

**The Strategic Logic of Japanese *Keiretsu*,
Main Banks and Cross-Shareholdings, Revisited**

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Comments Welcome.

Abstract

This paper introduces recent fundamental changes in Japan's political economy, and analyzes how these have affected the country's industrial architecture in terms of business group organization. Whereas previously, long-term, stable relations with other firms, banks and shareholders afforded great advantage to many companies, the new dynamic environment has led more and more banks and companies to turn away from stable "insurance" arrangements. The paper shows that a revision of corporate law towards more managerial flexibility paired with broader powers by shareholders matches this shift towards greater transparency, accountability, and competitive strategic positioning. Therefore, processes of corporate governance are also greatly altered. Our perceived wisdom of Japanese business organization needs to be updated.

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1. Introduction

From the heydays of Japan research in the late 1980s and early 1990s, we have established a “perceived wisdom” on how Japanese business works. Aggressive government policies geared towards fast export-led economic growth formed the backdrop to a particular “industrial architecture” (Lincoln/Gerlach 2004), consisting of clearly specified relations among large firms as main pillars, small firms as supporting staff, and banks as central operators of finance. Government policies consisted of regulated interest rates to lower the cost of borrowing for large firms, subsidies and tax measures supportive of a high rate of investment, and trade policies to protect infant industries and facilitate cooperative arrangements in innovation and technological “catch-up”. Because new entry was limited and technology policy managed such that all incumbents had access to new innovation streams, from this developed a stable competitive hierarchy, with a set of clearly identified leaders in each market segment.

The core of this industrial architecture were the so-called six horizontal *keiretsu* (inter-market business groups), whose preferential trade relations were cemented through cross-shareholdings anchored by a main bank that fulfilled three important functions: to provide smooth access to finance even to the most highly leveraged firms (by providing loans, and by acting as a delegated monitor, thus inviting loans from other banks as well); to monitor management based on superior insights into the company’s operations; and to structure a coordinated workout should a company encounter serious trouble, so as to avoid bankruptcy and ensure the company’s longevity (and thereby maintaining the competitive hierarchy). Disclosure rules and other regulation were geared towards

supporting informal workouts and other problem-solving. From this developed a peculiar setting for corporate governance based on internal processes, with the stock and bonds markets as well as the courts assuming the roles of rarely used sidekicks.¹

For the manager of a Japanese firm during the postwar period of the 1950s through the early 1990s, this industrial architecture created strong pressures to invest and grow constantly. Low costs of borrowing meant that in order to uphold a certain market share in a fast-growing market, firms had to invest at least as much as their competitors (Abegglen/Stalk 1985). Moreover, the system of lifetime employment that developed during the early part of the period turned a substantial portion of labor into a fixed cost, such that the breakeven point for firms was comparatively very high. In this setting, every sale that earned a positive income – however small – was desirable. Banks, too, were more interested in steady sales revenues than they were in profits, because their main interest was to collect interest on the significant amount of loans outstanding. The highly leveraged companies with high fixed costs operating in an environment of rapid technological “catch-up” had as their biggest concern survival.²

During the postwar period, the main vehicle most of Japan’s largest companies chose to reduce the risk of failure was to tie up with a certain bank and a certain business group. By joining one of the “Big Six” industrial groups, companies bought insurance against stock market fluctuations, precipitous drops in sales, and financial uncertainty.

¹ See Lincoln/Gerlach (2004) for the leading study on *keiretsu*; Hoshi/Kashyap (2001) and Aoki et al (1994) on the main bank system. On the policies of the “developmental state”, see, among others, Johnson (1982), Komiya et al (1988), Patrick/Rosovsky (1976), Calder (1988, 1993), Pempel (1998), and Schaeede (2000). Technology policies and R&D consortia are evaluated by Anchordoguy (1989), Callon (1995), Goto/Wakasugi (1998), Lynn (1998), Noble (1989), and Okimoto (1989). Whether industrial and technology policies were indeed successful has been hotly debated but is not of prime interest here: no one denies that these policies were attempted throughout the postwar period, and accordingly they formed the setting in which large companies formulated their corporate strategies.

² See Schaeede (forthcoming) for an in-depth analysis of corporate strategy in the setting of postwar industrial policies.

The first was accomplished by engaging in cross-shareholdings with other group members such that although a single firm's ownership stake in each of the other companies was rather small, taken together all group firms owned between 20% to 30% of total group equity outstanding, meaning that the group was close to a majority shareholder. The second piece of insurance was provided by preferential trade relations: group firms would purchase preferentially from other group firms, even when (or precisely when) a group member was overpriced or in trouble, thus helping the company to stay afloat and turn things around. And finally, each group comprised a set of core financial institutions that guaranteed access to credit and were large shareholders.

However, the fundamental changes in Japan's political economy between 1998 and 2006 have turned this business logic on its head, and a reorientation of corporate law has altered incentives, liberties and constraints faced by Japanese managers. Shareholder rights have been greatly strengthened. So crucial are these changes that they constitute a "strategic inflection point" (Burgelman/Grove 1996), meaning that the old ways of doing things have been irreversibly transformed. What it used to take to win does no longer promise success. Accordingly, in the early 21st century many Japanese companies have begun to reformulate their corporate strategies, in a process referred to as "choose and focus" (*sentaku to shūchū*). This term refers to strategies of corporate unbundling through reorganization and spin-offs, and concentration on the core business, sometimes through acquiring or merging with competitors. As a result, a process was set in motion away from high diversification (the previous dominant strategy) towards a concentration on core competences with more careful and guarded diversification around that core. In the process of making this change, many of the central features of the postwar industrial

architecture are being replaced with processes more conducive to aggressive global competition in a much more dynamic setting.

This paper begins with analyzing the strategic inflection point of 1998, triggered by the severe banking crisis of 1998 that greatly affected the entire banking industry and economy, as well as the relation between banks and their clients. Efforts to avert a financial meltdown contributed to an already ongoing process of dramatic shifts in regulation that began in 1998 and culminated in a new Corporation Law in May 2006. Next, the paper provides evidence of the decline in *keiretsu* cohesion and the unwinding of cross-shareholdings. As banks and companies began to disentangle their ownership ties, two new categories of investors have assumed dominant position among Japan's shareholders: Japanese institutional investors and foreign funds. Banks are being replaced in their role of main corporate "monitors" by institutional investors, and this has affected the underlying logic of corporate governance and accordingly corporate strategies by Japanese firms. Our existing understanding of Japan's industrial architecture has become outdated and needs to be updated to the new Japanese market environment of the 21st century.

2. The Transformation: Banking Crisis and Legal Reform

The fundamental reorientation of the legal framework for business, and with it the processes of regulation and oversight, set in with the banking crisis of 1998, during which Japan came perilously close to a financial meltdown. The combination of crisis, true market pressures towards change in the form of globalization, and political willpower

as exerted by Prime Minister Koizumi led to a series of reforms that were unprecedented in their reach and impact.³ As for the crisis, by 1997 the huge losses incurred by banks as a result of financial and real estate speculation in the bubble years (1987-1991) could no longer be downplayed. With the bankruptcy of two large financial institutions in November 1997, most large banks faced great difficulties to reach the capital adequacy ratio of 8% as required by the Basel Accord for banks operating internationally. Had any large bank dropped below this ratio, it would most likely have folded, potentially causing a bank run.

To avert this precarious scenario, the government injected a total of ¥9.3 trillion (roughly \$90 billion) into the countries' leading banks. This was accompanied by fierce political debate, and thus resulted in stringent rules for banks on how to improve their businesses. Finding themselves in the spotlight, banks began to reorganize and clean up their nonperforming loans. True reorganization was made possible by a legal revision that allowed financial holding companies. By the early 2000s, Japan's 15 leading banks had merged into four large financial groups (Mizuho, MUFG, Sumitomo-Mitsui, and Resona). Also in 1998, two long-term credit banks came under government receivership and were subsequently sold to U.S. equity funds that successfully turned them around into Shinsei and Aozora. Smaller banks were in a similarly perilous situation, and their restructuring triggered the "credit crunch" of the period 1998-2003, during which many small firms lost access to funding. All this exacerbated a severe recession, and since all other government attempts, including a "zero interest rate policy", proved futile, moving forward with legal

³ Shifts in politics and vested interests were critically important in this process, but are better discussed in research on political change in Japan. See Pempel (1998) for prescient analysis of the precursors to this "regime shift", Vogel (2006) for the interplay of government and business in this reform process, and Poe et al. (2002) for an early analysis of Commercial Code reforms from a political perspective. Amyx (2004) analysis the role of the Ministry of Finance and the political background of the 1990s financial crisis.

reform and fundamental restructuring became the only viable, and last, resort.

