

ASSA Annual Meeting Atlanta 2019
AFEE The Japanese Economy in the age of uncertainty
January 5, 2019

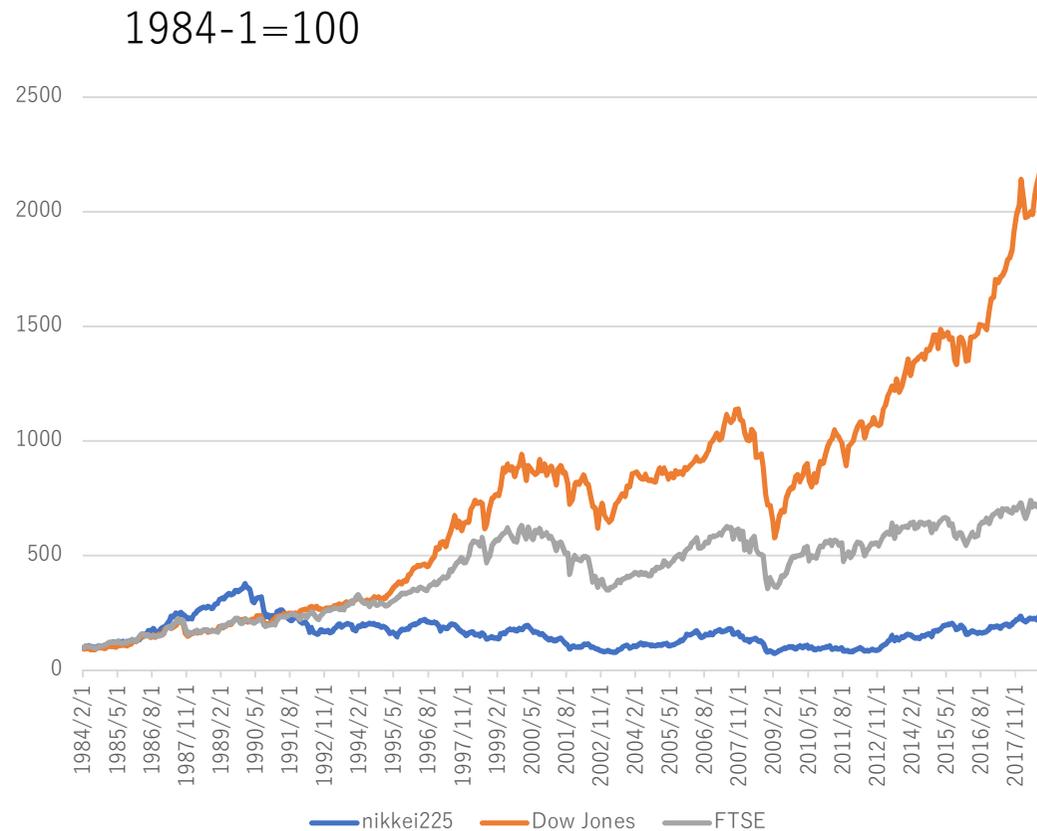
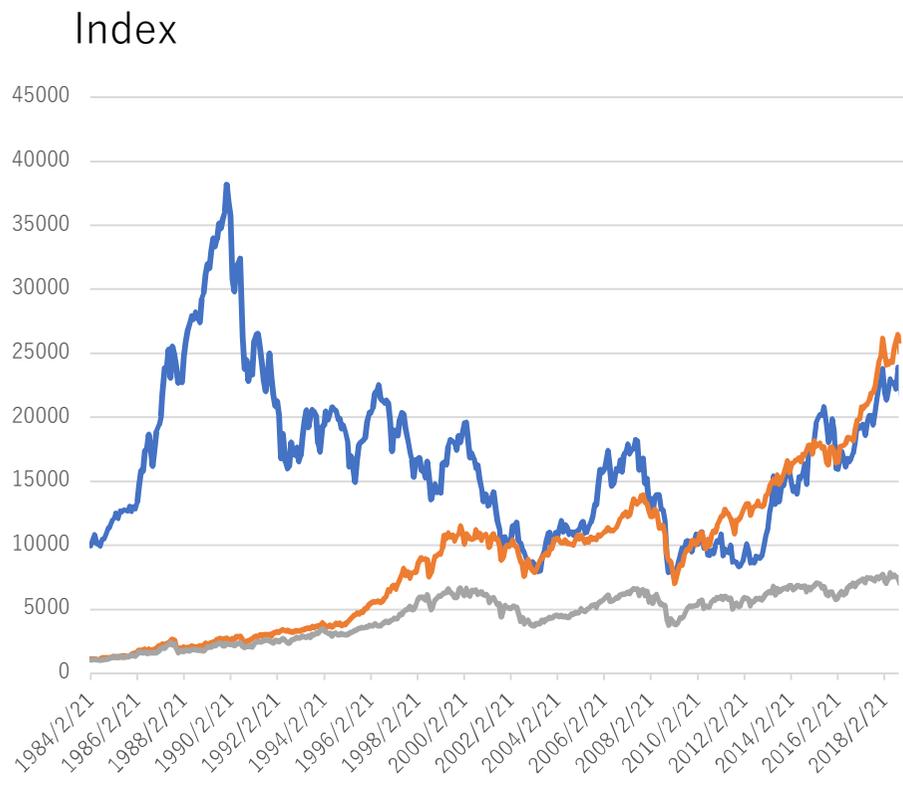
Changes in Corporate Governance in Japan and Financial intermediaries

Etsuko Katsu, Meiji University
Yasutoshi Noshita, Kokushikan University

Outline

- Low profitability of corporations and stagnant trend of stock prices in the past 30 years.
- Characteristics of corporate governance in Japan and main bank system from historical perspective
- Abenomics and Change in Corporate governance
- Huge earned surplus and corporate governance
- Conclusion

Stock Prices in japan could not reach 30 years high



<source> Reuter DATA stream

Comparison of ROE of Japan, US, and EU

		ROE	return on sales	turnover of capital
Japan	manufacturing	4.6%	3.7%	0.92
	service	6.3%	4.0%	1.01
	total	5.3%	3.8%	0.96
US	manufacturing	28.9%	11.6%	0.86
	service	9.7%	9.7%	1.03
	total	22.6%	10.5%	0.96
EU	manufacturing	15.2%	9.2%	0.8
	service	14.8%	8.6%	0.93
	total	15.0%	8.9%	0.87

Companies in TOPIX 500, S&P500, and Bloomberg Europe index500

<source>MITI(2014)p.51

Corporate governance; Anglo-Saxon and Japan, EU

- Shleifer and Vishny(1997)

Corporate governance deals ways that in which suppliers of finance to corporations assure themselves of getting a return on their investment. In other words, how to resolve the agency problem between shareholders and management.

- Allen and Gale(2002)

The term of corporate governance is used in two distinct ways. In Anglo-Saxon countries like the US and UK good corporate governance involves firms pursuing the interests of shareholders. In other countries like Japan, Germany and France it involves pursuing the interests of all stakeholders including employees and customers as well as shareholders.

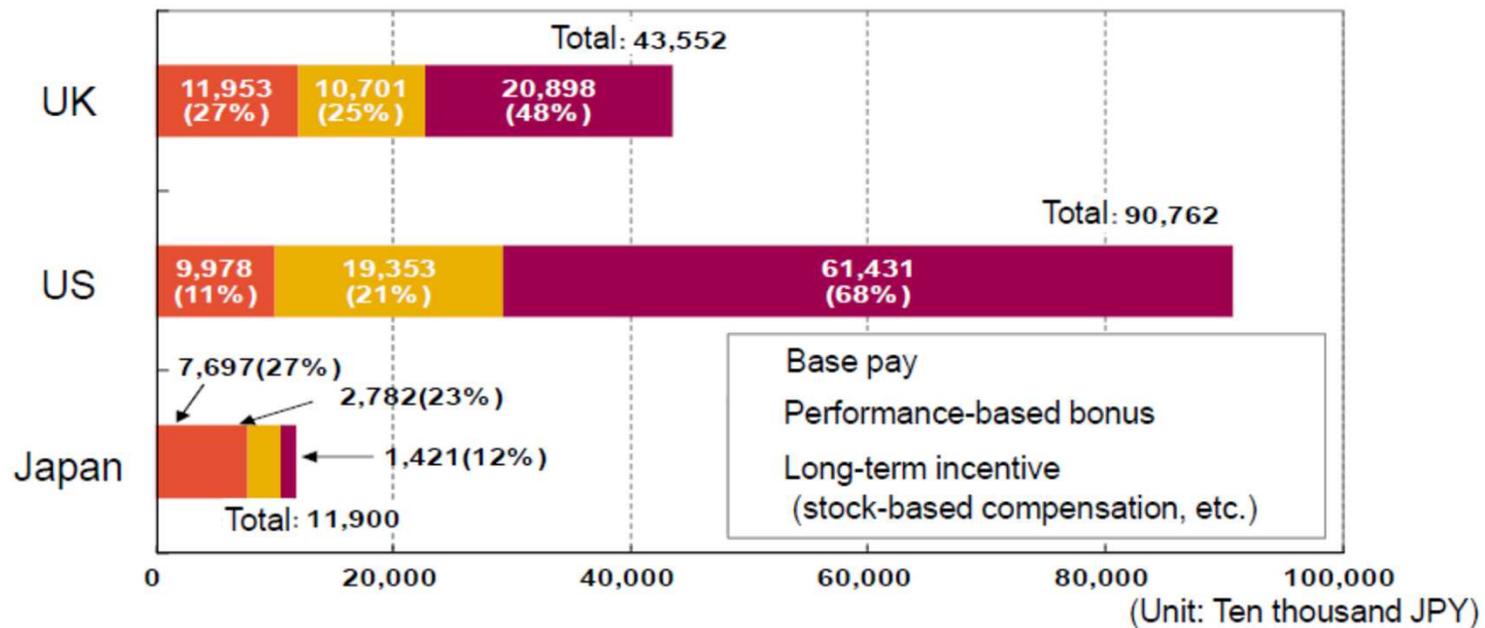
- Tirole(2001)

Japanese corporation tends to focus on securing employment rather than stressing shareholder's benefit .

Characteristics of Japanese corporate governance

- Cross-Shareholdings(Mochiai): Bank centered Stable shareholders, mainly in corporation group based on Zaibatsu, to avoid hostile M&A.
- Main Bank system: Japanese main bank plays a central role in monitoring management. Banks are largest shareholders and asset holders to have huge power to discipline the management, to support when, and to make human resource network.
- Life long employment, Seniority wage system, hierarchy with inner promotion, training through job rotation, a strong socialization into company culture, loyalty to the companies.
- Horizontal “Keiretsu”; Ex. Buyer-supplier relationship in automobile which works efficient for cheap goods producing.
- Board of directors: an extension of internal promotion system, employees’ interests play a predominant role (Dore, 2000)
- Trinity of corporate governance: Labor market, Financial market, and governance structure

