JAPAN

KEY POINTS

- Relationships within Japan's *keiretsu* corporate groups are weakening somewhat, so in future market forces should have more influence on corporate behaviour. This should substantially improve the corporate environment Australian businesses face in Japan.
- Some *keiretsu* main bank relationships are under stress due to high non performing loans and banks' need to defend their capital adequacy; the new requirement that banks mark corporate shareholdings to market could increase pressure to divest stocks of weaker group companies. Australian banks would be well placed to comply with these and other new bank regulations and compete successfully in this sector.
- Foreign investors now account for over 33 per cent of Japanese share market turnover, exerting pressure to increase the priority accorded shareholder value.
- Japan introduced many corporate governance reforms in the 1990s and early 2000s, including tightening company reporting requirements, increasing minority shareholder rights and introducing international accountancy standards. These reforms produce a regulatory environment more familiar to Australian investors.
- Since 1999, the Tokyo Stock Exchange has required listed companies to outline their corporate governance practices, but stopped short of including new corporate governance standards in listing requirements.
- Major internationally oriented Japanese companies are adopting smaller, more independent boards and focussing more on shareholder value.
- Deregulation, privatisation and foreign investment are changing business methods in major sectors like finance, autos and telecommunications, improving access for Australian producers. However, many industries continue to be characterised by a complex web of corporate, bank and bureaucratic relationships that prevent more rapid change in corporate behaviour.
- Minority shareholders and institutional investors still play a minor role in governing corporate behaviour, and many boards consist mainly of executive members and remain largely unaccountable to outside investors.

Relations between firms, their banks and customers are still significant in determining Japanese business behaviour. Although a relationship based corporate sector, working closely with government, successfully drove economic development for many decades, increasingly this model inhibits competition and market discipline. Relatively poor corporate governance and transparency standards, particularly in financial institutions and implicit prudential authority endorsement, contributed significantly to Japan's 13 years of slow to zero growth since its so-called bubble economy burst in 1988.

However, the Japanese Government now promotes more financial sector competition, including upgrading corporate governance standards and tightening regulatory controls. Bank restructuring and high non performing loans forces many *keiretsu* firms to compete more for finance than previously. Increased foreign ownership also should boost shareholders' interests as a corporate priority. Together with new regulatory reforms, including a revised Commercial Code, these developments eventually should guide Japan towards a more rules and disclosure based corporate governance system; this is already happening in the more progressive and internationally competitive firms.

CORPORATE STRUCTURE

The *keiretsu* system has dominated Japan's corporate scene in the post war period; longstanding banking and business relationships bind groups of firms in many sectors. Based around a large financial institution or a major manufacturer, this system appeared to serve key stakeholders well for many decades. However, the long downturn since 1988 and the banking crisis in the 1990s highlighted some of this system's inherent weaknesses. In the 1990s, reformers gradually recognised corporate governance needed to be based more on strong disclosure rules, shareholder involvement and competitive forces rather than *keiretsu* and bureaucratic relationships.

Keiretsu Dominance Deters Competition

Though somewhat weakened over the last decade, relationships in large *keiretsu* business groups still determine much Japanese corporate behaviour and governance. Banking, commercial and personal relationships and cross equity ownership vertically and horizontally link firms (Ostram, 2001). However, poor profitability during the long post 1988 recession, banking sector rationalisation, increasing import penetration and a growing foreign business presence impose significant pressures on these groups. Increasingly, member firms also look outside the group for finance, inputs and distribution channels.

Keiretsu group structures protect member firms from competitive pressures, and hence can reduce market discipline on corporate behaviour. A large bank, such as Mitsubishi or Sumitomo, often is at the centre of *keiretsu*. In others, including Toyota and Daihatsu, manufacturing companies lead the group, holding equity in other firms up and down the production chain (Ostram, 2000). While banks can hold only up to 5 per cent of a firm's shares, group firms often tightly hold most of the bank's and each other's shares. This limits market pressure on banks and group firms to provide shareholder value and minimise risk.[1]

Although the main bank generally does not discount interest rates to *keiretsu* members, it can provide favourable repayment terms and act as a clearing house for information within the *keiretsu*. In times of distress, main banks can expedite assistance, ensuring a firm's survival, although recently, this response is less assured.[2] Experience of the last decade indicates this system can permit badly run and heavily indebted firms to keep operating, reducing firms' caution in making investment decisions, and eventually creating weaker corporates, bad loans and failing banks (World Trade Organization, 2001).

As well as easier access to bank finance, advantaging *keiretsu*-linked firms over potential rivals, the Japanese Fair Trade Commission identified two other *keiretsu* practices impeding outsiders from entering the market and reducing competition (World Trade Organization, 2001). First, manufacturing based *keiretsu* members often own their group's distribution channels, preventing competition from other firms' goods or services (Ostram, 2000). Second, *keiretsu* firms often deal exclusively with each other, reducing business opportunities for new entrants. By sheltering *keiretsu* firms from competition in their product markets, these practices reduce *keiretsu* manager incentives to innovate and to act in the interests of consumers, investors and creditors (World Trade Organization, 2001).

For this and other reasons, competition in Japan's domestically focused industrial and service sectors is relatively weak, markedly reducing efficiency. For example, factor productivity in some sectors is as low as 63 per cent of US levels in similar industries (McKinsey Global Institute, 2000).

Share Markets Provide Less Discipline

As banks traditionally provided low cost, low risk financing, they reduced Japanese corporates' need to raise finance directly through equity and corporate bond markets. Japanese bank deposits exceed stock market capitalisation by around 50 per cent. In contrast, US bank deposits are only around 33 per cent of stock market capitalisation (Naughton, 2001).

