Japanese Financial Instability and Weaknesses in the Corporate Governance Structure

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The sudden collapse of major financial institutions in November 1997, which were subject to examination by the authorities and external auditors, brought about the extraordinary situation whereby financial institutions lost mutual trust in the soundness of business operations. The interbank money market started to malfunction and an intense credit crunch emerged. Japanese financial institutions, companies and Asian nations faced a severe tightening of bank credit. The biggest causes of this turmoil are the Japan's weak accounting system, and the excessive stock portfolio held by banks. To restore confidence in Japan's financial system, corporate governance of financial institutions must be overhauled. (*JEL* Classifications: E44, G21, G28, G30, M40)

I. Preface

In November 1997, the failure of Hokkaido Takushoku Bank and Yamaichi Securities sharply increased financial instability, and this in turn resulted in a loss of confidence in the accounting, auditing, and disclosure systems that form the basis of the Japanese credit system. As concern over financial instability increases, the interbank

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credit markets have become clogged and many banks have seen their cash flow tighten. As a result, bank lending started to contract, hurting the cash-flow of Asian companies as well as Japanese. It has induced corporate bankruptcies, and exacerbated the Asian currency crisis. In December 1997, falling share prices resulted in a reduction in the capital of banks, which hold large stock portfolios, and this caused banks to further reduce their lending, in the onset of a vicious cycle of credit contraction. The contraction has been abated somewhat by the Emergency Economic Package announced by the Liberal Democratic Party and Ministry of Finance at the end of the year, which helped share prices to recover after the holidays. However, the fundamental problems behind financial instability – the weakness of accounting and surveillance systems, the excessive stock portfolios of banks, and the existence of enormous amounts of bad loans – have yet to be addressed. There is reason to worry about credit instability spreading if the markets lose their confidence in the government's ability to deal with the problems. The near nationalization of the Long-Term Credit Bank of Japan in October 1998 has confirmed the remaining instability of the Japanese financial system.

The bankruptcy of major, listed financial institutions has resulted in the dismissal of large numbers of employees. Employees at large companies in Japan work and design their lives under the assumption that their employment is long-term (probably lifelong), and the layoffs have both increased worries about job stability and reduced resistance to changing jobs.

This paper focuses on the relationship between corporate governance and the weakness of the banking sector, which the author considers to be one of the important factors behind Japan's current financial instabilities. In the course of this paper, the author considers the changing relationships between Japanese companies and banks. It examines in particular detail how changes in the economic environment (i.e. the post-bubble stock market crash, the deregulation of deposit interest rates, and the liberalization of capital markets) will affect interlocking share-holding relationships between banks and industrial companies and how these factors will influence the main bank system. From there it goes on to consider what the impact will be for corporate governance in Japan.

In Section II, this paper demonstrates that the risks associated with banks' stock portfolios are excessive in comparison with their

capital, which has been weakened by the defaults generated in the aftermath of the "bubble". This raises the distinct possibility that banks will reduce their stock portfolios to more suitable levels in the future, and when this happens it will result in a substantial weakening of interlocking share-holding relationships. The author also points out that as the locus of the relationship between large companies and banks has shifted from lending to overall financial services and business information, the need for interlocking share-holding relationships has itself been reduced.

Section III discusses how the shares put back on the market as interlocking share-holding relationships are unwound can be expected to be absorbed and what kind of changes will be required in the system in conjunction with this. Many expect corporate pension funds and life insurance companies to buy up the shares, but it will be increasingly difficult for them to bear the risks associated with asset investments while at the same time insulating the household sector from share price fluctuations. Because of this, there may be a greater tendency for the household sector to shoulder the risk of share price movements directly. This will put upwards pressure on corporate cost of capital, which will make it necessary for companies to counter this pressure by internationalizing their shareholders. To do this, however, it will be urgent that the Japanese accounting system is reformed, since accounting practices in Japan make international comparisons difficult, which has served to limit companies' access to international markets. Stock investment trust services will be of growing importance as well, since they provide a means for households, which have not in the past borne the risk of stock ownership, to manage their risks by diversifying investments. It will therefore be urgent that Japan reform its stock investment trust system as well, which is hampered by many problems including taxation. This section also explains the institutional background to the bill being introduced by the Liberal Democratic Party to allow companies to use their legal reserves to buy back and retire their own shares.

Section IV discusses the impact on Japanese corporate governance from expected changes in the stock-holding structure. As major shareholders shift from financial institutions and companies with which the company has strong business relationships to pension funds, investment trusts and other institutional investors with which it has no direct transactions, or to foreign investors, the

emphasis in shareholders' demands on management will change from "expanding long-term business relationships" to "raising share prices and expanding profits". These changes are likely to influence companies' attitudes towards staffing reductions and the use of "unrealized" profits.

Section V, the final section, presents conclusions.

II. The Bank as Shareholder and Main-Bank Relationships

A. Banks' Stock Portfolios Too Large for Their Capital

Japanese banks hold enormous amounts of stock compared to industrial companies and foreign financial institutions. Though they are barred from owning more than 5% of the outstanding shares in any one domestic company (Antimonopoly Law, Article 11), there is no ceiling on the total amount of stock they may hold; as long as they invest in many different companies, they may hold as much stock as they wish. Large industrial companies (capitalization of at least Yen35 billion or net assets of at least Yen140 billion) are barred from holding stock in excess of their capital or net asset, but banks and other financial institutions are under no such restrictions (Antimonopoly Law, Article 9:2).[1]

Extremely loose regulations on large credit exposures also contributed to banks' heavy stock portfolios. Past regulations on large credit exposures looked only at loans and guarantees, not at the credit exposure from securities purchases (stocks and bonds) or from off-balance-sheet transactions. This made it possible for banks to use stock and bond holdings in addition to lending to supply large companies with large amounts of credit. For example, Sanwa Bank, Tokai Bank, and Sakura Bank, each held 4.8% stakes in Toyota Motors at the end of September 1997. This was worth Yen620 billion when calculated from Toyota's share price for February 12, which represents 37%, 79%, and 40% respectively of the capital of Sanwa, Tokai, and Sakura at the end of September

[1]As explained in the body of the paper, Japanese banks are under no restrictions regarding the total amount of stock they hold. This is in contrast with the EU, where universal banking has been adopted. The Second Directive on Banking limits banks' stock portfolios to no more than 15% of their capital for any one company and no more than 60% of their capital in total.

1997. This may be an extreme example, but it illustrates the large potential for stock portfolios to concentrate credit risks.

Japanese banks tend to keep their holdings in the companies for which they serve as main bank right at the 5% limit imposed by the Antimonopoly Law. Main banks are usually able to learn of poor results at their client companies earlier than ordinary market participants. However, insider trading regulations make it difficult for banks to sell their shares at such times. This makes main banks' holdings in their client companies an extremely fixed sort of credit exposure. Should the client's performance deteriorate, shares are subordinated to debts, and they cannot be sold if results are sour.

Table 1 illustrates the market value, book value, and unrealized profits on banks' stock portfolios, as observed from the banking accounts of Japanese banks. The market value of stock portfolios was not published prior to March 1990, so we have estimated backwards using the Nikkei 225 share price index and figures from the end of March 1991.[2] As can be seen, the book value of bank stock portfolios was Yen11.9 trillion at the end of March 1986, while the market value was approximately Yen47.0 trillion, or roughly four-times book value. These "unrealized profits" gave banks more than enough cushion to absorb the market risks from their portfolios. However, as banks increased their capital in the late eighties in preparation for the BIS rules, the book values of their holdings increased, in part because they entered into interlocking share-holding relationships at high share-price levels. Even when share prices were sliding in the nineties, book values continued to increase because banks were forced to realize profits in order to cover their write-offs of defaulted credits. This process quickly closed the gap between market and book values.

At the end of March 1998, the stock portfolios of all banks in Japan were worth Yen45.7 trillion in book value, which was roughly 90% above total capital (the total on the capital account) of Yen24.5 trillion (this does not include shares held on trust accounts for investment trusts and other clients). The market value of this portfolio, when appraised at a Nikkei 225 average of 16,527 points

[2]The figures for 1985-6 should be discounted, because bank stock portfolios have been gradually increasing, so that values estimated from the end of fiscal 1990 will have an upwards bias the farther back one goes.

TABLE 1

STOCK PORTFOLIOS AND CAPITAL IN THE BANKING SECTOR

(Yen1 trillion)

	A	*B*	*C*	$C+(A-B)\times 0.45$	I
Mar-86	46.90	11.90	12.30	28.05	15860
Mar-87	63.70	13.40	13.80	36.44	21567
Mar-88	77.60	17.60	17.20	44.20	26260
Mar-89	97.10	23.20	22.50	55.76	32839
Mar-90	88.60	29.70	28.60	55.11	29980
Mar-91	77.70	33.10	30.20	50.27	26292
Mar-92	56.40	34.50	31.30	41.16	19346
Mar-93	56.40	34.50	31.80	41.66	18591
Mar-94	61.90	36.50	32.30	43.73	19112
Mar-95	52.00	39.80	32.30	37.79	15140
Mar-96	64.30	43.00	27.90	37.49	21407
Mar-97	54.10	42.90	28.50	33.54	18003
Mar-98	50.81	45.65	24.50	26.82	16527

Note: Tables represent amounts on the banking accounts of all banks in Japan. The market value of stock portfolios was not published prior to March 1990, so we have estimated backwards using the Nikkei 225 share price index from the end of March 1991. However, the tables for 1985-6 should be discounted somewhat, because bank stock portfolios have been gradually increasing, so that values estimated from the end of fiscal 1990 will have an upwards bias the farther back one goes.

