CORPORATE GOVERNANCE IN JAPAN:

A FUTURE SCENARIO

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February 2, 2000

Japanese translation forthcoming in

Security Analysts Journal [Shouken Anarisuto Jaanaru], January 2000

Abstract

To reinvigorate the Japanese economy, corporate governance changes need to be backed by shareowner power to make them effective. One possible mechanism for coordinating shareowner influence is "corporate monitoring", in which they use company funds to hire an independent agency for advice on voting issues. This can enhance stock returns without suffering the shortcomings of American corporate governance, including low job security, excess CEO pay, and short-termism. Such a system could be implemented by shareowners of those Japanese firms with a low percentage of shares cross-held by other firms. The high levels of cross-holding (50% or more) typical of large Japanese firms can enable managers to out-vote the firms' owners. Government pressure may be necessary to decrease such management control. This corporate governance proposal can also be combined with reform of corporate tax and deposit insurance systems to recapitalize and revive failing banks.

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1. Introduction

There are many possible future scenarios for the evolution of corporate governance in Japan. This article presents one scenario, with a prescription for investor and government action to make it happen. The value of this exposition may lie more in stimulating thought and discussion than in forecasting accurately.

Many authors agree that improving the corporate governance of Japanese firms is essential for reviving the Japanese economy. To this end, the Corporate Governance Forum of Japan (1998) proposed its "Corporate Governance Principles", calling for such changes as choosing a majority of directors independent of company management. Fukao (1998) predicts that management accountability to shareowners will improve because of gradual unwinding of cross-holdings[1], and increasing share ownership by trusts and foreigners. Gibson (forthcoming) concurs with the call for greater board independence, and recommends more equity-linked compensation for boards and top management.

Section 2 of this article emphasizes that managers have both the power and the incentive to severely limit their accountability to shareowners, by maintaining the level of cross-shareholding. Section 3 explains how, if the cross-holding problem can be solved, shareowners will be able to implement a new system for ensuring management accountability, using the internet and independent agencies to advise them on voting and nominating directors. Section 4 describes how this system can be adapted to fit Japanese social and political preferences, especially regarding treatment of employees. Steps for implementing the system are laid out in section 5, including government policy options. Section 6 proposes a specific application designed for recapitalizing failed banks, with related banking reform measures. Conclusions are in section 7.

2. Cross-holdings prevent corporate governance reform

It is all very well to call for corporate governance improvements, but who is going to make them happen? Who has both the power and the incentive? It is not in managers' interests to be accountable to anyone; better to have full freedom of action. Cross-holding of enough stock by cooperating counterparties can prevent the firm's beneficial owners from exerting any control. We can not expect management to give up this arrangement voluntarily.

Consider the goal of increasing the number of independent non-executive board members. Who will choose them? The incumbent board, whose incentives are to maintain board loyalty to the group in power. With no incentive to support the goal of independence, director nominations will become an exercise in window-dressing, making the appearance of independence without the substance of it. Friendly directors will be chosen who satisfy the independence requirements on paper only. Those directors who support owners' interests over management will be dropped from nomination next time.

Gibson (forthcoming) points out that "a decline in cross-shareholding would also seem to be a prerequisite to an active market for corporate control." It is also a prerequisite to effective voting pressure of owners on management. Fukao (1998) describes how the need to fulfill capital requirements encourages banks to sell some of their stockholdings. But it is wishful thinking to believe that this will lead to the unwinding of most cross-holding in Japanese companies generally. The economic motive to keep voting control is too great, especially faced with rising investor activism and foreign ownership. In such situations, managers can be expected to *increase* cross-holdings unless something is done to prevent it.

Bebchuk, Kraakman and Triantis (1998) model the agency costs of cross-shareholding and other structures that separate control from cash flow rights. They find these costs can be very high, worse than majority-versus-minority-owner agency costs, and worse than highly leveraged capital structures. This supports the view that the cross-holding problem must be solved in order to improve corporate governance.