In addition, shareholding patterns and shareholder behaviour reduce the effectiveness of the share market in disciplining firms. In 2001, banks held about 37 per cent of corporate equity and other corporates held another 26 per cent. A significant share of these holdings were *keiretsu* holdings and until recently, were not traded. This reduces outside investors' and regulators' role in scrutinising these firms. It also reduces share market liquidity, raising new firms' direct financing costs, even for new ventures expected to generate high returns (Schulz, 2000). Furthermore, Japan's minority

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1 With the cross shareholding of banks and corporates limited to 5 per cent, more indirect mechanisms often provide control. Typically, *keiretsu* banks appoint directors to company boards and retired bank executives to management positions in *keiretsu* firms; this is known as the practice of *amakudari*, or 'descent from heaven' (Yasui, 1999). Using former bank staff in senior management positions can improve the firm's management skills and banks' access to the firm's financial information, protecting themselves and depositors from losses. However, this practice may disadvantage outside shareholders who want to scrutinise the firm's operations (PricewaterhouseCoopers, 2001).

2 This is known as 'contingent governance'.

shareholders traditionally are passive. Corporate and bank share owners rarely criticise management, at least at public shareholders' meetings. While *keiretsu* banks typically monitor group firms' management and performance, which can lift management standards, in smaller group firms, in many cases this oversight failed to discipline corporate management during the bubble economy and subsequent recession.

MARKET FORCES STRENGTHENING SLOWLY

Over the last decade, bank and corporate restructuring, trade and investment liberalisation and better prudential oversight have boosted competition in Japanese financial, goods and asset markets, slowly increasing incentives for firms and banks to break old relationships and operate in a more open, rules based environment. Deregulation and new competition policy initiatives also increase competition in final product and service markets. However, many years of transition will be necessary before Japan's corporates operate on a fully transparent and competitive basis, with shareholders mainly overseeing performance.

FINANCE MARKETS

Since the late 1980s, main bank relationships in many *keiretsu* have weakened. Sales and mergers of distressed banks and corporates gradually are increasing bank independence and forcing firms to compete for finance including raising finance directly. Growing foreign financial institution and institutional investor presence also undermine traditional financing approaches, including main bank lending, and increase institutional pressure to maximise shareholder value and corporate transparency. Pension system deregulation and an ageing population also encourage the growth of institutional investors and fund managers, including foreign owned ones, increasing regulator and investor scrutiny of listed firms. However, all of these influences are still developing, and have not yet eclipsed the *keiretsu* system.

Increasing Bank Independence

Following the early 1990s banking crisis, the Government's 'Big Bang' financial system reforms enhanced competition by allowing financial systems to restructure and merge and breaking down firewalls between financial institutions (East Asia Analytical Unit, 1999).[3] To meet tough new capital adequacy requirements, banks sold their shares in non performing firms and many firms reciprocated by selling main bank shares.[4] For example, in recent years, three banks belonging to the Mizuho Group sold ¥640 billion (US$5.8 billion) in cross held shares to offset bad lending losses. New regulations requiring banks to value their assets, including equity, at market prices should accelerate

3 In 1999, the Japanese Government recapitalised the banking system by injecting ¥60 trillion (US$600 billion) to restore bank balance sheets. In December 1998, it established the Financial Reconstruction Commission to facilitate financial services industry restructuring.

4 However, often mutual unwinding of ownership takes place through a 'gentlemen's agreement' at senior levels rather than from a rationalisation program signed off at a shareholders' meeting (Naughton, 2001).

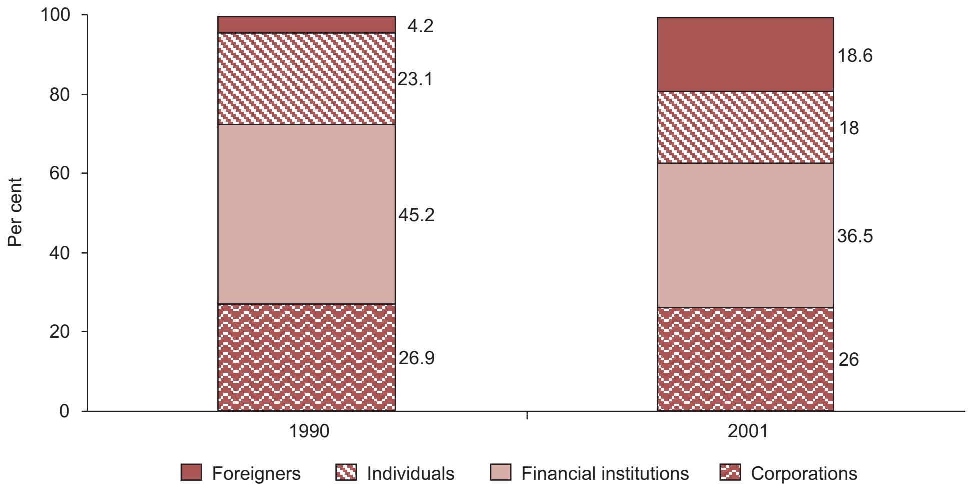
this process (Yokowo, 2001). Also, starting in 2004, banks' shareholdings must not exceed 100 per cent of their capital (Yanagisawa, 2001). Amended holding company laws encourage major bank mergers, and newly formed banks, including the merged Tokyo and Mitsubishi banks often sell down their *keiretsu* firm shares (Kurihara et al., 2001).[5]

Hence, in the year to March 2001, financial institutions' holdings of domestic shares fell to 37 per cent of market capitalisation, significantly lower than their 1990 peak of 45 per cent of capitalisation (Figure 6.1) (Kurihara et al., 2001).

Figure 6.1

Banks Selling Shares in Companies

Japanese Shareholder Ownership by Type



Source: Naughton, 2001.