A: Market value of shares

B: Book value of shares

C: Capital account

$C + (A-B)\times 0.45$: Capital account+45% of Unrealized profits

I: Nikkei Stock Price Index

Source of data: Federation of Bankers Associations of Japan, "Analysis of Bank Financial Statements," various issues; securities reports for individual banks. Note that both market and book values represent listed shares only.

(level at the end of March 1998), was Yen50.8 trillion, or almost twice as much as total capital. When 45% of unrealized profits on stock portfolios are added to capital to arrive at a total of Yen26.8 trillion, the market value of stock portfolios is still 90% higher than this effective capital. Since the write-off's of bad loans have been

inadequate, capital must be discounted. Taking account of this hidden loss from bad loans, banks in fact are holding shares worth more than twice their capital.[3]

Share prices can be volatile, so banks have an extremely large exposure to price risks. That leads to the question of how much profit banks have made on their stock investments. Between 1955 and 1974, the average annual rate of return on stock investments (dividends plus capital gains) was 21.0%, or 12.2 percentage points above the average long-term prime rate of 8.8%. Between 1975 and 1995, however, the rate of return on stock investments declined to 10.7%, a mere 3.7 percentage points above the average long-term prime rate of 7.0%. The six years from 1990 to 1995 were particularly bad, with the average rate of return from stock investments at minus 6.7%.[4]

The excessive size of bank's stock portfolios manifests itself in the large impact that share-price fluctuations have on BIS capital adequacy rates. Under the BIS rules, Japanese banks may count up to 45% of unrealized profits on their securities portfolios as supplementary capital. This is roughly equivalent to appraising stock portfolios at market value and then deducing the tax effect of

[3]In January 1998, the Ministry of Finance published tallies of a self-appraisal of assets carried out by banks between March and September 1997. These figures are useful in estimating the problem credits of the banking sector as a whole (city banks, long-term credit banks, trust banks, regional banks, and second-tier regional banks). According to these figures, Japanese banks had Yen65.3 trillion in "substandard" loans, Yen8.7 trillion in "doubtful" loans, and Yen2.7 trillion in outright "losses". This was far higher than the Yen21.7 trillion in published bad-loan figures (credits to bankrupt borrowers, credits with interest payments in arrears for six months or more, and credits for which interest payments had been waived or reduced) for the term to September 1997. Note, however, that the definitions of these two concepts differ, so direct comparisons cannot be made. It is likely that little reserves had been put aside for the credits in the "substandard" category since it was possible to recover virtually all of them in the years before the bubble collapsed. Since the bubble collapsed, however, there has been a rapid increase in the amount of "substandard" loans that have had to be written off. According to recent data from 18 sample banks published in the October 1997 issue of *Bank of Japan Monthly Bulletin*, during the first three years after being classified as "substandard", a total of 17% of credits must be written off. If we assume write-offs of about 20% of substandard credits, that alone points to a latent loss of Yen13 trillion.

[4]From Japan Securities and Economics Research Institute (1996).

corporate taxes to calculate the bank's capital. For most banks, the book value of their portfolios was far lower than the market value prior to the rupture of the bubble, so de facto capital levels, when these unrealized profits were counted in, were very high, enabling banks to absorb any risks associated with their stock holdings. The rents brought by regulated deposit interest rates enabled banks to maintain profitability and made it possible for them to hold large stock portfolios.[5]

However, now that deposit interest rates have been fully liberalized (with the exception of the ban on paying interest on demand deposits), banks have lost most of the rents that regulation brought. Meanwhile, the sharp decline in share prices that began in 1990, the increasingly serious problem of bad loans, and the practice of taking profits on stocks to fund write-offs, have caused banks to lose their ability to bear the risks associated with holding stock portfolios that are large in comparison with their capital.

Still, banks continue to hold large volumes of stock. The reason for this is probably that stocks held on investment accounts are accounted for using the "lower of cost or market value (LOCOM)" method. As long as banks are holding shares unhedged, however, it does not matter how the value of their holdings is appraised. They will, quite obviously, still be exposed to risks. Nonetheless, in the accounting used for disclosure, taxation, and reports to regulators, stocks can be appraised at LOCOM and as long as market prices are higher than book values they will have no direct influence on current profits. Undeniably, these accounting practices have enabled bank managers to suspend their considerations of the risk exposure from their stock portfolios.[6] However, when the Nikkei average dipped below 15,000 points in late 1997, many banks found the market value of their portfolios to be less than book

[5]The BIS rules allowing up to 45% of unrealized profits on securities to be counted as a supplementary capital have been criticized because of their potential to destabilize banks' lending attitudes. However, the essential issue is not whether banks can count their unrealized profits towards capital but the fact that they hold large amounts of stock that are subject to market risks.

[6]In the eighties, several banks tried to replenish their capital by issuing large volumes of foreign-currency convertible bonds. At the time, foreign exchange risks of these bonds were not recognized on the accounts and so risks were not managed as they should have been. This experience indicates that accounting treatment may have a large impact on risk management.

values. At the risk of overstating the case, it was only then that many bank managers realized that they were holding enormous stock portfolios.

One of the reasons why banks were able to suspend all thinking about the risk exposure from their stock portfolios was that their shareholders were weak in their ability to monitor bank managers. There were several reasons why the role of shareholders was weak: 1) Ministry of Finance regulation and surveillance were strong, so there was little incentive for shareholders to monitor bank managements; 2) banks thought that they were in the clear as long as they maintained the minimum capital adequacy ratios demanded by the BIS rules and did not even think about actively determining and achieving the capital levels required for internal management purposes;[7] 3) mutual life insurers are among the major bank shareholders and the corporate governance of mutual companies is weak because all the policy-holders are nominally shareholders;[8] and 4) the industrial companies that entered into interlocking share-holding relationships with banks raised their fund primarily through bank borrowings, which made their position as shareholders weak.

In addition to investment motives, most banks hold shares because of two reasons: to use interlocking relationships to have stable shareholders for themselves, and to cement business relationships with client companies. The latter is less important in recent years. The large companies that used to be banks' main clients have shifted their fund-raising from bank borrowings to capital markets, so relationships with banks are not nearly as strong as they once were. Indeed, in 1980s, declines in large companies' borrowings from banks caused a rapid shift towards smaller businesses in banks' loan portfolios (See Table 2). Parallel to this, borrowings account for a smaller proportion of large companies' debt, while funds raised from the capital markets are on the increase (See Table 3).[9]

[7]This point was made to me by Mrs. Yuri Okina.

[8]For a discussion of problems in the corporate governance of life insurance companies, see Komiya (1989).

[9]Since 1988, lending growth rates have been higher for life insurance companies than for banks, which has caused banks' share of the borrowings of large companies to decline even more than Figure 3 might indicate.

TABLE 2

LENDING SHARES BY SIZE OF COMPANY

Banking accounts of all banks	1980	1985	1990	1994
Large companies	33.30	30.00	21.70	23.00
Medium companies	27.00	25.24	12.50	11.90
Small companies	39.70	44.74	65.80	65.10
Total	100.00	99.98	100.00	100.00

Note: Tables indicate the year-end balance on the banking accounts of domestic branch offices. Tables for the end of 1994 include current account overdrafts. Large companies are defined as having stated capital of more than Yen1.0 billion, small as having less than Yen100 million, and medium as everything in between.

Because of the declining importance of bank borrowing and the falling of banks' share prices, industrial companies began to sell their bank shares. One valuable tool for understanding interlocking share-holding relationships is the time-series data on interlocking share-holding relationships first published by the NLI Research Institute in October 1998 (See Table 4). This survey defines:

(1) "Interlocking ratio" as the percentage of shares for which it can be confirmed that two companies hold each other's shares.

(2) "Stable shareholder ratio" as the percentage of shares held by banks and life insurance companies, plus the percentage of bank and non-mutual life insurance company shares held by industrial companies plus Interlocking ratio.

According to the survey, both the interlocking ratio and the stable shareholder ratio began declining around 1992 when viewed in terms of the entire stock market. Note, however, the fact that neither the interlocking ratio nor the stable shareholder ratio declined considerably for shares of non-financial companies, while both declined sharply for bank shares.

The report on the survey argues that banks are generally selling off shares because the industrial companies with which they had interlocking share-holding relationships began selling off bank shares first.[10] It would thus appear that it is not the banks that are

[10]NLI Research Institute (1997).