Comparison of CEO Compensation between Japan, the US and Europe



<source>MITI(2014) p.69

Main Bank System in Japan from historical perspective

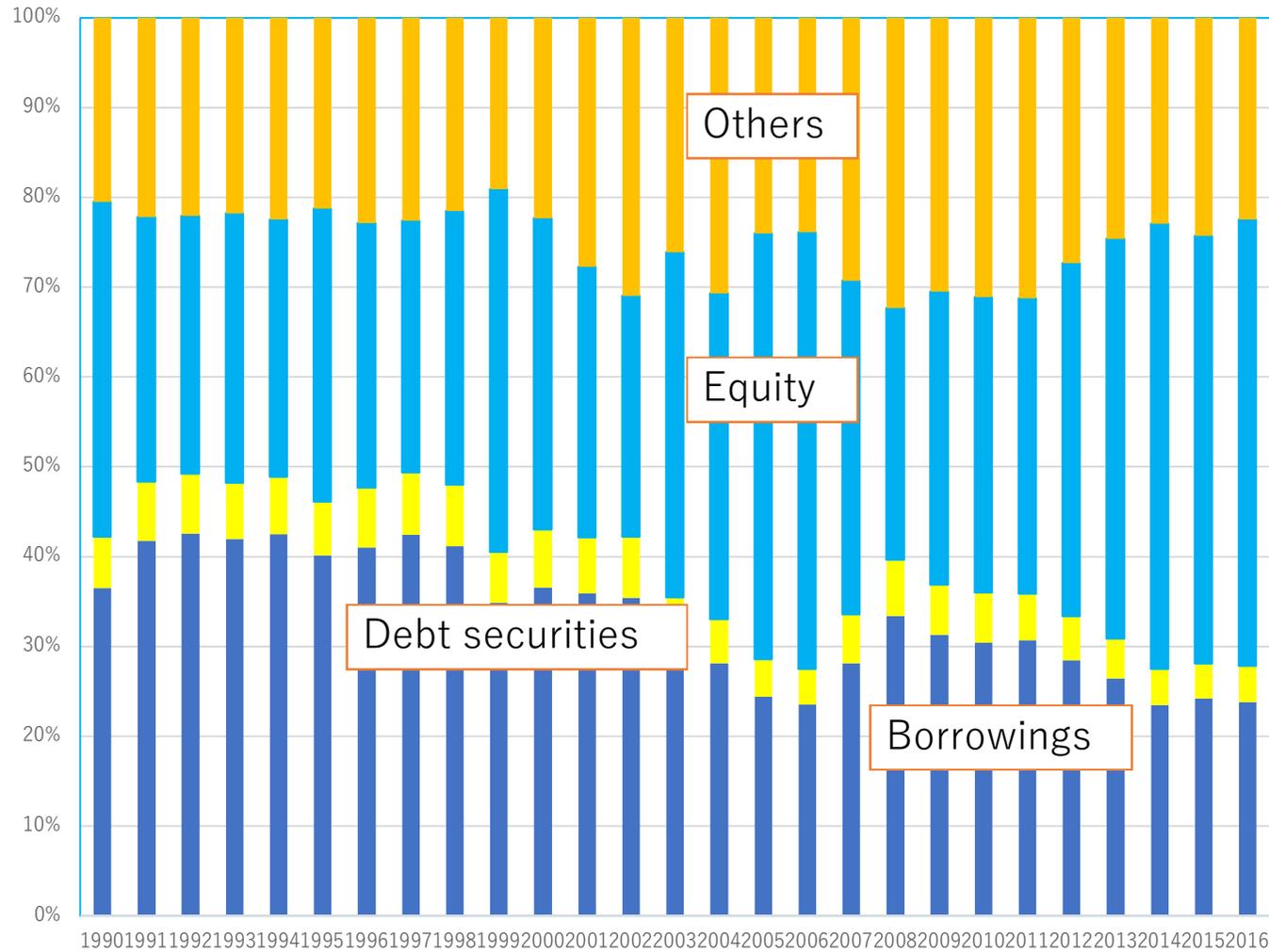
- Aoki and Patrick(1996) pointed out that ‘main bank’ refers to a system of corporate financing and governance involving an informal set of practices, institutional arrangements among industrial and commercial firms backed by the regulatory authorities.
- This relationship has many aspects, including reciprocal shareholdings, the supply of management resources and the dispatch of directors, and the provision of various financial services including guarantee, underwriting of bond issues, investment banking, advisory services, and when the corporate is in the distress, banks are sending directors to the corporate immediately to support.
- This system was thought to built in the war period in around 1940 to allocate needed cheap money efficiently to war-related industries, and money concentrated to zaibatsu related big banks and heavy industries(Hoshi, 1994). War time controls by policy makers and system were maintained after war.
- Since banks have ample information with deposit knowing flow of funds of each companies, main bank system is propriate and rational as share holders and asset holders.

Financial liabilities owed by private non financial corporation(%, 2016)



<source> Bank of Japan

Financial liabilities owed by non-financial private corporations

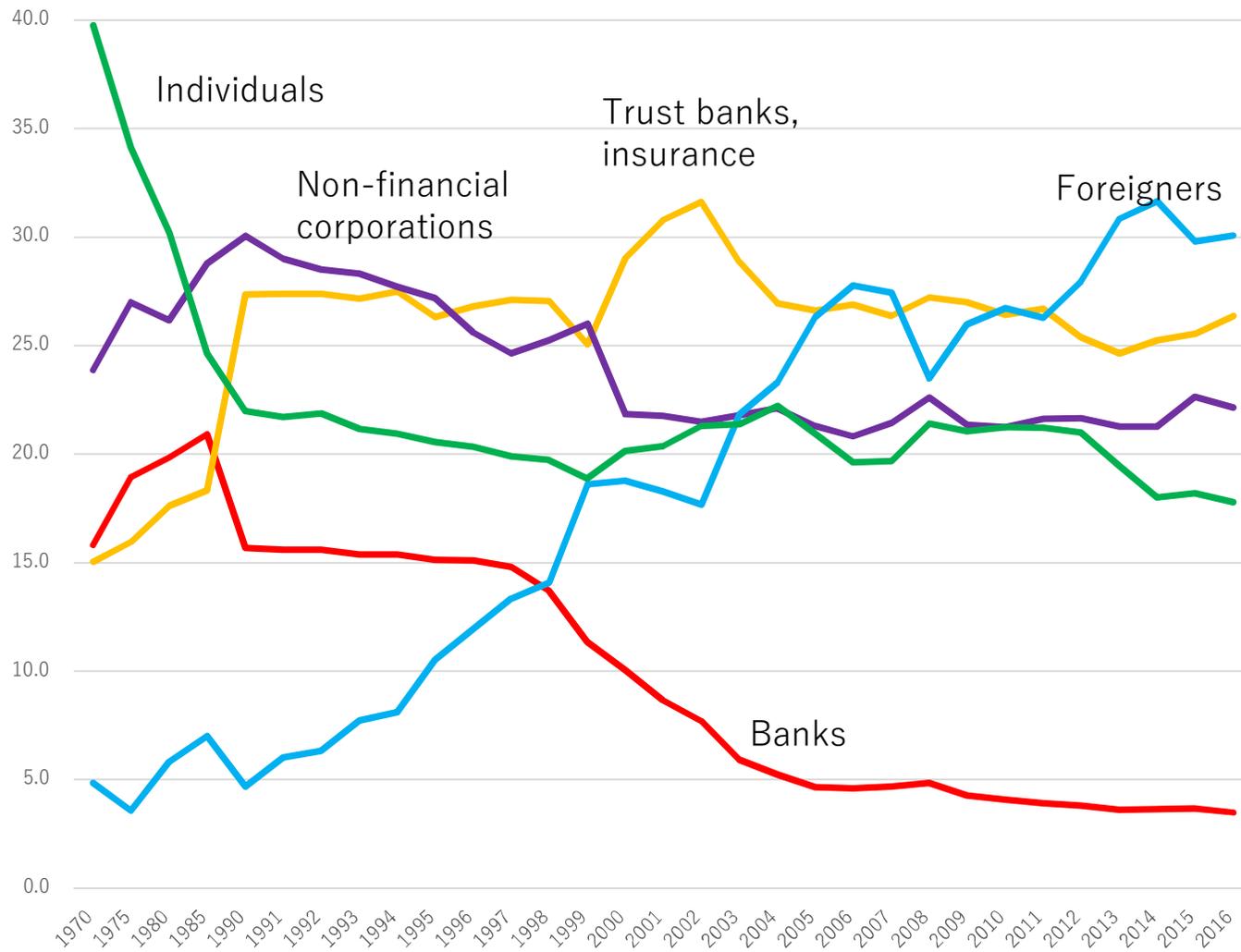


<source> Bank of Japan database

Three big phenomena which made change of the corporate governance in Japan after collapse of the bubble

- Financial crises in midst of 1990's and consolidation of financial institutions: Suffering a heavy non-performing loan, they sold retaining stock (exit from Mochiai) and they broke 'Zaibatsu ties' with consolidation like Mitsui and Sumitomo.
- Globalization: After the end of cold war in the beginning of 1990's, market all over the world were consolidated with deregulation of capital flow, and foreign investors were getting to be dominant in Japanese stock market.
- Emerge of Institutional Investors: Piling of the pension fund in aging society, institutional investors become dominant in the world security markets.

Structure of stock holders in Japan(%)



<source> Tokyo Stock Exchange

Main bank as a stock holder and as an asset holder

- As a stock holder, main banks have incentives to enforce discipline on listed companies. That is to say, main bank has huge amount of information on flow of money of their customers, which enables them to monitor their business and managements of companies.
- Role of main bank as a stock holder is diminishing , but as an asset holder, main banks pay attention on corporate's stability preventing falling into crises.
- And long-term relationship of banks and corporates are rational for both banks and corporates, as an insurance role of main banks(Ikeo,1995) .

Previous Studies on Change of Main bank system in Japan

- Hirota(2009):Relationship with main banks in terms of sending CEO or stock-holder is weakening, but tacit understanding 'they support in financially difficulties' remains , which made them to continue to use main banks even though a role of stock holders is decreasing.
- Hirota and Miyajima(2001) shows that Main bank system was weakening because (1) corporation strengthened their capital base for not easily dropping into financial distress, and (2) in the circumstances of declining of borrowing , their incentive to intervene the problematic corporations weakened.
- But caught in financial distress, corporations would like to rely on liquidity support of main bank, which make corporations keep relationship with those banks in syndicate loans or commitment line as an insurance(Ikeo,1985 Hirota,2009)

Japan Revitalization Strategy(growth strategy)2015

Revolution in productivity by investment in the future

<p>Further enhancement of growth-oriented corporate governance</p>	<ul style="list-style-type: none"> • promote constructive dialogue between companies and investors. • Policy dialogue between public/private sectors to expand investment • Stewardship Code and corporate governance Code have been introduced.
<p>Promotion of innovation and venture business</p>	<ul style="list-style-type: none"> • Reinforce incubation function of designated universities. • Fundamental reforms of universities.
<p>International expansion to growing markets including Asia</p>	<ul style="list-style-type: none"> • Promoting high quality infrastructure partnership.
<p>Developing personal capability and knowledge</p>	<ul style="list-style-type: none"> • promotion of women, elderly persons. • Improvement of labor quality .
<p>Promotion of local Abenomics</p>	<ul style="list-style-type: none"> • vitalize services industry and enhance productivity. SME, and micro enterprises.

<source> cabinet office

Third arrow : New growth Strategy announced June 24, 2014

Female labor participation	Increase childcare facilities and child care leave benefits. Removal of tax and social security disincentives for working spouses
Foreign labor	Relaxation of current points-based preferential immigration system. Expanding trainee program for immigrant workers in construction from 2015,.Expanding the trainee program also for other sectors beyond construction and including nursing in the program. Use SEZs to encourage use of foreign HR.
Reducing Labor duality	Encourage use of 'limited regular' contracts to reduce labor market duality and increase productivity. Expand subsidies for job mobility. Discussion underway to ease non-regular work rules(Bills related to dispatched workers and fixed term workers submitted to the current diet).

Core of Japan Revitalization Strategy -changes in corporate governance-

- The Japan Revitalization Strategy as revised in 2015 (Cabinet Decision, June 30, 2015) : adoption of Japan's Stewardship Code ("JSC"), and Japan's Corporate Governance Code ("JCGC"), as 'the two wheels of a cart' such that the sustainable growth of companies will be promoted by both sides of investors and companies.
- Corporate Boards Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid- to Long-Term .
- roughly 80% of the companies listed on TSE First/Second Section reported that they complied with more than 90% of the Code's principles.
- Separation of the role of management supervision and business execution

Corporate governance reform as a Growth Strategy

Date	Events
2014 February	Stewardship Code consist of 7 principles, was introduced.
2014 June	Company Act revised (Company with Audit and supervisory committee system was established)
2014 August	'Ito Report' was published by MITI. “ · · building favorable relationships between companies and investors”
2015 June	Corporate Governance code introduced; Comply or Explain basis. Independent directors should be a key role in managements.