Issuing new equity as part of corporate and bank restructuring introduces new owners, including foreigners who are unconstrained by relationship ties.[6] For example, US investors in the Long Term Credit Bank, renamed Shinsei, suspended lending to many failing firms, contributing to the bankruptcy of the 170 year old Sogo Department Store in 2000 (*South China Morning Post*, www.scmp.com, 14 May 2001). Increasingly, new owners pressure banks not to waive corporate debts, increasing discipline on firms to restructure and more wisely use funds (Kurihara et al., 2001).

Furthermore, the Financial Services Agency, entrusted with reforming Japan's banking system, increasingly disciplines banks in which the Government holds a share. For example, in 2001, it

5 Daiichi, Fuji and IBJ also merged, under the financial 'Big Bang', making it one of the largest banks in the world.

6 Of the top ten banks, a single large owner, mainly insurance or trust companies, accounts for an average of 30 per cent of total stock. Institutional investors hold a further third, and individuals hold the remainder (Bank of Japan, 2001).

threatened to exercise its voting rights against Ashikaga Bank if it failed to pay dividends, calling the bank's management to account (*Far Eastern Economic Review*, 13 September 2001, p. 54). The eventual sale of government bank equity to new private owners also should improve bank independence.

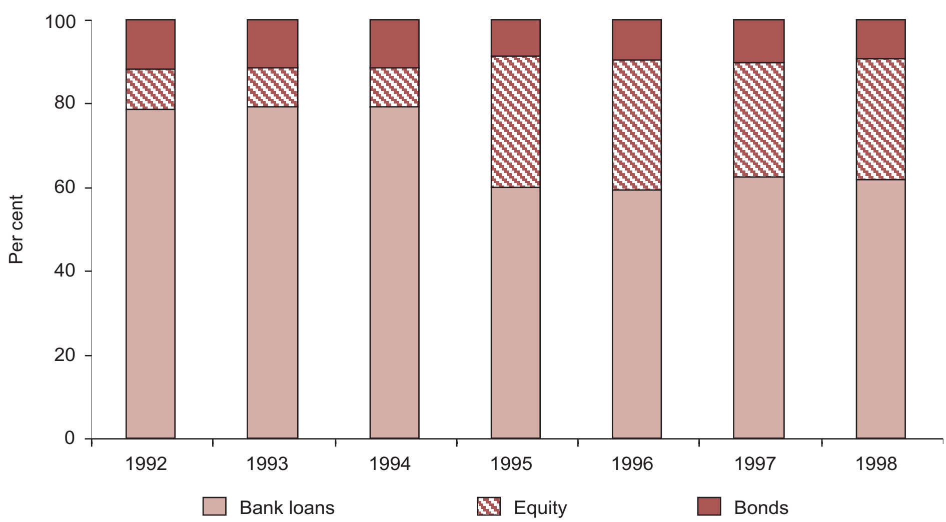
Direct Financing Increasing

A weaker but more independent banking sector forces firms to look elsewhere for funding, increasing the prominence of direct financing, especially from equity. Equity financing took off in the 1980s as financial markets deregulated and accelerated through the mid 1990s as bank finance became harder to secure (Figure 6.2) (Yasui, 1999). Initial public offer activity grew strongly, with 160 new firms launched across most sectors in 2000, well above the 40 to 50 average of previous years (Kurihara et al, 2001). 'Big Bang' reforms also boosted competition between the Tokyo Stock Exchange and other securities markets, such as over-the-counter and computer based trading facilities (Tokyo Stock Exchange, 1999). This competition and regulators' action against securities firms' anti-competitive behaviour should reduce listing and brokerage costs, encouraging smaller new entrants to list and more people to invest in the sharemarket.[7] Furthermore, firms increasingly worry about investor relations; by 2000, the Japan Investor Relations Association represented 500 members holding 66 per cent of market capitalisation, up from 117 members in 1993 when it began (*Far Eastern Economic Review*, 13 September 2001, p. 54). Despite these trends, hostile takeovers remain extremely rare, removing an important source of market discipline (Naughton, 2001).

Figure 6.2

Firms More Exposed to Equity Markets

Sources of Corporate Financing



Source: Bank of Japan, 2001.

[7] For example, many listed firms have reduced the size of minimum blocks of tradeable shares from 1000 to 100 shares, increasing retail participation (Naughton, 2001).

Institutional investors

Increasingly, institutional investors, holding around 10 per cent of listed stock, are influencing company management and supporting shareholder activism. For example, in June 1998, the Association of Japanese Corporate Pension Funds, *Kosei Nenkin Kikin Rengokai*, released its *Action Guidelines for Exercising Voting Rights* declaring pension funds have a duty to monitor corporate governance and urging them to utilise their votes to encourage long term strategies that maximise shareholder value (Institutional Analysis, 2001).[8] Under recent reforms, private managers can manage more funds from state owned postal savings accounts, assisting the growth in institutional investor activism.[9] Institutional investors also actively use their legal rights to enhance returns on shares (Yokowo, 2001). In October 2001, defined contribution pension plans were introduced, opening up opportunities for institutional investors, although these are likely to play a secondary role to corporate pension funds for the foreseeable future. At shareholders' meetings in June 2000, close to 33 per cent of attendees voted against, or abstained, on some issues and around 20 per cent now believe annual general meetings are more shareholder oriented (Schulz, 2000).

Foreign Investors More Prominent

Foreigners also increasingly participate in financing activity, accelerating the move to greater shareholder scrutiny of listed firms. By March 2000, foreign investors held over 19 per cent of Japanese market capitalisation, up from 14 in per cent in 1999 and just over 4 per cent in 1990 (Kurihara et al., 2001). Since 1998, around 50 per cent of domestic banks stock sales were to foreigners (*Far Eastern Economic Review*, 13 September 2001, p. 54). Furthermore, foreign investors influence the market more than these proportions suggest as many other shares are not traded actively. As early as 1998, foreign share trades reached a third of market turnover (Yasui, 1999).

