, show higher levels of equity ownership by management, higher equity ownership by bank blockholders, smaller boards, but similar fractions of outside directors on the board.

B. Structural Deficiency in the Main Bank System?

Our argument support that the traditional governance mechanism by the main bank does not work well in the current economic situations. Some radical commentators further stress the structural deficiency in the main bank system. Namely, inefficient loan allocation to non-banks, real estates and construction sectors, which was a major source of large bad loans in the banking sector, was blamed for insufficient monitoring and credit assessment by main banks, which relied too heavily on land collateral in their screening process. They argue that the inherent ineffectiveness of main bank governance had exacerbated the problems of the bubble economy and bred a hotbed of corporate scandals.

It cannot be denied that the decline in "franchise values" of banks and competitive pressure led to biased loan allocation toward riskier borrower, and weakened the incentive of costly monitoring to some extent, and that bank loans had played some role in the bubble propagation mechanism.[17] However, during the bubble era, when the expectation of a rapid and sustainable land price increase was predominant, more use of land collateral as a screening device was reasonably "rational" and a more cost-saving way than for banks to monitor, in an *ex-ante* sense. This lending behaviour, judged as inefficient *ex-post*, nevertheless, could not be attributed to the structural malfunction of the main bank system.

A more important question is whether another corporate governance system could have prevented the bubbles or not. Our answer

[17]Allen (1996) stress the role of "asymmetry" for the reason that bubbles and crashes occur. For example, consider the case of a real estate market in which purchases are financed by loans. A speculator can earn profits to no limit as long as land price continues to go up, while the possibility of defaulting on loan could limit the loss when the price goes down. This asymmetry could tempt him to pay a price above the fundamental value (the discounted expected payoff). Due to asymmetric information on the quality of assets the borrower is investing, it might be very difficult for banks to sort "good" and "bad" borrowers.

is basically negative. The literature of "noise traders, herd behaviour and social learning"[18] tells us that once a bubble starts, it is not very wise to stick to a "fundamentalist" strategy, even if you know the truth (that this is a bubble!). It might be too risky if you go against a dominant trend and you had better ride on "a band wagon." In this situation, no governance system would be effective in preventing problems related to the bubble economy. Even if you, who knows all about the future, could go to the bubble era of Japan by "a time machine," you would fail to prevent managers from misbehaving: they would simply say, "yes, I know, but, I can not help doing so."

C. Internal Promotion System in Transition

Internal promotion system, the other part of the Japanese corporate governance, has been in transition over the past decade, due to largely long-lasting stagnation. First, "pay-for-performance" has been introduced in Japanese companies, since expected wage growth has declined and the higher weight of middle-aged workers has significantly increased labour costs. Thus, a transfer of compensation over time or across workers in the same company has become more and more difficult. In particular, full-scale liberalization of stock options in 1997 is likely to have a large impact on Japanese corporate governance. The number of companies which had introduced stock options increased significantly from 181 in June 1998 to 335 in June 1999.

D. A "Different" Type of Managers Emerging in Excellent Companies

Second, a very bureaucratic internal promotion system may not work well in the rapidly changing business situations. Let us consider the case of a CEO selection process. Under the internal promotion system, a worker, who continues to be promoted to a "good" job at every step, should become a CEO. Indeed, it is very common that large and long-established Japanese companies have a series of so called "mainstream" jobs (posts), which most top executives have experienced in their internal promotion process. Thus, a "good" worker who is seen as a candidate for a future

[18]For a survey, see Shleifer and Summers (1990), Shleifer and Vishny (1990), and Bikhchandani, Hirshleifer and Welch (1998).

executive post, should have experienced a series of "good" jobs called "mainstream."

But, when economic circumstances surrounding a company change very rapidly, the good "reputation" of a worker, which has been given to him by past standards, may not be relevant to his ability to cope with the current or future management difficulties of the firm. This implies that in such a situation, the path-dependent promotion system might lead to human resource misallocation.