TABLE 3

BALANCE SHEET STRUCTURES

(RATIOS TO TOTAL ASSET SHOWN AS PERCENTS)

Large manufacturing companies

Assets	1980	1984	Liabilities and capital	1980	1984
Assets	100.0	100.0	Liabilities	77.9	71.9
Deposits	10.7	11.5	Liquid liabilities	55.3	52.3
Short-term securities	4.8	5.4	Bills payable etc.	22.1	21.1
Of which stocks	1.1	1.4	Short-term borrowings	17.7	16.6
Of which bonds	3.6	3.7	Liquid reserves	2.5	1.2
Of which other	0.1	0.3	Other	12.9	13.5
Investment securities	6.6	7.5	Fixed liabilities	21.7	19.7
Of which stocks	5.6	6.3	Long-term borrowings	14.2	10.2
Of which bonds	1.3	1.4	Bonds	3.1	4.8
Of which other	0.2	0.3	Fixed reserves	3.8	3.9
Bills receivable etc.	23.6	24.0	Other	0.6	0.7
Other financial assets	8.9	8.8	Special reserves	0.9	0.0
Intangible fixed assets	0.2	0.2			
Deferred assets	0.1	0.1	Capital	22.1	28.1
Inventory assets	20.0	17.1	Stated capital	6.6	6.9
Tangible fixed assets	25.1	25.4	Capital reserves	3.6	5.8
Of which land	4.0	4.2	Profit reserves	0.9	1.0
Of which buildings etc.	21.1	21.2	Other Surpluses	10.9	14.4
Total asset (Yen1 trillion)	105	134	Total asset (Yen1 trillion)	105	134

Assets	1989	1994	Liabilities and capital	1989	1994
Assets	100.0	100.0	Liabilities	62.7	59.7
Deposits	15.8	10.8	Liquid liabilities	40.9	36.8
Short-term securities	5.2	6.1	Bills payable etc.	17.1	14.4
Of which stocks	2.7	3.0	Short-term borrowings	10.4	10.3
Of which bonds	1.7	1.9	Liquid reserves	0.9	0.9
Of which other	0.7	1.3	Other	12.4	11.2
Investment securities	10.1	13.0	Fixed liabilities	21.8	22.9
Of which stocks	8.8	11.9	Long-term borrowings	5.4	7.8
Of which bonds	1.1	1.7	Bonds	11.5	10.3
Of which other	0.6	0.2	Fixed reserves	3.8	3.8
Bills receivable etc.	23.3	20.5	Other	1.1	1.0
Other financial assets	8.5	8.7	Special reserves	0.0	0.0
Intangible fixed assets	0.2	0.2			
Deferred assets	0.1	0.1	Capital	37.3	40.3
Inventory assets	12.2	11.2	Stated capital	9.4	9.8
Tangible fixed assets	24.7	29.2	Capital reserves	9.2	9.3
Of which land	4.9	6.4	Profit reserves	1.0	1.2
Of which buildings etc.	19.8	22.8	Other Surpluses	17.7	19.9
Total asset (Yen1 trillion)	191	223	Total asset (Yen1 trillion)	191	223

Source: *Bank of Japan Monthly Bulletin*, July 1996, p. 88.

TABLE 4

INTERLOCKING SHARE-HOLDING RATIOS

Unit: %

FY	Overall market		Financial-institution stocks	
	Stable shareholder ratio	Interlocking share-holding ratio	Stable shareholder ratio	Interlocking share-holding ratio
1987	41.53	21.20	56.46	32.99
1988	41.64	20.72	56.01	32.38
1989	40.27	20.37	52.19	29.06
1990	41.07	21.19	54.88	31.41
1991	41.08	21.15	54.53	30.66
1992	41.30	21.14	55.16	30.14
1993	40.58	20.79	54.82	31.66
1994	40.51	20.82	54.04	30.81
1995	39.03	20.61	51.10	30.40
1996	37.67	19.64	51.22	29.08
1997	35.69	18.18	48.21	26.51

FY	Industrial companies			
	Stable shareholder ratio	Interlocking share-holding ratio	Bank share-holding ratio	Life insurance company share-holding ratio
1987	26.20	15.47	10.24	9.81
1988	26.07	15.47	10.16	9.82
1989	25.57	15.98	10.20	8.98
1990	26.15	16.39	10.49	9.12
1991	26.68	16.52	10.65	9.40
1992	26.78	16.51	10.70	9.52
1993	26.21	16.36	10.48	9.21
1994	26.19	16.54	10.43	9.09
1995	24.43	15.80	9.91	8.12
1996	23.97	15.80	10.05	7.68
1997	22.60	14.87	9.70	7.17

Note: Tables were estimated by NLI Research Institute from major shareholders and detailed securities statements in disclosure materials, and from data on major shareholders provided by the Toyo Keizai Shimposha Company.
"Financial institutions" are defined as banks (excluding trust banks and Daiwa Bank) and life insurance companies.
"Industrial companies" are defined as domestic companies that are not financial institutions, casualty insurance companies, securities companies, or other financial companies.
"Interlocking share-holding ratio" refers to the percentage of shares for which it can be confirmed that two companies hold each other's shares.
"Stable shareholder ratio" refers to the percentage of shares held by banks and life insurance companies, plus the percentage of bank and life insurance company shares held by industrial companies plus interlocking shares.
Both ratios are evaluated at market values.

Source: NLI Research Institute (1997)

TABLE 5

POTENTIAL FOR SELLING SHARES FOR INTERLOCKING SHARE-HOLDING RELATIONSHIPS: PUBLICLY-TRADED COMPANIES

	(Percent)
When the other company sells our shares, we might sell theirs.	68.4
We might sell regardless	18.3
We will not sell	13.3

Note: Percentage of respondents choosing responses to the question "Do you think you will sell shares you hold from interlocking share-holding relationships?"
Valid responses: 573 publicly-traded companies.
Source: Fuji Research Institute (1993, p. 125)

unwinding interlocking share-holding relationships but industrial companies despite the fact that banks are holding excessive stocks given their weakening position. What is probably behind this is a judgement on the part of the top manufacturing companies who were relatively unscathed by the rupture of the bubble that the markets would be able to absorb any of their shares sold by banks should banks decide to retaliate for the sale of bank shares. Either that, or the manufacturer itself could buy the shares with its funds on hand and retire them. Just the opposite is the case for banks. Banks cannot retire shares because of the BIS rules, and weak capital position. Were they to sell shares of companies with which they have interlocking share-holding relationships, and were the other company to retaliate by selling the bank's shares, it could cause share prices to decline and undermine the trust placed in the bank by the markets. In other words, interlocking share-holding relationships are based on an understanding that neither party will sell the other's shares. When banks try to reduce their stock portfolios, it is extremely likely that industrial companies will respond by selling the bank's shares. In fact, a 1993 survey by Fuji Research Institute found 68.4% of the 573 publicly traded companies responding that they might sell shares from interlocking share-holding relationships if the other party sold their shares (See Table 5).

When one considers these trends, it seems likely that banks will be strengthening their risk management and compressing the total value of their stock portfolios. There are three reasons for this: 1)

their partners in interlocking share-holding relationships are selling off bank shares; 2) the experiences of the end of 1997 have strongly reinforced the perception that share-price drops are a major factor for instability in bank management; and 3) there are plans to improve rules on large exposures in the future, which will include rules on the concentration of credit risks (i.e. total credit, including loans, shares, and bonds).[11]

B. Changes in the Business Relationships between Companies and Banks

It is quite likely that the unwinding of interlocking share-holding relationships between industrial companies and banks will greatly weaken interlocking share-holding throughout the Japanese economy. This will in turn mean a significant decline in the role that banks have previously played as stable shareholders for large companies. Throughout the postwar period there has been a consistent rise in the percentage of stocks of publicly-traded companies in the hands of financial institutions (excluding investment trusts and pensions) and industrial companies, and a corresponding decline in the percentage owned by personal investors (Table 6). As banks and industrial companies unwind their interlocking share-holding relationships, it is quite likely that part of the shares will be picked up by other financial institutions and companies because companies still have a strong preference for stable shareholders (see Fuji Research Institute 1993, pp. 101, 132), but declines in the overall interlocking share-holding ratio seem unavoidable. As the interlocking share-holding relationships between banks and their client companies are unwound, there is likely to be an increase in the shares held by institutional investors (i.e. life insurance companies, investment trusts, and pension funds).[12]

When a company sells parts of its stock portfolio, it will experience no change in its net assets value since it can obtain cash in line with current share prices. Therefore, as long as share-price formation correctly reflects companies' net assets and profitability, the unwinding of interlocking share-holding relationships should

[11]See Financial System Research Committee (1998). The new legislation, "Financial System Reform Law" which tightened the large exposure rule, was passed by the Diet in June 1998.

[12]See Section III for more on this point.