Foreign investors are more accustomed to imposing investor discipline on corporates; their growing presence also puts pressure on main bank relationships and interlocking shareholdings when these fail to increase shareholder value (Naughton, 2001). For example, CalPERS, a US institutional investor group, now provides guidelines for institutional investors in Japan, indicating foreign institutions' continued interest in Japanese markets (Institutional Analysis, 2001). In 2001, the US based Institutional Shareholder Services opened its first office in Japan, advising institutional investors how they should vote on resolutions Japanese companies present to AGMs (*Far Eastern Economic Review*, 13 September 2001, p. 54). However, some foreign investors still report facing difficulties in voting effectively at annual general meetings.

8 The *Kosei Nenkin Kikin Rengokai* is pushing to draft more detailed corporate governance principles and strengthen domestic support for shareholder oversight of companies. Its 2000 manual for fund managers urged establishing proxy voting guidelines and active voting (PricewaterhouseCoopers, 2001).

9 The postal savings system holds about 19 per cent of individuals' financial assets. Under restructuring starting in April 2001, the mandatory redepositing of its savings with the Government's Fiscal Investment and Loan Program ended (World Trade Organization, 2001).

Keiretsu Links Weaken

Since the early 1990s, many pressures accumulated, somewhat eroding *keiretsu* dominance of corporate behaviour. The influx of new foreign owners keen to maximise shareholder value undermines *keiretsu* links (Table 6.1). Also, weak demand, the strong yen and low profits increased competitive pressures from foreign imports and investment, forcing many firms to buy from the cheapest suppliers, even if they were outside the *keiretsu*. As the recession eroded hidden assets and costs increased many firms were forced to sell off unprofitable assets, including group shares, diversifying ownership beyond group members (PricewaterhouseCoopers, 2001).

Table 6.1

Foreigners Increasing Their Share

Share of Foreign Ownership in Prominent Listed Companies

Company	Share (per cent)	Company	Share (per cent)
Nissan	53.3	Nomura Securities	29.0
Sony	44.5	Hitachi	28.9
Mazda	42.4	Fujitsu	27.5
Cannon	40.6	Toshiba	26.5
Fuji	35.5	Honda	20.4

Source: Bank of Japan, 2001.

Countering this trend, several new laws and initiatives could strengthen *keiretsu.* First, new laws permitting holding companies and streamlining reporting requirements for mergers and acquisitions are encouraging corporate consolidation.[10] Second, the 1999 Industrial Revitalisation Law grants firms tax breaks and loans from government-affiliated financial institutions once the Government approves their restructuring plans; this may reduce the risks these loans become non performing and enable vulnerable firms and *keiretsu* to survive (*South China Morning Post*, www.scmp.com, 14 January, 2002). Third, 1999 amendments to the Commercial Code allow firms to swap shares without incurring transfer taxes; this is likely to encourage mergers and acquisitions, or mutual investments or disinvestments within *keiretsu* (Naughton, 2001). In 1999, mergers and acquisitions totalled US$36.2 billion, two and a half times more than in 1998 (Naughton, 2001). More than half these mergers and acquisitions strengthened core business competency, while less than 25 per cent expanded peripheral business activities (Schulz, 2000). Unlike banks, other corporates are maintaining their net equity holdings in other firms, suggesting many *keiretsu* relationships remain intact for now (Figure 6.1).

[10] Toyota, Sony, NTT Communications and Japan Airlines all are moving to holding company structures. The competition authority has released guidelines concerning situations where mergers and acquisitions substantially restrain competition (World Trade Organization, 2001)

KEIRETSU FORCED TO COMPETE

Since the early 1990s, deregulation and market opening are increasing competition in goods and services markets, tightening discipline on managers to act in their consumers' and shareholders' interests. Stronger competition means firms are less able to maintain non-viable business relationships without running at a loss. New, cheaper providers of many goods and services forces *keiretsu* to reconsider traditional supply relationships.

Deregulation

Under various reform programs since the mid 1990s, deregulation gradually increased competition and discipline on Japanese corporations.[11] The 'Big Bang' financial sector deregulation package was the most effective sectoral reform program, but during the 1990s the Government also relaxed entry barriers in the distribution and large scale retailing sectors, and partially liberalised electricity, petroleum and gas retail supply. By 1998, new common telecommunications carriers could enter the national long distance market, reducing the dominant incumbent carriers' market share to around 50 per cent (World Trade Organization, 2001). The Government also encouraged foreign investment in key sectors, particularly financial services, and removed some informal barriers to non-agricultural trade. In December 2001, the Government announced it would abolish 19 state corporations and privatise another 45, aiming to reduce public corporations' financial support by 20 per cent (*South China Morning Post*, www.scmp.com, 19 December 2001).

However, in many areas outside the financial sector, vested private and bureaucratic interests have retained the web of regulations restricting competition, and reforms are slow and piecemeal.

Foreign Investment Reforms

Foreigners are investing significantly in manufacturing and key service sectors as the environment has become more welcoming. For example, foreign banks now can establish branches, agencies or subsidiaries without restrictions (World Trade Organization, 2001). The Government also eliminated foreign ownership restrictions on certain telecommunication services.[12] Nevertheless, complex regulations and high establishment costs continue to deter foreign investment in certain sectors, especially in health and distribution, shielding those producers from competition (World Trade Organization, 2001).

[11] Japan is in the third year of its latest program promoting deregulation. Initially the program covered 624 measures, such as eliminating restrictions on foreign participation in cable television, and deregulating port activity and sales of certain medicines. The 1999 revision contained 248 new measures, such as reviewing the electricity supply regime, while the 2000 revision included 351 new measures (World Trade Organization, 2001).

