Japanese Corporate Governance and Network Accountability

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Introduction

In 2014 the Ministry of Economy, Trade, and Industry (METI) published the ITO review, an analysis of the Japanese financial market, which advocated an increase in active ownership, in line with the global development (Nakagawa, 2017). In the same year, the Principles for Responsible Institutional Investors were launched in Japan, in order to address the problems identified in the ITO report. In line with the global active ownership movement, the PRII were launched "to introduce better corporate governance through investors' longer-term engagement in investee companies' governance" (Nakagawa, 2017, p.340). Responsible investment is therefore seen as a tool for corporate governance, especially with a focus on shareholder activism (Solomon, 2013). The assumption underpinning the aforementioned measure is that the organisation is at the centre of accountability. Through active ownership the organisation is being held accountable by active investors.

This paper is going to analyse the development of corporate governance in Japan at a time when investors are implementing the Principles for Responsible Institutional Investors. At the core of this analysis lies the question of accountability and its role in the changing corporate governance landscape in Japan.

Post-WWII Era

The corporate governance system in the post-WWII era can be described as a system of close networks and indirect financial markets. Companies relied primarily on bank loans to fund business activities, which is especially relevant in this period of rapid growth. Financing through stock markets as we know it today was not available, with stock markets having the reputation of a gambling establishment. Given the companies' reliance on banks as the most important provider of capital, companies allowed banks to play an active role in the governance of the company, establishing an accountability relationship between the company and the house bank. For example, if the bank did not have faith in the management anymore it could ensure that the management would be replaced. If the problem was even more substantial the bank would lead restructuring measures in the business (Hoshi, et al. 2018). Given the long-term

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nature of the loan-dominated relationship between companies and banks, an alignment of incentives in favour of long-term performance was in place (Redding et al. 2014, Solomon 2013, Ahmadjian and Okumura 2006, Hoshi et al. 1991).

In order to support the business relationship with their customers banks held shares of the customer companies. However, this approach was not limited to banks, companies would also hold shares of important suppliers or customers. This approach led to a network of cross-shareholding, built to align interests and create a stable long-term oriented environment. In this environment shares were hardly sold, as they were considered as a part of a bigger system of business relations and not an independent tool of wealth creation. In terms of corporate governance, the result was a stakeholder network system of governance, with the bank being in a dominant position. Every member of the network had an incentive in good governance of the other members, given the reliance on each other. This led to an ownership system where towards the end of the 1980s 40% of shares were held by financial institutions and 24% by non-financial corporations (Mizuno 2010, Araki 2009, Miwa 2006a).

The close links between companies, suppliers, customers and employees created a system in line with the concept of Sanpo-yoshi: the members of the network were perceived as the main priority, not the wealth creation of unrelated shareholders (Tanimoto 2013, Ahmadjian and Okumura 2006).

1980s – 2010s: Changes in the Ownership Structure

The period from the mid-1980s till today can be characterised as a period of change. Many different developments and counter-developments took place in the area of corporate governance. Starting in the 1980s companies revisited the ‘house bank’ approach, i.e. relying on one bank for all financial services required. The financial market has started to become more international, inter alia through the liberalisation of regulation, and companies sourced financial services from different providers. In addition, the stock market has lost some of its bad reputation. The role of cross-shareholding was reduced indirectly as a side-effect and directly through regulation in the early 2000s. As a consequence, the system of corporate governance through a tight network of stakeholders was weakened, as the reduction in reliance on a bank also reduced the power of this particular bank to oversee the company’s management (Seki and Clarke 2014, Dore 2009).

As cross-shareholdings were reduced the ownership structure in Japan changed fundamentally. The percentage of shares held by foreign institutions increased from 4.9% in 1970 to 30.1% in 2016. A catalyst in this ongoing development was the financial crisis in Japan starting in the

1990s. Banks had lent money to increasingly riskier business endeavours, resulting in a bubble, which burst with the Asian Financial Crisis in 1997. This caused considerable financial pressure on financial institutions, forcing them to sell off holdings in Japanese companies. The opposite effect can be observed in the global financial crisis in 2008: Foreign investors have to sell and Japanese financial institutions, businesses and individuals increase their holdings of Japanese companies. This, however, was only a brief and temporary development, not reversing the overall trend (Ahmadjian and Okumura 2006).

The Role of Institutional Investors in the Japan

The role of institutional investors in the UK and in Japan are very different: Whilst the institutional investors in the UK were a driving force in the development of Responsible Investment and Stewardship this cannot be said of Japanese institutional investors. Sakuma and Louche (2008, p. 431) write in their analysis of the development of RI in Japan that "[f]inancial institutions have been a passive group of actors in Japan's SRI arena.". This iterates earlier findings by Solomon et al. (2004, p.560) who call institutional investors "silent shareholders". Solomon et al. (2004) explain the reason to be the passive role of investment in the old system, as discussed previously.