TABLE 6

DISTRIBUTION OF SHARES OF LISTED COMPANIES

(Percent)

FY	Central/ local governments	Financial institutions (excluding investment trusts, and pension funds)	City, long-term credit and regional banks	Investment trusts
1949	2.80	9.90		
1955	0.40	19.50		4.10
1960	0.20	23.10		7.50
1965	0.20	23.40		5.60
1970	0.30	30.90		1.40
1975	0.20	34.50		1.60
1980	0.20	36.90		1.50
1985	0.80	40.20		1.30
1990	0.60	40.70		3.60
1992	0.60	40.20	16.20	3.20
1994	0.70	39.30	15.90	2.60
1995	0.60	41.40	15.40	2.10
1996	0.50	41.30	15.10	2.00

FY	Pension funds	Securities companies	Industrial companies	Personal investors	Foreigners
1949		12.60	5.60	69.10	
1955		7.90	13.20	53.10	1.80
1960		3.70	17.80	46.30	1.40
1965		5.80	18.40	44.80	1.80
1970		1.20	23.10	39.90	3.20
1975		1.40	26.30	33.50	2.60
1980	0.40	1.70	26.00	29.20	4.00
1985	0.70	2.00	24.10	25.20	5.70
1990	0.90	1.70	25.20	23.10	4.20
1992	1.10	1.20	24.40	23.90	5.60
1994	1.60	1.10	23.80	23.50	7.40
1995	1.80	1.40	23.60	23.60	9.40
1996	2.30	1.10	23.80	23.60	9.80

Note: Reported in unit-number terms after 1985. "Personal investors" includes unincorporated organizations. "Financial institutions" includes pension funds prior to 1978.

Source: Tokyo Stock Exchange, *TSE Handbook*, 1996, p. 76, p. 124 as updated with the data the TSE's web site.

TABLE 7

CORPORATE AWARENESS OF POTENTIAL FOR MAIN BANK SUPPORT IN TIMES OF CRISIS

(Percent)

	Total	First Section listed	Second Section listed	OTC registered	Non-public
Will obviously help.	49.40	63.00	52.90	39.40	41.90
May not help depending on our situation, but we hope they will.	39.15	30.10	37.40	50.50	42.90
We used to think they would but do not any more.	5.45	5.35	7.10	6.40	4.94
We have never expected them to.	6.00	1.56	2.60	3.70	10.24
Total	100.00	100.01	100.00	100.00	99.98

Note: Percentage of respondents choosing responses to the question, "Do you think your main bank will provide financial support and loans if you are in crisis?"
Valid responses: First Section 315, Second Section 115, OTC 109, non-public 508, total 1088. (In the original, non-public companies were left out to give a total of 508 companies, but this differs greatly from the number of other responding companies, so we assume that the Tables above are correct.)

Source: Fuji Research Institute (1993, p. 74)

theoretically have a neutral effect on share prices.[13] However, during the unwinding process of interlocking share-holding relationships, frictions and information asymmetry in the actual market are likely to cause share prices to decline and the cost of equity-finance to rise. Companies that have large amounts of retained earnings and unrealized profits on stock portfolios at their disposal will be able to use this money to buy back their own shares, thereby restraining any declines in their share prices. Banks, however, must maintain BIS-specified capital adequacy ratios, which makes buy-backs difficult.[14]

This unwinding of the interlocking share-holding relationships between banks and industrial companies will move funding of large companies further away from bank borrowings in favor of capital

[13]For a discussion of interlocking share-holding relationships and share prices, see Kobayashi (1990).

[14]Thanks to Masahiro Higo for his valuable comments on this point.

TABLE 8

HOW COSTS ARE PAID TO MAIN BANKS

(Percent)

	Total	First Section listed	Second Section listed	OTC registered	Non-public
Cooperation deposits	23.3	27.9	22.2	21.8	21
Concentrating payments and employee transactions	16.7	21.3	15.8	13.6	14.9
Added to effective interest rates	6.3	8.8	4.4	1.8	6.4
Buying of bank shares	6.1	7.5	5.1	5.5	5.6
Borrowing more than needed	3.6	2.8	4.4	2.7	4.1
Payment of high bond underwriting fees	3.5	8.8	1.9	0.9	1.4
Acceptance of personnel	2.9	5.6	3.8	0.9	1.4
Other	0.5	0.3	1.3	0	0.4

Note: Percentage of respondents choosing responses to the question, "If you pay costs for this, by what method(s) do you pay? Circle all appropriate." Valid responses: First Section 319, Second Section 158, OTC 110, non-public 618, total 1105.

Source: Fuji Research Institute (1993, p. 85)

markets. In spite of the declining importance of bank borrowings, however, most companies still have a strong desire to maintain tight relationships with a main bank or a small group of core banks. In a survey done by Fuji Research Institute, many companies said that they expected their main or core banks to provide emergency lending and other assistance in the event of a crisis (Table 7). In exchange for this, industrial companies keep unnecessary deposits (so called "cooperation deposits"), concentrate their payments, payrolls, and employee transactions with the bank, and pay high bond underwriting fees (Table 8).

The reason for these somewhat optimistic expectations is in part because older managers remember having been bailed out by their banks when they ran into trouble in the past. But companies may adopt a more dispassionate attitude towards bank transactions as a new generation of managers comes to the helm, especially if functioning of the capital market continues to be improved and large

TABLE 9

REASONS FOR CHANGING MAIN BANK

(Percent)

	Total	First Section listed	Second Section listed	OTC registered	Non-public
Main bank unable to lend because of BIS rules.	34.6	37.5	29.0	31.1	35.3
Main bank's financial health deteriorates and rating declines to the point that it loses social credibility.	34.0	39.1	30.3	31.1	32.6
Main bank reduces or eliminates interlocking share-holding relationship.	30.3	55.7	42.1	43.7	7.8
Ownership of trust or securities subsidiaries expands the gaps between banking groups in the services they are able to provide.	12.1	11.7	9.0	14.6	12.8
Internationalization of our business activities.	1.7	1.6	2.1	2.9	1.4
A banking subsidiary of a securities company enters the banking sector and develops into a new bank that is strong in securities services.	1.3	0.7	2.1	1.9	1.2
Other	2.6	1.3	0.7	1.0	4.3
No reason in particular.	41.2	31.6	42.8	35.9	47.8

Note: Percentage of respondents choosing responses to the question, "What would be the biggest factor that might cause you to change your main bank? Circle up to three."
Valid responses: First Section 307, Second Section 145, OTC 103, non-public 485, Total 1040.

Source: Fuji Research Institute (1993, p. 89)

industrial companies continue to enjoy higher credit ratings than most banks.

In this regard we would note that companies say that they would consider changing their main bank if (Table 9):

(1) The main bank reduced their share-holding or unwound interlocking share-holding relationships.

(2) The main bank's financial position deteriorated and rating declined to the point that it lost social credibility.

Indeed, bank ratings have already fallen substantially and banks

would find it hard to bail industrial companies out of crises (Figure 1). This and the need for stricter bank risk management and improved rules on large exposures would indicate that a decline in banks' share-holding might make companies consider not just a change in main banks but whether they need a main bank relationship at all.

III. Reduction in Financial Institutions' Ability to Bear Risks and Need for Capital Market Reform

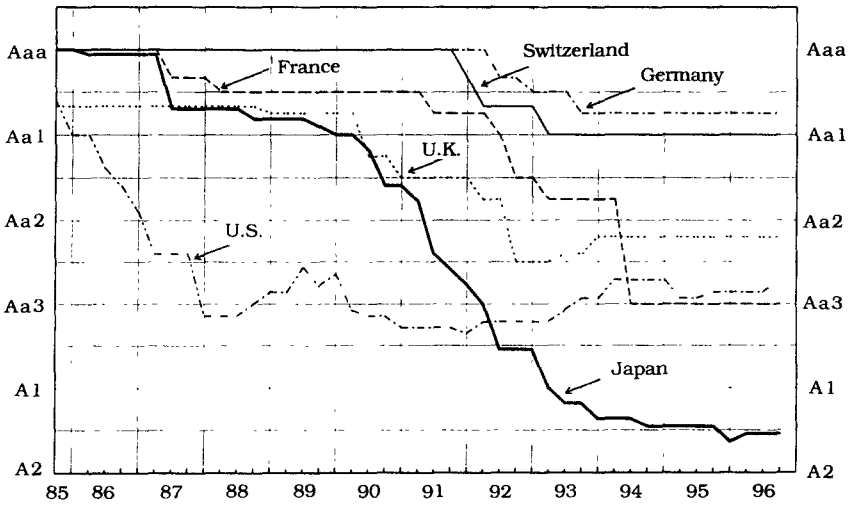
A. Institutional Investors' Ability to Bear Risk and Cost of Capital[15]

Corporate pension funds, life insurance companies, and other institutional investors own risky assets like shares and long-term bonds, but provide the household sector with what for all purposes are fixed-interest financial assets (investment trusts are the exception).[16] They absorb these risks with their own capital and the unrealized profits on their stock and land portfolios. But just like the banking sector, these financial institutions are also losing their ability to bear risks because of falling stock and land prices. This indicates that there is a possibility for a change in the extremely risk-averse financial asset selection behavior of the household sector, one of the traditional hallmarks of the Japanese financial system. When one attempts to foresee how the stocks released into the market from the unwinding of interlocking share-holding relationships will be absorbed, one of the following scenarios, or perhaps a combination of two or more, seems highly likely.

(1) Should households continue to make highly risk-averse investments, financial institutions will be forced to underwrite share-price fluctuation risks with reduced levels of capital, which will cause them to demand a higher risk premium. This will raise the cost of equity capital compared to that of safe assets.

[15]For a discussion of the concept of "cost of capital" and empirical estimations, see Fukao and Morita (1997).