[12] Foreign direct investment restrictions remain on the Nippon Telegraph and Telephone Corporation.

FOREIGNERS ACCELERATE CAR SECTOR CORPORATE CULTURE CHANGE

Foreign entry is changing corporate culture in Japan's automotive sector. By 2001, Renault held around 37 per cent of Nissan's shares; Daimler Chrysler held 34 per cent of Mitsubishi's shares; and GM held 49 per cent of Isuzu's shares, 10 per cent of Suzuki's shares and 20 per cent of Subaru's shares. Foreign involvement has spurred cost cutting, encouraging firms to shed non-core businesses and upgrade marketing and technological standards. For example, by 2004, Nissan and Isuzu will shed 9 700 workers. Under the stewardship of Carlos Ghosn, Nissan adopted best practice in all its operations and streamlined its business, quadrupling profits in 2000.

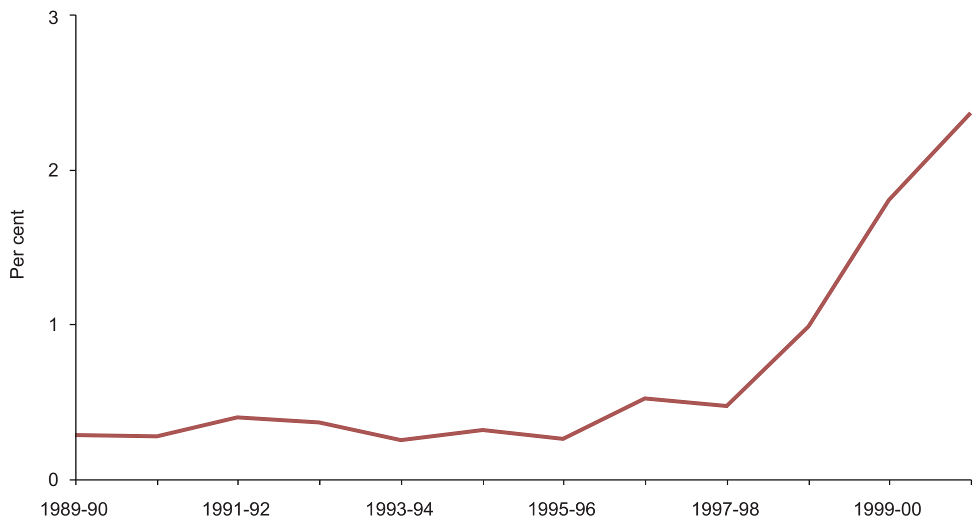
Source: World Trade Organization, 2001; *Australian Financial Review* 12 July 2001, p. 16; and *Economist*, 9 June, 2001, p. 67.

The reforms contributed to a dramatic increase in foreign direct investment from 1998 onwards (Figure 6.3).

Figure 6.3

Inward Direct Investment Rocketing

Inward FDI as a Percentage of Total Investment, 1989-90 to 2000-01



Source: CEIC, 2002

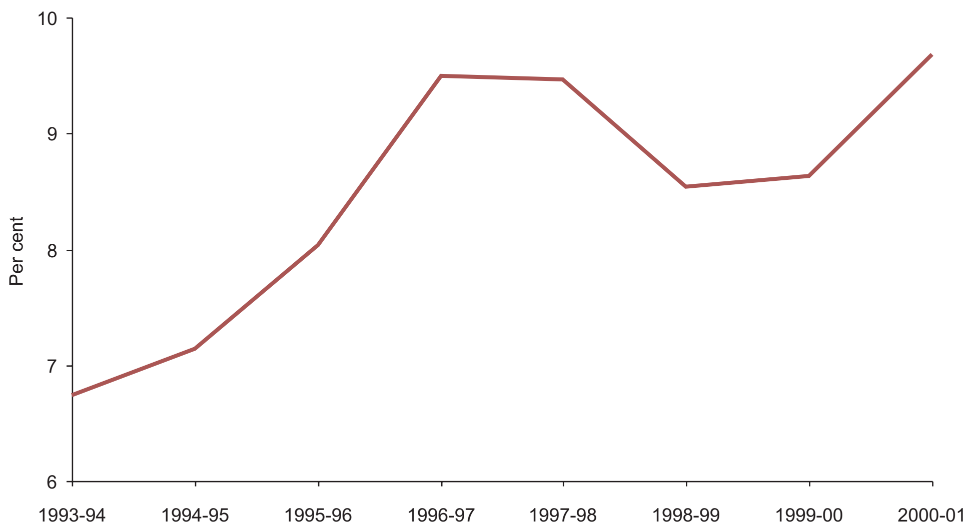
Trade Reforms

After many decades of non-tariff barriers producing a relatively closed domestic market, Japan's increasingly open trading environment complements its foreign investment reforms. At 1.7 per cent, the average tariff rate for non-agricultural products is one of the lowest in the world and over half of all tariff lines attract no tariff, the highest proportion in the world. Coupled with more gradual retail and distribution reforms, low tariffs are now increasing import penetration significantly in some areas, driving down prices and strengthening competitive discipline on competing firm managers (Figure 6.4).[13]

Figure 6.4

Import Penetration Growing

Share of Imports in GDP, 1993-94 to 2000-01



Source: CEIC, 2002

[13] In agriculture, formal tariffs and import quotas take protection well above OECD averages. Discussions continue about moving from price to income support, but little reform has taken place thus far. Sanitary and other non-tariff barriers, particularly on food and beverages, also significantly increase trade barriers (East Asia Analytical Unit, 1997). Despite these barriers, Japan produces less than 40 per cent of its agricultural requirements, pointing to a high level of import penetration in that sector. During the 1990s, average annual subsidies to agriculture exceeded the sector's contribution to GDP, which averaged 1.5 per cent.

