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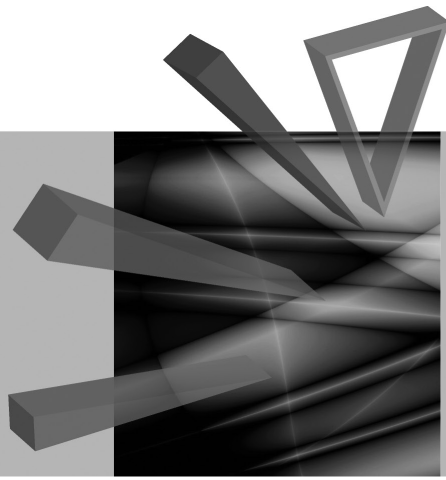

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INNOVATIONS IN THE CORPORATE GOVERNANCE SYSTEM AS NECESSARY IMPROVEMENTS OF THE CAPITAL MARKET IN JAPAN

Summary: The Japanese economy and corporate governance system is based on culture, so the most important rules are loyalty, obedience and avoiding rush when solving problems. In the conditions of the globalised economy, those rules are not enough to establish and hold competitiveness for Japanese companies and the whole economy. The tradition of making connection between the environment of business and politics, also not employing foreign managers and hiding negative information from investors is the main cause of problems and loss of trustworthiness experienced by many famous Japanese companies: Olympus, TEPCO and Toyota. Improving the system of corporate governance in Japan is the basic change to achieve as the next step in the development of the Japanese capital market. There are some suggestions of improvements, but they are insufficient in the case of the reluctance of government agencies and social opposition.

Keywords: capital market, Japanese model of corporate governance, financial malversation.

1. Introduction

Japan is the economy which is looking forward to be again at the top of the global market, despite of all problems with natural and nuclear catastrophes in 2011. In the history of this country there were episodes of decline – after the Second World War, but later it achieved the position of the second largest economy in the world. At the end of the second millennium, Japanese products were the symbol of modern technologies and the best quality, which was also an aim for American and European companies.

Japanese culture was always an object of interest and copying. The organisation of work and job safety system was not possible to achieve in other economies just because of values of life, natural in Japan. But nowadays there are problems, connected with this culture and the system of corporate governance, which are obstacles to searching a new way to necessary economy reconstruction.

After years of prosperity in Japan, the good mechanism became insufficient for new challenges of the globalised world. Thousands of companies, earlier profitable, faced problems with working as well as before, i.e., with competing on global markets and taking loans. Japanese banks started to give "bad credits", not supported by the value of companies. The symptoms of recession have been observed in Japan, and the causes of defects had to be serious, because of the long-term operation (about a decade) without a notable success. Those causes can be: omitting the opportunity for competing because of high costs of working, too wide a spectrum of products of Japanese companies, the policy of safe employment – without pressure on migration, and the most important for this article – a model of corporate governance not compatible with modern economy, based on Japanese culture (in the literature one can often find only legal and economic conditions). Without changes in this area there are problems with managing them and it is not possible for Japanese companies to be attractive for international investors.

2. Features of Japanese enterprises

The economy of Japan is based mostly on *kaisha* (great and small private enterprises). The characteristic economic structure for Japan is *zaibatsu* (*zai* means "fortune" or "money", and *batsu* – "family"). *Zaibatsu* were developed before the end of 19th century; it was a name for great groups of banks and capital owners, controlled by single families. The most important families were Mitsubishi, Yasuda, Sumitomo and Mitsiu. They controlled in the latter part of the Second World War one fourth of the capital on the Japanese market. Those groups had a structure of holdings, controlling on average 12 enterprises, running basic businesses, including banks, trade firms, fiduciary firms and insurance firms, together with their surroundings – clusters of different associations, branches or dependent companies. In 1946 they were dissolved by Americans and they started to be officially independent from their own firms. The fortunes of families were confiscated, however, holding companies, which were chiefs of individual *zaibatsu*, were eliminated. Boards of managers, key to the old system based on the co-ordination of enterprises, were illicit legally.[1]

Keiretsu (association, industrial group), in which the old mechanisms of the financial and administrative audit were destroyed, became heirs of the corporate heritage of *zaibatsu*. *Keiretsu* in the wide meaning can be described as an association. In post-war Japan enterprises from different sectors of the economy assembled around the main bank, a trade firm or the largest company. Within a single group, firms were not totally independent, but also far from integration. The structure of *keiretsu* gives an opportunity for different organisations to take advantage of capital, technological and human supplies, which are not available for companies outside a network.[2]

[1] I. Koładkiewicz, *Nadzór korporacyjny. Perspektywa miedzynarodowa*, Poltext, Warszawa 1999, p. 24.