To avoid tedious legal discussion, we will simply group the legal reforms into four large categories here, and zoom in on their main effects. The first set of changes concerned regulation, transparency and oversight, which arguably began with the “Big Bang” financial reforms of 1998. These covered almost all financial areas, and had in common a big push towards stricter disclosure (in particular, a shift to accounting at current market values as opposed to historical book values, as well as consolidated balance sheets such that firms could no longer conceal losses in nicely cloaked subsidiaries).⁴ The shift to disclosure and transparency was paired with a new approach to financial regulation, as the previous reliance on informal means of process regulation through administrative guidance and behind-closed-doors workouts was replaced with by-the-book inspections and meaningful sanctions of violators. In particular, with the establishment of the Financial Services Agency in 1998, and the fast rise to true authority by that agency, even laggard banks had to face the reality of their non-performing loan quandary.

A second important change came with the introduction of new bankruptcy legislation. Throughout the postwar period, large firms in trouble had typically been forced into an informal workout in which the main bank would assume the lead role in arranging the refinancing of debt and a managerial turnaround. Bankruptcy laws dating back to 1927 and 1951 were too cumbersome for “Chapter 11” type reorganizations, so that companies had little choice but to allow their bank to take over. In 2000, a new “Civil Rehabilitation Law” introduced such reorganization (including for individuals), and

⁴ The shift towards mark-to-market valuation was introduced in 2000, and in 2001 cross-shareholdings (i.e. stable share ownership by banks and companies) shifted to mark-to-market rules as well.

together with the 2003 revision of the “Corporate Reorganization Law” introduced new processes for efficiently structured turnarounds. The courts of Tokyo and Osaka established special divisions to handle such procedures without delay. A further reform in this area was a 2001 guideline for “out-of-court workouts” that clarified the structure of bank-led turnarounds. Finally, the 2004 revision of the Liquidation Law established clear-cut rules for a shutdown of debtors and a fair distribution of assets. All this triggered a wave of shutdowns and reorganizations, and helped greatly in cleaning up the aftermath of bubble period excesses.

The third area of change was implemented through annual revisions of the Commercial Code, starting in 1997. At the end of this process, Japanese companies now have a variety of options for reorganization through mergers and acquisitions and spin-offs, as well as executive compensation. Many of the legal revisions concerned types of stock, and what companies were allowed to do with shares. For example, in 1998 stock buybacks were introduced, which invited a large-scale repurchase of equity issued during the bubble years 1987-1991. It became possible to swap stocks to accomplish a merger, and by allowing a variety of different types of stock, companies could give different rights to different types of owners (e.g., for a takeover defense). In short, stock market rules were reconfigured to allow for the exchange of ownership stakes, friendly or hostile.

A final set of revisions concerned corporate governance, as eventually spelled out in the Corporation Law of May 2006. The significance of this law can hardly be exaggerated. Not only does it pull away from the archaic and convoluted Commercial Code all rules pertaining to companies, thus clarifying and streamlining rules and regulations, as well as categories of companies and how they are governed. What is more,

the law turned the regulatory philosophy of corporate legislation on its head, by shifting from the (originally German) logic of “ex ante regulation” (i.e., everything that is not explicitly allowed is therefore prohibited) towards “post-remedy” rules (everything that is not specifically prohibited is therefore allowed, with courts ruling on problematic issues as they occur).⁵

For corporate strategy, this meant greatly increased flexibility for managers in how to organize their companies, who to merge with, what business units to spin off, and how to earn profits. The Corporation Law is explicit about this increased flexibility, but also introduces new processes of oversight, by shifting significant monitoring powers to shareholders. Japanese annual shareholders’ meetings that in the past were known for record-breaking brevity (lest any trouble occur) and described as “*shan shan*” (“open-applause-close”) meetings, have been replaced by much more strictly regulated and governed processes (Fujita 2006, Diamond Weekly 2006).⁶

3. From Long-Term Ties to Dynamic Competition

The shift in legal logic means that the Japanese CEO of the 21st century faces significantly more freedom in strategic decision-making, but also greater pressures in terms of accountability, liability, and responsibility. An entrepreneurial company can now

⁵ Fujita (2006) describes the shift as one from “preemptive rules, with informal bureaucratic discretion in ambiguous areas” to “freedom in principle, with ongoing formal oversight”. This shift had formed the basis of Commercial Code revisions since 2000; see Ministry of Justice, “Japanese Corporate Law: Drastic Changes in 2000-2001 and the Future”, www.moj.go.jp/ENGLISH/information/jcld-01.html.

⁶ Annual shareholders meetings in Japan used to be 20-minute gatherings by passive shareholders who would simply acquiesce in management-sponsored proposals without asking challenging questions. More activist shareholders often had difficulty attending because most companies would hold the meetings on the same day at the same time, and so-called *sōkaiya* (mafia-related shareholders paid to protect management) guarded the doors like bouncers at a hip nightclub.

position itself like no other, gaining competitive advantage from new ideas and new processes. All this occurred at a time of great political change through the centralization of power in the Cabinet Office under Prime Minister Koizumi, which greatly curtailed the discretion and influence of ministries. One important part of the legal revisions of 1998 was the substitution of a new “Foreign Exchange Law” for the old “Foreign Exchange and Foreign Trade Control Law”. This law had been a great source of ministerial prowess in the postwar period, by affording ministries the power to withhold something (such as imports of raw materials or licenses for new technologies) that firms badly wanted, so that ministries could entice “good” corporate behavior. Trade controls had also provided protection from imports in many domestic markets.

The 1998 legal change removed the last vestiges of cross-border controls. Moreover, Japan’s financial markets had begun to turn global, and the leading Japanese firms themselves contributed to their exposure to global competition by increasingly outsourcing from abroad. Government-organized research consortia, to the extent they continued, had long shifted to basic research, meaning that competition had also arrived from innovation and new technologies. In short, the competitive setting for Japanese firms has completely changed. To be sure, a handful of protected industries remained, and some companies refused to acknowledge the new competitive environment. But as the changes in laws, regulations and markets were taking hold, an increasing number of companies in industry after industry began to reconsider their competitive positioning in this much more dynamic setting.

The Main Bank

To compete successfully in the 21st century, companies face challenges that are very different from those of the protected, fast growing environment of the postwar period. A first development towards this new market environment was the diversification of finance that set in as early as in the mid-1980s (Hoshi/Kashyap 2001, Schaeede 2000). Financial deregulation allowed firms to raise external funds more easily through the issue of stocks, bonds and short-term notes. As a result, the portion of bank lending directed at large firms began to shrink to a point where many no longer rely on bank loans for investment needs. Therefore, the financial leverage of Japanese firms, expressed as the ratio of debt (interest-bearing liabilities) to equity, has fallen from dramatic levels during the postwar period to a much more normalized situation. Figure 1 shows that from a peak of almost 600% (for large firms with capital exceeding ¥1 billion, and even higher on average) in the mid-1970s, the debt-equity ratio has fallen to less than 200% for large firms in the early 21st century. The chemical and electronics industries have been particularly aggressive at reducing bank loan reliance, with debt-equity ratios of around 100% in the early 2000s.

A lower debt-equity ratio means reduced dependence on banks. Companies finance projects increasingly through retained earnings, or to the extent they require external funds, through issuing stocks or bonds. To do this, however, companies have to fully disclose information on their business, and profitability becomes a critically important factor in determining the cost of financing. Not coincidentally, in the early 21st century Japanese companies began to publish information on their ROE (return on equity) and other measures of profitability to attract investors.

Given all the research hailing the virtues of the main bank system in terms of patient capital and insurance, why would banks and companies separate in this way? Four main reasons can be identified how this process happened, and why it demarcates an irreversible change in banking. First, financial deregulation has already been mentioned; the fact that companies so eagerly diversified their external financing portfolio bespeaks of the pressures that were inherent in the main bank system, as highly leveraged firms were constrained in their strategies by the main bank which was interested mostly in growing sales through high diversification. Not all companies found this monitoring situation enjoyable.

It became even less palatable after the burst of the bubble, when banks, struggling with financial difficulties, began dropping the ball on their main clients. When in 1997 Fuji Bank announced that it was too financially stressed to rescue Yamaichi Securities, some companies confronted with serious financial challenges and more stringent disclosure rules themselves, began to sell off cross-held shares that were a drag on profits.