Anti-trust Reforms

To increase competitive pressures in still sheltered and inefficient non-traded sectors, the Government has somewhat strengthened competition policies. In recent years it has removed exemptions under the Anti-Monopoly Act, allowed private parties to initiate cases against perceived violators and increased the Fair Trade Commission's enforcement capacity.[14] In 1999, the Fair Trade Commission monitored 24 sectors and prosecuted 32 firms for undesirable market performance under the Anti-Monopoly Act, up from 27 cases in 1998 (World Trade Organization, 2001).[15]

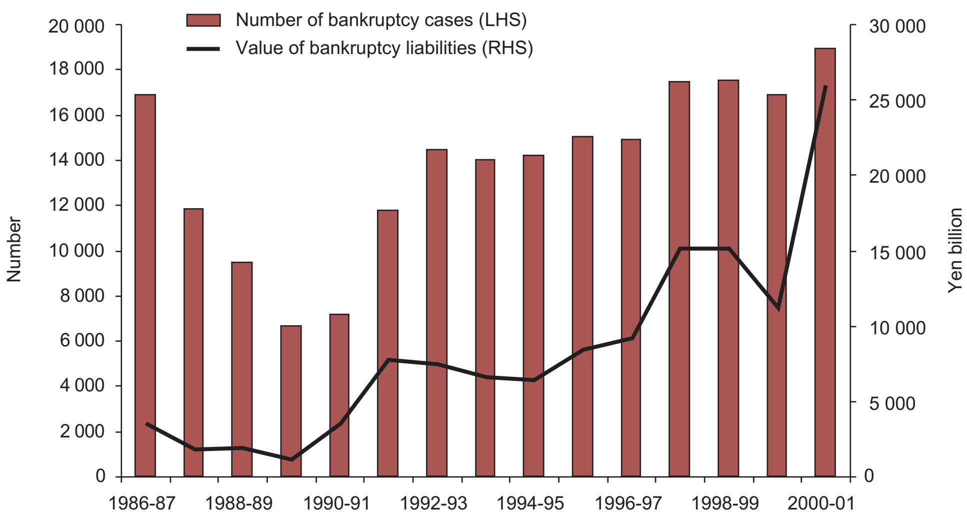
Bankruptcies

More bankruptcies are occurring in recessed markets and the size of bankrupt firms' liabilities is up sharply, as competition increases and banks are less willing to support non-viable firms (Figure 6.5). Rising bankruptcy levels undermine old relationships and increase sanctions on poorly managed firms. However, one estimate is that around 2 million more financially fragile Japanese firms may need to be liquidated (*Economist*, 24 March 2001). Many firms still avoid bankruptcy by merging, forebearance of their lenders or by exploiting political influence, especially in the retail, construction and banking sectors (Yokowo, 2001).

Figure 6.5

Bankruptcies Growing

Number of Firms Declared Bankrupt and Value of Debt, 1986-87 to 2000-01



Source: CEIC, 2002.

14 The Government modestly increased the Fair Trade Commission's budget, by 2 per cent per year since 1997, and increased personnel from 248 to 263.

15 The Fair Trade Commission defines 'undesirable market performance' as a situation where entry barriers, extraordinary price increases or extremely high profit rates persist.

REGULATORY REFORMS

Since the mid 1990s, new regulatory reforms have supported Japan's gradual transition to a more rules based, arm's length business environment, aiding the development of markets and the disciplines they bring.[16] A range of reforms protect outside investors, targeting improved disclosure, accountability and minority shareholder rights. Key reforms include ongoing amendments to the Commercial Code in 2000 and 2001, and the 1997 release of the Corporate Governance Forum of Japan's voluntary corporate governance code, 'Corporate Governance Principles – a Japanese View'. The Financial Services Agency, the Ministry of Justice and the Tokyo and Osaka stock exchanges implement these new corporate governance standards.

NEW COMMERCIAL CODE

The Ministry of Justice's new draft Commercial Code is slated for implementation in sections during fiscal 2001/02. The draft code lowers the shareholders' voting quorum for non-routine agenda items from one-half to one-third and introduces consolidated accounting. It also allows electronic submission of proxy votes and permits companies to issue stock options to subsidiaries' directors. It will allow firms to abolish statutory auditors if they appoint committees to elect board members, audit business administration and decide salaries. These committees would need to include outside directors. However, not all aspects of the draft may survive, as some quarters have raised considerable opposition, particularly to introducing independent directors. Australian business will need to pay close attention to developments on this issue.

Source: www.japaninvestmentforum, 2001.

TRANSPARENCY

After the bubble economy burst, poor banking and corporate transparency were central to the crisis in public and foreign investor confidence in Japan's financial system. Consequently, over the past decade, the Government has sought to restore public confidence, particularly by increasing transparency and reporting standards.

[16] Maurice Toyama, Jo Lennox and Anna Guthleben, PricewaterhouseCoopers and PricewaterhouseCoopers Legal, contributed to this section.

NON-GOVERNMENT ORGANISATIONS PROMOTING CORPORATE GOVERNANCE

A range of non-government bodies promote improved corporate governance in Japan.

Corporate Governance Forum of Japan

Established in 1994, the Corporate Governance Forum of Japan is devoted to raising corporate governance standards. In 1998, it published a set of principles discussing traditional corporate governance systems and recommending improvements. The new Commercial Code and Listing Rules embody many of the Forum's principles. One recommendation not adopted was that independent directors should comprise more than half the seats on the board of directors.

Keidanren

Keidanren, the Japan Federation of Economic Organisations, the main employer group for large industry, actively encourages wide ranging regulatory and economic reforms. It openly acknowledges Japan needs better corporate governance and more foreign involvement in the economy and opposes government attempts to support financial markets.

