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CHAPTER 9

THE MAIN BANK SYSTEM AS PART OF JAPANESE CORPORATE GOVERNANCE

One of the differentiating features of classical models of corporate governance is the role of banks in financing enterprises [Milhaupt, 2001]. Banks play an important part in corporate governance in countries embracing the continental-Japanese model, and especially in Japan[1], and are less important in countries with the Anglo-American model.

Several key features may be distinguished in the Japanese system of corporate governance, namely the main bank system in which banks supervise their customers–companies, the lack of an external control market, company boards dominated by employees focusing mainly on operational management, and the system of lifetime employment [Milhaupt, 2001]. Japanese banks play a major role in gathering savings, allocating capital, monitoring investment decisions taken by the management of companies functioning within the main bank system, and managing risk. The assessment of these relationships and their impact on the growth of business and economy is not clear, both in theory and practice.

Japan did not join countries developing capitalist economies until the mid-nineteenth century (after a period of two hundred and fifty years of isolation), and therefore began industrialization much later than such countries as the United Kingdom, the United States, or Germany. However, within half a century (during the Meiji era[2]), the Land of Cherry Blossoms managed to bridge the gap and become one of the most economically developed countries, which it has remained to this day. A number of factors have contributed to this success: the consistent policy of the government, the activity of entrepreneurs, tradition, and also banks. The

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[1] The key features of the Japanese system of corporate governance include: the main bank system, company boards dominated by employees and focused on operational management and the system of lifetime employment.

[2] The following periods (eras) may be distinguished in the development of Japanese economy: Meiji (1868–1912), Taisho (1912–1926), Showa (1926 – 1989), and Haisai (since 1989).

key factors of success include the ability to learn from the best models, namely from the achievements and knowledge of the leading countries. The Tokyo Stock Exchange was based on solutions derived from Brussels, the banks were established and developed according to patterns derived from Germany and railway investments were developed based on the knowledge and experience of Scottish engineers.

The Meiji period was characterized by dynamic industrialization, free competition, the desire to maximize profits, and yet a relatively weak position of the government [Teranishi, 2000, p. 43]. The lack of a strong middle class meant that the country's industrialization and development initiatives were undertaken by the state.

During this period the capital market began to play an important role in the economy. Medium and large enterprises – zaibatsu – specific forms of monopoly, sought funds on this market. The market fulfilled its functions, namely generated capital and enabled valuation of assets. Companies routinely issued shares and trade in shares was very active. Cross-ownership of shares was extremely rare [Hoshi and Kashyap, 2001, p. 3].

Bonds were a more important source of financing than bank loans. More than half of household savings were invested in securities, which were also used as collateral for loans since 1915.

The number of banks was rapidly increasing; in 1881 there were 90 banks, in 1889 – 210, and in 1900 as many as 2060 banks. They were important, but not dominant.

The former system of corporate governance was very similar to the current U.S. system, the capital market was very important, a policy of maximizing dividends and remuneration for managers was pursued, external directors were engaged, and industry trade unions were in existence [Dore, 2000, pp. 32–33]. In order to reduce (agency) conflicts, companies used to regularly pay high dividends and the remuneration of the managers was linked to the performance of the company. Sanctions were introduced against managers as they could lose their reputation in the manager market (managerial capital losses); managerial freedom of decision making was restricted (law and statutes) and prominent businessmen were appointed to boards [Miwa and Ramseyer, 1999].

At the beginning of the 20^{th} century (the Taisho period, 1912–1926) Japan was already a strong capitalist state ruled by political parties, bureaucracy, high financial circles (zaibatsu) and a military clique, planning to expand its territory and political influence. The Japanese military plans had a very strong influence on the country's economy. To a large extent this policy was inspired by zaibatsu conglomerates (financial cliques) or konzerns (named after German Konzern) which could be defined as a kind of consortium or syndicate. They were usually organized as holding companies (mochikobukaisha), but comprised also other forms of organization. The equity of the main company (honsha) was usually owned by a family. [3]

The honsha held the shares of production, financial, and trade companies (branches) owned by the organization and exercised full control over their operational activities. Initially, the constituent entities forming holdings were partner companies since it was not until the 1930s that they began to sell their shares.