After the Financial Services Agency introduced a definition of a “non-performing loan” in 1998 and then pressured banks to close such loans in their portfolios, banks began to lean more heavily on clients to sell off non-profitable or strategically secondary assets, including real estate, golf courses, factories, business units, and even cross-held shares. At the same time, banks themselves underwent a similar process, and a 2001 law further pushed the process of banks’ selling off their ownership stakes in corporations (see below).

Perhaps most importantly, interest rate regulation as well as restrictions on

external funding, including abroad, had eventually been phased out. For companies, bank loans were no longer the cheapest or even easiest way to secure funding. For banks, less dependency on loans translated into much reduced influence over companies, but also less financial interest in monitoring and supporting companies. This divergence of interests was extended by a strategic shift in the banking industry, away from the previous reliance on lending (which used to be their bread and butter under regulated interest rates) and towards fee-based income (such as underwriting of securities issues or syndicated loans). Both, banks and companies had begun to move towards more flexible means of funding that allowed them to react better and faster to changing market situations.

A 1999 Cabinet Office survey on the merits of the main bank system supports these findings. Table 1 shows the three primary benefits of a main bank relation, both reflecting back on the past and estimating future needs, as listed by 1,361 listed companies (of which 806 in manufacturing). As for the past, the answers were predominantly about “stability”, “long-term relations”, and “service”. In looking forward, however, the “stability” type of responses dropped by half. In their stead, companies now valued creditworthiness due to the bank’s reputation, support in global business, and specialized advice on financial strategies, including how to structure mergers and acquisitions. This shift in demand has triggered restructuring within banks, including human resource practices (from generalists to specialists, and from seniority to meritocracy). Overall, the survey suggests that the main bank system *per se* is still valued, but the functions and the role of the main bank have begun to change. Rather than being a stable source of long-term support, the main bank is turning into a resource for knowledge, information, and execution of unbundling strategies.

Keiretsu Membership

Throughout the postwar period, Japanese firms strove to shield themselves from the threats of competition – both in the form of corporate control and takeovers, as well as market share loss – through corporate tie-ups. These tie-ups came in three main forms: large, inter-market groups; vertical lineups of subcontractors and other suppliers; and vertical tie-ups with exclusive wholesalers and retailers in distribution. All three have undergone great transformations: the supplier relations have become more diversified, and the retail revolution that began in the late 1990s has all but undermined exclusive wholesaler arrangements (Schaede, forthcoming). The focus here is on the “Big 6” horizontal groups.

Excellent research on these groups paired with superb data, unavailable for most other countries, has afforded us great insights into the workings of these groups during the postwar period. From data based on Toyo Keizai’s annual *Kigyō Keiretsu Sōran*, we can measure cross-held ownership stakes, personnel dispatches, and within-group loans. Regular surveys by the Japan Fair Trade Commission (triggered by the economic dominance of these groups) from 1977 through 2001 have added qualitative information over time. Sociologists (Gerlach 1992, Lincoln/Gerlach 2004, Lincoln et al. 1996, 1998) have used these data for in-depth statistical network analyses, while economists have provided us with studies on the implications of these networks for corporate finance and industrial organization (e.g., Hoshi/Kashyap 2001, Hoshi 1994, Lawrence 1993, Nakatani 1984, Caves/Uekusa 1976).

From this research four main insights have formed our knowledge of these

groups. First, there are two types of “horizontal groups” – three that are descendants of prewar *zaibatsu* reconstituted in the 1950s (Mitsubishi, Mitsui, and Sumitomo), and three that were anchored by banks (Fuyō, Sanwa, and Dai-Ichi Kangyō (DIK)).⁷ Each of these groups had several core firms (such as a large bank, a trading house, and perhaps a heavy machinery company), but no company was dominant in terms of ownership stake; rather, each group member owned, on average, 1-2% of the shares of other group members. The groups followed a fairly strict rule referred to as “one-setism”: one group would not include more than one competitor in each industry, to prevent intra-group competition (leading Caves/Uekusa (1976) to label these groups “inter-market”). With increasing diversification, this rule was loosened over time; for example, Mitsubishi Heavy and Mitsubishi Electric eventually began to compete in several product segments. Note that “one-setism” means that a business group was not a cartel in the economic sense of the word, because it did not dominate any one industry segment. It has been pointed out, however, that one effect of these arrangements were “repeated oligopolies” (Hadley 1970): in product market after product market the top three or four leading firms would be from one of these groups. Overall, groups numbered between 20-40 members, so that roughly 200-220 of the largest Japanese firms of the postwar period were members of the Big 6 horizontal *keiretsu*.

The main purpose of these groups has been presented as “insurance”. In the 1950s, companies attempted to shield themselves from foreign hostile takeovers. When

⁷ Interestingly, the group anchored by the Industrial Bank of Japan (IBJ) has not been considered in this context, although it has been referred to as the “*chō-erito, jitsuryoku Number 1*” (super-elite, most influential group, Ōsono 1991), and due to the Mizuho merger is now amalgamating with the DIK and Fuyō groups. Members of the IBJ group included Japan Airlines, Nissan Motors, Central Glass, Japan Steel, Dai-Shōwa Paper, Aoki Construction, Kuraray and Japan Railways West. See Calder (1993) on the role of IBJ as a signal setter of directions of industrial policy.

the government proved it could effectively implement foreign exchange controls (through 1964, and in different shape after Japan joined the IMF and GATT), the emphasis of protection shifted to insurance against the domestic stock market, through an agreement that reciprocally held ownership stakes would not be sold, especially in times of crisis, and that dividends would be kept low (a custom developed to cap them at 10% of a stock's face value, which was either ¥50 or ¥500).⁸ Thus, for group firms the foregone return on investment in shares represented an insurance premium against their own stock's price volatility.

Various studies have shown that group firms had lower average profitability than non-group firms, but also lower variance in profitability over time (e.g., Nakatani 1984, Hoshi/Kashyap 2001). Thus, group membership came at a cost, and the foregone profits were an insurance premium against market uncertainty. The finding of lower profits can be explained by the more conservative attitude of companies that joined and remained in groups. Over time, it is also possible that group firms were increasingly "old industry" firms (such as cement, steel, shipbuilding, chemicals, etc.) which after a growth spurt lost out in Japan's changing industrial structure after the oil crisis of the 1970s (Suzuki 2005). Another important contributor to lower profits were the preferential trade agreements among group firms: one underlying facet of group membership was that all firms would buy at least a certain portion of their input materials from other group firms, in particular in times of crisis (Schaede, forthcoming). While this was most relevant in intermediate

⁸ The majority of stocks in the early postwar period had a par value of ¥50, so that most companies paid dividends of ¥5 per share. Hodder/Tschoegl (1985) calculate for the period 1960-1983 that the 1,500 largest firms listed on the 1st Section of the Tokyo Stock Exchange paid an average of between 5.92 and 6.88 yen per share; during that same period, the TSE index increased sevenfold, so that average dividend yields declined to roughly 1% of the share price during that quarter of a century. Even under regulated interest rates more profitable venues of investment could have easily been identified.

products and equipment (e.g., steel, chemicals, turbines, or machine tools), it was visible even to the naked eye: at a Mitsubishi plant, only drinks from Kirin (a group member) would be served. When Mazda fell into crisis in the 1970s, in addition to providing financial support and absorb some surplus labor, Sumitomo group firms kindly requested that all employees purchase a new Mazda car (Pascale/Rohlen 1983). Preferential trade overrode cost considerations, and only a most blatantly inefficient group member may have been subjected to a “modernization” campaign by fellow group firms. The important gain for a member firm from preferential trade was to establish a minimum quarterly sales volume that served as a buffer against sales variations over the business cycle. As we have already seen, during the go-go years of high investment and high leverage in the 1960s and 1970s, maintaining revenues was critical to please the bank. As profitability was secondary in those years, the tradeoff between higher profits and group insurance was easy to make.

Taken together, these various elements bespeak of the main *raison d’être* of horizontal groups during the postwar period: protection, long-term stability, and reduced uncertainty in a fast-changing market. However, a number of indicators suggest that much of this has come to change. Table 2 summarizes the most critical measures of Big 6 impact and cohesion. From the upper part of the table, we realize that the economic role of the horizontal groups has declined significantly between 1970 and the turn of the century: whereas the Big 6 accounted for almost one fifth of total capital and assets, and 15% of total sales in Japan’s economy in the 1970s, these ratios have fallen to the low 10% range. Again, some of this decrease may be attributable to many core group firms operating in “old” (i.e. structurally depressed) industries. Regardless, so clear is the

evidence that horizontal groups no longer dominate Japan's economy that in 2001 the JFTC has terminated its economic impact survey of the Big 6 groups.