3. Idea: Collective action for dispersed shareowners

If management's control of voting could somehow be reduced, we must consider how shareowners are expected to wield their newfound voting power. This section proposes a new system of corporate governance that gives shareowners considerable influence, even more than in America today. It is designed to correct some shortcomings of American corporate governance, including excess CEO power and pay, short-termism, and mass layoffs.

So suppose for now that there is no cross-holding. (Later we return to how this could be achieved.) All shares are held by their beneficial owners, or by trusts that are more loyal to their beneficiaries than to managers of firms whose shares they hold. Suppose further that ownership is dispersed as in America, with no one holding more than 5% of the shares at most firms.

Shareowners can influence management by how they vote their stock, by nominating directors, by making proposals put to shareowner vote, and other means. All take time and/or money. Any shareowner spending time or money to improve the company's profitability, will be helping all the other shareowners. Even with an ownership stake as large as 5%, she will only reap 1/20 of the benefit, while paying 100% of the cost of her effort. The other owners are "free-riding". This cost/benefit imbalance discourages voluntary monitoring of management by any individual or institutional investor.

The board of directors is supposed to solve this free-rider problem, by monitoring management on behalf of the shareowners. They are paid from company funds, and hence by all the owners, so no free-riding there. However, even in America selection and compensation of directors are influenced more by management than by owners, so the board tends to serve management interests and not monitor effectively.

Formally, shareowners elect directors, but there is typically just a single slate of candidates, nominated by the incumbent board. Nominating competing candidates and becoming informed about them so as to vote intelligently, are both limited by the free-rider economics described above.

A solution to this problem can be designed based on proxy advisory firms (PAFs), which for a fee advise institutional investors on how to vote their stock. American pension fund regulations require them to vote, in spite of the free-rider problem. Rather than pay their own staff to research each voting issue, most pension funds buy advice from PAFs. But individual investors and many mutual funds choose not to buy such advice, so many of them don't vote, or unthinkingly vote with management.

Independent voting advice benefits shareowners as a group, so they should buy it as a group, not one at a time. Proxy advisory firms should be paid from company funds to make their voting advice available to all. This idea was first conceived by Latham (1999b) and formally proposed to nine American companies, listed on the web at www.corpmon.com, to be voted on at the year-2000 shareowner meetings.

In contrast to the selection processes for directors and for auditors, management and the board would not nominate advisory firm candidates. Any PAF could offer its services and name its price. Shareowners would then vote to choose among competing advisors. The key factor for success of this system is then the ability of investors to easily assess the quality of each PAF. They will do so in much the same way as consumers assess the quality of personal computers: by reading compilations of informed opinions in the media. It will be much more feasible to learn PAFs' reputations than to learn director candidate reputations, because there would be only about ten PAFs nationally versus hundreds of director candidates for all companies. That is why competition for director positions would not work.

Nonetheless, some free-rider problem would remain -- the time required to choose among PAFs. Some shareowners would still save time by not bothering to vote. Fortunately, the internet will make voting very easy, both physically and mentally, as predicted in Latham (1999c). To take advantage of the fact that increasing numbers of investors will be connected to the internet, it will be used for transmitting proxy materials, advice on voting, and for voting itself. Already in America, many stocks can be voted via the internet. Eventually, shareowners will be able to rank advisors (including management and independent advisors) once, and tell their computers to automatically vote all their stockholdings according to that ranking for the indefinite future, until they change the ranking. Thus those who wish to can spend minimal time and still vote independently, while those willing to spend more time to decide on their own can still do so.

After instituting this company-pay system and learning to trust proxy advisory firms, investors will realize that they can benefit even more by expanding the function of such an intermediary. Voting advice is not the only way to monitor management. Even more important is to determine what will be voted on. The proxy advisors could expand into nominating directors, negotiating compensation packages, and drafting proposals, effectively assuming the role of activist investors, becoming the "corporate monitoring firms" described in Latham (1999a). That article focused on nominating directors; by starting just with voting advice, the current article offers a more modest intermediate step. This sequence of enhancements to shareowner influence would result in higher stock returns, more realistic CEO pay, and a balance between profits and social goals.

