Section 3 Changes in the corporate economic system – diversity of corporate systems and commonalities in efforts to implement improvement –

<Key points>
1. Changes in the corporate economic systems of each country

There is great diversity in both the current status of corporate economic systems and measures to improve them in each country. Presumably, such diversity reflects the variegated circumstances of each country, namely the following: the development stage of each country, the relationship between business and government, the financial structure including the corporate fund procurement structure and the shareholding structure, management-labor relations, the market for executive talent, and view on corporate social responsibility (CSR). At the same time there are some commonalities in the direction of system improvements\(^{(1)}\). That is to say, a direction of improvement in governance through mutual supervision, and improvement in basic mechanisms to that end (such as the sharing of necessary information and disclosure of corporate information) is a feature common to all countries and each country is endeavoring to improve corporate systems\(^{(2)}\) with the aim of maximizing long-term corporate value based on the perspective of various stakeholders\(^{(3)}\).

(1) There are two methods of resource allocation: one is through the “market,” the other is through “organization.” The latter is typically represented by a corporation. In the case of the “organization” mechanism, which allocates resources by authority, the distribution of authority and the information system within the organization (i.e. how information is created and shared) are key. The commonalities of direction discussed here refer to both of these aspects.

(2) There has recently been lively debate over corporate systems and over corporate governance in particular. It is evident that even among companies with outstanding performance, corporate governance comes in various shapes and forms, and that there are differences in form even within a country. On the other hand, each country displays a unique pattern in data such as the ratio of direct and indirect finance (macro) compiled from individual corporate data (micro).

I believe it is difficult to say with any certainty that the form of corporate governance bears no relation to corporate or national economic performance, because firstly it would make it impossible to explain the fact that companies are diligently searching for better forms of corporate governance, unless we are prepared to accept that corporations are totally irrational beings. Secondly, the fact that diversity exists in the governance of corporations does not prove that it does not have an impact on performance. It would be like saying “no two Major Leaguers who have recorded a batting average
over .3 used bats that had the same shape and weight as others or shared the same training methods as others; therefore the choice of bats and training methods is meaningless and a player may use any type of bat regardless of his physique or batting style.”

(3)

With regard to the objectives of corporate governance, there are two schools of thought, one emphasizing stockholder profits, the other the profits of employees, creditors and stockholders. In the 1990s the former, which was the driving force behind the flourishing US economy at the time, was prevalent. Recently, however, broader concepts of corporate governance are emerging, as evidenced by the debate over CSR in the recent years. For the basis of the analysis contained herein, I would like to use Tirole’s definition cited by Osano (2001) which states that it is “a structured design that disciplines the management in order to increase the economic welfare (economic gain) of all stakeholders.” It has been pointed out that even in this concept, under certain conditions – when decision-making is prompt, for example – the objective of corporate governance is to maximize stockholder value.

(1)UK

In the UK, given the series of corporate scandals starting around 1990, reforms are being advanced with the aim of making corporate boards of directors function effectively, focusing on the use of outside directors and the separation of the chairman of the board of directors and the CEO. In the implementation of the reforms, rather than legal enforcement, a code has been formulated, and compliance advisories are issued. In addition, institutional investors are strongly expected to play a useful role in corporate governance.

(2)US

In the US, the fund procurement structure is dominated by direct finance. It is generally believed that corporate ownership and management are separated to a high degree, and that outside directors play a significant monitoring function in the protection of shareholders. However, there are many cases in which CEOs serve concurrently as chairmen of the board of directors and in such cases, outside directors and audit firms cannot function effectively in the face of such strong management control, which some view as contributing to the corporate misconduct of recent years. For this reason, the Sarbanes-Oxley Act for corporate accounting was passed in July 2002, which focuses on improvements on the aforementioned issues, and this law forms a part of further efforts toward reform. As in the UK, the role of institutional investors as major equity holders is also being actively discussed.

(3)Germany
In Germany, which has a financial structure that places priority on indirect finance, banks known as *Hausbank* have played a certain role in monitoring management. The German scene is also characterized by a “joint decision-making system” through which employees are directly involved in company management, which is part of the unique German corporate culture. In recent years the progress of globalization has seen some signs of change such as the introduction of management methods that place importance on stockholder value (SV).