Ito Report by MITI(2014)

- In order for Japanese companies to drive innovation – which is the source of competitiveness – from a long-term perspective, Japan will require an inflow of long-term capital that can support such initiatives, not investment of short termism.
- In comparison with US, EU, ROE(return of equity) of Japanese big companies is much lower, low profitability due to short termism, or lack of propriate corporate governance.
- Enhancement of profitability and capital efficiency are needed.
- Dialogue between companies and investors should be promoted.

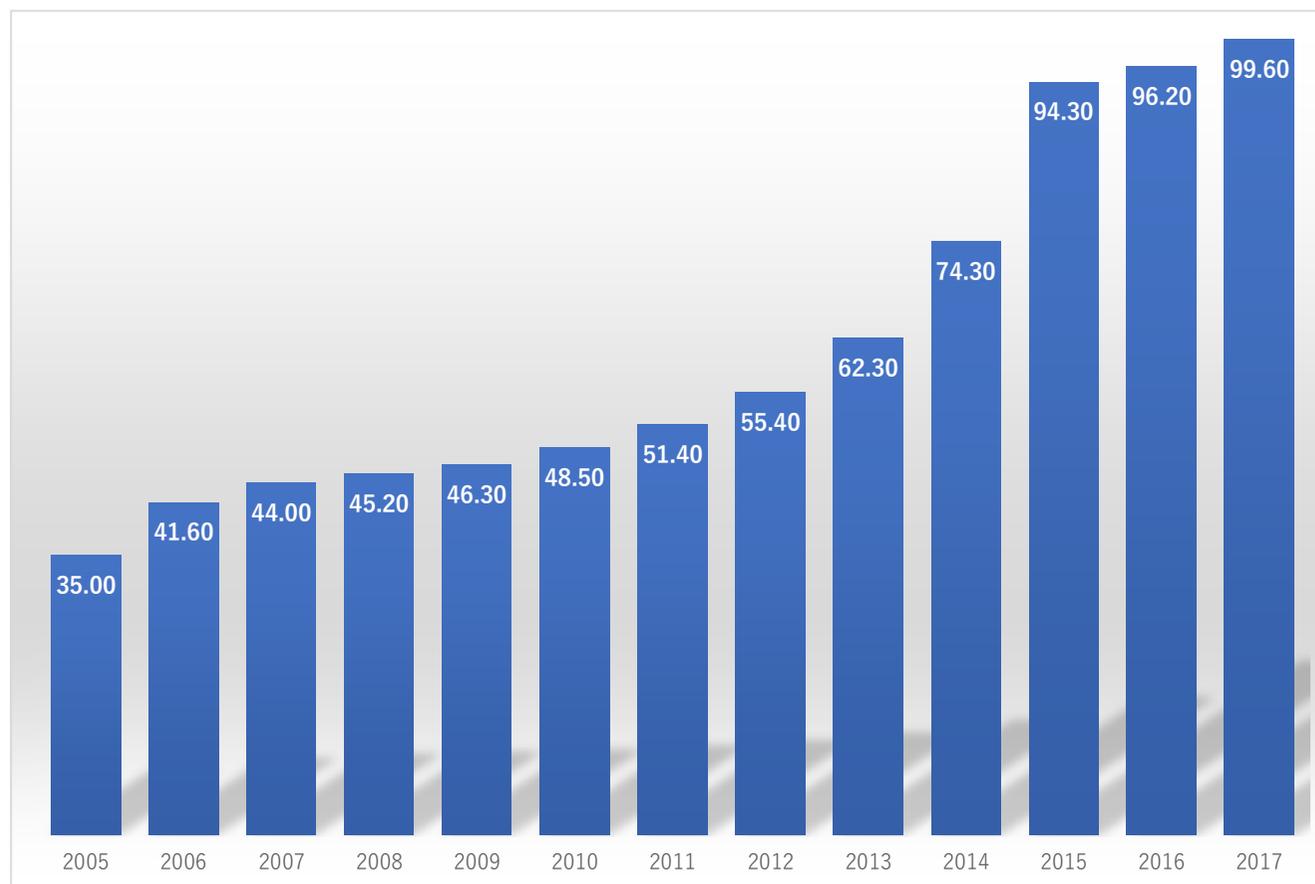
Kay Review and corporate governance in UK(2012)

- To Enhancing profitability and capital efficiency in Japan --Japanese Government adopted UK Corporate governance model rather than US corporate governance.
- Short-termism is a problem in UK equity markets, and that the principal causes are the decline of trust and the misalignment of incentives throughout the equity investment chain.
- Asset managers – specialist investment intermediaries – have become the dominant players in the investment chain, as individual shareholding has declined and pension funds and insurers have responded to incentives (including demographic changes and regulation) to reduce their investments in equities.
- All participants in the equity investment chain should act according to the principles of stewardship
- The Stewardship Code should be developed to incorporate a more expansive form of stewardship

General principles in Corporate governance code(June 2015)-Comply or Explain-

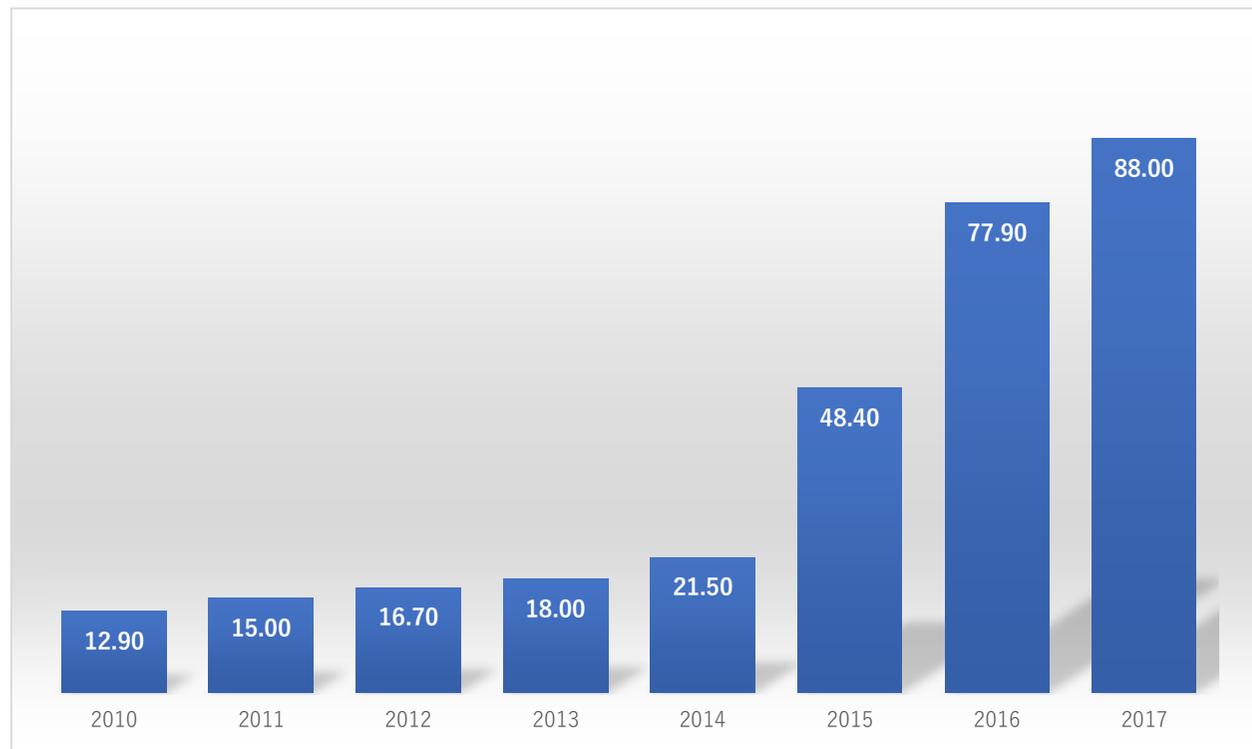
- Securing the Rights and Equal Treatment of Shareholders
- Appropriate Cooperation with Stakeholders Other Than Shareholders
- Ensuring Appropriate Information Disclosure and Transparency
- Responsibilities of the Board : Dividing execution and Oversight and carrying out effective oversight of directors and the management from an independent and objective standpoint.
 - ⇒ at least, two or more independent directors are needed
- Japanese government follows UK model of corporate governance, where they have a long-term perspective in UK equity investment and hate short-termism. Japanese Government do not follow US model of corporate governance where investors have strong power to discipline the management for their pursuit profit.

Big companies who have independent directors(%,
TSE first section listed 2021 companies)



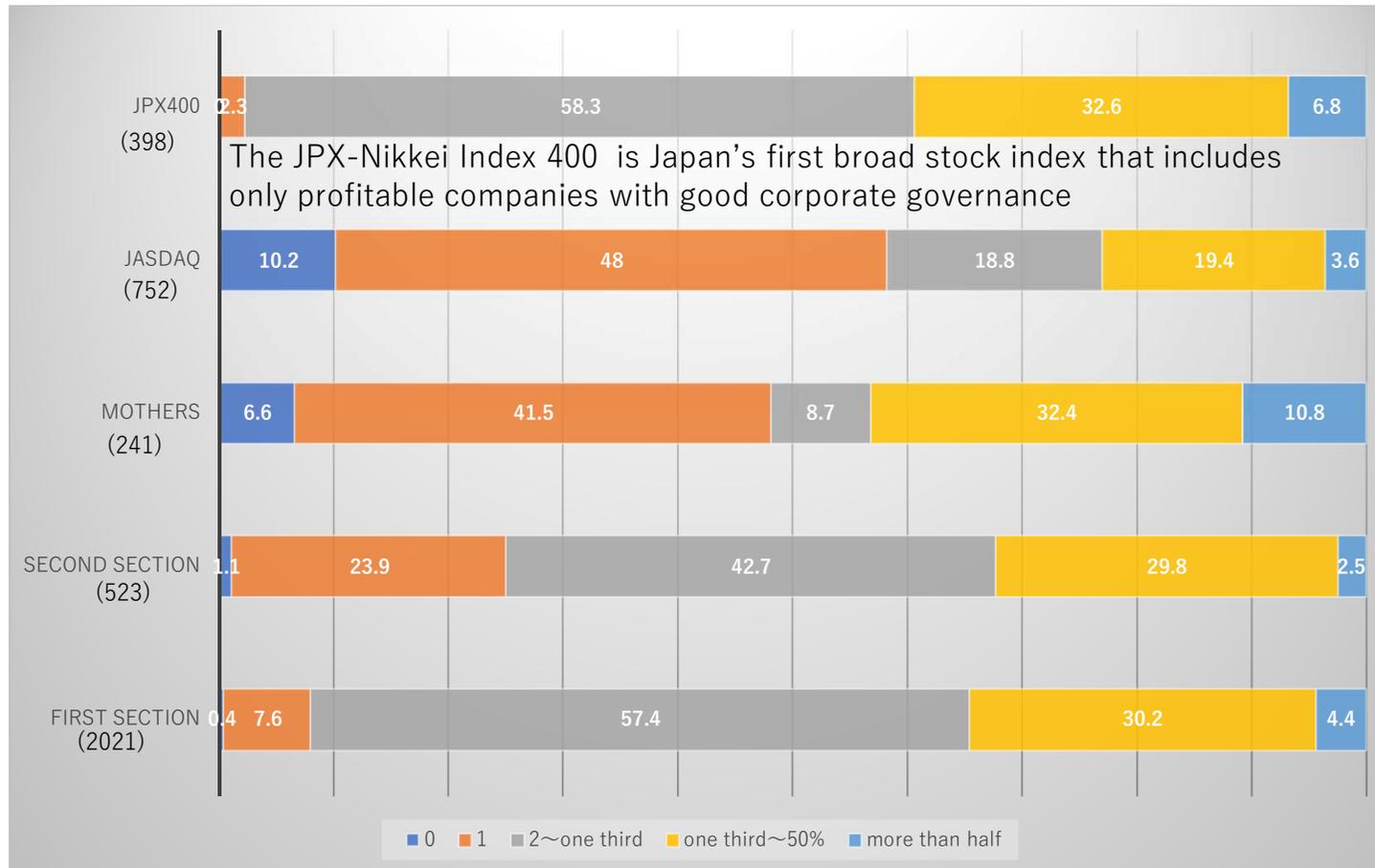
<source> Tokyo Stock Exchange

Big companies who have more than 2 independent directors(%²³, TSE first section listed 2021 companies)



<source> Tokyo Stock Exchange

More independent directors in larger companies...