It is interesting to note that some "blue-chip" companies in Japan have recently selected top managers (presidents) of a "different" type.[19] Some of these, who have become CEOs in these leading Japanese companies, have not experienced "mainstream" sections for long, and have instead usually had prolonged experience abroad. Free from their company's tradition, they could drastically restructure these companies, and contribute to improved performance. The selection of a "different" type of managers, which might happen accidentally in some cases, actually played an important role in these companies.

E. More Pressures from Shareholders

While the main bank governance has been damaged, pressures from some shareholders in turn have increased. Among them, shareholder litigation and foreign shareholders are more important. A decline in transaction costs with respect to the representative shareholder litigation[20] has had a real effect on managerial behaviour in Japan. The law change and a subsequent significant increase in litigation cases (from 31 cases in 1992 to 219 cases in 1997) (Kubori *et al.* 1998) have actually played a role of "credible threat" on directors. The best example is that in 1995, some city banks expressed their explicit concerns for the possibility of a shareholder litigation case, when they decided whether they should follow the MOF's guidance to share loan losses related to "the jusen" (housing loan companies).

Next, Foreign shareholders have been more dominant in the

[19]They include Mr. Idei (Sony), Mr. Okuda (Toyota), Mr. Nishimuro (Toshiba) and Mr. Ujiie (Nomura Securities) (see Nishioka and Nagaoka 1998).

[20]An introduction of the uniform fee (8,200 yen) for the representative shareholder litigation in 1993.

scene of Japanese corporate governance. As the share of foreign shareholder has significantly risen in stock ownership from 4.3 per cent at the end of the fiscal year (FY) 1990 to 18.6 per cent at the end of FY 1999 in terms of value. The share of foreign investors has also exceeded those of banks and individuals (respectively 11.3 and 18.0 per cent at the end of FY 1999). Thus, it has become important for managers to pay sufficient consideration to their "voices" explicitly (at the general shareholder meetings) or implicitly.

F. Recent Reforms in Board System

A "credible threat" from the litigation has also provided an opportunity for a number of companies (first initiated by Sony and thereafter followed by many) to restructure a board system, by splitting large number of existing directors into a limited number of "real directors" and other "executive officers." The latter group is free from litigation. This arrangement is also aimed at speeding up board's decision-makings.

Another reform is the appointment of outside directors, which we have recently seen several examples in large companies. Some commentators propose mandatory appointment of outside directors (*e.g.* Corporate Governance Committee 1998). But, their majority may not be necessarily linked with higher performance as seen in the US. Outside directors in a company usually have a close and long-term relationship with the CEO. Thus, the collusion between the outside director and the CEO is likely to occur. One potential mechanism to prevent such collusion is to create a market for outside directors. When the thickness and mobility of this market is sufficiently high, their reputation of "toughness" is evaluated with more weight and this prevents collusive behaviour between the outside directors and the CEOs.

III. The Future of Corporate Governance in Japan

To sum up, the main bank mechanism and the internal promotion system, which consist of the two-tier and contingent governance system in Japan, have been out of order to some extent. The trouble of main bank might be much more severe. New mechanisms or players responsible for corporate governance have emerged, but

their effectiveness seems to be rather limited and uncertain so far.[21] Whichever corporate control mechanisms would die out or emerge, the effective system should maintain a "carrot-and-stick" mechanism. In particular, it is badly needed to breed a new mechanism ensuring an efficient transfer of control rights at "bad" times.[22] Some breaks in the traditional selection process of CEOs are an encouraging sign but further institutional design would be appropriate.