(4) Republic of Korea

In the Republic of Korea efforts are being made at reform centered on reform of the large corporate conglomerates, which are viewed as being the cause of the management inefficiency highlighted during the Asian currency crisis. The monitoring functions of boards of directors are being strengthened and excess diversification is being eliminated through a “Big Deal” (large-scale swapping of businesses), and tackling these issues will continue to require serious and sustained effort.

2. Changes in the corporate economic system of Japanese companies

While there is indeed great diversity by country, Japan is also experiencing a move toward reform of economic systems, focused mainly on corporate systems in a global environment in which corporate system reforms are being advanced.

(1) Change of institutions

On the legal side, improvements have been seen in information disclosure including the introduction of new accounting standards that are in line with global standards. In addition, reforms have been implemented to enhance management mobility, as represented by the lifting of the ban on holding companies. In such circumstances the Commercial Code was revised in 2002 (enacted on April 1, 2003), which makes it possible for methods of choosing corporate governance to include a committee method.

(2) Change of reality

The reality is that in an environment in which the relationship between companies and main banks is said to be undergoing change, the role of banks in the fund procurement structure is waning, at least in large companies, due partly to adjustments to balance sheets. In the stock-holding structure, in recent years the proportion of shares held by financial institutions and industrial corporations has been decreasing. This is thought to be a result of the present situation where companies are beginning to withdraw from the conventional Japanese practices of cross-holding of stocks and stable stocks. Institutional investors, including foreign investors, may take over these cross-held and stable stocks, and in the future hopefully will play a role in monitoring corporate management. Compared with the
trend for M&A and IPO in the US and UK, the slowdown in Japan in the wake of the IT boom has been relatively insignificant. Aggressive utilization of M&A and IPO – the former for business restructuring and the latter for procurement of new funds – is expected in the future. In management-labor relations, the emergence of a flexible and diverse labor market is evidenced by trends towards performance-based salary systems and the widespread adoption of year-round recruitment systems.

(3) The perspective for the future

Although there are now many voices that say that the Japanese economy is in a state of stagnation with no changes taking place, exemplified by the phrase “the lost decade,” the fact is that steady progress has been realized since the mid-1990s, and further changes are expected in corporate economic systems. Even in a stringent economic environment, there are companies that are making ceaseless efforts in management reforms, and performing to a high standard. Of such companies there are a considerable number that are paying a good deal of attention to this relationship with society through conducting corporate activities, and it is expected that discussion will be further expanded from a broader perspective, including the modality of CSR.

Reforms are also underway in East Asia that share similarities in their direction, despite the diversity among the various countries. Constant efforts in reform are required in each country, including in Japan, from the perspective of maintaining and enhancing corporate competitiveness in an area of ever-expanding economic globalization, in order for companies to achieve sound development as members of civil society.

How will economic systems in each country change as the globalization of the world economy advances? Cross-border movements of capital are becoming active and corporations are becoming freer in choosing where to conduct their businesses. One of the fields that is most affected by globalization against such a backdrop is the corporate system centering on corporate governance, which will be analyzed in this section. Furthermore, establishing a corporate governance system is important in advancing sound economic integration in East Asia, especially from the viewpoint of the necessity of realizing a stable inflow of funds from outside the East Asian region.

First of all, there is great diversity in both the current status of corporate economic systems and measures to improve them in each country. Presumably, such diversity reflects the variegated circumstances of each country, namely the following: (i) the development stage of each country; (ii) the relationship between business and government (responses to rule makers and rule keepers as indispensable factors for establishing markets); (iii) the financial structure including the corporate fund procurement structure and the shareholding composition; (iv) management-labor relations; (v) the market for executive talent; and (vi) view on corporate social responsibility.
(CSR).

However, while diversity is evident, it is also true that there are some commonalities in the direction of system improvements. That is to say, a direction of improvement\(^1\) in governance through mutual supervision, and improvement in basic mechanisms to that end (such as the sharing of necessary information and disclosure of corporate information) is a feature common to all countries and each country is endeavoring to improve corporate systems\(^2\) with the aim of maximizing long-term corporate value based on the perspective of various stakeholders\(^3\).