<source> Tokyo Stock Exchange

Stewardship responsibilities by FSA (2014 February)(1)

1. Institutional investors should have a clear policy on how they fulfill their stewardship responsibilities, and publicly disclose it.
2. Institutional investors should have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities and publicly disclose it.
3. Institutional investors should monitor investee companies so that they can appropriately fulfill their stewardship responsibilities with an orientation towards the sustainable growth of the companies.
4. Institutional investors should seek to arrive at an understanding in common with investee companies and work to solve problems through constructive engagement with investee companies.

Stewardship responsibilities by FSA (2)

5. Institutional investors should have a clear policy on voting and disclosure of voting activity. The policy on voting should not be comprised only of a mechanical checklist; it should be designed to contribute to the sustainable growth of investee companies.

6. Institutional investors in principle should report periodically on how they fulfill their stewardship responsibilities, including their voting responsibilities, to their clients and beneficiaries.

7. To contribute positively to the sustainable growth of investee companies, institutional investors should have in-depth knowledge of the investee companies and their business environment and skills and resources needed to appropriately engage with the companies and make proper judgments in fulfilling their stewardship activities.

the list of institutional investors who have notified the FSA of their intention to accept the Stewardship Code
(as of Nov. 15,2018)

Institutional Investors	number	Change from previous
Trust Bank	6	± 0
Investment managers	170	+ 18
Life Insurance Company	22	± 0
Non-life insurance co	Included to above	
Pension Funds	32	± 6
Others (service providers etc.)	7	± 0
Total	237	+ 24

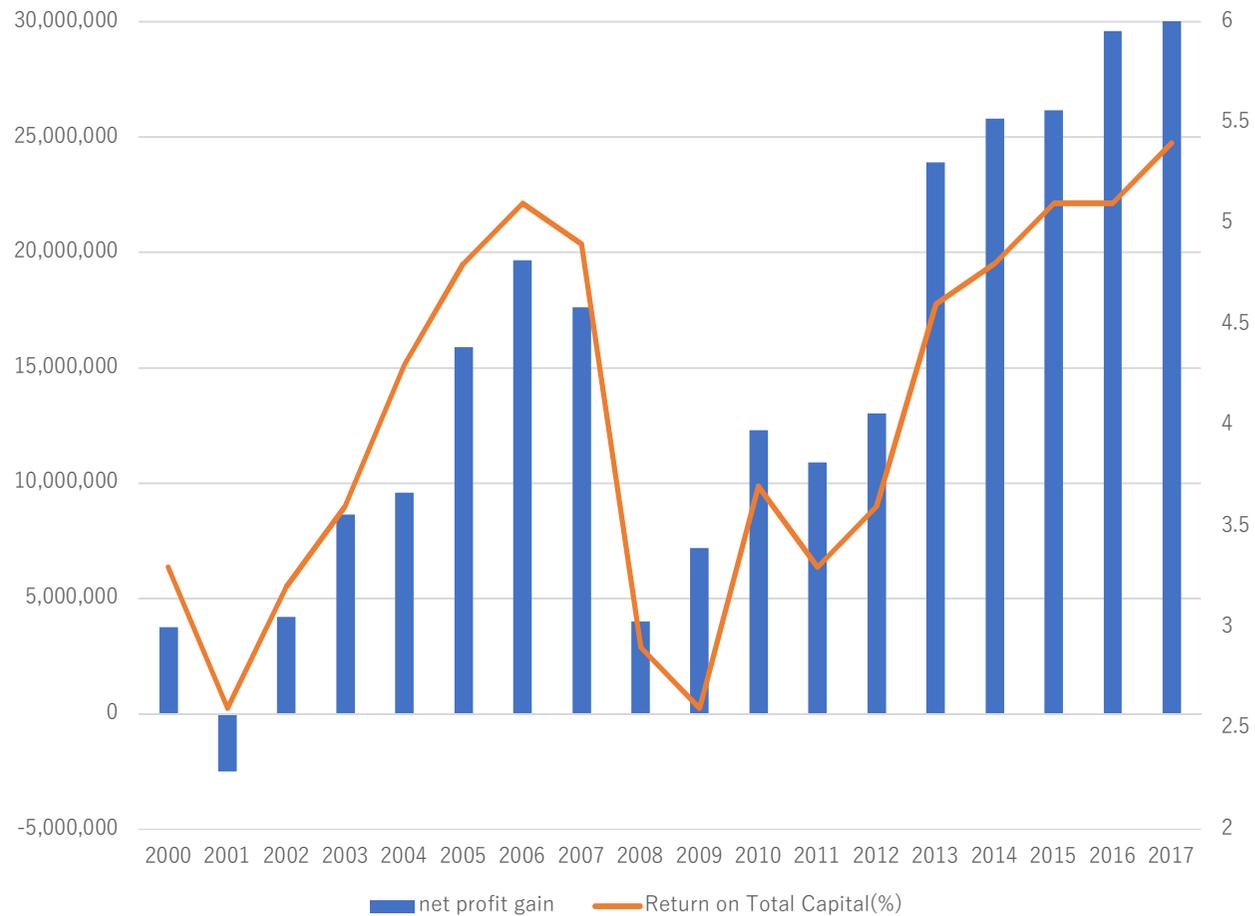
< source > FSA

Challenges of the Stewardship code in Japan

- Investment managers are not fully independent, sometimes related with the group institutions, which impedes management of conflict of interests.
- Institutional investors should have a clear policy on voting and disclosure of voting activity, however, some do not yet have clear policy, relying on the consultant company for voting.
- GPIF, or Bank of Japan, who has tremendous volume of corporate stocks, have tend to have a passive type of investment strategy, and do not appropriately engage with the companies and make proper judgments in fulfilling their stewardship activities.

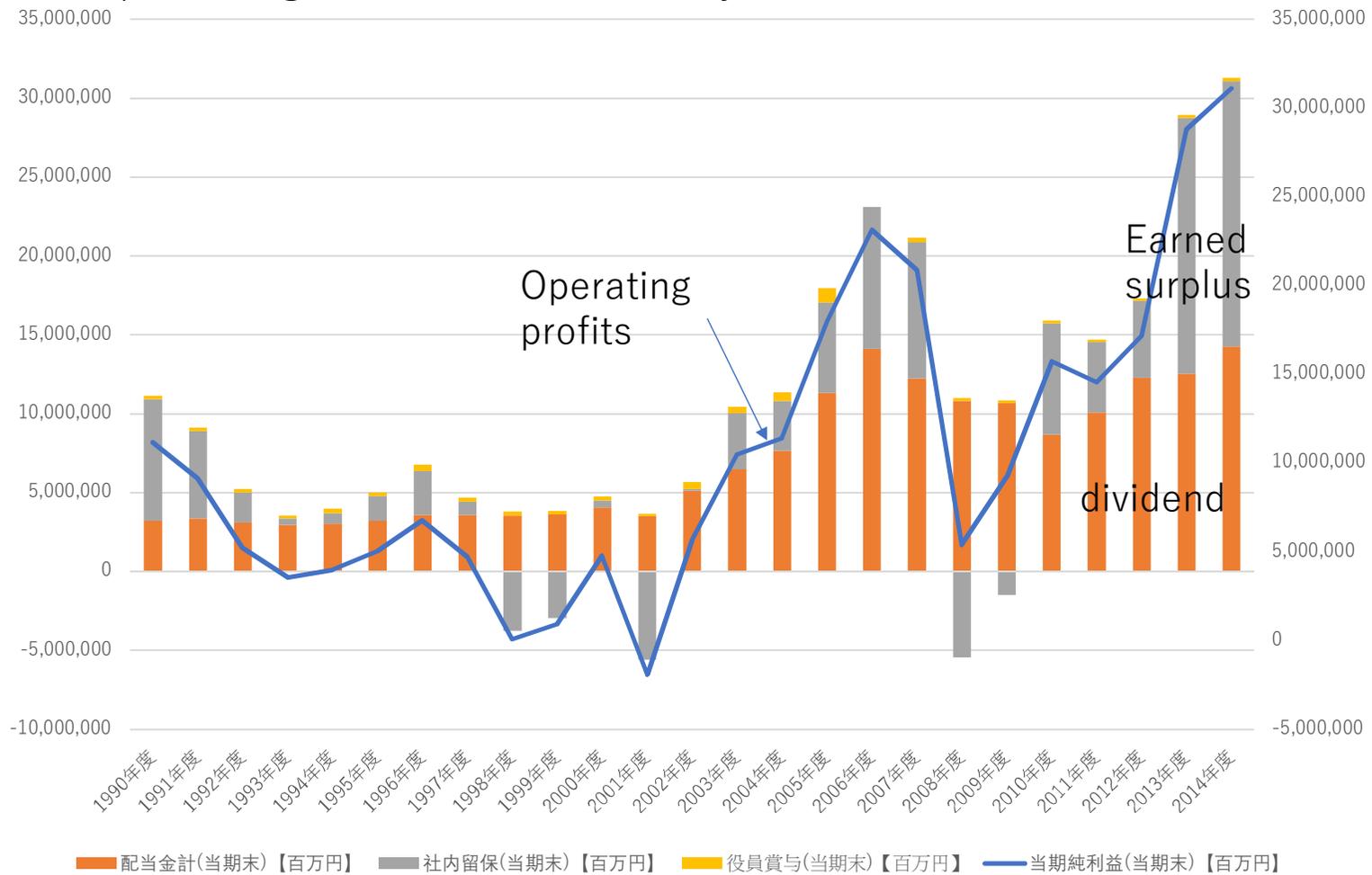
Profits are increasing in Large corporations...

(capital: larger than 1 billion yen)



<source> Ministry of Finance

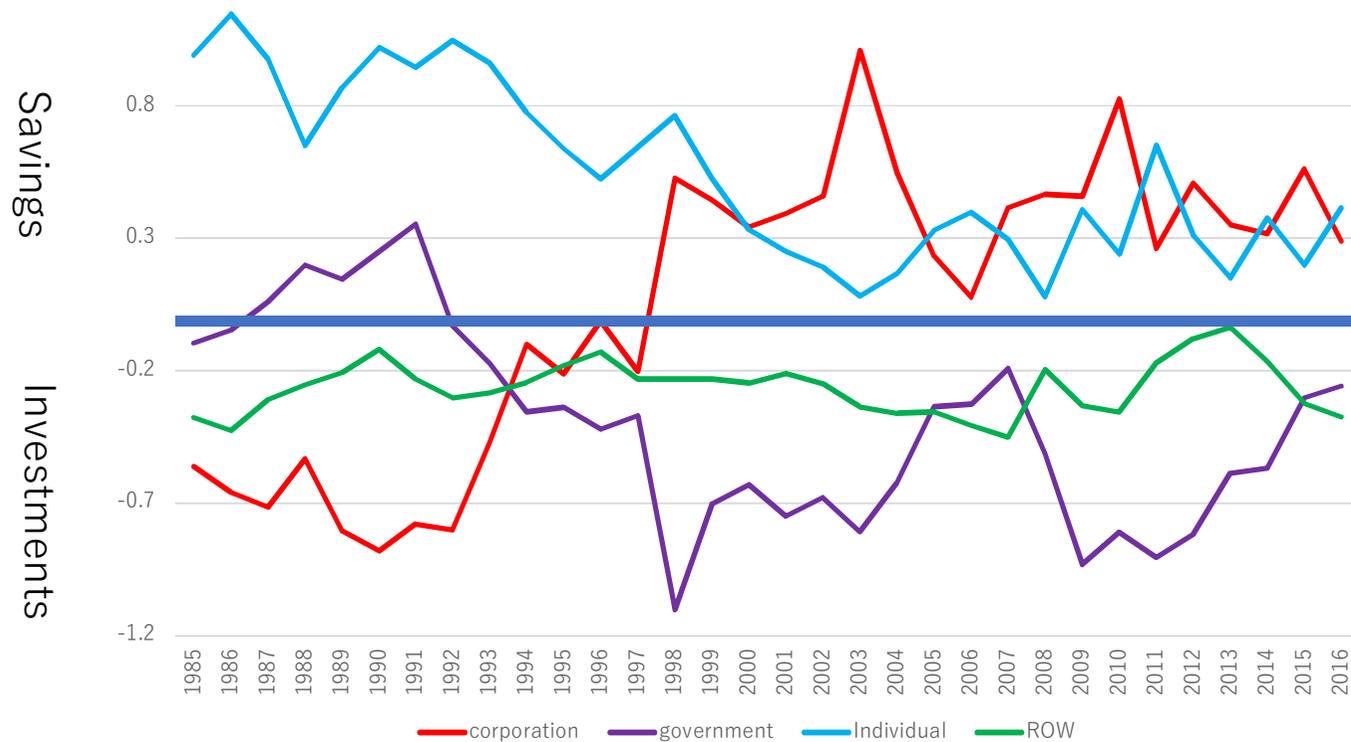
Operating profits, Dividends, and earned surplus (all industries, capital larger than 100 million yen)



<source> Ministry of Finance

Flow of Funds in Japan

(as of nominal GDP)



<source> Bank of Japan, Flow of funds data base.