[16]In Japan, corporate pension funds themselves are not organized as financial institutions. Rather, they entrust the investment of their assets to trust banks, life insurance companies, and investment advisory services. However, recent deregulation makes it likely that there will be a growing number of pension funds that set up their own investment management systems.



Notes: 1. Figures calculated as non-weighted averages of following major financial institutions (based on Moody's investors service).
Japan: Sanwa Bank, Ltd; Dai-ichi Kangyo Bank, Ltd; Fuji Bank, Ltd; Sumitomo Bank, Ltd; Sakura Bank, Limited; Bank of Tokyo-Mitsubishi Bank, Ltd; Tokai Bank, Ltd; Industrial Bank of Japan Ltd; Long-Term Credit Bk. of Japan Ltd; Mitsubishi Trust & Banking Corp; Norinchukin Bank
U.S.: Citibank, N.A.; Bank of America NT and SA; Chemical Bank; Nations Bank N.A.(Carolinas); Morgan Gty. Trust Co. of NY; Bankers Trust Company; Bank One, Columbus N.A.
Germany: Deutsche Bank AG; Dresdner Bank AG; Westdeutsche Landesbank GZ; Commerzbank A.G.
U.K.: Midland Bank plc; National Westminster Bank plc; Barclays Bank plc; Abbey national plc; Lloyds Bank plc
France: Caisse Nat'l de Credit Agricole; Credit Lyonnais S.A.; Societe Generale; Banque Nationale de Paris
Switzerland: Credit Suisse; Union Bank of Switzerland; Swiss Bank Corporation
2. Prior to 96/1Q, rating on Bank of Tokyo-Mitsubishi Bank, Ltd is the average rating of Bank of Tokyo, Ltd and Mitsubishi Bank, Ltd. Prior to 96/2Q, rating on Chemical Bank is the average rating of Chemical Bank and Chase Manhattan Bank N.A.

FIGURE 1

RATINGS ON FINANCIAL INSTITUTIONS

(2) As costs rise for domestic equity capital, companies will increase their equity issues overseas, where it is possible to raise capital more cheaply.
(3) Investment trusts, which provide the household sector with diversified investments and other risk management services, will see their business expand.
(4) Companies involved in interlocking share-holding relationships will purchase and retire large volumes of their shares from each other.

Were the first of these scenarios to come true, it would probably result in a higher cost of capital for Japanese companies. This would in turn restrain corporate investment activities and reduce Japan's economic vigor. Japan will need to make an effort, therefore, to achieve scenarios two and three if it wishes to maintain its vigor. For the fourth scenario to come true would require amendments to the Companies Law, which currently places strict restrictions on paying out paid-in capital. The purpose of these restrictions is to protect creditors of the company.

In the pages that follow, we consider four aspects of Japanese capital markets that will require reforms if Japan is to avoid increasing the cost of capital in the process of unwinding interlocking share-holding relationships: the accounting system, investment trusts, corporate pension funds, and the provisions for maintaining paid-in capital in the Companies Law.

B. The Internationalization of the Stock Market and the Need to Review Accounting Standards

Let us begin with the second scenario, an increase in foreign investments in Japanese stocks. For this to happen there will need to be reforms to Japan's accounting standards, which are undeniably more opaque than those of the United States or Great Britain. In particular, Japanese financial statements used for consolidated disclosure purposes will need to be brought into line with America's GAAP (Generally Accepted Accounting Principles) or with the standards of the IAS (International Accounting Standard Committee), which are close to the GAAP. Some large companies in European countries—namely Scandinavia, Switzerland, and Germany—are already doing so. In view of their narrow domestic capital markets, they are publishing financial statements prepared under

IAS or GAAP standards in addition to statements prepared under domestic standards in order to be better able to raise funds internationally.[17] As an illustration of how important this is, we would point to the Bank of Tokyo Mitsubishi, which has the highest price to book value ratio of any of Japan's city banks (as at February 14, 1998; see Table 10). There are two reasons for this. First, it has lost less capital due to bad loans than other banks, and second, it is the only city bank listed on the New York Stock Exchange. This means that it must disclose GAAP-based financial statements, and these have earned it high levels of credibility and trust.

In other words, the use of international standards to disclose financial information that is both trustworthy and easily compared to that disclosed in other countries will increase the demand for and liquidity of a company's shares, which will have the effect of boosting share prices and reducing the cost of capital. For foreign investors, this will expand the possibility for high-return investments and international risk diversification. These changes are therefore desirable from the point of resource allocation, and also because they may, as will be discussed later on, provide the impetus for a change in the way Japanese companies are governed.

In relation to the accounting system we would note that the actual amount of bad loans discovered at failed financial institutions has been far larger than the published amount prior to failure. To take a recent case, the Hokkaido Takushoku Bank was forced into bankruptcy even though it posted profits and paid dividends for the year to March 1997. Financial statements for that year reported Yen297.6 billion in capital; inspections after the failure found a negative equity of Yen1172.5 billion as of March 31, 1998.[18] This indicates a window-dressing of almost Yen1500 billion.

Likewise, Yamaichi Securities was carrying Yen270 billion in losses on securities investments – worth more than half its capital – that neither Ministry of Finance inspections nor Bank of Japan examinations were reportedly able to uncover. There are other examples of similarly staggering losses being hidden. Nissan Life,

[17]For example, in Switzerland, Ciba-Giegy, Rosche Holdings, Sandoz, and Nestle all publish IAS-based financial statements.

[18]"Hokkaido Takushoku Bank: Negative Equity of Yen1172.5." *Japan Economic Journal*, May 27, 1998.

TABLE 10

PRICE TO BOOK VALUE RATIO FOR MAJOR BANKS

	A (Yen)	*B* (Yen)	*B/A* (multiple)
Daiichi Kangyo Bank	487	1070	2.20
Hokkaido Takushoku Bank	320	1	0.00
Sakura Bank	453	521	1.15
Bank of Tokyo Mitsubishi	393	1860	4.73
Fuji Bank	576	926	1.61
Sumitomo Bank	566	1560	2.76
Daiwa Bank	335	372	1.11
Sanwa Bank	571	1450	2.54
Tokai Bank	387	883	2.28
Asahi Bank	412	710	1.72
Industrial Bank of Japan	568	1090	1.92
Long-term Credit Bank of Japan	399	338	0.85
Japan Credit Bank	160	172	1.08
Mitsui Trust	332	425	1.28
Mitsubishi Trust	395	1520	3.85
Sumitomo Trust	385	926	2.41
Yasuda Trust	218	261	1.20
Nihon Trust	-112	277	-2.47
Toyo Trust	357	890	2.49
Chuo Trust	606	435	0.72

Note: Net asset per share as of March 1997 for Hokkaido Takushoku Bank.
A: Net assets per share (September 1997)
B: Share price (February 14, 1998)
B/A: Price to book value ratio

Source of data: *Nikkei Company Information*, January 1998; Nihon Keizai Shimbun, February 14, 1998, morning edition.

another failed institution, held privately-placed investment trusts that did not need to be appraised at market value. It used these trusts to boost its current profits by receiving higher-than-market interest payments and then taking losses when principal was returned. A comparison of its balance sheet immediately before and after going under indicates that it was hiding latent losses on securities in excess of Yen200 billion.[19]

These financial-institution failures have exacerbated suspicions both at home and abroad regarding the financial statements and

[19]At the end of March 1997, Nissan Life's balance sheet showed Yen981.1 billion on the securities account and a negative equity of Yen59.1 billion. The balance sheet for May 31, after the company failed, showed Yen721.9 billion on the securities account and a negative equity Yen302.9 billion.

regulatory supervision of Japanese financial institutions. It is mistrust of financial statements that is widening the "Japan premium" charged in overseas markets, increasingly blocking the domestic call market (which is used for short-term interbank loans), and multiplying the number of cash-pressed financial institutions turning to the Bank of Japan for loans. Japanese markets are experiencing a kind of credit crunch because of a rash of failures, declining asset prices, and growing mistrust of financial statements and regulators. This credit crunch is in turn cutting into corporate investment and hiring, increasing bankruptcy rates, and reducing consumption and housing investments because workers fear for their jobs. That results in a further contraction of credit in what becomes a vicious cycle. In other words, unreliable financial statements have proved a serious impediment to the functioning of a market economy.

The problems in the Japanese accounting and regulatory systems can be divided up into three categories:

a) Accounting principles unable to adapt to economic change

While the Japanese economy was experiencing robust growth, appraising financial assets and particularly stocks at the cost of acquisition was a conservative accounting practice. However, after growth rates slowed and the bubble ruptured, appraisal of tokkin accounts and investment trusts at acquisition costs became a tool for hiding unrealized losses. These distortions in accounting practice appear to stem from the fact that financial accounting was molded to fit tax regulations, and tax regulations themselves are designed to increase tax revenues. Financial accounting should accurately reflect the financial health of the company, regardless of how taxable income is appraised for tax purposes. Accounting professionals should not use the tax system as an excuse for failing to implement appropriate accounting standards.[20]

[20]See Daigo (1995). It was announced around the end of 1997 and on into early 1998 that land held by banks would be revalued at market prices tax free and that banks would have the option of using either the lower of cost or market value (LOCOM) or cost of acquisition methods in valuing their stock portfolios (rather than being forced to use LOCOM). These changes are designed to make it easier for banks to meet BIS rules and are indeed little more than an attempt to fiddle with the books so as to show bank balance sheets in a better light. They are hardly a fundamental solution.

b) Auditing as an empty formality

Outside CPAs and auditing firms audit the accounts of large companies. These auditors have the responsibility to carefully check and verify that the balance sheets and profit and loss statements published by companies have been prepared in an appropriate manner. Should auditors fail to discharge that responsibility, they are liable to make compensation for any damage to corporate assets or damage to third parties who trusted the financial statements published by the company. Should creditors be harmed by window-dressing, it is the auditors who risk claims for large settlements.