4. Design: How to adapt corporate monitoring to Japan

Is shareowner power compatible with Japanese society? In particular, would it induce mass layoffs of employees who thought they had jobs for life, and are ill-prepared for the devastating prospect of unemployment? The corporate monitoring system proposed here is designed to correct various corporate governance problems in America today, including the frequency of mass layoffs. Furthermore, there are several ways it can be adapted to suit the Japanese preference for more stable employment.

When considering the effects of shareowner power on layoffs, it is important to distinguish one-time transitional effects from ongoing steady-state effects. Section 5 below will show how to protect Japanese workers in a transition to increased shareowner power. If such protection is lacking as in America, companies that have overexpanded are likely lay off workers in a transition back to an economically justifiable size. The problem in America is that shareowner power is not exerted consistently. It is only exerted after the effects of mismanagement have become painfully obvious. Only then will a raider or shareowner activist have sufficient incentive and support to force corrective action. The result is a cycle of corporate bloat followed by drastic cuts, a wasteful cycle which does not maximize share value, although it's better than never taking the corrective action. Better still would be not to allow the corporate bloat in the first place. A corporate monitoring system that makes managers act in the owners' interests would prevent such overexpansion.

Another reason for poor treatment of employees in America is "short-termism" -- management to maximize short-term profit at the expense of the long-term value of the company. A company that neglects training and fires workers easily may make more money temporarily, but will get a bad reputation as an employer, and have difficulty in attracting and retaining good people, thus damaging its long-term value. Would increasing shareowner power make this better or worse? Many observers blame shareowners for making managers overemphasize short-term quarterly earnings.

The root of this problem is that shareowners lack information about management policies, so they overreact to what little information they have, such as quarterly earnings. It is too difficult for investors to assess accurate reputations for managers and directors of each company in their portfolios. A key benefit of corporate monitoring firms is that there will be few enough of them, in business for long enough, that the investment community can learn their reputations. Then suppose shareowners in a company are voting to choose between two monitors. Monitor A has a reputation for encouraging management to maximize short-term earnings at the expense of long-term value.

Monitor B has a reputation for encouraging maximization of long-term value, although short-term earnings may suffer. Choosing which monitor would maximize the short-term stock price? Answer: monitor B!! If traders believe that the stock price will be enhanced in the long run, then it will be enhanced in the short run also, in spite of poorer earnings. Thus corporate monitoring will reduce short-termism. This will not only improve treatment of employees, but also other consequences of short-termism such as distorted accounting.

Several enhancements can further strengthen the cooperation between employees and shareowners. One is for employees to become shareowners. Then they naturally participate in the empowerment of owners, and benefit from profitability gains.[2] Another enhancement is employment contracts with explicit compensation for being laid off. Finally, if it is felt that existing Japanese law does not provide sufficient protection, it could be strengthened. However, there seems to be a growing recognition among Japanese that individuals should assume somewhat more risk than they have in the past.

Japan and other countries are reluctant to adopt American corporate governance because it seems to allow unreasonably high CEO pay and power. Corporate monitoring would enable owners to limit both, while at the same time enhancing profitability. The monitoring firm would have the resources and incentive to determine what level of compensation will maximize shareholder value, in contrast with the current system's lack of checks and balances. Truly independent nomination of directors would permit a meaningful separation of the board chair from the CEO role. Impartial accounting could then be enhanced by having the CFO report to the chairman instead of the CEO. A less hierarchical power structure would develop, supporting more consensus in decision making.

Effective monitoring of management by owners would also reduce the characteristic Japanese problem of *soukaiya*, who extort payments by threatening to embarrass managers, and earn fees for suppressing shareholder dissent. Clearly, this is not in the owners' interests, so investors would vote for monitors with reputations for preventing them.