What is Retained Earnings?

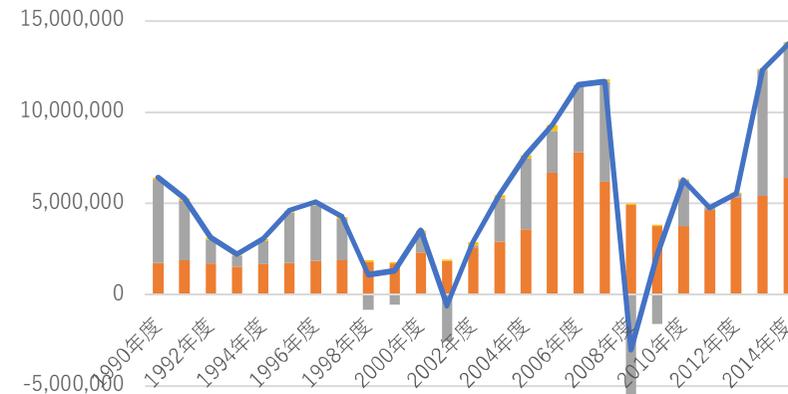
Profits after reduction of tax, dividends, and wages, which are to reinvest in the business or to be kept as a reserve for specific objectives

ASSET		LIABILITY CAPITAL	
Liquid Assets	Cash.deposit		Liquid liability
	Securities		Bills and accounts payable
	Bills and accounts receivable		Short term borrowings (less than 1 year)
	Inventories		Others
	Others		
Fixed Assets		Buildings	Fixed liability
	Tangible fixed assets	Machinery	Long-term borrowings, bonds
		Real estate	Others
	Intangible fixed assets		
		Tax deferred	
	Investments, others	Bonds	
		Long term borrowings	
Deferred Assets			Net Asset
			Capital stock
			Capital surplus
			Earned surplus
			Shareholders equity
			Evaluation differences
			Stock option warrant
			Minority interest share
Total asset			liability + net capital

Criticize for huge earned surplus of Japanese corporations

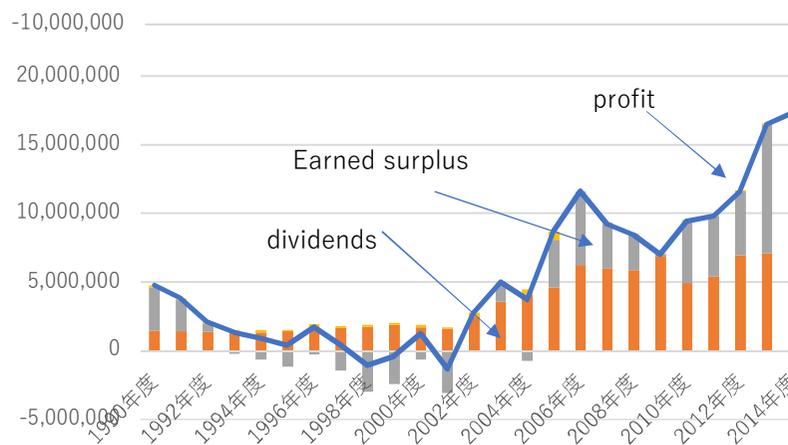
- Hoarding cash makes only negative contribution of private investment to grow.
- It does not increase nominal wages in the face of positive labor productivity growth
- Not pay out the dividends to the stock holders.
- After the financial crises, they pay more attention to retain the financial stability of the corporation, which have held excess labor, excess debt, and excess investments in 1990's.
- Prepare for hostile merges and acquisition

Manufacturing
(capital larger than 1 million dollars)



- when profits increases, pararelyly manufacturing industry increase dividends
- in 2011,2012, even though profits fall, they keep some amount dividends.

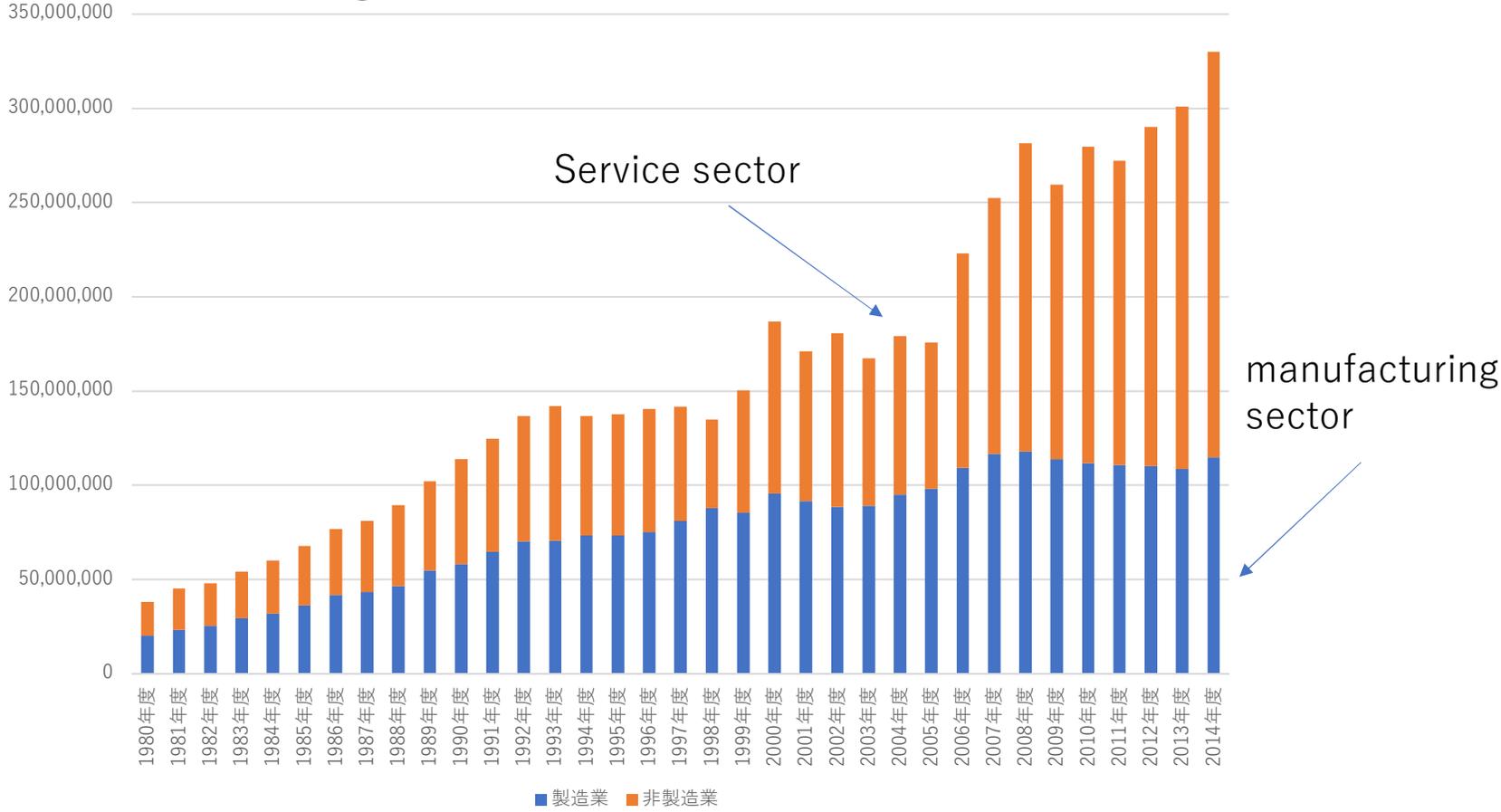
Service (capital larger than 1 million dollars)



- in service sector if they make profit, they prefer earned surplus instead of increasing dividends

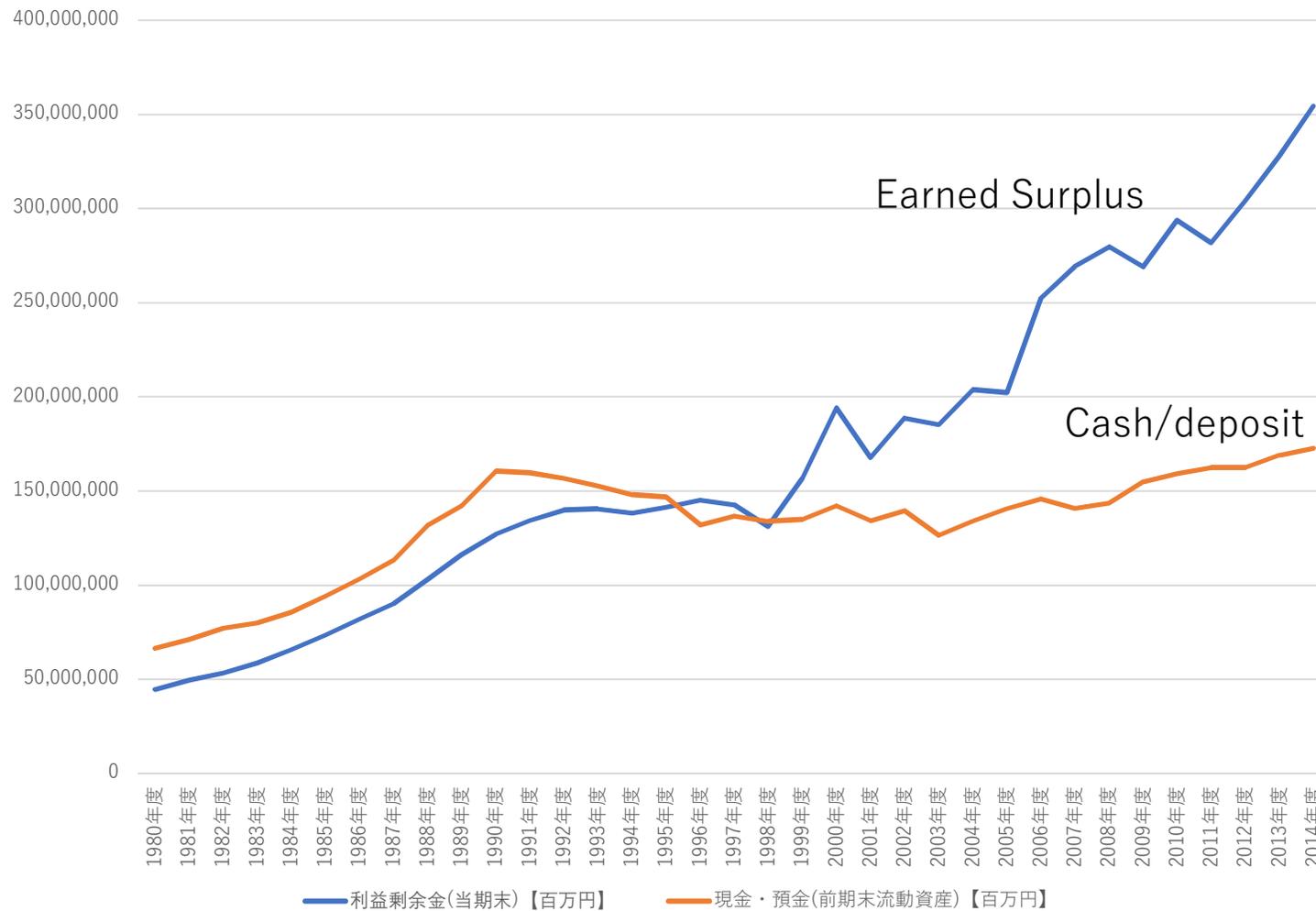
■ 配当金計(当期末)【百万円】 ■ 社内留保(当期末)【百万円】
■ 役員賞与(当期末)【百万円】 — 当期純利益(当期末)【百万円】

earned surplus increasing in service sector
 Manufacturing remains same level.