However, in the recent bankruptcies of the jusen housing finance companies, large construction companies, and financial institutions, there are many cases where one can only assume that some of the accountants and auditors effectively turned a blind eye to window dressing in order to get work. One of the factors contributing to this behavior on the part of the accountants and auditors is the fact that companies shun those that insist on performing strict checks and refuse to give them auditing work. In addition, before the bubble ruptured it was rare for a listed Japanese company to go bankrupt, so the risk of law suits was limited. That is no longer the case. Creditors of Japan Housing Finance, one of the failed jusen, sued its auditors for compensation after it failed; if these suits result in stiff penalties to the auditors, then it will represent a major opportunity to restore the relationship of checks and balances between auditors and companies that is necessary for auditing to function properly.

c) Mistrust of internal auditing

The internal auditing systems of Japanese companies are losing their credibility. News reports indicate that the Big Four securities houses made payments to sokaiya mobsters by transferring profits from the accounts of the company to the accounts of the sokaiya. What this says to companies and households is that when they trade through securities companies, the broker might not strictly separate the profit of customers and that of the company. It has also created an suspicion that securities companies might be failing in their fiduciary duties. This has resulted in a growing tendency to withdraw securities from shaky security houses, even though customer and company accounts are supposed to be kept separate

even in cases of bankruptcy (as long as the law is obeyed).

It will be necessary to rethink internal and external auditing systems, which are among the key facets of corporate governance, in order to alleviate this basic mistrust. It is not desirable, however, to enact laws that prescribe uniform internal organizations for all companies. Rather, these are things that must be established by the managers themselves in cooperation with their shareholders and outside auditors. What is needed are for business groups like the Keidanren and Keizai Doyukai to bring out and adhere to "codes of best practice" that would outline voluntary ways companies could improve their governance.

C. The Need to Review the Investment Trusts System

For personal investors, investments in individual stocks are not always attractive because the size of the investment is small, making diversification difficult and causing trading fees to rise. Professionally managed investment trusts which are similar to mutual funds in the United States, should offer personal investors a powerful investment tool. Indeed, in the financial markets of the United States, mutual funds have expanded sharply, taking a place along side pension funds as one of the most broadly utilized personal investment tools. Japanese stock investment trusts have, unfortunately, lost all credibility. There is a pressing need to restore the faith accorded them.

In Japan, bond investment trusts have little risk of principal and thus function similar to deposits. There are constraints on their settlement services, however, which have prevented them from developing into the kind of major product that MMF accounts are in the United States. Stock investment trusts ought to be able to offer high yields, though with some risks attached. However, between the post-bubble share-price slump, the past sales tactics of security firms, and taxation problems, investors place no faith in them. The balance of funds in stock investment trusts declined from Yen45.6 trillion at the end of 1989 to Yen10 trillion at the end of 1997 (Table 11). Meanwhile, in the United States, mutual funds have expanded sharply. In many cases, mutual funds are becoming the main financial institution for affluent households, using tie-ups with banks to provide integrated mutual fund, checking, and stock custodial accounts. The main factor constraining

TABLE 11

OUTSTANDING BALANCES HELD BY STOCK INVESTMENT TRUSTS

(Yen1.0 trillion)

Year end	Unit	Open	Total
1986	16.79	2.32	19.11
1987	28.13	2.48	30.61
1988	35.41	3.85	39.26
1989	37.06	8.49	45.55
1990	25.95	9.12	35.07
1991	18.89	9.68	28.57
1992	12.07	9.03	21.10
1993	8.97	10.58	19.55
1994	6.29	11.16	17.45
1995	4.30	10.38	14.68
1996	2.51	10.37	12.88
1997	1.22	8.76	9.98

Note: Year-end balances.

Source of data: Tokyo Stock Exchange, *TSE Handbook*, 1996.

bond investment trusts in Japan is restrictions on settlement functions, which we will not deal with in this paper. Rather, in the pages that follow we concentrate on the problems in stock investment trusts.

The first long-standing problem in Japanese stock investment trusts has been that securities companies have recommended customers to cancel investment trusts and switch to new funds once the closed period ends. For the securities company, this has been a good way to earn fees, but the funds themselves have been unable to engage in the kind of stable, long-term investments that would increase return, and investors have been dissatisfied with their performance, especially when they are charged trading fees. The second problem is that investment trust companies have not in fact been independent of their parent security companies. Investment trusts are essentially a "stock" business, but they have been dominated by brokers, which are essentially a "flow" business. These two problems are indeed closely related and have been largely responsible for damaging the credibility of investment trusts in the eyes of ordinary investors.[21]

The solution to these problems and the restoration of faith in

[21]See Ueda (1994).

investment trusts must begin by changing securities companies' penchant for churning investment trust accounts in order to maximize fee revenues. This will probably not be achieved unless investment trust companies achieve real independence from brokers and autonomy over their product sales. One encouraging trend in this regard is the entrance of foreign investment trusts into the Japanese market, as exemplified by Merril Lynch's hiring of large numbers of former Yamaichi employees. These foreign players may bring with them new strategies that give investment trusts a new image. Some investment trusts are also shifting from paying fees based on the volume of accounts sold to fees based on the outstanding balance in those accounts. This will give brokers an incentive to market accounts in a more suitable manner rather than just churning.

A third problem facing stock investment trusts is lack of adequate provisions in the tax code. There are large differences in tax treatment for stocks held personally by the investor and stocks held by the investor through an investment trust, and these differences put investment trusts at a disadvantage. For example, when a personal investor cashes out of an open-ended investment trust, he pays both the securities trading tax and a 20% withholding tax on any income. This is based on the "average trust funds method" of taxation. Rather than considering the principal (upon which income calculations are based) to be the cost to individual investors, it is considered to be the average cost of total invested principal (average trust funds). What that means in actual practice is that if share prices rise so that the fund has unrealized profits, and then a new investor is added but quickly cancels his account, this investor will be taxed on the unrealized profits in the fund even though he personally has not made any money. Should the fund, after it is established, experience a rise in share prices followed by a drop, and should there be inflows and outflows of cash during this time period, investors who were with the fund from the beginning will incur losses because of taxation. The "average trust funds method" therefore represents a severe impediment to anyone trying to design an open-ended stock investment trust in Japan, and it is one of the reasons why high quality index funds (which attempt to mimic share-price indexes) have not been developed. This can be seen clearly in the fact that investment trusts linked to the Nikkei 300 index have been granted the sole

exception to the "average trust funds method".

Tax issues are now under review. Any changes should at the very least enable personal investors to invest in trust funds under the same conditions as they invest in individual stocks. Doing this will require that the "average trust funds method" be eliminated and investment costs tracked for individual investors, thereby making taxation fairer.

D. Need for Defined-Contribution Corporate Pension Plans

Corporate pension funds in Japan are eligible for preferential tax treatment, but companies are obligated to use defined-benefit pensions. Should investment yields fail to meet their expected rate of return, the company must make up the difference. As funds mature and their assets increase, companies are exposed to larger and larger investment risks. The result is that even though stock investments offer potentially higher yields over the long term, the risk exposure is so great that companies entrusting their pension funds to trust banks, life insurance companies, or investment advisory services tend to overweight their portfolios for bonds.[22]

Tax breaks only for defined-benefit pension plans detract from the funds' ability to supply risk capital. We therefore recommend giving the same tax breaks to defined-contribution plans, in which the employees bear the investment risks. Doing so would enable Japan to develop pension funds that could provide risk capital for long-term investment horizons.[23]

E. Capital Maintenance Provisions in the Companies Law

Japan's Companies Law (Commercial Code) restrict dividend payments in order to protect corporate creditors. These rules impose stiff restrictions on the use of the company's paid-in capital (defined as all capital paid into the company in the process of establishment and subsequent capital increases) to pay shareholder dividends or buy back shares. Because of these restrictions, the net

[22]There are also many other faults in the corporate pension funds that are urgently in need of correction. For an outline of Japanese corporate pension system and their problems, including accounting and taxation issues, see Morinaga and Fukao (1997).

[23]Mrs. Yuri Okina provided valuable insights into the relationship between fixed-contribution pension funds and risk capital.

assets of Japanese companies cannot be thought of merely as assets belonging to shareholders. For example, even when there is little hope that a company's performance will improve in the future, shareholders cannot use the company's net assets as collateral to borrow money which will then be paid out as dividends.