Source: PricewaterhouseCoopers, 2001.

Corporate Reporting

Since the late 1990s, the Government significantly tightened corporate disclosure requirements. Under the Commercial Code, each six months, all large firms must publish summary annual balance sheet and profit and loss statements.[17] Since April 2000, under the Securities and Exchange Law, all listed companies must prepare consolidated reports and the new Commercial Code extends this to non-listed companies. Firms must disclose related party transactions, although they need not disclose the beneficial share owners. Shareholders obtaining at least 5 per cent of total issued shares in a public company must disclose their intentions and finance sources. Under stronger disclosure rules, firms also must report new developments likely to affect share prices.[18]

Accounting Standards

From January 2000, Japan introduced its so-called 'accounting Big Bang' reforms to increase the compatibility of Japanese and International Accounting Standards.[19] Japanese accounting standards now are notionally in line with international best practice; however, critics argue that operational standards are weak. Since April 2001, companies must measure all financial assets at market values, 'mark to market'.

17 Large companies are defined as joint stock companies with either capital of over ¥500 million or total on-balance-sheet debt of over ¥20 billion.

18 The Commercial Code provides detailed rules on recognising, measuring and reporting joint stock company assets and liabilities.

19 Japan has a dual accounting system of company law (from nineteenth century German law) and securities law (imported from the United States after the Second World War). The two accounting standards were harmonised so they do not excessively burden companies (PricewaterhouseCoopers, 2001).

In 2001, responsibility for setting accounting standards shifted from the Ministry of Finance to the Financial Accounting Standards Foundation, a private sector body created by a group of other organisations including Keidenren and the Japanese Institute of Certified Accounting. In 2000, nine new standards were implemented, including on interim financial statements, financial instruments and retirement benefits, modelled on International Accounting Standards (PricewaterhouseCoopers, 2001).

Despite recent improvements, Japanese accounting still lacks some specific rules, and concerns persist about professional ethical standards. For example, rules do not cover segment reporting of liabilities and accounting for employee benefits other than severance indemnities (PricewaterhouseCoopers, 2001). In addition, disclosures of systematic, large scale accounting cover ups preceding surprise insolvencies in major financial institutions highlighted serious shortcomings in Japanese companies and professionals applying accounting and auditing standards.

Auditing

Auditing standards traditionally are weak; though 1995 reforms strengthened standards somewhat.[20] Since 1995, shareholders elect the statutory audit board which comprises three to four people independent of each other and management, and one outside auditor. The statutory audit board is designed to supervise management in lieu of boards of directors, which are large and comprise mainly company insiders and executives. Audit boards audit the financial documents which independent accountants prepare before they submit them to the annual shareholder's meeting (American Chamber of Commerce in Japan, 2001). However, many audit boards do not effectively supervise boards of directors. Often boards of directors select corporate audit board candidates, with shareholders merely endorsing these selections; this weakens auditor boards' ability to scrutinise independently board of director activities (American Chamber of Commerce in Japan, 2001).

As audit boards have not proved effective supervisors of boards of directors, the new draft Commercial Code allows boards to replace the statutory audit board with various committees for deciding directors' and managers' remuneration, nominating directors and undertaking audits; these committees would comprise a majority of non-executive directors (Japan Investment Forum, 2001). The Ministry of Justice also intends to increase the number of outside auditors and tighten the definition of 'outside' auditors.

SHAREHOLDER PROTECTION

Traditionally, Japan's minority shareholders had limited protection with annual general meetings often short and ceremonial in nature (PricewaterhouseCoopers, 2001). However, awareness is growing of the need to improve minority shareholder rights, with the Tokyo Stock Exchange and non-government groups taking the lead.

20 Checking of accounts is done in three stages. External accounting firms prepare the raw accounts; internal auditing officers then check these; and finally the statutory audit board, *kansayaku*, sign off on them (Kanda, 1999).

Listing Rules

Since March 1999, the Tokyo Stock Exchange has required listed firms to demonstrate their efforts in raising their corporate governance standards; it now requires them to report their steps to improve corporate governance in their semi-annual reports (PricewaterhouseCoopers, 2001; Kurihara et al., 2001; Tokyo Stock Exchange, 2000).[21] It also awards prizes to companies showing exemplary commitment to corporate disclosure. Despite this progress, the Tokyo Stock Exchange is reluctant to enforce compliance with Corporate Governance Forum of Japan principles by making them part of its listing rules (Kurihara et al., 2000).

Shareholder Representation

Although the Commercial Code embodies the 'one share, one vote' principle, current shareholder representation standards are weak. Minority shareholders may call a general shareholder meeting and ask the courts to appoint an inspector to check general meeting procedures. Amendments to improve voter participation, such as allowing proxy voting and the electronic notification of meetings, also are proposed as part of the new draft Company Code.

1993 amendments to the Commercial Code reduced the burden on shareholders wanting to initiate actions. Consequently, shareholders successfully sued Daiwa Bank for ¥83 billion for failing to detect illegal transactions by a futures trader working for the firm. The number of shareholder suits pending increased from 31 in 1992 to more than 280 in 1999 (*Far Eastern Economic Review*, 13 September 2001, p. 54).

Board Structure and Duties

Most boards of directors still comprise mostly insiders and are dysfunctionally large, but more progressive firms now are responding to outside shareholders, especially foreign investors, downsizing boards from an average of 30 directors to 12 to 15 and introducing external directors (Yokowo, 2001). If passed, the new draft Commercial Code requires independent directors be appointed to the board; a recent Tokyo Stock Exchange survey shows only half of all listed companies currently have external board members (Tokyo Stock Exchange, 2000).[22]

Japanese legislation does not define clearly the concept of fiduciary duty. For example, the concept of insolvent trading by directors and legal sanctions on such trading do not exist. Instead directors are expected to exhibit 'bona fide' loyalty and an 'honest manager's care' (PricewaterhouseCoopers, 2001). As most directors are promoted from within the firm's middle ranks, board members often represent employee and management interests and give loyalty to them rather than shareholders.