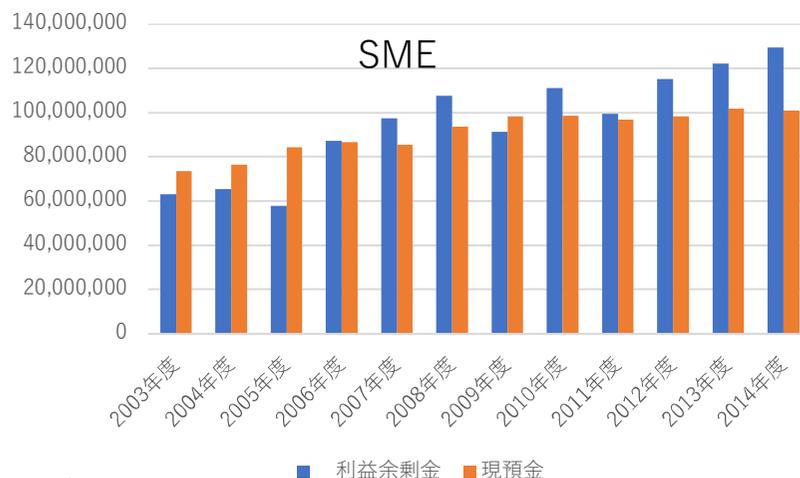
<source> Ministry of Finance

Earned surplus (all industries excluding financial · insurance companies, million yen)



<出所>財務省「法人企業統計」利益剰余金 = 利益準備金 + 積立金 + 繰越利益剰余金

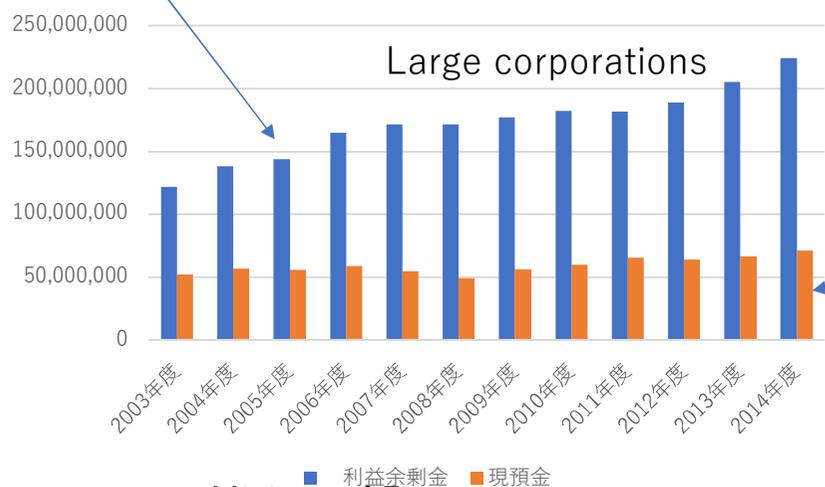
Earned surplus and cash holding in big companies and SME



- SME hold cash larger than retained surplus up to 2005, however large corporations hold cash far below retained surplus

- SME tends to hold cash in preparation for cash management whose operating money and fund relies on banks.

Earned surplus

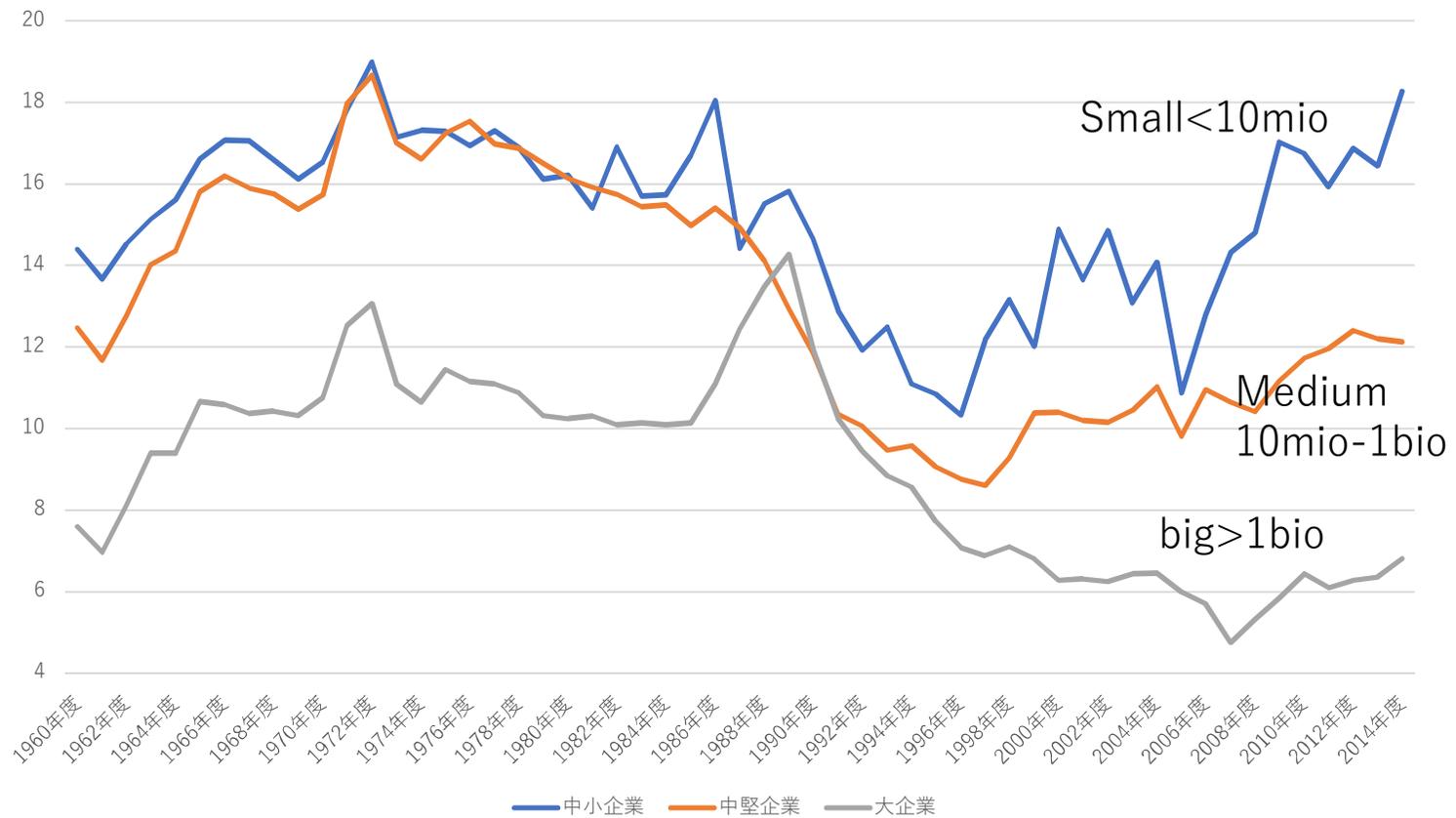


Cash and Deposit

<source> Ministry of Finance

Cash and Deposit holdings by firm size(%)

cash & deposit outstanding / total assets



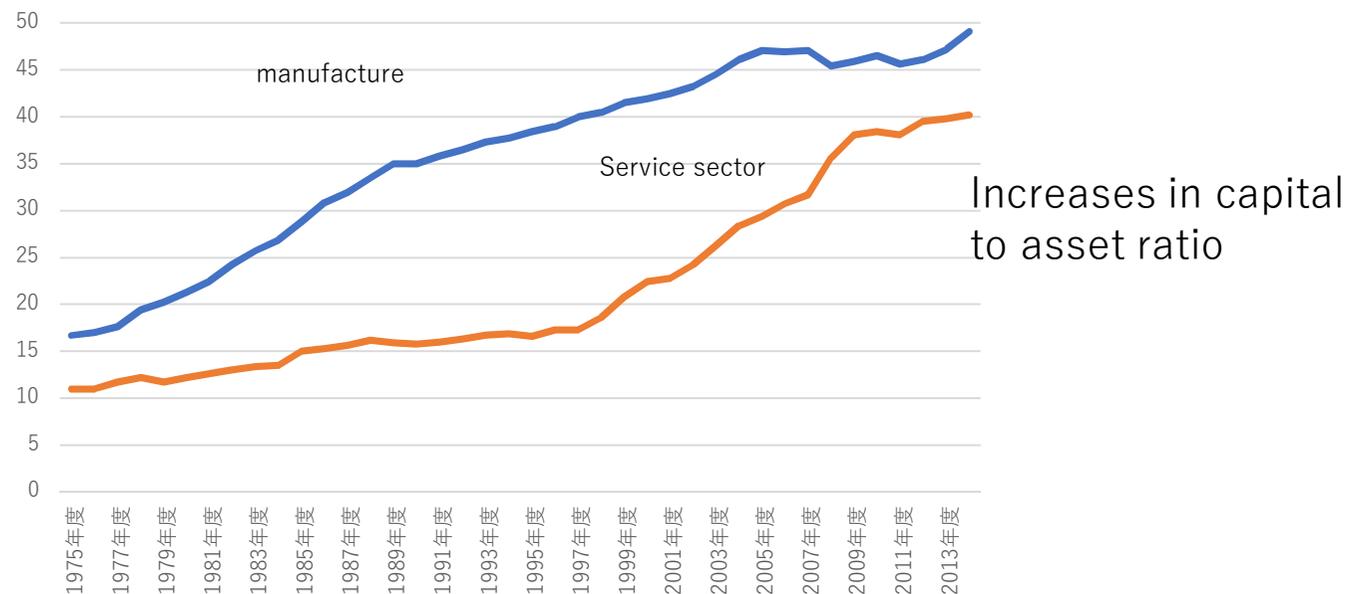
(注) 大企業：資本金10億円以上、中堅企業：同1億円以上10億円未満、中小企業：同1億円未満

What makes increase of cash holdings theoretically

- Trade-off theory (Opler et al. 1999; Dittmar et al. 2003): Firms hold more cash when they are smaller, have higher investment opportunities, and have higher cash flow concerns, because these are characteristics which either increase the cost of cash shortfalls or increase the cost of raising funds.
- the financing hierarchy theory(Opler et al.,1999): there is no optimal amount of cash and cash balances are simply the outcome of firm profitability and financing needs
- Pecking Order Theory : Due to the asymmetry information between stockholders and management, and agency problem, managers prefer retained surplus, debt, equity finance
- Weak Corporate Governance : COE tends to focus their benefits not maximizing the stockholders profit but cumulate retained earnings for solvency risk

Capital to asset ratio is increasing(%)

- Increase of earned surplus, squeeze the debt made strengthen the balance sheet of Japanese corporations