[2] *Ibidem*, p. 27.

Japanese firms function mainly within a group of companies following the principle of the long-term co-operation. In their activity financial institutions are involved (mainly banks, which for their agents and on managers' advice take part in making most investment decisions). The most frequent situation is when the stocks of a Japanese company are in possession of tradesmen and customers, so the structure of shareholders is stable. The corporate form of the board of directors let Japanese firms develop big structures, which dominate in the Japanese economy. Families are still often dominating owners, but they hand over managing processes to professionals – Japanese managers.

Table 1. Market capitalisation (in USD) of shareholdings in Japanese listed companies by shareholder type (end of June 2002)

Shareholder	Market capitalisation	Percent of total	Percent of total institutional investors
Households	60,762	4.88	
Corporations (non-financial companies)	420,077	33.75	
Banks	427,294	34.33	
Institutional investors	336,572	27.04	100
Total	1,244,705	100	
Breakdown institutional investors			
Insurance companies	154,940	12.45	46.03
Investment firms	162,459	13.05	48.27
Pension funds	19,173	1.54	05.70

Source: Y. Altunbas, A. Kara, A. van Rixtel, *Corporate Governance and Control Ownership: The Investment Behavior of Japanese Institutional Investors*, Documentos Ocasionales, No. 0703, Banco de Espana, 2002.

Lots of companies listed in Japan are the property of banks and corporations as the majority stockholders (see Table 1). The second largest group of investors is institutional investors, insurance companies and investment firms. What is almost insignificant is the property of pension funds, although they are the biggest group among institutional investors. This is caused by different conditions of the Japanese social safety system – employees are protected after retirement by their firm, so the first principle for workers is loyalty.

Human resources management in Japan is based on a few simple rules: loyalty, obedience, faith in infallibility of management and respect for hierarchy. Employees' and employers' behaviour is strictly connected with the philosophy of Japanese management and mentality, based on two principles: consensus and *kaizen*, which means in a traditional translation: "good change – continuous process of improvement". The tradition of raising the quality of companies and products in Japan is based on culture conditions. But there are also negative sides of this kind of thinking – loyalty and perfection can be a cause of hiding real thinking and pushing away problem-solving.

The cultural heritage is a hindrance to the modern Japanese economy. Foreign managers are rarely engaged in Japanese concerns, but when they are, they should obey classical rules. Those who are not able to adapt, for example, reveal shortcomings, plan the closing of sections, ask problematic questions and disclose hidden data, are the first to be dismissed.

Japanese companies must change their model of managing if they want to be still competitive on the global market. The internal processes should be more international, open and with a transparent character. But it is obviously not the matter of a single decision – it should be a transition process of the whole market, especially capital market.

3. The Japanese model of corporate governance

Corporate governance system is the dominating style of managing companies and institutions in the economy of the country. In practice, the matters of properness structure in the system of corporate supervision are mainly connected with conflicts and co-operation between:[3]

– managers and stockholders (mainly in the case of the crumbled structure),
– dominating stockholders and minority stockholders (in the case of the concentrated properness structure and pyramidal structures),
– different types of stockholders groups (institutional and individual, external and internal, such as managers or workers).

There are several different models of corporate governance. The Japanese model of corporate governance is realised in a situation in which the capital market plays a significant role in the economy of the country. The concentration of the property is low; however, the company is treated as an independent institution. The rewards of managerial personnel (one-level) are not connected with achievements of companies. However, what is of great importance is pressures, exerted by interest groups: banks, different financial institutions, capital groups (*keiretsu*) and by worker groups.

The Japanese model of corporate governance is the most specific and closed, and relatively unknown to external subjects (see Table 2). Its peculiarity is connected unambiguously with the culture, in which relations inside one family are one of basic values (and connected with it: loyalty and discretion), but there are also some solutions coming from Western economies. One of them is the assurance of long-lasting position and stabilisation as the basic aim of the existence of an enterprise.

[3] F. Allen, M. Zhao, *The Corporate Governance Model of Japan: Shareholders Are Not Rulers*, May 2011, http://finance.wharton.upenn.edu/~allenf/download/Vita/Japan-Corporate-Governance.pdf, p. 55.