An important change can be seen with one key driver in the development of the concept of stewardship in the Japanese financial industry being the proactive adoption of the PRII by the largest pension fund in the world, the Japanese Government Pension Investment Fund (GPIF) in 2016 (White 2017, GPIF 2017). However, as the interviews for this study were conducted predominantly in 2014, the study focuses on the time period after the introduction of the initial principles.

Japanese Corporate Governance and Accountability

The introduction of the Principles for Responsible Institutional Investors in Japan in 2014 echoed the UK approach after the global financial crisis. The Japan-specific aspects are based on the Ito report, which was conducted in parallel and published in its final form briefly after the introduction of the PRII. The lessons learned from the global financial crisis were that investors were too passive and that portfolio companies should be held accountable through active ownership. This idea of accountability underpinning the UK Stewardship Code and the Japanese PRII is based on the understanding that one organisation, in this case the portfolio company, is being held accountable by another organisation, in this case the investor.

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Analysing the role of accountability in Japanese corporate governance it is essential to define accountability further. Based on Ebrahim (2009), O'Dwyer & Boomsma (2015) create an accountability framework relying on three types of accountability: imposed accountability, felt accountability and adaptive accountability. Imposed accountability relies primarily on coercive regimes, e.g. oversight rights enshrined in regulation like public reporting. Felt accountability is the opposite and is defined as voluntarily opening up to scrutiny, with the legal requirements. Adaptive accountability is a hybrid of both types of accountability: accountability through coercive requirements combined with voluntary accountability beyond those requirements.

Pre-1990s Accountability networks

The analysis of the corporate governance structure in Japan pre-1990s shows, as aforementioned, that there is an important role of stakeholders. Those close stakeholders create a network within which the company acts. The assumption that underpins the PRII that one organisation is held accountable by another organisation is therefore too simplistic as it ignores the existence of the network corporate governance. This corporate governance relies on adaptive accountability: The house-bank enforces coercive accountability; however, the company allows for additional scrutiny, i.e. felt accountability. This can be seen in cases of bank-led corporate restructuring as discussed by Hoshi, et al. (2018).

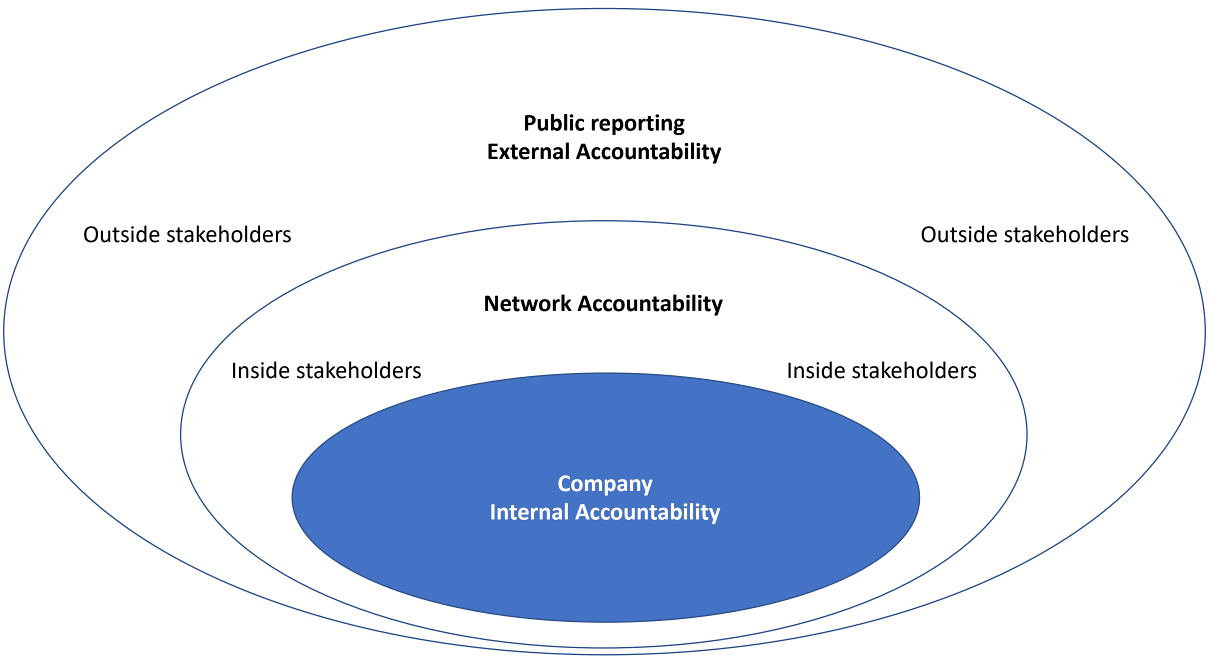


Figure 1: Visualisation of network accountability underpinning network corporate governance in Japan.