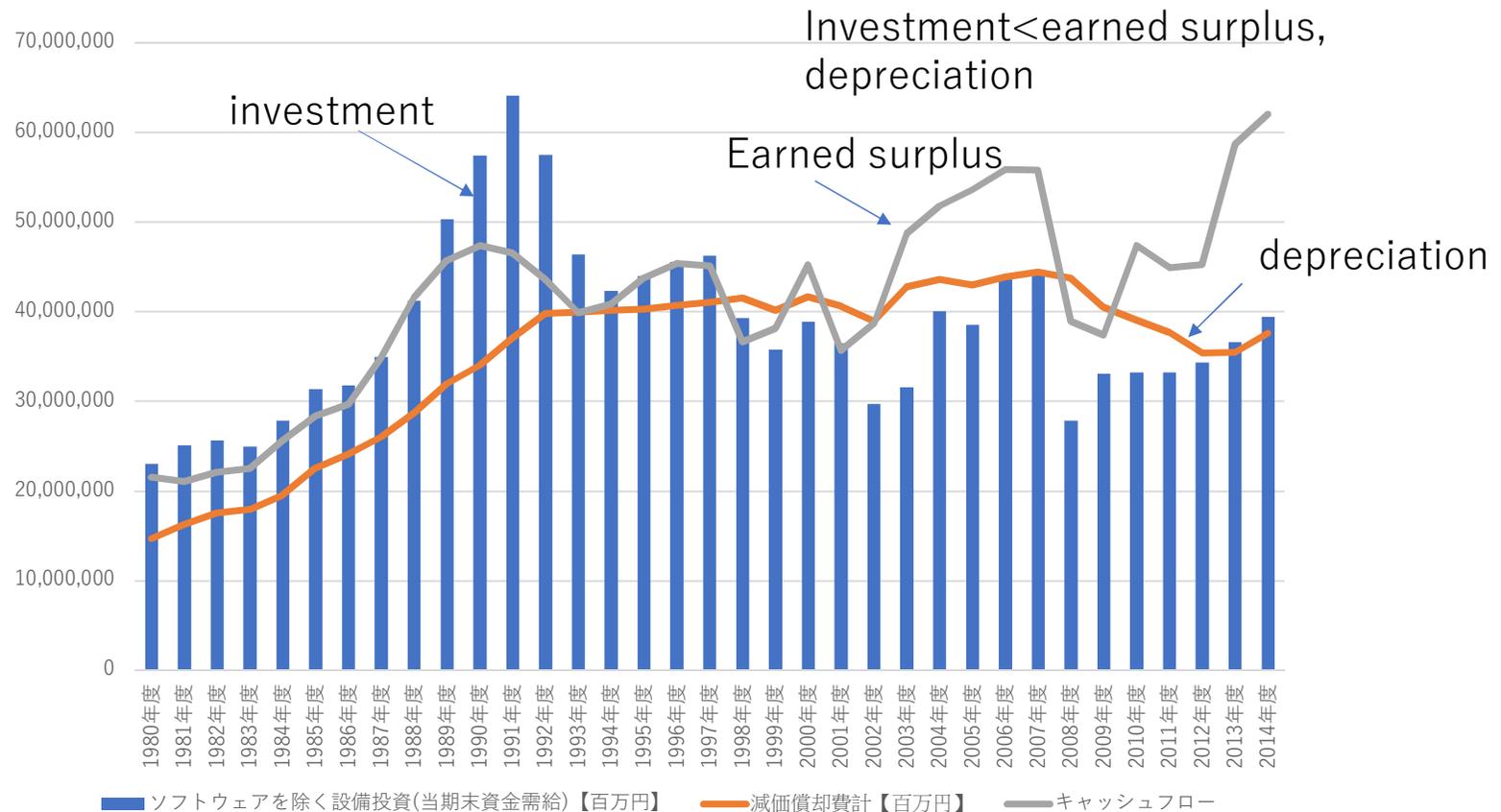


<source> MOF, “Financial statements statistics of corporations in industry”

⁴¹ Specific reasons for Japanese corporations to earned surplus

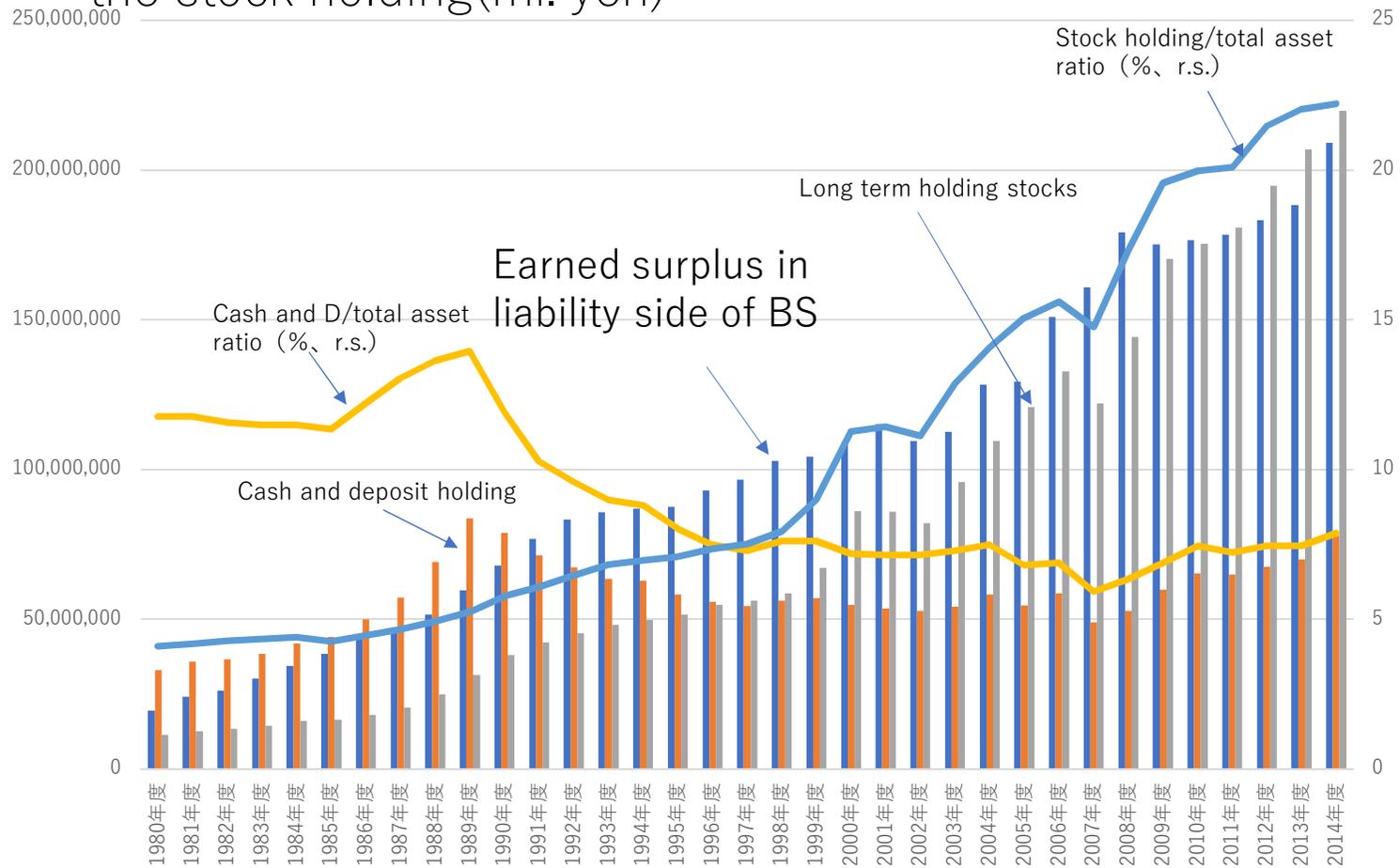
- Entrenched deflation expectations
- Aversion to bankruptcies and lack of pre-packaged bankruptcy procedures. Japanese firms tend to accumulate larger cash balances as a form of insurance against having to file for bankruptcy (Kinoshita, 2013)
- SME tends to have more cash as capital.
- Large corporations advance in the emerging markets to invest
- Weak corporate governance (Aoyagi and Giovanini, 2014)

Private Investment(million yen)



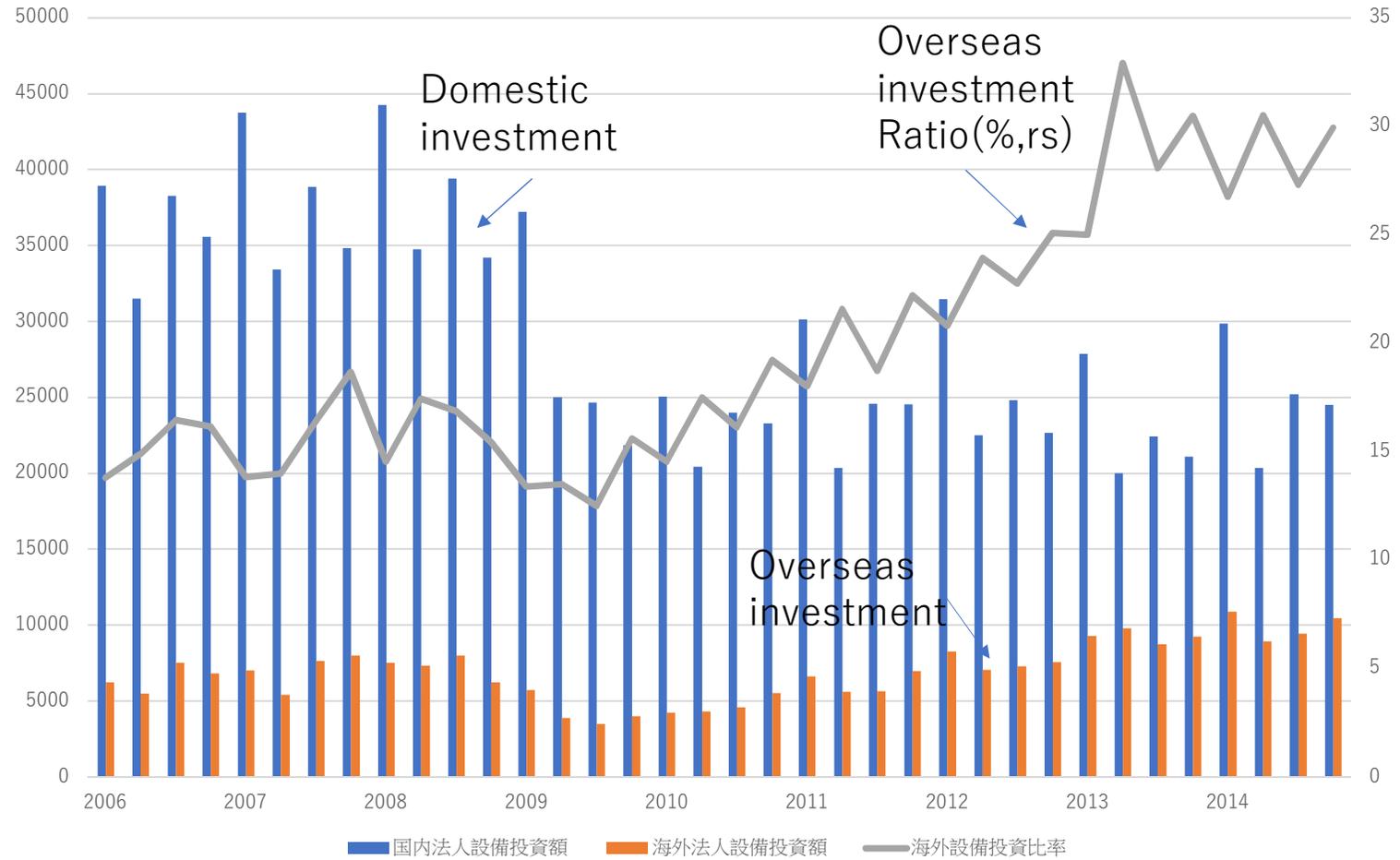
<source> MOF, "Financial statements statistics of corporations in industry"

Large corporations reduced cash holding and increase the stock holding(mi. yen)