Because of that, there are connections between business and politics (the aim of which is the assurance of long-lasting prosperity).[4]

Table 2. Features of the corporate governance model and practice in Japan

Group of interest	Features
Directors, managers	– they are recruited from the group of present or past employees; – in smaller corporations they are recruited from other companies, connected and linked in cross-stocking; – their priority is to assure the growth of an enterprise
Stockholders	– they are passive – individual investors are minority among stockholders
Board of directors	– it is supported by institutional stockholders and a friendly block of the stock, so it can ignore the pressure from individual stockholders; – it is composed of about 10–20 managers, organised in stable hierarchy, based especially on the duration of employment and connections, not knowledge or experience
Supervisors	– members are chosen on behalf of stockholders, they may be managers in a company and they can monitor managers with the aim of the assurance of effectiveness; – audit of a company and assurance of maximisation of worth is the main task of the supervisory advice; – special functions in companies are ascribed to the leader, who is often called *shacho*, a chief manager and the main supervisor; he or she is appointed in favour of the workers of a company

Source: author's own study based on K.A. Lis, H. Sterniczuk, *Nadzór korporacyjny*, Oficyna Ekonomiczna, Kraków 2005, pp. 139–140.

The law for public companies is gathered in the document *New Japan's Corporation Law* from 2005. Previously corporations were covered by the *Yugen Gaisha Law*, Chapter II of the *Commercial Code* and the *Commercial Code Special Corporations Law* (established in 1974). The new document was worked out to modernise the corporate legislation in new conditions of the societal and economic global situation. The *Law*... is intended to develop "the formation of new companies and allow more flexible corporate management".[5] Also, it brings some facilities for mergers and acquisitions and gives new tools for companies to defend against hostile takeover bids. The source of knowledge for functioning of the Japanese model of corporate governance is constituted by two codes:[6]

[4] S. Prowse, Corporate governance in an international perspective: A survey of corporate firms in the USA, UK, Japan and Germany, *Financial Markets and Institutions* 1995, No. 1, p. 8.

[5] *Japan's New Corporation Law (Part 1)*, April 2012, http://www.pwc.com/ja_JP/jp/taxnews/pdf/jtu14_oct05.pdf.

[6] M. Jerzemowska, *Nadzór korporacyjny*, Polskie Wydawnictwo Ekonomiczne,Warszawa 2002, p. 127.

– *The Principles of Corporate Governance* – which was established by Japanese businessmen and scientists (Corporate Governance Forum of Japan) in 2001, later reviewed;
– the document worked out by the association of pension funds in Japan (*Keidanren* – Japan Pension Fund Association).

Public companies are listed on the one of three stock exchanges in Japan: in Tokyo, Nagoi and Osaka. Each of them has an individual code of corporate governance, but they are similar and compatible with the general law.

In Japanese capital groups (*keiretsu* – a net of tradesmen, customers, banks, etc.), there are often stocks crossing, so there are very close connections between companies. Structures are often related vertically and strongly integrated. Stockholders and workers are the most important groups of stakeholders inside companies (which often form coalitions), which is connected with the policy of long-lasting employment. Stockholders, in contrast to the Anglo-Saxon model, do not only expect financial advantages from accomplished investments, but mainly positive linkages with different participants of a capital group. The stable foundation of property leads to the concentration in the hands of banks and different companies, related to capital (together approximately 70%[7]). The system of the management in Japanese companies is one-level, and internal workers are only managers in the board of directors (the cases of external directors are very rare).

The Japanese capital market plays a significant role in the economy of this country, being the largest (and the oldest) in the Asia-Pacific region. The Japanese model of corporate governance excludes the necessity of the existence of the market of enterprise control, because the transactions of hostile takeovers are rare.

4. Failures of corporate management in Japan

The managing system in the Japanese economy is one of the weakest among the world capital markets.[8]At the GMI index (Governance Metrics International[9]), in the ranking of the quality of corporate managing, Japan is in the 33rd place, with 38 all countries included in the study. Even China and Russia are higher on the ranking list.[10] But the biggest Japanese federation of the business – Keidanren – is against any changes in the system. Also the philosophy of *bushido* makes patience and slow

[7] J. Jeżak, *Ład korporacyjny. Doświadczenia światowe oraz kierunki rozwoju*, Wydawnictwo C.H. Beck, Warszawa 2010, p. 164.

[8] *Skandal wokół firmy Olympus*, January 2012, http://www.azjapacyfik.pl/index_2501.php?a_2501=3718&b_2501=139.

[9] GMI ratings coverover 4,200 companies on the global market. GMI rating criteria are based on securities regulations, stock exchange listing requirements and various corporate governance codes and principles. It has been published annually since 2000.