The lower part of Table 2 compares four measures of group cohesiveness between 1981 and 1999. The first measure is the percentage of total group firms' shares outstanding that is owned by other group firms. On average, this ratio has fallen from 25% to 20%, although the three "old *zaibatsu*" groups have always recorded a higher shareholding ratio than the "new bank" groups. As of 1999, in no group did the group shareholdings represent the majority owner (33%) any more.

A similar downward trend is also observable for preferential trade. On average, in 1999 group firms purchased but 6.4% of all inputs or goods from other group firms. This decline of 50% reflected a growing concern with costs at a time of market opening and globalization. The dispatch of senior executives to other group firms' board of directors has also halved from 8.6% of group directors sitting on other group boards, to 4.2%. In this category, even the "old *zaibatsu*" groups do not stand out. Finally, intra-group lending refers to the percentage of loan volume in group main banks that is furnished to own group firms. It has always been the case that while the main bank was the largest lender to group firms, it was rarely the only one; instead it functioned as a delegated monitor for loans from other large banks (Sheard 1989, 1994). Moreover, we have already seen that main banks are no longer as actively engaged in lending, as opposed to other financial services, and beginning in the mid-1980s even the large (city) banks furnished most of their loan to medium- and small-sized firms. Table 2 suggests that the level of main bank dependence by group firms has dropped to an almost negligible level.

Figure 2 maps the two main categories of intra-group ownership and preferential trade from Table 2 into a two-axis repositioning chart. The longest distance, reflecting the biggest loss in cohesion, was covered by Sumitomo, and the smallest by Dai-Ichi Kangyō. The “old *zaibatsu*” Mitsui group is no longer more cohesive than the “bank group” DIK, but Fuyō and Sanwa take the lowest spots. The Mitsubishi group, always the tightest and most conservative of all, remains in that situation, and the decline is more in terms of purchasing than it is in shareholding. Overall, the cohesiveness of all groups has waned considerably.

Table 3 is similar to Table 1 in that it reports survey data on the perceived costs and benefits of cross-shareholdings for the past and the future. Note a fourfold increase in the number of responses that see no merit in cross-shareholdings. At the same time, reported costs include potential economic loss, lack of outside monitoring due to *keiretsu* dominance, and the fetters of preferential trade. Just as in Table 2, whereas stable, protected, long-term relations were valued in the past, the inefficiencies associated with these tie-ups are now often considered too severe, and the tie-ups too restrictive, for companies to compete successfully in the 21st century.

With the changing market and legal environment the value of *keiretsu* networks in their old form has weakened. This does not mean that *keiretsu* are necessarily going to disappear (although the bank mergers, such as that of Sumitomo and Mitsui, may lead to the merging of groups). Rather, to survive and remain meaningful, these groups have to rework their value proposition. Stability, longevity, and reciprocity are all beneficial for high-leverage, high sales strategies, but in the new 21st century pursuit (and disclosure) of profitability these virtues apparently are losing their appeal and usefulness.

Cross-Shareholdings and the New Shareholder Structure

Cross-shareholdings were the glue that held business groups together, thus providing the various aspects of insurance through group membership. Recall that these table shareholdings were based on an understanding that they would not be sold, in particular in times of crisis or market downturn, to cushion the effects of stock market fluctuations on management decision-making. Perhaps like no other aspect of change involving *keiretsu*, the steep decline in cross-shareholdings and the new composition of Japan's overall shareholder structure have brought great forces for change in the country's corporate governance.

For the years 1987 through 2003, we have detailed data on cross-shareholdings from two annual surveys that collate data from corporate Annual Reports with survey responses on large shareholders: the Nihon Life Institute's annual survey (NLI 2004) and the Daiwa Research Institute survey (DRI 2004). NLI also takes credit for introducing a strict distinction between "stable shareholders" (*antei kabunishi*, stock ownership that may be unilateral but is long-term, aimed at buttressing a trade relationship or for other political reasons) and "mutual shareholders" (*mochiai kabunishi*, reciprocal commitments, even if unbalanced, to cement even tighter corporate relations). Thus, reciprocal shareholdings constituted the superglue of group cohesion.

Figure 3 presents the percentage of stable shareholders and *mochiai* of total stocks outstanding. The top line shows that whereas stable shareholdings remained fairly unchanged at over 45% of all shares until 1995, this ratio has dropped by half, to a level of under 25% in 2003. The upright bars in Figure 3 illustrate that the percentage of firms

that identified themselves as having at least one stable stock in their portfolio dropped from its previous level of over 95% up to 1996 to 83% in 2003.

The decline is even more remarkable for the superglue – the restrictive reciprocal (*mochiai*) shareholdings. The second line in Figure 3 shows that whereas in the 1980s and early 1990s more than 17% of listed firms were intertwined in mutual ownership, this ratio fell to 7.6% in 2003. Expressed in absolute terms for the year 2002, of a total market valuation of ¥237 trillion for all 2,674 listed firms, ¥17.6 trillion was identified by survey respondents as being “mutual”. This not only represented a decline of ¥10 trillion over a one-year period, but the downward trend continues. The year 2003 was the 17th year in a row in which the percentage of *mochiai* declined. In April 2005, NLI, the research institute that introduced the differentiation between stable and reciprocal shareholdings, announced that it would discontinue its survey, for the phenomenon had become too small to measure accurately (NLI web site, April 7, 2005; Kuroki 2003, NLI 2004, Suzuki 2005).

Banks Selling Out

Data breaking down reciprocal shareholdings by industry show that the largest contributors to this unraveling were the large commercial (or city and long-term credit) banks. Whereas these 16 top banks held about 11% of total stock market capitalization in 1991, their holdings reduced to just 3.6% in 2003 (DRI 2004: 6). If we include in the group of “large banks” the 47 regional banks, as of March 2006 these banks owned 4.7% of total shares at the Tokyo Stock Exchange. The sell-off began with the onset of bank failures in the mid-1990s. Adding to this were the bank mergers, planning for which

began with the Financial Big Bang in 1998. Moreover, increased disclosure and pressures on profits, paired with loosening business group ties, shifted the economic balance of cross-shareholdings towards selling out.

Although some banks had idiosyncratic or temporary reasons to sell shares from their portfolio, the trend is industry-wide and unlikely to be reversed, because the most important trigger of the mass sell-off after 2001 was the new Law Limiting the Bank's Stock Ownership (*Ginkō-tō no kabushiki-tō no hoyū no seigen-tō ni kan suru hōritsu*; hereafter "Ownership Limit Law"). Designed to limit the banks' exposure to risky assets and thus improve the stability of the banking system, this law limits the total amount of corporate equity that one bank can own to its own Tier 1 capital.⁹ In other words, the Ownership Limit Law reduced the scope of bank shareholdings to the bank's size, strictly defined as capital. In Fiscal Year 2001, the largest four banks alone were estimated to face an "overhang" of about ¥7 trillion that had to be sold off. Remarkably, the banks did much more than required: whereas in March 2001, commercial banks (excluding trust banks) held ¥35.7 trillion of shares at current market value, their holdings shrunk to ¥26.9 trillion in March 2002 and ¥18.2 trillion in March 2003. During this time, the stock market moved largely sideways, with the Nikkei Index closing at 10,542 in 2001, and 10,676 in 2004. In other words, in Yen terms banks halved the value of their stockholdings within a two-year period, not due to stock price levels but to sell-offs (TSE 2006b: 66, 79). The decline in the role of banks as shareholders was due to the 2001

⁹ "Tier 1 capital" is terminology from the Basel Accord, which requires a capital adequacy ratio for internationally operating banks of at least 8%. In the Basel Accord calculation, there are two types (tiers) of capital, of which the Tier 1 refers to the bank's paid-in capital, shareholder's equity, and retained earnings not yet appropriated at the end of the fiscal year. Tier 2 capital, in contrast, consists of the bank's stock portfolio, plus loan loss reserves and subordinated debt issued by the bank. The new law says that Tier 2 capital (ownership in other firms) must not exceed Tier 1 (the bank's own equity).

Ownership Limit Law, and therefore not easily reversible.