A. Rethinking Relationship Financing: The Role of Venture Capital in Controlling Start-Ups[23]

In order to overview the future of corporate governance in Japan, first we have to ask what kind of governance role banks will play. The typical role of the main bank for large companies would become less and less important, while relationship financing (control-oriented financing) will be still indispensable for small and medium sized companies. Relationship financing is also found to be important for small businesses in the US, where financial liberalization and innovation are highly developed (Berger and Udell 1995; and Petersen and Rajan 1994). To focus more on small business financing, the Japanese banking industry should scale down and specialize more in regional operations. In this sense, recent announcements on some consolidations of city banks are heading towards a totally opposite direction.

Among small businesses, start-ups in new industries have recently become important vehicles for spurring technological innovation in Japan. Thus, it is interesting to ask what the best way to control these start-ups are, and the experience of venture capital industries, which have been the most developed in the United States (see Gompers (1998) and Sahlman (1990) for surveys of venture capital). Venture capitalists are professional investors

[21]Among new potential mechanisms that are not covered in this paper, OECD (1996) emphasizes the disciplinary pressure from pension funds managers (life insurance companies, trust banks and investment advisors), which could be a potential force toward changing corporate governance in the future, and under regulatory changes.

[22]Russia failed to exert a transfer of control rights at the time of mass privatization, and the subsequent insider control might have resulted in stagnated performance of privatized firms.

[23]This part is heavily borrowed from Tsuru (2000).

who raise money from third parties (*e.g.* wealthy individuals and institutional investors) to invest in promoting start-up companies. Start-ups or young small firms, who have not yet established a reputation in capital markets, might be the most severely affected by agency conflicts associated with informational asymmetries between borrowers and lenders. Thus, typical start-ups do not involve much finance, but often use their internal funds, borrowing from family and friends or sources of personal finance. But, when they do not have sufficient funds to finance projects themselves, they must seek outside financing and venture capital which could alleviate the financial constraints faced by these companies.

To mitigate agency problems related to information asymmetries (*e.g.* adverse selection and moral hazard), relationship-based financing can do better since it can provide a good incentive for screening, monitoring and controlling borrowers. However, banks are unlikely to lend their money to companies that lack substantial tangible assets and have a large degree of uncertainty about their future. They might face many years of negative earnings and are unable to make interest payments or meet principal repayments.

In this sense, venture capital has many unique control mechanisms, as an active intermediary to providing strong and close monitoring mechanisms. A typical venture capital is a limited partnership run by general partners who are experienced at bringing up start-up firms and have good knowledge of their portfolio company and related industries. Hence, with this expertise, they can provide management assistance to start-ups, for example, by recruiting management and technical personnel when needed. This means that a venture capitalist is a more informed investor than other intermediaries.

Venture capitalists have strong incentive to monitor the firm, stemming from their equity holdings in the firm that they finance, sharing in both upside and downside risks. In addition, they usually sit on the boards of directors, having effective control rights to appoint or remove the managers or design their compensation packages. However, the most important control mechanism that a venture capitalist employs comes from the staged timing of capital infusion. Funds are always provided in stages, and the entrepreneur receives only enough funding to reach the next stage. Venture capitalists can maintain their option to terminate funding, thus imposing a credible threat and discipline on the portfolio firm.

Other important control mechanisms include the syndication of venture capital investments for the purpose of multiple checks and the use of convertible securities as a contractual arrangement between a venture capital and a portfolio firm.

All these unique control mechanisms can reduce agency costs associated with financing start-ups or young companies, and significantly improve resource allocation. However, the most important concern for a venture capitalist is its exit strategy, namely, how they can successfully cash in their investments. In the case of the United States, successful venture capital investments are often realized by making an IPO in the NASDAQ, the best known of the second-tier markets for trades in young and innovative companies.

The financial challenges to start-ups are their agency costs and high risks. Agency costs can be reduced by various control mechanisms by venture capitalists. These mechanisms are partly similar to those of main banks in Japan, but staged financing in particular appears to give more control power to venture capitalists. High risks associated with these companies can be diversified only by well-developed stock markets by facilitating the use of IPOs as an exit route. Hence, fund raising, interim-control and exit mechanisms are equally important and complementary for venture capital finance. In fact, the venture capitalists control mechanisms by reducing informational problems, can facilitate an efficient exit via IPOs. Then, a successful exit by an IPO can establish a venture capitalist reputation ("reputation capital"), and further attract investors and the organizing of new funds.