In fact, in recent years there has been a great deal of discussion on CSR that corporations should not only be active in the pursuit of profit in the short term, but also conduct activities where due consideration is paid to social values such as the environment and employment. Particularly in Europe measures to advance CSR are actively promoted not only at the private sector level but also at the European Union (EU)\(^4\) and government level. Furthermore, the following international

\(^1\) There are two methods of resource allocation: one is through the “market,” the other is through “organization.” The latter is typically represented by a corporation. In the case of the “organization” mechanism, which allocates resources by authority, the distribution of authority and the information system within the organization (i.e. how information is created and shared) are key. The commonalities of direction discussed here refer to both of these aspects.

\(^2\) There has recently been lively debate over corporate systems and over corporate governance in particular. It is evident that even among companies with outstanding performance, corporate governance comes in various shapes and forms, and that there are differences in form even within a country. On the other hand, each country displays a unique pattern in data such as the ratio of direct and indirect finance (macro) compiled from individual corporate data (micro).

It is difficult to say with any certainty that the form of corporate governance bears no relation to corporate or national economic performance, because, firstly, it would make it impossible to explain the fact that companies are diligently searching for better forms of corporate governance, unless we are prepared to accept that corporations are totally irrational beings. Secondly, the fact that diversity exists in the governance of corporations does not prove that it does not have an impact on performance. It would be like saying “no two Major Leaguers who have recorded a batting average over 0.3 used bats that had the same shape and weight as others or shared the same training methods as others; therefore, the choice of bats and training methods is meaningless and a player may use any type of bat regardless of his physique or batting style.”

\(^3\) With regard to the objectives of corporate governance, there are two schools of thought; one emphasizing stockholder profits, the other the profits of employees, creditors and stockholders. In the 1990s the former, which was the driving force behind the flourishing US economy at the time, was prevalent. Recently, however, broader concepts of corporate governance are emerging, as evidenced by the debate over CSR in the recent years. For the basis of the analysis contained herein, Tirole’s definition cited by Osano (2001) is used which states that it is “a structured design that disciplines the management in order to increase the economic welfare (economic gain) of all stakeholders.” It has been pointed out that even in this concept, under certain conditions—when decision-making is prompt, for example—the objective of corporate governance is to maximize stockholder value.

\(^4\) The European Commission released the “Promoting a European framework for corporate social responsibility – Green Paper” in 2001. This paper argues the importance of corporations actively bearing social responsibility, including environmental friendliness and concern for employment, as it will increase their competitiveness and contribute to the realization of sustainable growth of the economy and society as a whole. The European Commission released a report on CSR in 2002 and has announced that it will strive to promote CSR in future EU policies.
organizations have also proposed various codes of practice. At the World Economic Forum (commonly known as the Davos Conference) in January 1999, Mr. Kofi Annan, Secretary-General of the United Nations (UN) proposed the Global Compact as codes of practice for corporations. This initiative is composed of nine principles on the three topics of human rights, labor standards and environment. In 1976, the Organisation for Economic Co-operation and Development (OECD) announced the Guidelines for Multinational Enterprises as codes of practice for multinational enterprises. This has been revised a number of times since then. In light of the fact that the globalization of corporate activities had further advanced in the 1990s, the OECD released the revised Guidelines in June 2000 which include additional provisions on prohibiting child labor and forced labor, and combating bribery. These Guidelines set specific standards of behavior on the following points in addition to general policies that corporations should observe: (i) disclosure; (ii) employment and industrial relations; (iii) environment; (iv) combating bribery; (v) consumer interest; (vi) science and technology; (vii) competition; and (viii) taxation. In particular, as the general policies state that it will support the OECD Principles of Corporate Governance\(^5\) in order to develop desirable corporate practices, these two codes of practice are mutually complementary. Furthermore, the International Organization for Standardization (ISO), which establishes standards concerning quality and environment, has been moving forward since 2001 in its considerations in establishing standards concerning CSR. It is expected that the ISO will decide on its basic direction on CSR standards by the end of 2003. As such, it is expected that discussions on corporate social responsibility will increasingly take place in countries including Japan around the world.

In this section, a comparative study will be provided on the characteristics of each country, and a review of the current conditions of the economic system surrounding Japanese corporations.