Zaibatsu employees were very strongly associated with the family owners and with other employees of the holding. Employees participated in the distribution of zaibatsu income; the managers received very high remuneration and other bonuses. In this way the specificity of Japanese companies was created and has continued to fascinate Western countries ever since.[4]

Zaibatsu pursued specific military goals by carrying out government contracts. Companies manufacturing for war needs acquired the necessary funds primarily from banks, so the government had to ensure that the banks had sufficient resources and made them available on favorable terms. Moreover, some banks were entrusted with financing specific companies important from the military point of view. This contributed to the formation of a strong relationship between banks and companies and a new relationship between the lender and the borrower was established – bank-centered financing. This policy led to a gradual reduction of the function of the capital market because of the implementation of strictly defined objectives of zaibatsu and thus of the government. The securities market was dominated by government bonds and began to decline. Between 1930 and 1945 (the Showa era), the Japanese financial system evolved from a system based on a capital market into a system dominated by banks. The existing legal regulations made it possible to build mighty banks, especially zaibatsu banks. This also resulted in a change of the corporate governance system as managers became increasingly important, particularly those in the banks [Jerzemowska, 2002, p. 80].

3 The roots of some zaibatsu reach back to ancient times, e.g., the 16th century (Sumitomo), 17th century (Mitsui), or 19th century (Mitsubishi, 1871). These three zaibatsu conglomerates strived to reach an oligopoly position in various fields of economy. Another large group was the Yasuda financial group, while smaller groups included Okura, Furukawa, Asano, Fujita, and Kawasaki, established in the 1870s. After World War II, Americans reported that there were 31 such families.

4 It is difficult to determine the power and strength of zaibatsu because they did not prepare consolidated accounts. It is known that the largest zaibatsu, Mitsui, covered one-tenth of the economic activity of the country, Mitsubishi was one-third the size of Mitsui and Sumitomo one-ninth. During this period, the zaibatsu were too big to fail.

The defeat of Japanese militarism meant that the country came under U.S. occupation (1945–1951) [Nowa Encyklopedia Powszechna PWN, 1996, pp. 141–142], and the main goal of the U.S. policy was to destroy the military power of Japan. To achieve this it was necessary to break the power of zaibatsu which were the basis of Japanese nationalism and the expansionism of the Showa era. In 1948, the use of prewar zaibatsu names, trademarks and logos was banned.[5] These measures had serious implications since they affected one-third of the capital invested by all Japanese corporations in 1945.

The Japanese economy emerged from the turmoil of the war badly damaged and weakened, national funds were insufficient in relation to the investment needs, companies had huge debts to banks and each other, and there was a general lack of liquidity.

In addition, the Japanese government made a decision to control foreign investments and ration capital, but, more importantly made sure that people's savings were deposited at those banks which suffered the least damage in the course of the war. Regular inflows of capital increased the importance and power of those entities and soon the banks became the center of the system financing the reconstruction and development of Japan. Performing such an important role in the financial reform of companies and the country also strengthened their position as the dominant financial institutions. One of the features of the post-war Japanese financial system was a clear separation of banking and securities trading, as the Securities and Exchange Act of 1948 (Section 65) forbade banks to trade in securities [Hamao and Hoshi, 2000, p. 105].

In 1949, the ban on cross-ownership of shares was lifted and companies began to mutually acquire their securities (cross-ownership) as part of recapitalization. It was a way to avoid, especially in the 1960s, hostile takeovers (form U.S. investors), resulting in an increase in shareholder equity [Dore, 2000, p. 34]. In a situation where issues of bonds and shares were controlled and constrained by formal and informal rules, many companies found it impossible to raise capital from those sources. Thus banks became the only source of capital for companies, because funding with foreign equity was forbidden [Hoshi and Kashyap, 2001, p. 6]. Banks were also the only possibility for household saving and offered their customers a low interest rate, determined by the Minister of Finance. The role of banks, because of the existing regulations, consisted in receiving deposits from the public and in granting credits to companies. This resulted in a very strong relationship between banks and companies in the field of acquiring and granting

[5] This ban was lifted in 1952 and companies began to adopt the names of their former zaibatsu, or new companies adopted those names.

loans, cross-shareholding, personal and supervisory relations. The obligatory social theme was "united in development." The Minister of Finance (enjoying very broad powers) presided over the financial system and "convoyed" banks in the sense that he protected them from falling into bankruptcy and therefore the system was called "the convoyed system." The minister also oversaw the finances of the country.