When shareholders deliver cash to the company in exchange for share certificates, the money must be put in either the "stated capital" or "capital reserve" accounts. In principle, companies are obligated to deem at least half of the money from stock issues as an increase in stated capital, with the remainder an increase in capital reserves. For the company to pay out the investments of shareholders (including any money in excess of the par value of shares), the board of directors must decide to convert capital reserves to stated capital and then engage in a capital reduction. Capital reductions, however, require a special resolution two-third majority of the general meeting of shareholders, since they involve shrinking the size of the company and therefore impinge substantially on shareholder interests. During the process of capital reduction, all the creditors have the opportunity to voice objections, and the company is obligated to guarantee certain satisfaction of the debt, either by repaying the objecting creditors immediately or by providing appropriate collateral.

A company cannot purchase its own shares to retire unless its articles of incorporation allows it. In general, it can only be done within the scope of funds that could have been paid out as dividends. Other cases that companies can buy their own shares are rather limited; for capital reductions (see above), or for mergers or full acquisitions of the business of another company. Thus, even though retiring shares is the most rational way to unwind interlocking share-holding relationships, there has been stiff legal provisions against doing so.

These legal restrictions have been eased at the end of March 1998 when the Diet passed a temporary law amending the Commercial Code. This legislation has enabled companies to use their capital reserves to buy back and retire shares so long as the sum of the capital reserves and profit reserves (mandatory reserves companies have to set aside when they distribute their profits) is more than 25 percent of their stated capital (see Iwahara 1998).

According to the fourth quarter 1996 edition of Quarterly Corporate Statistics, large companies capitalized at Yen1.0 billion or

more had Yen165.3 trillion on their capital account, of which Yen46.6 trillion was stated capital, Yen43.3 trillion capital reserves and profit reserves, and Yen75.3 trillion "other surpluses" (retained earnings). Allowing the use of capital reserves to retire shares would therefore mean a large expansion in the amount of money available for this purpose. Under this new temporary law, companies can buy back and retire shares by a resolution of the board of directors up to the amount specified in their articles of incorporation. This new law also significantly eased the creditor protection procedure. As a result, the new law will provide a powerful tool for absorbing the selling pressure that will be generated as interlocking share-holding relationships unwind. At the same time, however, they will change the nature of companies' net worth into something far more unstable than before, which may in turn change the nature of Japanese corporate governance.

The author considers the former rules on capital reductions in the Commercial Code to be too strict for top companies with strong equity-debt ratios and advocates making them more flexible. On the other hand, creditors, business partners, and employees have all evaluated risks on the assumption that the capital maintenance provisions would remain in place. Amending the Commercial Code to suddenly change these provisions vastly changes the conditions upon which transactions were based and is therefore problematic in and of itself. For example, if a company that had a high credit rating because of its strong equity-debt ratio were to suddenly dip into its capital reserves and buy back shares, its rating would be reduced, which would in all likelihood subject bond investors to losses. Likewise, those that deal with a company or those that agree to work for a company because of its excellent financial health, which was predicated on the traditional restrictions, are substantially harmed when there is an increase in the risk of the company's going under. There must be provisions to offset this. For example, there could be a low ceiling set on the percentage of capital reserve that a company could use to retire shares in any one year, or share retirement could be permitted only to companies that maintain a certain equity-debt ratio.

IV. Changes in Corporate Finance and Their Impact on Governance Structures

A. Changes in the Relationship between Shareholders and Companies

The major shareholders in Japanese companies have traditionally been financial institutions and industrial companies with which the company had dealings. However, ties between banks and companies are eroding and their interlocking share-holding relationships are gradually being unwound, resulting in an increase in the holdings of foreign and institutional investors (pension funds, investment trusts and the like). As this happens, shareholders' motivation for owning shares will be shifting away from maintaining stable business relationships towards a greater emphasis on investment yields. This emphasis on the return on the investment will not necessarily mean that shareholders will insist that companies immediately and over the short term maximize their share prices, but it will probably change the relationship between shareholders and companies to something far less cozy than it has been.

These changes in the share-holding structure are likely to substantially reduce the ratio of stable shareholders. In traditional interlocking share-holding relationships, shares were not sold without the agreement of the company. At work in this was a mutual checking function—when both Company A and Company B hold shares in each other, Company A can retaliate by selling Company B's shares if Company B sells Company A's. This practice of holding shares that were difficult in practice to sell has had an influence on the way in which investment trusts and pension funds hold shares through life insurance companies and trust banks, and this has made it difficult for them to adopt clear-cut, returns-oriented investment policies. However, foreign investment trusts are moving into the Japanese market, and poor pension performance is having a large impact on the results of sponsoring companies. These trends are likely to produce a switch away from cozy investment relations to a more dispassionate emphasis on returns.

These changes in the relationship between managements and their shareholders will have an impact not just on share prices, dividend policies, funding methods and other strictly financial concerns, but also on employment practices and relations between

companies. For example, a survey on corporate dividend pay-outs found 86.6% of listed companies citing the fact that "the stable shareholders provided by interlocking share-holding relationships put little pressure on the company to raise dividends" as the reason why Japanese companies have lower pay-out ratios than American. That makes it probable that pay-out ratios will rise as interlocking share-holding relationships are gradually unwound.[24] In this same survey, the majority of publicly-traded companies thought that reductions in interlocking share-holding ratios would have a very detrimental influence (10.7%) or a somewhat detrimental influence (43.6%) on the stability of corporate management. Most, in other words, perceive the unwinding of interlocking share-holding relationships as an issue that will impact how their companies are run.[25]

In this section we consider the impact on corporate behavior of changes in the relationship between shareholders and managements.[26] The author is of the opinion that the defining characteristics of Japanese companies are most clearly manifest in the relationship between companies and their employees when business turns sour, and that this has a vast impact on how the company functions even when profits are good. In other words, when business turns sour, there must be a decision on which of all the parties with a stake in the company – creditors, shareholders, managers, employees – bears the risks and in which order. This is influenced by their commitment to the continuation of the company, the need to maintain employee morale, and the cost of raising funds. In the pages that follow, we compare the behavior of Japanese and US companies in these situations and attempt to develop formulas to express the ideas discussed.

B. The Impact on Japanese Corporate Governance

"Japanese-style management" is usually thought to be distinguished by the following:

[24]Fuji Research Institute (1993, p. 110).

[25]Fuji Research Institute (1993, p. 120).

[26]Systems in the capital markets and systems in the labor market have an influence on each other and tend to increase the stability of the system as a whole in a phenomenon known as "institutional complementarity". For a discussion of this point, see Okuno (1993) and Aoki (1995).

(1) Lifetime employment, in which the company sacrifices some profits in order to ensure employees of long-term, stable employment and seniority-based wages.
(2) The main bank system, in which companies enter into long-term interlocking share-holding and borrowing relationships with one or a small number of banks, in order to obtain their support in times of crisis.
(3) The keiretsu system, in which 'corporate groups' are formed to provide for stable, long-term business dealings between companies (including some interlocking share-holding relationships).

These behaviors are supported by explicit and implicit contracts and business practices in the capital, labor, and other markets where companies are active. However, the relationship between shareholders and corporate managements in the capital markets is headed for seemingly inevitable change as accounting moves from "historical cost" to "market value (fair value)" standards, interlocking share-holding relationships unwind, and greater numbers of institutional investors and foreigners join the ranks of shareholders.

a) Changes in the position of shareholders and employees in Japanese companies

Below we outline the de facto positioning of various stakeholders' portions of the assets held by large listed companies. Our goal has been to schematize the relationships involved.[27]

(1) Creditors > Core employees > Top executives > Shareholders (only realized profits that could be used for dividends) > Other employees

In other words, it is possible to see the "pecking order" shown above in the claims that banks and other creditors, core employees, top executives, shareholders, and part-timers or other non-core employees have on the assets of the company.[28]

This relationship is best illustrated by examining how large Japanese companies behave when business turns sour. The first to

[27]The inequalities used here do not stem from theories of "employee sovereignty". Rather, they express the de facto priorities of the claims held on the company by its stakeholders. Our inequalities are similar in their concept to the theory of "conditional governance" discussed by Aoki (1995, pp. 107-12).

[28]See Fukao and Morita (1997).

be cut are the part-timers and contract employees. Overtime is also cut for core employees. Next to be cut are dividends and director bonuses and wages. During this time, the company attempts to maintain the jobs of its core employees by reassigning them or seconding them to other companies. As long as the company has a certain amount of retained earnings on hand, it will not directly fire core employees even if current profits go negative. If anything, companies cut their hiring and wait for natural attrition to take its course, or give employees incentives to take early retirement. Should results grow even worse, then the company will begin dismissing core employees, though only after discussing the matter fully with the labor union. When the company is in danger of bankruptcy, its main bank and other major shareholders step in and take control over top management, usually replacing some executives with directors seconded from the bank.