Reducing banks' shareholdings to Tier 1 capital was a process that lasted through April 2006. To facilitate this self-off and cushion its effects on the stock market, two "overflow repository" (*ukezara*) mechanisms were put into place. The first was the establishment, in January 2002, of the "Banks' Shareholdings Purchase Corporation" (*Ginkō-tō hoyū kabushiki shutoku kikō*). This government-backed entity was created by its members (large commercial banks, Norin Chukin and Shinkin Chukin) for a limited lifespan of 10 years. Equipped with funds of ¥2 trillion and the ability to issue government-backed bonds, the company was tasked with buying shares from its members, and for a fee selling these to the market in due course. In addition, when banks still found it difficult to find buyers, between November 2002 and September 2004 the Bank of Japan (the central bank) stepped in and within a few months absorbed another ¥1.7 trillion worth of banks' shares (Nikkei May 11, 2006; Kuroki 2003:6).¹⁰

The New Shareholders: Institutional Investors

The unraveling of stable cross-shareholdings has affected the shareholder structure for Japanese firms. At the height of the postwar system, in 1987, corporations and large banks together owned 71% of shares traded (or held stable) at the Tokyo Stock Exchange. Who, then, bought all these shares? Figure 4 reveals that the unraveling has given rise to

¹⁰ In addition, the Deposit Insurance Corporation had assumed vast shareholdings from the two failing long-term credit banks in 1998 (now Shinsei and Aozora). By May 2006, it was estimated that the Bank of Japan had earned paper gains of ¥1.8 trillion on its investment, and the purchase corporation another ¥1 trillion, making up for some of the losses of the banking system in the previous years (Nikkei May 22, 2006). Note that the purchases by the Bank of Japan and the Banks' Shareholding Purchase Corporation have not affected the share of government ownership at the TSE, because these are considered "corporate investors" (the Bank of Japan is 50% in private ownership). Therefore, the "corporate" share in Figure 4 below would be even smaller without those "repository" holdings, or said differently, will not increase markedly even if all those bank shares were to be sold back to corporations.

two new dominant groups of shareholders in Japan: Japanese institutional investors (in the form of trusts) and foreigners.

One important mechanism of stock absorption was for companies to buy back their own shares. This became possible with a 1998 amendment of the Commercial Code, and successively easier with subsequent revisions of that law. By June 2002, 822 listed firms had repurchased ¥3.1 trillion of their own shares. Analysts believe that a large portion of these buy-backs were shares previously held by banks in reciprocal arrangements (Kuroki 2003:6). This implies that the previous reciprocal owners were not all replaced by other stable owners, but rather that a part of the former bank-corporate *mochiai* holdings have been completely dissolved. Nevertheless, the share of corporations in total stock ownership in Japan dropped from over 30% in 1986 to 22% in 2004.

Figure 4 illustrates the remarkable increase in the role of foreign investors at the Tokyo Stock Exchange: in March 2006, they represented the largest groups of investors at the TSE with 27% (in comparison, the share of foreign investors at the New York Stock Exchange was roughly 7% at the time). Industries in which foreign investors held more than 30% in 2004 included transportation equipment, electronics, insurance, pharmaceuticals and precision machinery, while financial services, chemicals, real estate and petroleum were also above 24% (TSE 2006a: 8).

While some of these purchases were due to tie-ups among companies (such as Nissan and Renault, or Ford and Mazda), foreign investors also increased their ownership stakes through so-called “street name” trusts, such as Chase Manhattan Bank, London, or State Street Bank & Trust Co.. Japan had become an investment opportunity for investors who were betting on an imminent recovery of the stock market or a long-term devaluation

of the US-Dollar. Another significant source of investment was acquisitions of Japanese firms by foreign investment funds, in particular real estate, private equity and management buyout funds. As mentioned, when banks forced accelerated non-performing loan cleanup beginning in 1998, they increased pressure on their clients to spin-off business units that were either not profitable or not central to the core business. Many of these spin-offs were acquired by foreign turnaround funds. Finally, in the early 2000s Japan's market for mergers and acquisitions began to heat up. About one third of mergers and acquisitions in that period were "out-in" deals, meaning foreign investments into Japan (Schaefer 2006).

However, it is important to note that not all "foreign" investments was necessarily from foreign money, as there was reason to believe that many of the foreign investment funds had attracted Japanese money (Diamond Weekly 2005). Japanese banks in particular would have been interested in such indirect investment in Japan for two reasons. They were cash-rich during a period of zero interest loans in which they curbed their lending due to BIS constraints and the nonperforming loan crisis. Yet, they did not want to appear unpatriotic "vultures" by buying up assets underlying their competitors' or their own bad loans. Therefore, in addition to launching their own buyout funds, Japanese financial institutions invested in foreign funds. Regardless who was behind the money, however, and even if foreign shareholdings were to decline somewhat with fewer investment opportunities, foreign investors had arrived, ready to challenge the processes of corporate governance in Japan.

The second group of new shareholders is Japanese institutional investors in the form of trust banks. Figure 4 shows although financial institutions as a group (large

commercial banks, trust banks, insurance companies, and others) reduced their holdings, the shrinkage in bank and insurance company holdings was counterbalanced by a substantial increase in the role of trust banks, from less than 10% in the 1980s, to 18.4% in 2006. Trust banks have always enjoyed special status within Japan's banking system, as they were commercial banks (collecting deposits) allowed to offer pooled securities investing (such as mutual funds). The seven trust banks of the postwar period suffered badly after the bubble period, but in the early 2000s they became parts of the newly emerging financial holdings, to play an increasingly important role in the 21st century.

The increase in trust investments triggered the meteoric rise of “re-funds” (funds of funds) to the position of main shareholder for many firms. In 2000, the Japan Trustee Services Bank, Ltd. (*Nihon turasuto saabisu shintaku ginkō*) was founded, with Sumitomo Trust & Banking, Resona Bank, and Mitsui Trust Holding each owning one third. In a process referred to as *sai-shintaku* (“re-trust”, apparently meant to be similar to re-insurance), this bank manages the investment trust businesses of two of main financial groups. It claims to employ highly specialized human and technological capital when investing both assets and retirement benefits entrusted of their owners and their clients. With ¥144 trillion (roughly \$1.3 trillion) in assets under management, Japan Trustee Services serves as a major shareholder for many major listed firms.

Similarly, the Nippon Master Trust (*Nihon masutaa turasuto shintaku ginkō*) was established in 2002 as the specialized trust investor of the Mitsubishi UFJ group. In addition to Mitsubishi UFJ Trust&Banking, Nippon Life Insurance, and Meiji Yasuda Life Insurance, this bank also counted Nōchū Trust, the trust arm of the umbrella bank for all agricultural cooperatives, as a shareholder. With ¥106 trillion (almost \$1 trillion) to invest,

this bank became the second seemingly ubiquitous shareholder in the early 2000s.¹¹

Table 4 presents the largest ten shareholders for a sample of large Japanese firms, by category of investor. For this impressionistic demonstration, firms were selected simply by *keiretsu* affiliation (there is one for each of the Big 6, as well as two independents) and by virtue of being in different industries; Canon and Orix are included because they are often hailed as two opposing models of corporate governance. A reader skeptical of the selection is invited to pick any number of other firms and see for herself: In 2006, finding a large Japanese company where neither Japanese Trustee Services nor Nippon Master Trust was among the top 10 shareholders was the difficult task. In Table 4, institutional investors were the largest group of investors at each of the firms presented. This is true both for the most traditional of companies in the old *zaibatsu* groups, as well as for non-affiliated firms. The face of Japanese stockownership has clearly begun to change.

The super-trusts act as custodians, as they specialize in securities processing, i.e., the administration of funds sold by investment banks (mutual funds), pension funds, or investment trusts. The large trusts vote on proxy as asked by the retail fund managers. Unlike the main owners of the postwar period (corporations and banks) these fund managers are in competition with each other for returns on investment, and therefore are unlikely to exhibit the same long-term, patient approach. Rather, fund managers aim for high-profit companies and invest in industry leaders. While those who doubt true change

¹¹ Moreover, in January 2001 the Mizuho Financial Group established Trust&Custody Services Bank, Ltd. (*Shisan kanri saabisu shintaku ginkō*). Owned by Mizuho (54%) and four life insurance companies that become part of that financial group after the merger of the three original banks (Dai-Ichi, Asahi, Meiji Yasuda, and Fukuoka Mutual Life), as of 2006 this company was investing assets of ¥94 trillion (roughly \$900 billion). See the trusts' website for more information: www.japantrustee.co.jp, www.mastertrust.co.jp, and www.tcsb.co.jp.

in Japan may augur that trust investments may simply replicate “stable” owners, it can be expected that the more assets these trusts manage and the more diversified their clientele becomes, the more concerned about returns will they become. It is inconceivable that a trust fund investing retirement benefits for hundreds of Japanese firms will not, eventually, be under pressure to earn above-average returns. Moreover, even if their subscribers are dominantly conservative, the trust banks have already changed the rules and processes of corporate governance, as they push to see profits. Market share expansion, high diversification, long-term technological bets and other strategies so valued by the highly exposed banks of the postwar era are no longer satisfying to these new dominant shareholders.