By 1955, as a consequence of voluntary or forced implementation of multi-directional changes, the financial system in Japan had evolved into one that was entirely different from its predecessor. The new system, called the main bank system, or keiretsu (enterprise group), was created after the war by the companies of four major zaibatsu. By the end of the 1960s, there were established six interrelated groups of manufacturing companies and financial institutions forming "enterprise groups" (Kigyo shudan or keiretsu), in which banks became market leaders.[6] Already in the 1950s, the dependence of manufacturing companies on the banks which financed them became clear. The system of keiretsu financing matured by the end of the 1970s.

It should be noted that there are significant differences between the zaibatsu group and the keiretsu group. Companies forming a keiretsu group are much more independent than Honsha companies. This is due to the nature of ownership and control. Such companies are not controlled by one family and there is no company that would have the right to manage the other ones because each company within the group is separately listed on the stock exchange.

Relations within the main bank system meant the establishment of long-term relations between a company and its bank, as the bank supported the activity of the company and assumed the risks of its activity [Koyama, 2003]. The benefits of such a system were much higher than the costs.

However, it is not possible to clearly define keiretsu. The main bank system is not a legal institution. Its functions are not specified in any regulations or statutes, and its responsibilities are not defined with respect to group companies. In this form of business organization, the bank becomes the main organizer of capital for the company, holds its shares, and provides it with all other financial services. The bank helps the company to enter the capital market by providing it with financial guarantees or floating its shares. The bank monitors company managers and is obliged to rescue the company in the event of financial difficulties. The

[6] The three largest were developed from pre-war zaibatsu. In the other three a particularly important role (the core) was played by banks. The largest was created around the Fuji Bank, a successor to Yasuda zaibatsu. The two remaining groups were developed already after the war around pre-war banks.

main bank has a decisive influence on the appointment of members of the board of directors (who usually cannot be external directors) and also, if need be, on the replacement of the managing staff. The bank also provides information and advice to the managing staff on matters of company management. In the event of financial difficulties, the bank develops or participates in the development of recovery plans for companies in trouble, provides financial help and also acts a coordinator of its borrowers.

The term keiretsu is used in relation to two different groups: vertical groups (supply chains with one parent company) and horizontal groups (groups of equal companies). More precisely, horizontal groups are called “Kigyo shudan” (enterprise groups), but this term is little known outside Japan. However, the distinction is important and this name should be used.

The term “enterprise alignments – Kigyo keiretsu” began to be used during the Second World War and is difficult to translate into other languages. It includes not only branches (50% of equity), affiliated companies (20% of equity), but also a large number of subcontractors who are divided into first, second and third-ranking. Similarly, affiliated companies differ in terms of the power of their status in respect of the parent company [Okumura, 1984]. The main characteristics of the group are: cross-holding of shares in the group and regular meetings between the presidents of corporations (Sacho-kai) within the group. In fact, these are meetings of shareholders controlling a given corporation. Another feature is the creation of joint ventures by members of the group. The main bank, supported by other financial institutions of the group, grants preferential loans to members of the group. These loans used to be called “keiretsu yushi – alignment loans”. The fifth feature of enterprise alignments involves the presence of a “sogo shosha” in the group, i.e., a large commercial corporation which forms the core unifying the companies of the group. The corporation conducts transactions within the group, increases the number of these transactions and coordinates projects for international expansion. The benefits resulting from the synergy of the group are yet another feature, and especially the direct use of wage disparities that are present in the economy (wages in small and large companies); reduction of the risk faced by major corporations through the use of related companies; and protection against the trophic expansion of large corporations [Hoshi and Kashyap, 2001; Yamada, 2000; Dore, 2000, pp. 32 – 33; Nowa Encyklopedia Powszechna PWN, 1996, pp. 191 and 197].[7]

[7] It is worth mentioning that the Japanese post office to this day remains the largest financial institution engaged in individual deposits and loans, life insurance, and postal services.

Despite the fact that banks were the largest shareholders (in the mid-1970s they owned one-sixth of the companies listed on the Tokyo Stock Market), they did not exert a direct impact on the operational activity of companies. However, their role in the corporate governance of those companies became very important.