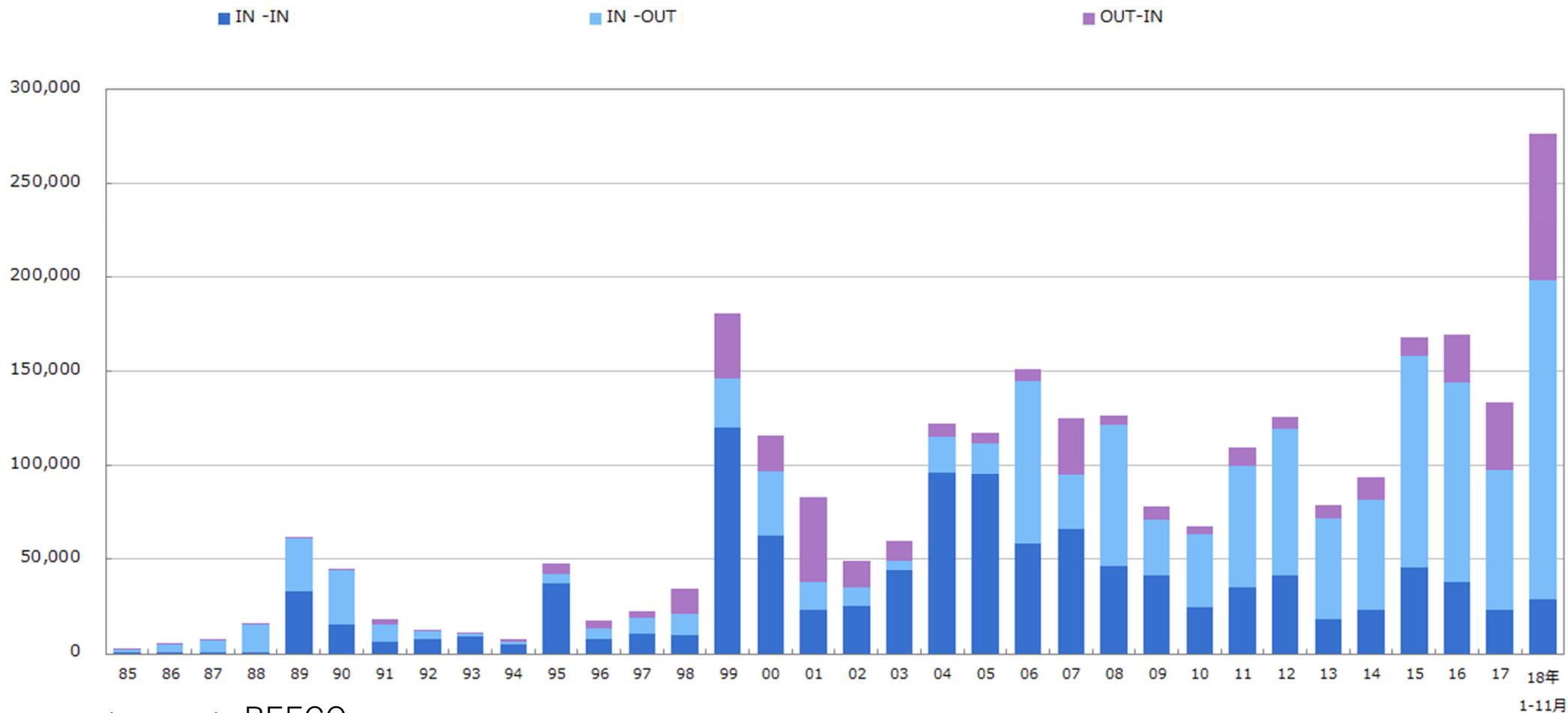
<source> MOF, “Financial statements statistics of corporations in industry”

Overseas investment ratio in manufacturing (%)



< source > MITI data

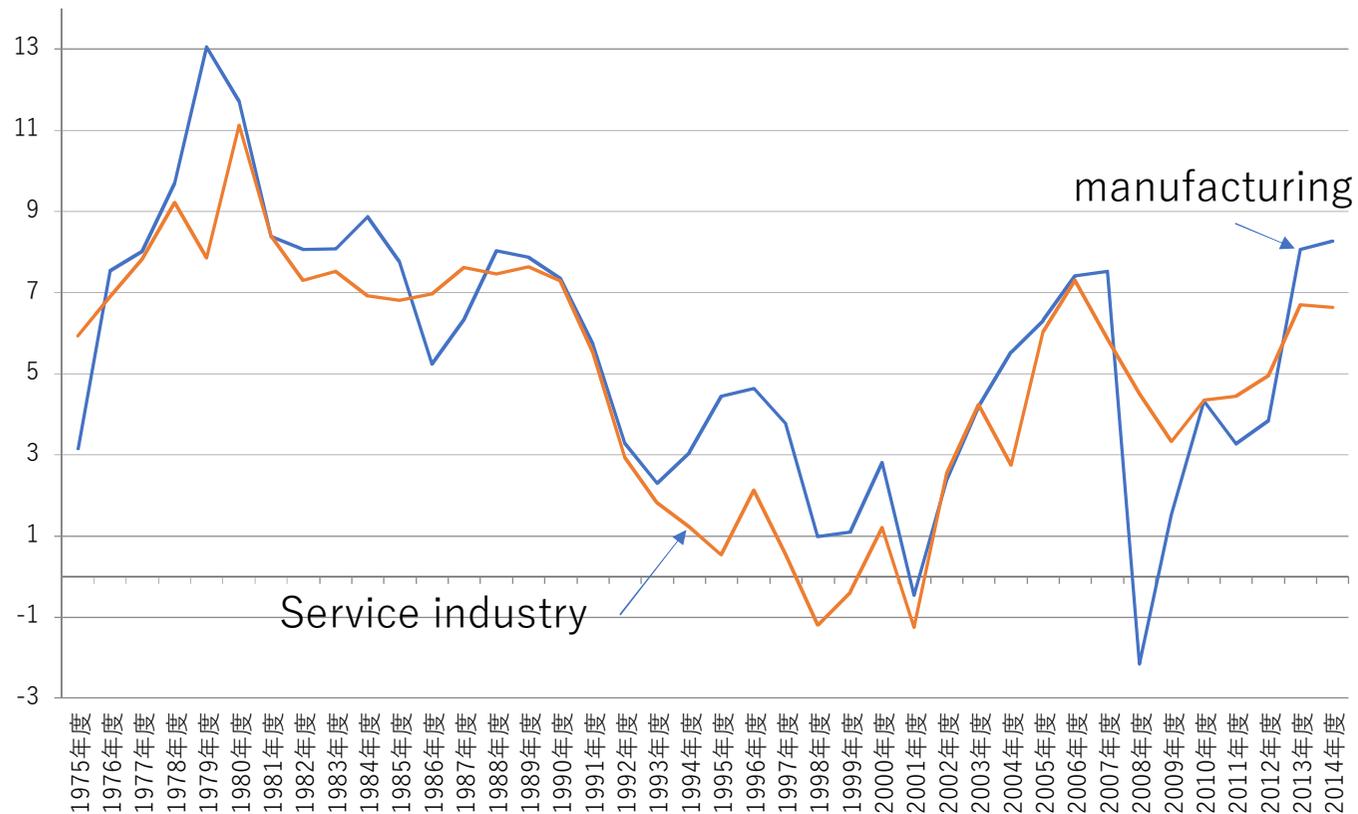
Merges and Acquisition(M&A) Value basis (100 million Yen)



<source> REFCO

1-11月

ROE(Return on Equity) ratio (capital more than 100 million yen)



< source > ministry of finance 「financial statements of corporations」
(1) net profits ÷ net capital.

Empirical Studies of Aoyagi and Giovanni(2014)

- 3,412 nonfinancial firms for the 14 years between 2000 and 2013 . The dependent variable is the stock of cash and cash equivalents in percentage of market capitalization.
- their indicator of corporate governance always has a negative sign, suggesting that improving corporate governance would reduce corporate cash holdings in Japan.
- the free cash flow per share which we expect to have a positive sign, in accordance with predictions of the financing hierarchy theory that firms with high cash flows will hold more cash
- results suggest that better corporate governance reduces cash holdings
- the debt-to-equity ratio, which we interpret as a broad measure of banks' monopolistic power in lending and have a positive sign.
- The number of employees has a positive and highly significant coefficient, which is in contrast with the prediction of the trade-off theory, but could be explained in the Japanese context by the “aversion to bankruptcy”

Table 2. Determinants of Cash Holdings in a Panel of Japanese Firms: Regression Results 1/

	Fixed Effects	Fixed Effects (Robust SE)	Random Effects	Arellano Bond (2 lags)
Dependent Variable: Cash Holdings in Percent of Market Capitalization				
Governance Index	-0.089 [-1.82]*	-0.089 [-1.44] 2/	-0.380 [-8.59]***	-0.327 [-4.87]***
Log of Common Stock	-0.380 [-0.69]	-0.380 [-0.78]	0.280 [1.35]	0.232 [0.28]
Log of Number of Employees	8.179 [4.45]***	8.179 [2.81]***	2.002 [5.17]***	10.367 [4.08]***
Cash Conversion Cycle	-0.009 [-0.72]	-0.009 [-0.37]	-0.003 [-0.82]	-0.014 [-0.92]
Log of Capital Expenditure	-1.838 [-3.42]***	-1.838 [-2.30]**	-2.187 [-7.78]***	-0.790 [-1.23]
Debt-to-Equity Ratio	0.010 [3.70]***	0.010 [1.61]	0.005 [2.61]***	0.011 [3.77]***
Free Cash Flow per Share	0.007 [2.77]***	0.007 [2.20]**	0.002 [1.18]	0.014 [5.38]***
Lagged Dependent	0.095 [7.26]***	0.095 [1.93]**	0.786 [98.32]***	0.129 [6.47]***
Lagged Dependent				-0.158 [-11.53]***
R-squared (overall)	0.060	0.060	0.647	...

Source: IMF Staff Calculations

1/ T-statistics are reported in parenthesis. * denotes significance at 10% level, ** significance at 5% level, and *** significance at 1% level.

2/ Level of significance is 15 percent

Empirical analysis

- Dependent variable: log of Earned Surplus in percent of asset
- Log of debt/asset ratio : how the corporations rely on banks lending
- Log of share holding ratio of big banks(1st section, city banks)
- Log of independent directors ratio (1st section)
- Corporations with capital size more than 1 billion yen.

$$\log \text{earned surplus} = \beta_1 + \beta_2 \log \text{debt asset ratio} + \beta_3 \log \text{Share holding ratio} + \beta_4 \log \text{ratio of independent directors} + \varepsilon$$

Regression
results of
Empirical
Studies

Dependent Variable: LN_EARNEDSURPLUS

Method: Least Squares

Date: 12/28/18 Time: 22:31

Sample: 1990 2017

Included observations: 28

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	2.949825	0.300002	9.832699	0.0000
LN_DEBTASSET	-0.312315	0.163141	-1.914388	0.0676
LN_BANKHELD RATIO	-0.130252	0.049606	-2.625743	0.0148
LN_DIRECTOR	0.248379	0.041678	5.959412	0.0000

R-squared	0.973796	Mean dependent var	2.815961
Adjusted R-squared	0.970521	S.D. dependent var	0.221164
S.E. of regression	0.037973	Akaike info criterion	-3.572320
Sum squared resid	0.034607	Schwarz criterion	-3.382005
Log likelihood	54.01248	Hannan-Quinn criter.	-3.514139
F-statistic	297.2974	Durbin-Watson stat	0.769695
Prob(F-statistic)	0.000000		

Findings from the regression

- Dependent variable is earned surplus, and we use variables including debt/asset ratio and the share holding ratio of big banks, to make clear the discipline of main banks as stock holders.
- Empirical result shows us both variables are significant negative coefficient, confirming the main bank functions are diminishing.
- As a corporate governance, variable of percentage of external directors is significant positive coefficient , which could contribute to improve corporate governance.

Conclusion

- A role of Main Bank as a stock holder has diminished.
- Increase of earned surplus shows us that big corporations strengthen their capital base, which suggest us that they do not need necessarily rely on the main bank as an asset holder.
- It has been already pointed out, Japan introduced UK model of corporate governance with an engagement among institutional investors and corporations. However, it could not yet work well.
- US enjoys their model of corporate governance, where many diversified market participants' discipline works effectively. Japan needs to diversify market participants further, instead of relying on concentrated main banks.

- References

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