1. UK

(1) Changes in the corporate system from the systemic viewpoint

(a) Background and trends in corporate governance reform in the UK

<Three committees on corporate governance in the UK>

In the UK, from the second half of the 1980s to the beginning of the 1990s, there was a spate of scandals at large corporations, corporate bankruptcies and slowdown in business performance. It

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\(^5\) This was supported by the OECD Council Meeting at the Ministerial Level in May 1999. These principles are not legally binding. The goal is to present principles on the legal and systemic framework of corporate governance to corporations, investors and other concerned parties in each country. These principles set out the rights of shareholders, the role of stakeholders in corporate governance, disclosure and transparency, and the responsibilities of the board. Furthermore, it was decided at the OECD Council Meeting at the Ministerial Level in May 2002 that evaluations would be conducted with the aim to review these principles in 2004.
has been said that in the background of these developments included the fact that top management, possessing strong individuality, was doing as it wished, without other management being able to contain it, as well as the fact that there were false accounting reports in corporate finance such as fabricated accounts. In addition, there was mounting criticism about the excessive remunerations for directors as well as the lack of accountability. These circumstances spurred active discussions on the necessity for corporate governance reform. The *Cadbury* Report: Report of the Committee on the Financial Aspects of Corporate Governance was announced in 1992, which recommended strengthening the accountability of board of directors and auditors and ensuring the effectiveness of the board of directors by assigning non-executive directors (equivalent to outside directors). In 1995, the *Greenbury* Report: Directors, Remuneration was announced, which called for the clarification and appropriate management of the directors’ remuneration system. The Hampel Committee was established in 1998 as the successor to the Cadbury Committee, and a final report was released which took into consideration the situation of responses taken by corporations to date. Furthermore, in the same year, the Combined Code was announced which was based on the three previously mentioned reports. This has served as the foundation of corporate governance reform in the UK thus far (Fig. 1.3.1).

**Figure 1.3.1 Overview of three corporate-governance related committees in the UK**

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1. The Cadbury Committee
   - Twelve members from the academic circles, audit corporations, the legal community, securities market, and the Bank of England, established the Committee on the Financial Aspect of Corporate Governance with Lord Cadbury as the chairman.
   - The initial objective of the Cadbury Committee was to hold debates focused on financial (accounting) and accountability-related issues, though as corporate scandals occurred involving board of directors and functions of accounting audit, the Cadbury Committee held debates over a much broader range of corporate-governance systems, including redefining role of board of directors auditors, shareholders, in addition to accounting.
   - In December 1992 the Cadbury Committee issued a report comprised of nine chapters. The core of the report was Chapter 9 “The Code of Best Practice,” which was created in line with the principles of disclosure, honesty, and accountability, and which defined the codes of practice for 1) the board of directors, 2) non-executive directors 3) executive directors, and 4) reporting and controls.

2. The Greenbury Committee
   - The "Study Group on Directors' Remuneration," chaired by Lord Greenbury, was established to review the issue of directors remuneration, against the backdrop of criticism that directors' remuneration in partly privatized public companies, including stock option system, are unreasonably high.
   - In July 1995, the Greenbury Committee issued a report comprised of eight chapters. "The Code of Best Practice" were presented in Chapter 2, defining codes of practice for 1) the remuneration committee, 2) disclosure and approval provisions, 3) remuneration policy, and 4) service contracts and compensation.

3. The Hampel Committee
   - The "Committee on Corporate Governance" chaired by Lord Hampel was established as a successor to the Cadbury Committee. The Hampel Committee issued its interim report in August 1997 and its final report in January 1998.
   - The Committee supported almost all findings of the previous two reports, and stated that the most important duty of any board of directors is the long-term development of the business, and that balance is necessary between business success and accountability.
   - The Committee also stated that in order to establish the ideal corporate governance system, the interests of the enterprise must match the interests of institutional investors, who are important shareholders, and it is required that institutional investors should approach investments from a long-term point of view.
   - While the previous two committees presented the "Codes for Best Practice," the Hampel Committee proposed "Principles of Good Governance." Unlike the previous two committees, which raise the question "How strictly are codes being complied with?" the Hampel Committee raises the question "How are principles being applied in practice?"

Source: Created by METI from various materials.