[10] GMI ranking 2010, March 2012, http://www.gmiratings.com/pri.aspx.

reactions for micro- and macroeconomic crises the most wanted features of companies and managers.

Japanese corporation culture is known as the most loyal for the group with a guarantee of long-term employment and salary based on the period of experience. This is the reason why the labour market can be called safe and based on existing internal castes as well as an aversion to external specialists. The scandal concerning the Olympus case shows the shortcomings of the Japanese corporate governance system and the necessity for changes in managing, especially in public companies.

One of the failures of corporate governance in Japan can be observed in the case of Olympus, but it only shows a broader context of the problem. The reason why all the problems of Olympus (one of the biggest world producers of electronic, medical and photographic equipment) were published was dismissing the only foreign executive manager in that company, Michael Woodford, in October 2011. All the losses of the company for over 20 years have been shown, previously hidden by managers of the company from the stockholders and the public opinion. At the end of 20th century, there were losses amounted to over 481 billion JPY (about 6.25 billion USD). Part of that amount, about 105 billion JPY (1.3 billion USD) was booked in 2000–2009 as different suspicious transactions. So far 376 billion JPY (4.88 billion USD) has not been booked.[11] Hiding malversations was also very expensive.

At the beginning of the problems, Olympus used foreign deposits to hide losses, but in the case of an increase of loss in 2005 management started to create fictional investment and acquisitions to justify the lack of financial means. There was also a settlement with irrationally high salaries for an adviser company, which was supporting the acquisition of a British medical equipment producer – Gyrus Group in 2008. Irregularities were not reported by the management or the auditors, and also not detected by the supervisors. The public scandal started, when director Woodford wanted to know all the details of financial management of the company, so he was dismissed for "the lack of knowledge about Japanese culture". In this case there was also a matter of mafia (*Yakuza*) involvement. Similar cases of financial malversations were observed in Yamaichi Securities Co. (in 1997) or in Daio Paper Corporation.

Another example of Japanese problems with corporate governance is TEPCO (Tokyo Electric Power) – the operator of a nuclear power station in Fukushima, which was damaged in a natural disaster on 11 March 2011. In 2009 TEPCO and METI (the controller of the electricity market) ignored research studies about the possibilities of the catastrophe like this. Those studies could help in the process of introducing improvements in security procedures. But the problem is in the close relations between the sphere of business and administration, which block the inflow of independent knowledge in managing processes. There is a necessity to enlarge the independency of supervisors in Japanese companies, also with loosening the criteria of employing external experts without corporate or family connections.

[11] *Skandal wokół firmy Olympus*, *op. cit*.

The beginning of the scandal in TEPCO was in 1989. The experts in safety from American General Electric Corporation during the standard control of the cooling system in Fukushima, noticed some important shortcomings and included them in report. The unwanted fragments of the report were later removed from it, without any reaction of METI. After the disaster in March 2011, all manipulations were shown to the public.[12]

It is common in Japan to find employment in firms, which are connected with previous workplace of bureaucrats (marriages between their children and business families are also arranged). The best way to make Japanese firm more innovative and stronger is to give managerial positions to independent experts, external specialists, foreigners and women.

This caste system of the Japanese market is also a problem among politicians and the media. This can be visible in voting – the representatives of the main party are officially loyal to their leaders, not to their programme or voters. This is the reason why the leading party has arguments inside, not with the opposition. In the media there is reluctance to involve in problematic and controversial topics; thus, the case of Olympus was published so late and by the foreign press.

Japanese firms are close to honour and loyalty, so it was a shock for the capital market to find out about the scandals with Olympus or fabricating safety reports by TEPCO. The traditional way of managing is anachronistic and deep changes are needed (this is obviously the point of view of American and other Western specialists in corporate governance; Japanese managers and politicians are convinced about the superiority of the traditional model).

Toyota started to introduce changes earlier, because its management had understood that the quantity and perfection cannot be the only aims of prospering, i.e., that they should think also about employees, the knowledge of communication and the requirements of the global economy. The centralistic management is not compatible with the size of the company and the process of making decisions (like in the case of defects of accelerator pedals, when only the top management knew about it). In 2010 Japanese managers gave more independency for plants in Europe to make it possible to be a federal giant in the motorisation sector.

Most companies are aware of the necessity of changes. It is good for the market that scandals have been revealed even if it caused temporarily problems for the capital markets (like in the case Olympus, because their stocks can be withdrawn from the market). The flows of foreign managers and return of Japanese managers from foreign practices give a stimulus for improvements.