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21 Firms must disclose management policies on corporate governance in their preliminary financial results, including information on management goals, shareholder and investor roles in decision–making, and firms' approaches to distributing profits. Firms also must disclose any change to management that may affect corporate governance.

22 The Corporate Governance Forum of Japan now urges firms to ensure independent directors comprise more than half the board (Principle 8B).

Only a minority of directors receive share options, reducing directors' incentives to maximise shareholder value (Kurihara et al., 2001). Also, individuals can sit on any number of boards and directors' training is not mandatory. These factors limit directors' professionalism and commitment, and the time they can devote to their duties.

REFORMING JAPAN'S BOARDS OF DIRECTORS

Sony Corporation was one of the first major corporates to undertake corporate governance reforms. In 1997, Sony downsized its board from 38 to 10 directors, and increased its independent directors from 2 to 3, making it among the first Japanese firms to restructure its board (Yasui, 1999). Other reforms included separating director and management functions, and holding open conferences with shareholders after the annual general meeting. Following these reforms, more than 300 companies reduced their boards' size, and several, including Fuji, NTT, Sanwa Bank, Sanwa Electric and Softbank, appointed independent directors.

Source: PricewaterhouseCoopers, 2001.

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Japan's failure to resolve an estimated ¥18 trillion to ¥100 trillion in non performing loans after the collapse of the bubble economy in the late 1980s is partly due to bankruptcy system failure. This failure exacerbated Japan's economic stagnation in the last decade. Despite recent reform attempts, these issues remain largely unresolved, undermining managers' incentives to improve corporate governance and risk management, and creditors' willingness to lend.

Bankruptcy Laws

In 1996, the Japanese Government embarked on a five year program to reform insolvency procedures.[23] Reflecting bankruptcy's social stigma and expense, many firms in financial distress favour informal approaches, including corporate reorganisation. However, the Government now is taking a tougher approach, as the Sogo and Hanwa collapses demonstrate. Recent reforms include the 1999 *Civil Rehabilitation Law*, which provides a mechanism for rehabilitating businesses in financial difficulties, similar to Chapter 11 in the United States. The Government also enacted new laws governing cross border insolvency and consumer bankruptcy. 1999 reforms allowed many firms to waive their bank obligations, as long as they provide a debt reconstruction plan to the bank and the Government.

[23] Japanese insolvency laws derive from the Bankruptcy Law (Law No. 71 of 1922), the Commercial Code (Law No. 48 of 1899) for special liquidation, and the Corporate Reorganization Law (Law No. 172 of 1952).

Prudential Supervision

In 1998, to deal with the imploding financial system crisis, the Government upgraded prudential supervision regulations and capacity. It established the Financial Reconstruction Commission; in 2001, this became the Financial Services Agency to oversee all financial institutions and expedite financial institution restructuring (East Asia Analytical Unit, 1999).[24]

Under 1998 Bank Law amendments, the Government raised bank reporting requirements. All financial institutions must disclose their financial positions to the Financial Services Agency; banks must submit a Business Performance Report twice yearly; and banks' securities holdings and attendant risks for bank capitalisation are assessed each month. Also each month, banks meet with the Financial Services Agency to discuss compliance with prudential standards.

The Financial Services Authority claims its standards for classifying non performing loans now are in line with world best practice. The Financial Services Agency and Bank of Japan enforce them and scrutinise bank loan quality every six months.[25] When deposit protection declines in April 2002, pressure on banks to use their funds wisely will increase.

Litigation against bank executives is increasing. For example, administrators of failed Niigata Chuo Bank filed for damages against 11 former bank staff for ¥2.1 billion, claiming their lending resulted in irrecoverable loans totalling billions of yen (*Japan Times*, www.japantimes.co.jp, 14 March 2001).

ENFORCEMENT

Previously, enforcement of the corporate framework was weak, but now stronger regulatory bodies are starting to enforce new regulations more rigorously. Other institutions which normally assist in enforcing new regulatory standards, including the press and the legal system, have played a limited role.

Press

Japan's commercial press traditionally plays a very limited role in enforcing good corporate governance. However, it recently became more prominent in disclosing corporate malpractices and major scandals, including Nomura Securities kickbacks, the Yamaichi Securities insolvency cover up and prudential oversight failures.

[24] Until 1998, the Ministry of Finance supervised all financial institutions. The Bank of Japan maintains on-site inspections of banks and off-site monitoring of banks which hold a current account with it (Bank of Japan, 2001).

[25] However, banks estimate that they hold around ¥61 trillion in bad loans, more than the official estimates of ¥30 trillion. The Bank of Japan interprets this as meaning banks are more stringent in their risk management than world standards demand (Bank of Japan, 2001).

Legal System

During the 1990s and the early 2000s, Japan's bankruptcy law and antiquated court system proved inadequate to the task of expediting corporate restructuring, resolving bankruptcies or retrieving collateral. Unfortunately little improvement has occurred in the courts to date, obstructing deeper structural reform.

IMPLICATIONS

A decade of significant change is slowly but perceptibly steering Japan towards a more open, transparent and rules based business model. The gradual weakening of the *keiretsu* system, the long recession, increased trade and investment openness, and prominent foreign business presence in key sectors like finance and automotives reinforce the impact of stronger prudential, accounting, competition policy and corporate governance standards. While major shifts in corporate culture take a long time and vested interests persist, Japan's transition to a more modern, accountable and transparent corporate governance culture appears irreversible.

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