The nature of venture capital can well explain why it has been poorly developed in Japan (*e.g.* Milhaupt 1997). Most venture capital funds are affiliated to banks or securities companies. Employees in these funds, who are usually seconded from the parent's bank, are unlikely to have special expertise for start-ups or high-technology industries. In addition, Japanese venture capitalists provide funds mainly through bank loans, unlike American counterparts providing primarily equity financing.

Under these circumstances, the need for facilitating IPOs of high-growing start-ups has been seriously considered. An important step was taken to create new markets, the "Nasdaq Japan Market" and the "Mothers" (the market of high-growth and emerging stocks) in the OSE (Osaka Securities Exchange) and the TSE (Tokyo Securities Exchange) respectively in 1999. However, the US

experience tells us that effective governance system by well-experienced venture capitals should go hand in hand with the activation of stock markets.

B. Corporate Governance and Restructuring: The Transfer of Control Rights and Creative Destruction

To conclude this paper, we discuss the implication of corporate governance for industrial restructuring. The past decade has often been called "the lost decade" in which the Japanese economy has continuously suffered from stagnation. Non-performing assets in terms of loans, human and physical capital stocks have been a large burden on the recovery of the economy. The history of capitalist economies demonstrates that Shumpeterian "creative destruction" process can allow for the reorganization of these non-performing assets and free resources to move to new and productive use.

In this creative destruction process, transfer of control rights, or the mechanism of "markets for corporate control" can play a crucial role, since new management has few commitments in the past decision-making of the firm and can more freely reorganize the firm. In Japan, a transfer of control rights to the main bank was one of the effective mechanisms in corporate restructuring. For example, Kang and Shivdasani (1997) examine the restructuring of 92 Japanese firms that experienced a significant decline in their performance between 1986 and 1990 and implemented a number of downsizing measures. They find that the frequency of asset downsizing and layoffs in these firms increases with the ownership by their main bank and other blockholders.

An obstacle to more radical corporate restructuring necessary for Japan may be a nexus of implicit and long-term relationships, and implicit commitments, between firms and their stakeholders, which was believed to be a competitive edge of the Japanese economy in the past. To maintain these relationships, related parties have committed themselves to make relation-specific investments (*e.g.* monitoring). Since these costs are normally sunk, it is difficult to break such relationships, even when this relationship is *ex-post* unprofitable. A typical example is a theoretical model of "soft budget constraints" by Dewatripont and Maskin (1995).[24]

Thus, a drastic transfer of controls like takeovers can do better,

by breaking up a set of implicit contracts with their stakeholders and making it easier for corporate management to get out from a trap ("co-ordinated failure"). Shleifer and Summers (1988) criticise such a mechanism as "breach of trust," since a loss of these "invisible assets" could weaken the *ex-ante* incentives to undertake specific (sunk) investments (*e.g.* workers' moral), and thus might be related to a decline in the US industrial competitiveness over the 1980s. It is, nonetheless, noted that diversified conglomerates that were assembled during the 1960s and 1970s were dismantled by takeovers and related corporate restructuring in the 1980s. This process was likely to be more value enhancing for the US firms, as shown by the recent literature on corporate diversification (Tsuru (2000) for survey). While restructuring-oriented takeovers are still rare in Japan, we hope that Japanese firms will reorganize themselves very flexibly by using newly introduced measures including pure holding companies and corporate spin-offs.

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[24]In a similar context, Cremer (1994, 1995) stresses that monitoring, by giving a "second chance," can weaken an *ex-ante* discipline. Aghion and Tirole (1997) discuss that intervention by monitoring can lower the initiatives of agents.

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