What this means, however, is that large Japanese companies are carrying an "implicit off-book obligation" to maintain the jobs of their core employees. Understood in these terms, it is easy to see why shareholders are almost never able to recover their investments from out of paid-in capital when management starts to wobble. Traditional interlocking shareholders probably understood that this was the position of shareholders and acted accordingly. However, as interlocking relationships unwind and share-holding switches to institutional investors and foreigners with whom companies have less cozy relations, this off-book labor liability is unlikely to be permitted and a larger percentage of shareholders will press for sharp staffing reductions than would have in times past. We would note in this regard that it was common for French companies to guarantee their white-collar workers stable employment, but European monetary union and the privatization of state enterprises have brought a sharp increase in the number of foreign shareholders, particularly from Britain, and as a result France is experiencing more white collar unemployment than ever before.[29]

b) Pressures on management for "unrealized profits"

Microeconomics tends to assume that all of a company's net assets belong to its shareholders. However, the traditional behavior

[29]There are other factors as well for the decline in white collar jobs. For example, the development of telecommunications technology has made it possible to shift routine clerical processing to lower-wage developing countries.

patterns of Japanese companies would seem to indicate the following ownership patterns for companies' net assets.

Capital, statutory reserves(including capital reserves): Guarantee of the company's continued viability.

Realized profits: Shareholders.

Unrealized profits: Net assets to be used at the discretion of the board of directors.

It is this unwritten understanding that is probably behind the otherwise impossible statements often made by Japanese companies as they announce their results: "The company turned in a current loss this year, but was able to cover it from the realization of latent capital gain so that no harm was done to its shareholders." Kaplan (1993, 1994) maintains that changes in the board are more frequent when Japanese companies begin to turn in current losses that cannot be covered by the realization of latent profit, and this fits with the ideas we have been advancing.

Share prices obviously reflect unrealized profits. If the assets corresponding to these unrealized profits are used effectively to generate profits, then the total profits belonging to shareholders grow and there is no problem. However, when unrealized profits are tapped to cover losses, share prices decline, so shareholders actually take a loss. As share-holding shifts from companies and financial institutions that sought to maintain business relationships to institutional investors and foreigners that emphasize share prices, the unwritten understanding that we have been discussing will probably collapse. This will leave managements with less room for discretion over unrealized profits.

Note in connection with this the discussion in Section III *E* of the idea that use of capital reserves to buy back and retire shares would result in a large reduction in the owned capital that guarantees the company's continued viability. It would appear likely that the stable capital that was a hallmark of Japanese-style management will be growing more unstable.

c) The future of corporate governance in Japan

We have seen how changes in the share-holding structure will change the relationship between shareholders and employees and the unwritten understanding on unrealized profits. As this happens, we expect the relationship between the stakeholders in Japanese corporate assets to change from (1) above to something more like this:

(2) Creditors > A smaller group of core employees > Top executives > Shareholders (all profits, including unrealized profits*) > The vast majority of employees

*: If the Commercial Code is amended, shareholders will have a say over capital reserves as well as profits.

Changes along these lines will mean large changes in the relationship between companies and their employees. Even companies turning profits may come under pressure from shareholders to cut their workers so as to become even more profitable. While it will be difficult, because of legal restrictions and past court rulings, for Japanese companies to engage in the same kind of lay-off and firing practices as are seen in the United States, companies are likely to narrow down their core employees and place greater weight on part-timers, contract employees, and temporaries. They are also likely to make the wages of their core employees more flexible.[30]

In the relationship between shareholders and managers, managers will find themselves with less room for discretion over unrealized profits. It will therefore be difficult for managers to avoid taking responsibility for the company's performance by resorting to unrealized profits to cover losses. As more shareholders emphasize share prices and profits rather than stable business relationships, keiretsu based on capital ties will probably decline in importance as well.

These changes do not, however, mean that Japanese companies will be transformed into US-style companies in all their aspects. Below we have a formula for a typical US company that would correspond to the formula (1) above for a typical Japanese company.[31]

(3) Top executives > Creditors > An extremely small group of core employees > Shareholders (profits and most paid-in capital) > The vast majority of employees

In the United States, the board of directors has the authority to decide management compensation, and it is doubtful that this is

[30]The precedent in postwar labor cases is that before an employer can fire an employee, it must first prove that it needed to cut surplus workers, make adequate efforts to avoid dismissing the employee (for example, reassignment), use objective yardsticks in determining who to dismiss, and negotiate with its labor union if it has one. Because of this, it is very difficult to make layoffs or to fire individuals in ordinary circumstances.

[31]For more on this topic, see Fukao (1995, p. 40).

adequately controlled by shareholders. Even after hostile takeovers, top executives leaving the company are able to take "golden parachutes" (large severance packages) without the approval of shareholders. Even when the company goes under, the executive can file for "Chapter Eleven" relief under the US Bankruptcy Law, becoming a "debtor in possession" (DIP) and maintaining its position for a considerable period of time.[32] The result is that executive compensation has the highest priority in claims on the assets of US companies. It is this that leads to the first inequality sign in our formula. The second and third inequalities stem from the fact that the truly core employees of US companies are those it absolutely must have for the company to continue to be viable. Shareholders have broader rights to claim a portion of corporate assets in the US than they do in Japan, and US companies can use paid-in capital to pay dividends, and this is reflected in the portion allocated to shareholders in our formula. The final inequality is due to the unstable nature of employment for the vast majority of employed workers in the United States. These employees are laid off with short notice.[33]

A comparison of the three formulas would indicate that Japanese corporate governance will be growing close to that of the United States. In particular, employee job security will be reduced and

[32]However, in these cases the courts often order cuts in what they consider to be excessive management compensation.

[33]The hypothesis regarding the structures of Japanese and US companies advanced here is deeply related to the Japanese/US corporate models developed in Aoki (1995).

Aoki's theory attempts to model the relationship between internal decision-making process and personnel management structures on the one hand and corporate finance on the other. In other words, Japanese companies decentralize the coordination of their internal organizations (information processing an decision-making) and centralize their personnel management. By contrast, US companies centralize the coordination of their internal organizations and decentralize personnel management. Japanese-style corporate structures assume close relationships and common understandings between people in the company, which makes them suited to forms of finance like the main bank system that make it easy for the company to maintain its viability.

The hierarchy of claims on corporate assets discussed in the body of the paper attempts to formulate one aspect of Aoki's theory in a way that lends itself to verification. It also attempts to elucidate relations with accounting rules, bankruptcy law, and securities transaction law.

shareholders' say over net assets will increase. On the other hand, there are still many institutional differences remaining between Japan and the United States, particularly in terms of labor relation laws, the authority of managers in the commercial code, and bankruptcy procedures. We would also underscore the large gaps in practices and social consensus when it comes to the relationship between companies and their employees. This indicates that for the foreseeable future Japanese companies will still be quite different in their activities and behavior from the standard US company.[34]

V. Conclusion

In this paper we have analyzed how the rise and fall of asset prices since the late eighties gave Japanese banks stock portfolios that left them with clearly excessive exposure to market risks compared to their capital. The liberalization of capital markets and the reduction in bank credit ratings have shifted the funding activities of large companies away from banks in favor of capital markets. These structural changes are in turn exerting pressure on banks and large companies to unwind their interlocking shareholding relationships.

In the past, banks, corporate pension funds, life insurance companies, and other institutional investors took in funds from industrial companies and households at fixed or near-fixed interest rates and invested them in stocks and other high-risk assets. Institutional investors bore most of the risk associated with stock ownership. However, the rupture of the "bubble" has depleted much of the unrealized profits that financial institutions had been using as a cushion and thereby reduced their ability to bear risk. This will probably raise the cost of equity finance for Japanese companies. To restrain the cost of capital so as to maintain investment and economic vigor, Japan will need to reform its corporate disclosure rules by making its accounting system comparable to international standards, and will need to make stock in Japanese companies attractive to foreign investors. In addition, Japan will need to restore the faith of the household sector in stock

[34]For an analysis of the differences between Japanese and US companies from the perspectives analyzed in this part, see Fukao (1995) and Fukao and Morita (1997).

investment trusts so that households put greater emphasis on stocks in their asset investments.

The capital markets have been gradually changing in this direction since the early eighties. The pace of change has accelerated after the rupture of the bubble weakened financial institutions. Meanwhile, the labor market is also becoming more liquid as the population rapidly ages, the development of Asian economies spurs changes in the industrial structure, and competition policies are introduced into previously protected industries. Even the "lifetime employment" system is changing as companies gradually reduce the range of core employees and the periods to which they are willing to commit. Labor unions view this trend "partly as something that cannot be avoided because it is brought about by changes in the economic environment, and partly as something that individual employees should welcome".

In an extremely interesting paper, Okazaki (1993) argues that prewar Japanese companies had many of the characteristics that are now seen as hallmarks of American companies. The typical Japanese company before the war was a classic shareholder-driven capitalist company. When ownership of shares changed, so did management, and employees' jobs were likewise unstable. The current "Japanese-style" management system emerged out of the wartime controls that were imposed on the economy in the late thirties and the upheavals of the early postwar period.

If Okazaki is correct, it has not been all that long ago that "Japanese-style" management structures were established and they are far from unchanging. One of the hallmarks of Japanese-style corporate systems has been the credible commitments that managers have been able to give to their employees and business partners. Managerial stability has been what has secured the "unwritten contract" between companies, their employees, and their business partners. However, capital markets are weakening the long-term relationships between shareholders and managements, and this, in conjunction with changing structures in the labor market will be gradually changing how Japanese companies are managed.

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