Research question

The expectation of the ITO review and the resulting PRII is a transformation in the role of the 'silent shareholders' (Solomon et al., 2004, p.560) towards an active owner in order to in crease accountability. The question is whether the underlying assumption of organisational accountability holds, or whether a network accountability is at play, as analysed above. This article analyses the development in Japanese Corporate Governance with focus on the investment industry as the key actor in this intended transformation.

Research Method – Semi-structured interviews

The interviews were conducted as semi-structured in-depth interviews, in order to be able to build a dataset for analysis. The link between 'Responsible Investment in Japan', especially with a focus on engagement and stewardship, and accountability and corporate governance has not been researched extensively. Therefore, the amount of existing literature is limited. In addition, with the Principles for Responsible Institutional Investors just being introduced weeks before the interviews, no Japan-specific literature was available that would have allowed for fully-structured questions to be created. Thus, semi-structured in-depth interviews were chosen in order to not restrain the interviewees and to draw on the expert knowledge of the interviewees, rather than imposing the interpretation of the interviewer (Brinkmann 2013). A common disadvantage of unstructured interviews is that interviewees tend to 'venture out', which is being addressed by using a semi-structured approach.

For this study 31 interviews were conducted with experts in the financial industry with Japanese portfolio companies. The sample was divided into three groups: Investment managers (12 interviews), investment analysts (11 interviews), and academic, researchers and consultants (8 interviews, 9 interviewees). The key element of distinction between the three groups is the distance between the interviewee and the investment decision along the investment chain: The first group, Investment Managers, directly manage money and make investment decisions. The second group, Investment Analysts, directly influence the investment decision by providing data that is use by the investment managers to make the investment decision. The third group, Academics, Researchers and Consultants influence either of the first two groups indirectly through consulting and or research reports, which are not directly concerned with the investment decision around specific assets.

Methodology

Once the interview was conducted, a verbatim transcript was produced; all interviewees but two (in one interview) agreed for the interview to be recorded and transcribed. Whilst noises were edited out – e.g. coughs or clearing the throat – no changes were made to grammar, word order, etc. at this stage.

The transcript was then coded based on the themes identified in the literature, which already shaped the questions of the semi-structured in-depth interview. Level 1 themes are:

- Engagement and Dialogue
- Japanese Culture
- Materiality and ESG Performance
- RI / ESG in Japan
- ESG Data
- Japanese Stewardship Code
- Japanese History / Development / Economy

There are 52 level 2 sub-themes and 58 level 3 categories – please see '10.6 Appendix A: First Coding' for details. As shown below, the coding processes 'coding 1' and 'coding 2' were iterative analyses of the underlying data and took place in several stages:

<u>Coding 1, stage one:</u>

Reading through the interview notes and transcripts, highlighting content that falls within the existing level 1 themes. The level 1 themes are derived from the existing literature and are based on the themes around which the semi-structure interviews were conducted. Themes were amended or added during the interviewing process, based on the interview data.

<u>Coding 1, stage two:</u>

Identifying broad topics that overlapped amongst the different interviews. The level 2 sub-themes are sub-themes within the overarching level 1 themes. These level 2 sub-themes arose from the data, however guided by the framework provided through the level 1 themes and therefore the existing literature.

<u>Coding 1, stage three:</u>

Breaking down the broad topics identified in stage two and creating narrower categories suitable for critical in-depth analysis. The level 3 categories arose from the analysis of the underlying data. However, whilst to a lower degree than levels 1 & 2 they still exist in the framework provided by the existing literature.

First Coding Process

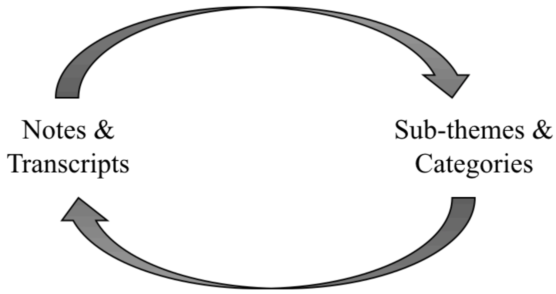
Level 1: Themes	Themes from the literature to guide semi-structured interviews
Semi-structure, in-depth interviews: **Level 2: Sub-themes** **Level 3: Categories**	
Theoretical Saturation	End of the interviews: No new themes, sub-themes or categories come up.
Database	After line-by-line microanalysis and coding all quotes were collected in three databases. Total number of quotes: IM – 721, IA – 458 , ARC – 265

Figure 2: Overview of the methodology used for this study with focus on the first coding process.