5. Implementation: How to start corporate monitoring in Japan

This article has presented the view that increasing shareowner power by creating a corporate monitoring system can revitalize the Japanese economy without causing unacceptable levels of unemployment. What would it take to bring about such a transition? A number of current trends are already leading in that direction, but market forces may not be enough to break management's voting control of major companies. Government pressure may ultimately be needed to reduce cross-holdings or change the way they are voted.

Corporate monitoring is likely to be tried in the U.S. before it is tried in Japan. As mentioned in section 3 above, a proposal for the company to pay for voting advice for all its shareowners was recently submitted to nine American firms. If that initiative is successful, especially for improving stock returns, investors in Japan and other countries will want to implement it too.

Internet use by Japanese equity investors is growing rapidly. Especially when more investor communications are conducted via internet, that will increase investor participation in voting, and make it easier for investors to share information on voting issues.

Ownership of Japanese equities is changing in several directions that will amplify shareowner voice. Holdings by Japanese trusts and foreigners are growing, while cross-holdings by banks and industrial companies are falling, at least to some degree -- see Fukao (1998) and Tokyo Stock Exchange (1999).

Venture funding of Japanese startup companies is taking off, with Y600 billion of private equity raised in 1999 versus less than Y30 billion in each of the four prior years [Edwards (1999)]. It will be much easier to implement a new value-enhancing corporate governance structure when these new companies go public, than to shift power away from entrenched management of a mature firm with cross-holdings in place. Likewise, many existing Japanese firms have less than 25% of their shares cross-held, so their shareowners may be able to use voting pressure to institute corporate monitoring.[3]

It is ironic but perhaps inevitable that governance improvement will come last to those companies that need it most -- large mature Japanese firms. Maintaining cross-holdings over 50% could enable management to keep control for a long time. Over a period of decades, corporate monitoring should enable its more efficiently managed companies to grow larger than old-style firms, so eventually dominating the economy anyway. But much waste could be saved by accelerating the process.

Why does the law require shareowner voting at all? Why aren't all decisions left entirely to management? Because management has obvious conflicts of interests in such decisions as whether to fire themselves, and how much shareowner money to pay themselves. So allowing managers to vote stock that they do not personally own, but rather was purchased with shareowner funds, is similarly fraught with conflict. The fact that it is not their own company's stock that they are voting does not remove the conflict, because of the well-known arrangement of friendly voting of mutual cross-holdings. These votes are bought.

The laws regulating voting of customer shares by brokers in America provide a useful comparison. On routine matters such as voting for directors when there are no opposing candidates, brokers are permitted to vote their customers' stock, and they vote overwhelmingly following management recommendations. But because of the likelihood of management influence through business connections, brokers can not vote customer stock on contentious issues, such as on shareholder proposals, and for directors when there is an opposing slate. For the same reason, on contentious issues cross-held stock should only be voted by its beneficial owners. It is not personally owned by the managers. If systems are developed to pass votes through from shareowners of the cross-holding firm, then that voting would be appropriate. Otherwise, those shares should not be voted. This applies also to stock held in corporate pension funds, since management can easily influence those votes.[4]

Managers may claim that they are protecting the interests of employees, who might be hurt by increased shareowner power. But Japan's current economic malaise indicates that employees are not so well protected by this kind of governance system after all. As outlined in section 4 above, corporate monitoring will encourage owners to cooperate with employees for their mutual long-term interests, and can be further adapted to provide secure employment.

For yet another layer of worker protection, legal prohibition of cross-held voting could be made conditional on approval by majority vote of employees. To arrange this, beneficial owners could first be empowered to use company funds to hire an independent negotiator to design an employee compensation package. For a simple example, the company's owners could offer to give enough newly issued shares to every employee, to persuade them to approve the transition to a shareowner-controlled firm. If this corporate governance reform would truly increase social welfare, then a mutually beneficial deal should be possible.

6. How to transform a failed Japanese bank

Banks deserve special consideration in any plan to revive the Japanese economy. The ideas presented here for improving corporate governance can be applied to banks, but several other problems must be addressed at the same time. In particular for insolvent banks, the government must decide how to protect depositors and employees while minimizing the cost to taxpayers, and most importantly, how to prevent recurrence of such a wasteful crisis. The silver lining of bank failure is that it provides a unique opportunity to implement fundamental change. For example, the old equity of a failed bank is virtually worthless, so cross-holdings can be eliminated in a recapitalization.