Many large Japanese companies belong to financial keiretsu, which are characterized by a complex network of internal relationships centered around the bank. Other large companies have created similar groups called industrial keiretsu (manufacturing keiretsu), which are centered around large industrial organizations. Companies in industrial keiretsu also have their own main bank, related to them through share ownership. Banks, as well as other companies of the equity-linked group, are so-called stable shareholders, whose holdings do not change over time [Morck et al., 2000].

Until the 1970s, the Japanese central bank system consisted of several complementary components [Aoki and Saxonhouse, 2000, p. 19]: contractual relationships of a specific type between banks and companies; specific inter-bank relationships (delegation of monitoring), a definite set of measures regulating bank deposits and their guarantees, financing constraints, and obtaining loans.

In 1973, the oil crisis led to a significant budget deficit in Japan, which was financed with government bonds. It also started a new period of development of the Japanese financial system. It was necessary to create a secondary market for trading securities, which in turn implied the gradual deregulation and modification of the existing financial system.

Since the end of the war, the Japanese government pursued a policy of avoiding a deficit, and therefore had no experience of eliminating it. The lack of a developed bond market became a problem at that moment. It was necessary to open the government bond market, thus starting the process of deregulation and transformation of the financial system. The restrictions on the issuance of bonds and foreign exchange were lifted. The 1980 "Foreign Exchange Act" reform allowed the inflow of foreign capital to Japan and its generation abroad. Deregulation of the stock market, however, took place at a slower pace.

Summing up, it can be said that during this period the capital market and objective valuation did not grow in importance, while certain weaknesses and disturbances resulting from the limited significance and function of the capital market slowly began to appear.

Since the 1970s, the Japanese financial system has been undergoing changes facilitating the issuance of bonds for companies. In 1977, a regulation was adopted according to which banks were allowed to hold no more than 5 per cent of companies' shares and were given ten years to make appropriate adjustments.

Despite that, between 1976 and 1982 banks remained strong and continued to exert a significant influence on companies as they were the only source of external capital for companies since the capital market made it difficult to issue bonds and companies were not allowed to issue bonds abroad. On the other hand, the years 1989–1995 were a period of a serious weakening of the banks. They lost their monopoly in terms of providing capital for companies because companies were now allowed to raise capital from foreign markets and the banks began to feel increasing stress resulting from bad debts. The late 1980s and the early 1990s are called the "bubble economy" in Japan. This was the result of the government's macroeconomic policy, to a large extent imposed by the U.S. government (Plaza Accord, 1985), as well as the consequence of the progressive liberalization of the financial system.

The period of the Japanese crisis can be divided into three stages. The first one covers the years 1990 to 1993, a period of collapsing asset prices and declining economic growth Between 1990 and 1993, companies listed on the TSM lost on average 57 per cent of their market value and the banks suffered because of the crisis [Koo-Kang and Stulz, 1997]. Companies which were more indebted to the banks performed worse and also invested less, which indicates the negative consequences of dependence on banks for financing.. The government made the first intervention in the financial market to form the basis for future reforms. The 1993 reform (introduced on 1 April 1993) allowed banks to broaden their activity and the range of services they could offer. The banks were permitted to establish subsidiaries specializing in securities and trusts and could diversify their core business [Hamao and Hoshi, 2000, p. 105].

However, because of the delay in reform actions, Japanese difficulties turned into a major crisis[8] in 1997 (the second crisis concerns the 1997–1999 period). The following symptoms of the crisis can be specified in banking activity [Corbett, 2000]:

- A decrease in the value of collateral in relation to the value of loans meant increased risk for the banks;
- A decline in asset prices entailed changes in the banks' balance sheets;
- The value of overdue loans in relation to total loans increased;
- Reserves for loans and write-offs resulted in reduced bank profits;
- Bankruptcies of companies and bank write-offs on overdue loans reached such proportions that the banks became insolvent.

[8] According to the interpretation of the IMF, a crisis (recession) occurs when the value of nonperforming loans divided by the total value of the loan portfolio is higher than 2 per cent, the cost of corrective measures accounts for at least 2% GDP.

During the second crisis, it was very difficult to obtain bank loans due to very strict restrictions. However, the measures taken during this period led to a recovery in the credit market and in the economy between 1999 and 2003 [Hoshi and Kashyap, 2008].