4. Implications for Corporate Governance: From Contingent to Continuous Monitoring

So far, we have seen evidence suggesting a reorientation in corporate relationships in Japan. The main bank is assuming a new role, as it is no longer the largest lender or the largest financial shareholder for most companies. *Keiretsu* are being repositioned – with the possible exception of the Mitsubishi group – to provide not so much stability and long-term reciprocal trade, but rather information, know-how, and brand image. Business groups are beginning to provide benefits that help companies to compete more aggressively.

One major purpose behind the erstwhile stable arrangements was protection from the influence of out-of-group shareholders, be those frequent traders causing price fluctuations or hostile corporate raiders. Moreover, bankruptcy legislation was

cumbersome, making a rescue by the main bank, however disliked, the most efficient means of reorganization. Stock market rules were rigid, with no flexibility in the use of shares (for stock options, repurchases, or otherwise; even the nominal face value and trading unit was described by law). Corporate managers had little freedom in thinking up new and clever strategies, for rules and regulation had squeezed them into managerial straightjackets. At the same time, they faced little oversight: the board of directors consisted of inside executives, resulting in an overlap of management and monitoring. A 1950 revision of the Commercial Code had even granted the Board of Directors the power to change the company's by-laws without shareholder vote (Wakasugi 2006). The main bank, the “delegated monitor” for other borrowers, would observe the client but take action only when things got very bad. Thus, managers were confined by rules but not monitored in their routine managerial decision-making.

The multiple and fundamental revisions of business laws have changed all this. A revision of the Commercial Code afforded companies a choice to alter their board structure by adding outside directors and adopting a “committee system” of audit, nomination and compensation committees, with the majority of members being outside directors (defined as never having been directly affiliated with the company or its subsidiaries). This system was even stricter than in the U.S. where a company may have one or all of such committees; in Japan, a company adopting the “committee system” has to introduce all three. Together with the simultaneous introduction of different types of shares, stock options, and increased possibilities for corporate reorganization through mergers and acquisitions, these changes opened the door to new processes of governance (Hashimoto 2002, Ahmadjian 2003).

Although celebrated at the time as a major breakthrough, only 5% of large firms adopted this “committee system” within the first three years. Even for those few firms, the committee system did little to change the role of shareholders in monitoring management. Moreover, critics voiced doubts as to whether the nominating committee would be co-opted by the company leadership, i.e. chosen to reflect executive interests (Itami 2005).¹² For 95% of firms, the 2002 reforms changed little.

As discussed above, the 2006 Corporation Law revised the legal logic, and on this no company was offered a choice: while CEOs are afforded greater freedom and new flexibility, they also face more stringent outside monitoring processes and clearer liabilities through a vastly empowered shareholders’ meeting. For example, while companies enjoy unprecedented liberties in revising their bylaws, any such change requires a 2/3 majority vote at the annual shareholders’ meeting (this is stricter than in the U.S., where a simple majority suffices). Other areas where approval at the shareholders’ meeting is now required include: (1) approval of balance sheet and budget; (2) dividends (shareholders decide when and to what extent these are to be paid); (3) executive compensation and stock options; (4) mergers and acquisition, both as raider and as target; (5) appointment of directors; (6) defense mechanisms against hostile takeovers; and (7) change of bylaws. Although this may look fairly standard, except for (5) all these could previously be decided upon by the board of directors; i.e. management itself.

Thus, the previous internal approach to corporate governance, based on consensus in an overlapping board and management leadership, has been replaced by

¹² This has been shown to hold for the United States as well: in about 80% of Fortune 500 companies in the 1990s, the CEO was also the Chairman of the board and in that role assembled nominating and compensation committees, which often existed of individuals interested in supporting current executives (Belliveau et al 1996).

much clearer processes established through laws and courts. Management is further observed by the FSA which has strengthened its stance as a watchdog, as became evident during the Livedoor scandal of 2005 and the subsequent criminal prosecution of related instances of insider trading (such as of the managers of the Murakami fund in June 2006). In addition to regulatory supervision, Fujita (2006) identifies four mechanisms through which the 2006 Corporation Law can be expected to make a real difference. The first is the rise of institutional investors that can be expected to utilize their new powers as shareholders, and thus fill the oversight vacuum created by the changing role of the main bank. This, together with new rules on disclosure, internet-based dissemination of corporate information to shareholders, and new voting rights for owners, is expected to fuel shareholder activism. Third, building on the multiple revisions of the Commercial Code since 1998, the new Corporation Law allows the creation of a viable market for corporate control. Whereas in 1995 Japan witnessed just one hostile takeover, in 2005 a total of 53 successful hostile takeovers were recorded (Schaede 2006). Finally, the 2006 law is also expected to contribute to better corporate governance by greatly curbing the influence of *sōkaiya* – mafia-related attendants at shareholder meetings that influenced the agenda, for appropriate pay, such that no unkind questions could be raised. Electronic voting and a larger range of means to influence management for all shareholders may combine to undermine the *sōkaiya*'s control over information and ability to shape discussion and coerce votes.

All this combines to a fundamental change the logic of corporate governance in Japan that is best described as a shift away from the previous “contingent monitoring” by banks to a new “continuous monitoring” by a variety of actors ranging from investors and

regulators to securities analysts and rating agencies. In the “contingent” system of the postwar period, the main bank, relying on inside information gathered through years of repeated financial interactions with a company, would extend loans and provide financial services. In the event of impending collapse, it would substitute for the market for corporate control (Sheard 1989). While the main bank might have dispatched an employee to a struggling company to gather more information, it would step into true action only after a client had fallen into negative net worth and needed a debt restructuring. In that case, a turnaround team replaced incumbent managers, and refinancing schemes were worked out with other lenders. All this was done informally, with the goal of ensuring the company’s long-term survival, regardless of its economic viability. The economic costs associated with this system of governance contingent on bankruptcy was that a company could operate below its potential for many years before action was taken, creating economic efficiency losses. These losses did not just occur at the level of the underperforming but for the economy overall, as resource (labor, capital) were tied up in suboptimal usage.

In contrast, in “continuous” governance, monitoring occurs through constant, proactive, sampling by many different actors that are constantly checking up on the firm. These monitoring agents include institutional investors (domestic and foreign) as well as the market for corporate control (hostile takeovers). The previous stronghold over corporate information by the main bank has been replaced with quarterly earning statements, stricter accounting and disclosure rules, and a growing industry of information intermediaries, such as rating agencies and securities analysts. The incentive structure of these agents is radically different from that of banks as monitors, for they will be

activated at the first indication of sub-potential performance. They may simply sell underperforming stocks (thus inviting takeovers), practice “voice” by replacing the company’s leadership, or push management towards reforms. The biggest costs of this “continuous” system are legal, consulting and time expenses incurred in defending against a hostile takeover bid, and the economic waste created when securities analysts get it wrong, or when corporate raiders tear apart a healthy firm suffering from a temporary stock price slump. The biggest gain is that underperformance is made public at a very early stage, allowing management and owners alike to take action before the company falls into negative net worth.

In the early 21st century Japan’s system began to move away from its almost exclusive reliance on contingent governance to continuous monitoring. This is evidenced not only by the reduced role of banks, but also the decline, by half, of intra-group dispatches of senior executives to other group firms’ boards (Table 2). The 2006 Corporation Law subjects even those companies that choose not to switch to a committee system with outside directors to face scrutiny by shareholders. Over time, more and more companies will realize that pressures towards higher profitability may be better answered by exposing management to a market of corporate information and early intervention.

5. Conclusions: The Business Perspective

The 1990s have sometimes been described as “Japan’s lost decade” – a period of recession and crisis. However, as we look back on this decade, we realize that it constitutes a “strategic inflection point” for Japan, in that the changes, reforms, and

reorientation of rules, regulations, and the markets have resulted in a fundamentally and irreversibly different system. In this new context, Japanese companies have begun to adjust their corporate strategies to compete in the new, open, and much more dynamic markets.