[12] Rok po tsunami. Japonia zamiotła ruiny pod dywan, *Bloomberg. Businessweek Polska* 2012, nr 05/12, p. 9.

5. Necessary improvements of the corporate governance system in Japan

The essential matter of the financial system of Japan is its form, based on banks. It can be characterised as preferential for operations guaranteeing high stability of the system. Moreover, this means that the flow of the capital in the economy follows the bank system, where the credit is the main instrument. It would be better for the effectiveness of companies to start implementing changes into the market-based system, which is concentrated more on generating profits and the flow of financial means is realised through the capital market. Also, financial institutions need to solve the problem of joining market competition. Traditionally, they are protected by the system of *keiretsu* and are less effective than in other economies, so the level of financial services must be improved.

The basic government organisation which regulates the operations on the stock market is the Financial Service Agency. It guarantees safety of exchange, but also it must assure transparency, fairness and confidence of the Japanese capital market. In new circumstances "it has become necessary for the agency to compile the cross-sectional and comprehensive rules for the user protection".[13]

To carry out necessary reforms of the capital market in Japan, the government provided a financial deregulation, known as the Japanese Big Bang in 1996. It planned to improve the Japanese capital market so that it could achieve the international level. It started to find solutions for problems of the real financial structure. It was supposed to end by March 2001, but the complications of the system of capital markets in Japan make it still in progress.

The solutions for the problems of Japanese corporate governance are the most strongly connected with cultural patterns. Some of them must be started by state supervisory and can be similar to those mentioned earlier. It is necessary:

– to aspire to attach greater importance to market factors than the influence of non-market conditions of the economy, like informal mechanisms;
– to limit the claim and pro-effective attitudes for all stakeholders;
– to limit confidence as a factor in concluding contracts;
– to lower the level of social acceptance for dishonest behaviour of stakeholders;
– to allow external (especially foreign) managers to the boards of directors of Japanese companies, because of their skills and culture-free thinking;
– to improve the system of internal control and create a linkage between it and the external system of investors relation (to avoid situations of frauds and failures);
– to assure that the system of auditing companies is independent and not involved in companies under scrutiny;

[13] *Functions of Financial Service Agency, Japan*, April 2012, http://finance.mapsofworld.com/capital-market/global/japan.html.

– to limit bureaucracy, and also complex and complicated law, to make the corporate governance system more transparent;
– to limit cross-shareholding, because of the threat of bankruptcy – the problems of one company concern others, also in public opinion;
– to standardise financial and accountancy information, to make it more legible for international markets;
– to discover positive consequences of employing well-educated women at managerial levels.

The best option for Japanese capital markets was established in 2007, and started to be binding on 1 January 2008 – a document called *Financial Instruments and Exchange Law*. New rules are a departure from the traditional Japanese style of business, based on trust and good will. The new law provides a new duty for public companies to make an estimation of internal control system over financial commentary. This estimation of top management must be later checked by an independent auditor. The structure of the board of directors in many companies has been changed recently; first of all, they were reduced. Structural and personal modifications were a result of processes occurring in the global economy, in conditions of globalisation and the economic crisis.

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INNOWACJE W SYSTEMIE ŁADU KORPORACYJNEGO JAKO KONIECZNE UDOSKONALENIE FUNKCJONOWANIA RYNKU KAPITAŁOWEGO W JAPONII

Streszczenie: Gospodarka i system ładu korporacyjnego Japonii opierają się na wartościach kulturowych tego kraju, więc podstawowymi ich regułami są: lojalność, posłuszeństwo i unikanie pośpiechu w rozwiązywaniu problemów. W warunkach globalizującej się gospodarki światowej wartości te nie są wystarczające do osiągnięcia i utrzymania pozycji konkurencyjnej japońskich spółek i całej gospodarki. Tradycyjne powiązania pomiędzy środowiskiem biznesu i polityki, unikanie zatrudniania zagranicznych menedżerów oraz ukrywanie negatywnych informacji o spółkach przed inwestorami doprowadziły do problemów i utraty zaufania społecznego do wielu japońskich korporacji, takich jak Olympus, TEPCO czy Toyota. Poprawa funkcjonowania systemu ładu korporacyjnego w Japonii jest konieczna do osiągnięcia kolejnego etapu rozwoju japońskiego rynku kapitałowego. Proponowane są różne rozwiązania zmierzające do poprawy sytuacji, nie są one jednak wystarczające w sytuacji niechęci agencji rządowych i sprzeciwu społecznego.

Słowa kluczowe: Japonia, rynek kapitałowy, system ładu korporacyjnego, malwersacje finansowe.