Changes in political and economic factors initiated further transformation of the financial system (deregulation), and especially of bank-centered financing. Large companies with international operations gradually reduced their dependence on banks, which in turn began to provide loans to small and medium-sized companies which did not have stable relations with large banks. In this way, the main bank system, a system based on direct long-term market relationships between banks and companies, began to fall apart, or at least to loosen. Companies not only began to reduce their dependence on bank loans, but also decreased the number of directors appointed to their boards by banks. These changes diminished the ability of banks to monitor their clients and many interventions aimed at getting companies out of difficult financial situations were very turbulent. Banks also significantly decreased their commitment to reducing the risks of the companies in the system. Japan did not have a corporate governance system that could predict and minimize the impact of the situation. Because of cross-shareholding, general meetings of shareholders became ceremonies. The distinguishing feature of the Japanese system is the board of auditors. The auditors have a lower position, resulting from tradition, than CEOs and often must respect the CEOs' decisions, especially that usually they are former employees of the company [Yamada, 2000, p. 105].

Evaluation of the effectiveness of long-term bank interventions is difficult and ambiguous [Aoki et al., 1994], and largely depends on the period to which it relates.

Some authors believe that it is not reasonable to claim that main banks play a special role in relation to companies [Hall and Weinstein, 2000, pp. 64 - 65]. There is no evidence that keiretsu make more effective investments and develop faster than other companies. The main bank system helps companies raise capital, but does not increase their profitability. Studies show that when facing financial difficulties Japanese companies reduce research and development costs as fast as Anglo-American companies. A major drawback of the main bank system is the fact that well-informed banks can use their position to achieve their own benefits and companies may become hostages to their banks. Furthermore, restricting the sources of raising capital to bank loans only may be a problem for companies, especially in a situation where the bank itself faces a difficult financial situation. Many companies could not raise capital from the capital market since they did not meet the requirements. In such a situation companies were forced to abandon even very profitable investments.

Until the beginning of the 1990s, companies, as a rule, did not change their main banks. At that time, there were no problems with the financing of companies by banks, but in the last decade of the 20th century the situation changed in this respect considerably.

Other authors are of the opinion that the key advantage of the main bank system is the concentration of companies' debts in specific banks. This was particularly important at a time of financial difficulties within companies. The banks had adequate information and helped implement appropriate corrective actions. The banks were therefore a constant source of capital for companies – dedicated entities which the companies could always count on, contributing to increased efficiency of companies [Schaede et al., 1998]. Some authors argue that such actions usually resulted in serious losses for the banks while the companies' performance improved only slightly. There were no individual programs adapted to the specific situation of particular companies and routine operations turned out to be less effective [Schaede et al., 1998, p. 179]. Some authors think that the principal task of the main bank system is to overcome the weakness of the capital market or to gain tax advantages, or possibly to combine these objectives [Hayashi, 2000, p. 60]. Some authors believe that the advantages include the fact that Japanese companies with strong ties to banks make more profitable acquisitions and also investment decisions of companies with strong relations with banks are less dependent on their state of liquidity. A main bank usually intervenes very quickly, even before a crisis strikes, making the corrective action more effective, which confirms the advantage of the main bank system over the Anglo-Saxon system. The main difference between the two systems lies in the communication between the company and the external entities supervising it. The main bank constantly gathers information about the company, and also can obtain confidential information from its management. The main bank can therefore intervene quickly, and with a good knowledge of the activities and financial position of the company these interventions can be effective. Investment decisions in the capital market are taken by investors with high asymmetry of information. The American system is the opposite of those in Germany and Japan. The latter countries have established a system minimizing the impact of impatient shareholders, while the Anglo-American system is oriented at maximizing the impact of impatient shareholders [Thurow, 1993, p. 136].

Only after thorough research and profound analysis is it possible to decide which approach to embrace. The implications of the reforms and opening up of the Japanese economy to foreign capital have resulted in significant changes to the main bank system and have serious repercussions for Japanese corporate governance. However, it should be noted that despite the gradually decreasing importance of the main bank system it continues to be a significant feature differentiating the Japanese corporate governance model from the Anglo-Saxon one [Koo-Kang and Stulz, 1997].

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