During the postwar period, corporate strategies were directed at stability, longevity, and growing sales revenues to balance aggressive investments. The latter was accomplished through diversification, i.e., expansion into additional product markets. In the growth environment of Japan's go-go years, the biggest threat to a corporation was not new competition (since industrial policies proved fairly effective in keeping new entry at bay). Rather, it was high exposure to risk of failure, due to high leverage. To hedge against this risk, many companies sought to buy "protection" by way of stable relationships with their banks, their trading partners, and their owners. This they found most conveniently in large business groups, the *keiretsu*, where the membership dues were foregone profits on investments (low dividends on stock holdings) and lower profitability, partially caused by preferential trades. The main bank, besides owning up to 5% of a customer firm, provided easy access to funds for ever more investments in production capacity, but it reserved the right to interfere with management in exchange for its increasingly risky exposure. Banks were interested in receiving interest payments as scheduled, which pushed the highly leveraged and diversified firms to pursue revenue growth above all. Profits were not a main concern, so that the costs of *keiretsu* membership were clearly trumped by the benefits of higher certainty of survival, and thus ability to continue highly leveraged operations.

However, the 1990s challenged this logic along several dimensions. First,

industrial policy had run its course in terms of “strategic” growth sectors, for technological catch-up had been accomplished. Protection was phased out and markets opened up. Second, the banking crisis of 1998 had proven previous processes of informal regulation inadequate to maintain the banking sector’s health and reputation. Even before the crisis, financial regulation had turned the banks’ business model on its head: whereas previously, under fixed interest rates and rapid growth, every loan was a good loan given the guaranteed spread, interest rates now had to be adjusted for risk, which had to be evaluated not on the existence of real estate collateral but the viability of a business project. When the banks eventually emerged from the nonperforming loan dilemma, they did so with a new business model oriented more strongly towards fee income: the more transactions and clients, the higher this income. Rather than providing business mostly to group firms, banks sought for larger circles of customers. From the banks’ perspective, then, being just a main bank was insufficient to compete. Moreover, fewer large firms were highly dependent on bank loans, which lowered the incentives of banks to be watchful monitors. When a new law intended to increase the banking sector’s stability required the unwinding of banks’ shareholdings, they happily and eagerly began to sell off cross-held shares.

In the new environment, what is the value of an inter-market group, a main bank, or cross-shareholdings? For risk-averse firm (such as some Mitsubishi group members), in a more dynamic setting the appeal of insurance needs may rank even higher than before, which may lead to a smaller, more protective group, perhaps even with a more hierarchical organization and chain of command (not unlike the former *zaibatsu*). For aggressively competitive firms, in contrast, stability through insurance has turned into an

undesirable drag on profits. The fetters of group membership and preferential trades have proven too costly in a new setting of higher transparency and much stricter disclosure rules, where low profitability is immediately apparent. For these firms, value in group membership will result from benefits that make members more competitive and profitable than non-members. Information sharing, brand name recognition, and advanced financial support have been among the main responses to a 2001 questionnaire (JFTC 2001). One can think of pooled labor (to reduce the high fixed cost component in employment), exchange of specialized knowledge in new technologies, or joint subsidiaries as new patterns to be developed in the near future. Whatever it is, for most Japanese firms, the real value proposition of *keiretsu* and main banks will be not about safety, stability and insurance, but about forward progress and the ability to compete in dynamic and fast-changing global markets.

The stock market, meanwhile, reflects these ongoing changes, with new institutional investors taking over where cross-shareholdings have begun to untangle. Investment trusts are evaluated based on the return on investment, and they often trade actively to earn high returns, thereby causing variance in stock price to variance and perhaps even inviting hostile takeovers. Management will fare better heeding the concerns of these new shareholders.

These changes make companies and banks more interested in new governance processes, and the new Corporation Law of 2006 reflects this interest. In the new dynamic markets of the 21st century, Japan's old system of behind-closed-doors deals and "open-applause-close" shareholder meetings are no longer the most efficient way to run a successful corporation. Of course, some old-style companies in old-style industries may

continue previous practices, but their fate is preordained: either they are irrelevant and their practices inconsequential, or they are viable and subject to acquisition in due course. Either way, knowingly or unwittingly, the dinosaurs that resist Japan's new market realities have begun their long march out.

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Figure 1: The Debt-Equity Ratio of Japanese Firms, 1960-2004
 (calculated from *Hōjin kigyō tōkei*)

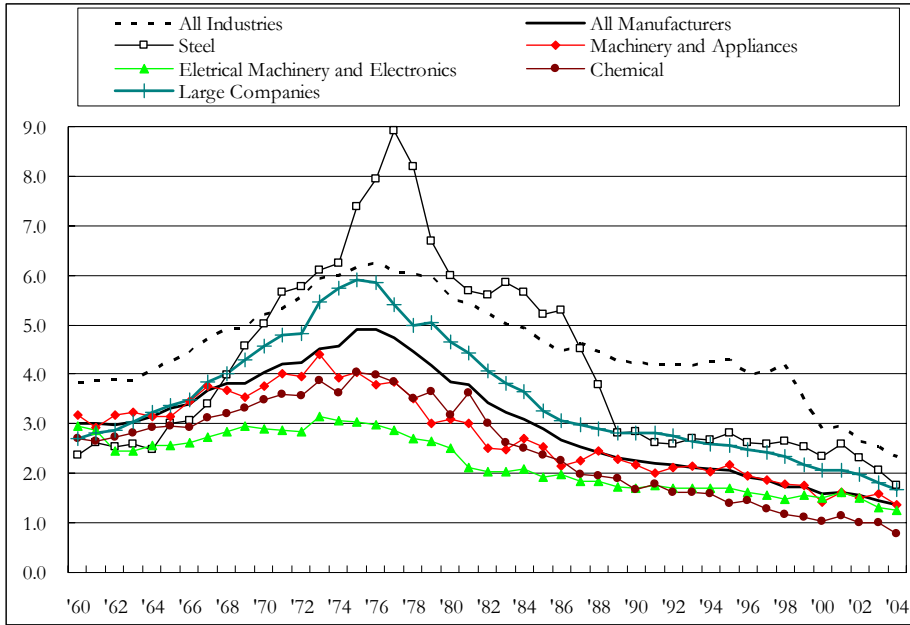


Figure 2: Changing Keiretsu Cohesion: The Combined Effect of Declining Cross-Shareholdings and Preferential Trade in the Big Six Keiretsu
 Source: JFTC (2001)

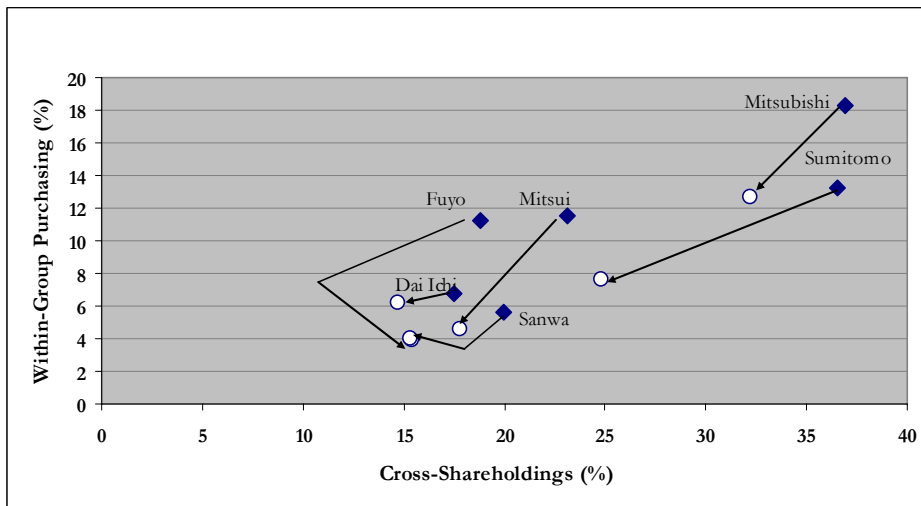


Figure 3: Stable Shareholdings and Reciprocal Shareholdings, 1987-2003
 Source: adapted from NLI: 2003, pages 16-20