Besides poor corporate governance, there are two other main causes of the banking debacle: double taxation of equity, and subsidized deposit insurance. In Japan and the U.S., not only for banks but for all firms, returns to equity are taxed twice -- at both corporate and personal levels -- whereas returns to debt are taxed just once, at the personal level only. Interest paid on debt is tax-deductible to the corporation, while dividends are not. This creates a strong incentive to use more leverage, especially for financial intermediaries.[5]

A clear illustration of this unequal tax treatment is the securitization of bank loans. Such transactions have been used to "solve" the problem of nonperforming assets on bank balance sheets, by selling them for a discounted cash amount. They are then held in pools, with payments passed through to investors. Contrast the tax treatment of such a pool with a hypothetical "bank" that holds the same assets, has no deposits, and is 100% equity financed. The "bank" would pay corporate income tax, whereas the securitized pool would pay none. This distortionary tax system causes banks to lever, and then regulators worry about inadequate bank capitalization!

Briefly then, a failed bank could be taken over by regulators, recapitalized by injecting enough government funds to raise its capitalization to a comfortable level of perhaps 25% of assets, then sold to the public in a new equity offering. It would then operate under a new tax regime, with no tax penalty for equity.[6] With no incentive to lever, regulation to maintain minimum capital requirements would be much easier. An accelerating schedule of insurance risk premia could keep capital around 25% of assets or above, with no economic harm from maintaining such a high level. A detailed example is in Latham (1998).

Bank management that is accountable to shareowners will make lending decisions on a sound economic basis. Thus implementing a corporate monitoring system will complete the conditions needed to prevent a recurrence of disasters. As described in previous sections, this transition can be designed with sufficient employee protection. Just as owners will find it in their long-term (and thus short-term) interest to treat employees well, they will be led to treat borrowers well too. Anticipation of better management will enhance the recapitalized bank's stock issue price, lowering the net cost to taxpayers.

7. Conclusions

The Corporate Governance Forum of Japan (1998) recommendations are inadequate, because cross-holdings prevent accountability of managers to shareowners. For any such reform to be effective, shareowner power must increase to back it up. Fortunately, several trends are now leading toward greater investor influence, including growing stock ownership by trusts and foreigners, and spreading use of the internet.

A new mechanism for coordinating shareowner voice is now under consideration in America, and may become a useful tool for investors in Japanese companies. "Corporate monitoring" lets shareowners use company funds to hire an independent agency to provide advice on voting and other matters, such as director nominations. By putting owners' interests ahead of management, this promises to increase stock returns while avoiding short-termism and excessive CEO pay. Because it is in the owners' long term interest to treat employees well, a level of job security compatible with Japanese society can be maintained.

Corporate monitoring can be implemented by shareowners of Japanese firms with low levels of management cross-holding. For most large mature firms where cross-holding is high, government pressure will be needed to enable owners to exercise their property rights.

Bank failures provide a unique opportunity for fundamental reform, not only of bank corporate governance, but also of tax laws and the deposit insurance system that distort incentives and encourage waste.

Endnotes

1. About half of Japanese company shares are owned by other companies -- see Tokyo Stock Exchange (1999).

2. To avoid the agency costs of employees voting to overpay themselves, employee ownership should be restricted to either below 30%, or else 100%. It is probably best to apply this same restriction to any potential controlling group.

3. Policy-holders could also institute corporate monitoring of mutual life insurers.

4. Confidential voting would also help guard against vote-selling, in its various forms.

5. Discussion of why this causes less trouble for industrial firms and for U.S. banks would overly lengthen this article.

6. There are several ways this could be arranged: taxing income only at the personal level, taxing corporate income before interest, taxing total assets etc. The tax rate should be determined so that this unlevered bank pays a comparable amount of tax as the typical levered bank.

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