Coding 2: During the second coding the three groups of interviewees were treated as one set as the three databases were combined. In this step themes arising across all the available data were identified, beyond the previously established framework of levels 1, 2 and 3.

Second Coding Process

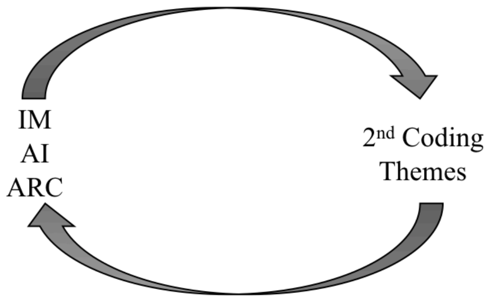
Themes	Coding without any guiding themes using the data from all three groups.
	
Database	Cross-referencing database between the codes from the 1st Coding and the codes from the 2nd coding. 68 codes were created in the 2nd Coding.

Figure 3: Overview of the second coding process.

Coding 1 was done to give the qualitative interview data a structure that allows for an in-depth analysis and critical discussion of the data in light of the existing literature. It also allows to compare and contrast the three distinct groups of interviewees.

Coding 2 was done to unearth themes overarching the previously determined levels. This step is necessary for the critical analysis of the collected data of all three groups of interviewees, without the restrictions provided by the literature through the themes used during the first coding.

When selecting the final quotes for the text, grammar was corrected and filling words were removed. Any changes made to the quotes are highlighted through the use of brackets.

Stable holdings

Interviewees from the ARC group mention that amongst funds that follow a concentrated portfolio strategy there is a tendency to have 'stable holdings', i.e. to hold companies for a long period of time. This is to be expected as more attention can be paid to the companies held, given the small number of holdings. Also, one key-characteristic of the concentrated portfolio funds is that they are long-term oriented funds with a low portfolio-turnover. For a company being held by such a concentrated portfolio fund means being held by a stable investor. This seems to resonate well with the companies in general, according to all three groups of interviewees. The situation of stable shareholdings is a characteristic of the indirect financial system that underpinned the system of network corporate governance. Trying to build a good long-term relationship with the investor through open and honest dialogue is seen as a means to the end of a stable holding. This goes beyond legal requirements and forms part of felt accountability within the network

It seems that there is an expectation for stable long-term oriented investors to take over the role of that the house bank used to play in the network. Analysing the Japanese ESG approach, it is almost identical with the traditional network approach: The aim is to provide companies with stable holdings, to align incentives within the network so that the long-term success of the company and its stakeholders is the focus of all activities, and to have mutual governance through open dialogue and adaptive accountability within the network.

The key requirement for the Traditional Japanese approach to work is the reliance of the company on the house bank, paired with felt accountability on the side of the company towards the stakeholders within the network. However, due to the previously discussed developments, the banks cannot fulfil these roles anymore. In the Japanese active ownership approach the banks are therefore replaced by the trusted stable active owners, especially the institutional investors with significant holdings.

As a consequence, once the concepts of Stewardship – Active Ownership and ESG have enabled Japanese investment managers to take the role previously fulfilled by the house banks, and the overseas investors have collected the short-term returns and withdrawn from the Japanese market, a traditional network corporate governance 2.0 based on network accountability is likely to be established. This would in essence recreate the Traditional Japanese approach.

Conclusion – Post-PRII Network Accountability

The main contribution of this paper is to analyse the concept of accountability in detail that underpins Japanese corporate governance. The concept of accountability that underpins Japanese corporate governance cannot be seen as one organisation is being held accountable by another organisation. In fact, it is necessary to distinguish between the stakeholders inside the network and the stakeholders outside the network: Within the network adaptive accountability is at play. The company provides information as part of the regulatory requirements and in addition, due to felt accountability, the company opens itself up to additional voluntary scrutiny. The stakeholders outside the network, however, only have access to information based on imposed accountability. The information available will be the basic minimum necessary to fulfil the regulatory requirements.

Future research on active ownership in Japan needs to include the role that network accountability plays in Japanese corporate governance. In addition, further research is requires to analyse the transition from the stable pre-1990s system to the post-PRII system through a current stage of turmoil.

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