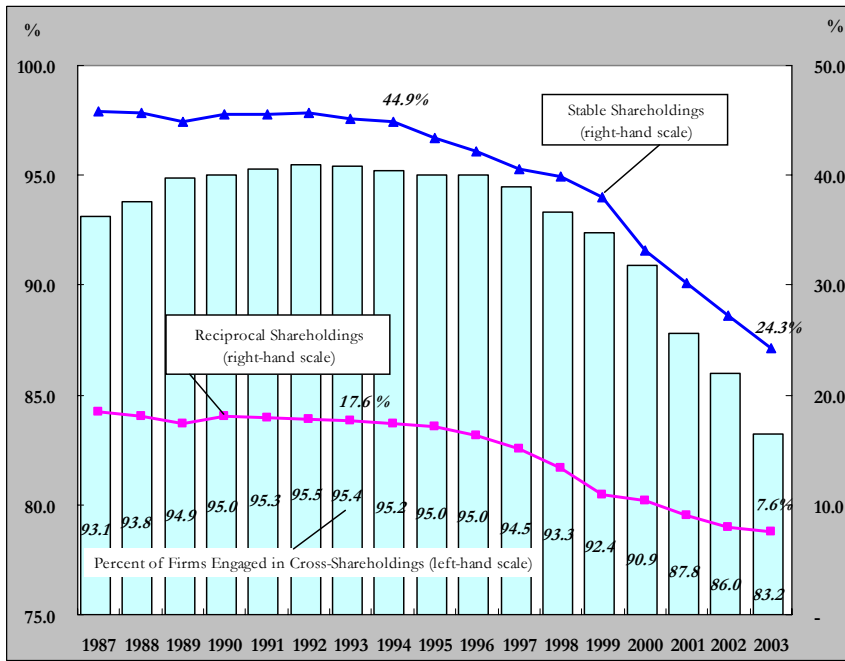


Figure 4: Ownership Percentages, by Type of Investor
 Source: TSE (2006a), in % of total market capitalization, as of March each year

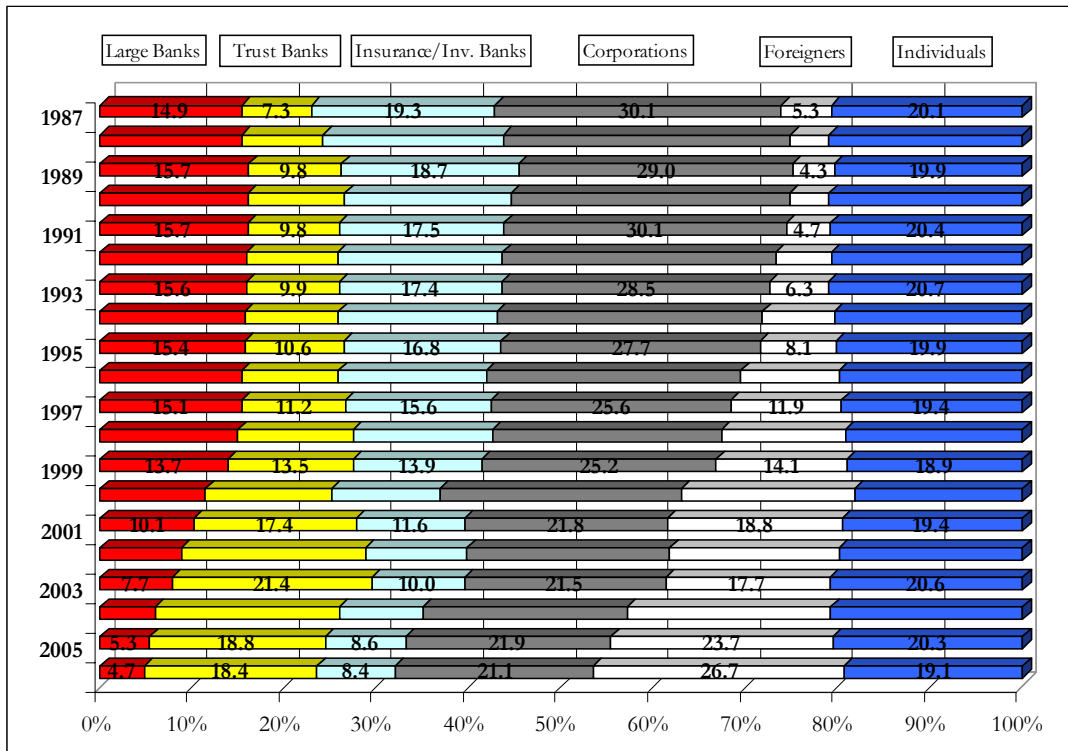


Table 1: Survey on Benefits from the Main Bank System

In bold: response with the deepest drops or increases

(Total n=1,361 listed companies, up to 3 answers allowed; Source: CAO 1999)

Merits of Having a Main Bank (up to 3 answers)	Important in the Past	Important for the Future
Having stable access to funds	59.7	50.3
Having main bank as a stable shareholder	49.5	27.6
Existence of a long-term trade relationship	32.4	16.4
Financing at conditions and interest rates that meet the firm's needs	28.6	35.1
High level of service in settlements and other transactions	24.9	23.4
High level of information and help on financial management	20.2	30.7
Rescue and support in times of crisis	18.0	17.4
Higher credit rating and financial health due to bank's reputation	9.8	20.6
Information and support in corporate strategies, such as M&A	5.2	18.0
High level of support in international business needs	5.2	11.2
Support through dispatch of executives	3.3	1.6
High level of management monitoring on fiscal and risk management matters	2.8	5.6
No merit	1.6	2.1

Table 2: Summary of Changing *Keiretsu* Role and Cohesion

Source: collated from TK (various years) and JFTC (2001)

Aspect of <i>Keiretsu</i> Role	Average for Big 6		Average for 3 "Old Zaibatsu" Groups		Average for 3 "Bank Groups"	
	1970	1998	1981	1999	1981	1999
1) Overall Role in the Economy						
% of Total Capital	18.9	13.2				
% of Total Assets	17.5	11.2				
% of Total Sales	15.0	10.8				
2) Measures of Group Cohesion	1981	1999	1981	1999	1981	1999
Intra-Group Shareholding Ratio	25.5	20.1	32.2	25.0	19.1	15.2
Intra-Group Procurement Ratio	11.7	6.4	14.8	8.1	9.1	4.9
Intra-Group Directorships	8.6	4.2	11.4	4.7	6.0	3.7
Intra-Group Lending	6.9	2.3	-	-	-	-

Table 3: Survey on Costs and Benefits of Cross-Shareholdings

In bold: response with the deepest drops or increases

(Total n=1,361 listed companies, up to 3 answers allowed; Source: CAO 1999)

	Important in the Past	Important for the Future
Merits of Cross-Shareholdings		
Stable stock price due to long-term holdings	69.9	55.2
Long-term trade relations with the stable shareholders	52.3	42.9
Protection from hostile takeovers	33.0	36.8
Easier issue of new shares thanks to underwriting by stable shareholders	5.3	3.8
Long-term capital gains through stable holdings	4.8	0.9
Lower financing costs due to lower dividends	1.6	1.8
No merit	2.2	9.3
Demerits of Cross-Shareholdings		
Hidden capital losses should share price fall	58.6	41.1
Low liquidity of funds due to pressures to hold shares long-term	37.8	40.8
Lower efficiency due to limited pressure on financing costs	11.5	19.4
Destabilized stock price due to low liquidity	10.5	11.8
Limited choice and flexibility in trading partners	7.7	12.0
Reduced discipline on management due to limited shareholders influence	6.8	6.9
Increased interference in management by stable shareholders	5.4	7.2
No demerit	9.7	10.1

Table 4: The Top 10 Shareholders of 8 Listed Companies, by Category of Investor(in %, data from *Kaisha Shikihō* March 2006)

Company Name	Mitsubishi Heavy	Nihon Seifun	Sumitomo Corp	Canon	Teijin	Shimizu	Orix	Nomura Holdings
Industry	Electric Machinery	Processed Food	Trading	Electronics	Chemicals	Construction	Finance	Investment Banking
Traditional Keiretsu	Mitsubishi	Mitsui	Sumitomo	Fuyō	Sanwa	DIK	none	none
Japan Trustee Services Bank	4.4	6.1	6.9	5.4	10.3	6.7	11.3	5.3
Nippon Master Trust Bank	4.3	4.6	6.7	4.4	11.2	7.3	7.3	4.0
State Street Bank&Trust	1.9	-	1.6	5.1	1.2	1.3	11.5	3.5
Chase Manhattan	-	-	2.4	2.0	-	-	4.6	3.4
Other trusts	8.5	2.2	-	-	1.3	-	3.7	5.5
Total Institutional Investors	19.1	12.9	17.6	16.9	24.0	15.3	38.4	21.7
Group Firms	-	2.7	-	-	-	9.6	-	-
Group bank	-	-	-	2.1	3.4	2.0	-	-
Group insurance companies	4.1	9.4	4.9	8.3	1.3	-	-	-
Total Direct Group Holding	4.1	12.1	4.9	10.4	4.7	11.6	0.0	0.0
Other Investors	-	11.9	4.1	7.7	2.4	9.7	1.5	4.2
Total Top 10 Shareholders	23.2	36.9	26.6	35.0	31.1	36.6	39.9	25.9