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6 Kikuchi and Hirata (2000), pp. 77-78.
7 Former chairman of the food company Cadbury Schweppes.
<The Combined Code>

The Hampel Committee compiled the Combined Code, which combined the Principles of Governance outlined in the Hampel Report with the Code of Best Practice that had been included in both the Cadbury and Greenbury Reports and announced it in June 1998. In June of the same year, the London Stock Exchange announced the revised listing rules that had been formed based on the content of the Combined Code. The revised listing rules were applied to the annual report for the fiscal year beginning after December 31, 1998 and required the disclosure of the status of compliance with the Combined Code.

The Combined Code consists of two sections: Section 1 is the Principles of Good Governance and Section 2 is the Code of Best Practice. The basic content of Section 1 is carried over from the Principles of Governance of the Hampel Report, while Section 2 is derived from the Code of Best Practice found in both the Cadbury and Greenbury Reports. Sections 1 and 2 are both discussed from the standpoint of corporations (A. directors, B. directors’ remuneration, C. relations with shareholders, D. accountability and audit) as well as the viewpoint of institutional shareholders (E. institutional investors).

The distinctive feature of the Combined Code, as can be gathered from the above, is that the scope of the recommendations are not limited only to corporations, but also include codes for institutional investors, who are the other important players. In other words, on the one hand, given the fact that the listing rules of the London Stock Exchange which incorporated the Combined Code had been applied to listed companies, they were in turn obliged to state in their annual reports and financial statements how they had applied the Principles of Good Governance and how strictly they complied with the Code of Best Practice. At the same time, institutional investors were also called to fulfill their external check function through voting, dialogue with corporations and an evaluation of the corporate governance system.

<Recent trends>

In January 2003, the Review of the Role and Effectiveness of Non-Executive Directors was announced, which focuses on non-executive directors, and it is expected that the listing rules will be revised by July 2003. The report is centered on stipulations such as that the majority of directors shall be composed of non-executive directors (excluding the chairman of the board of directors), that non-executive directors shall not be elected for three terms with each term lasting three years, and not allowing remunerations by stock options. This paper is in line with the trend of corporate governance reform to the present and focuses on the further role of non-executive

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9 Chairman of distributor Marks & Spencer.
10 Chairman of chemical company Imperial Chemical Industries (ICI).
directors.

Furthermore, the UK is a country where measures in CSR are actively undertaken at the national level. It is believed that this trend began with the amendment to the Pensions Act in 2000. This amendment, to be precise, did not make Social Responsibility Investment (SRI) obligatory in pension funds, but it referred to CSR indicating the nation’s stance to promote CSR. Since then, measures to promote CSR have been vigorously implemented, which included the creation of disclosure guidelines concerning SRI by the Association of British Insurers (ABI) in November 2001. In addition, a Non-Cabinet Minister of the Department of Trade and Industry (DTI) was appointed as the world’s first Minister of CSR in April 2001 and, still further, the Social Responsibility Bill was deliberated for the first time in Parliament in October 2002.

(b) Structure of corporate governance in the UK as seen in boards of directors

<Mechanism of boards of directors>

As in the US, boards of directors in the UK are one-tier systems in which they are responsible for decision-making and supervision of business operations. Directors are elected by a simple majority at the stockholders general meeting, and dismissal is decided by ordinary resolution of the stockholders general meeting. The Combined Code stipulates that all directors shall periodically, and at least once every three years, go through reelection procedures. The term of directors is set at three years and usually one-third of directors are newly elected every year. The Combined Code establishes that the structure of the board of directors shall be balanced between executive and non-executive directors, with over one-third composed of non-executive directors. Furthermore, the Combined Code also stipulates that the majority of non-executive directors shall be made up of independent directors.

Furthermore, because separation of ownership and management is advanced in publicly-held companies, it is expected that boards of directors will be able to keep management in check. In order to guarantee that this function is fulfilled, it is generally the case that different committees (audit committee, remuneration committee and nomination committee) are established within the board of directors with non-executive directors playing a central role.

<Separation of the chairman of the board of directors and the chief executive officer (CEO)>

According to the Combined Code, management is charged with two important roles—to operate the board of directors and bear responsibility for business operations. It is required that in principle the chairman of the board of directors and the CEO are separate to ensure that certain individuals do not have unrestricted power of decision. In the event that an individual holds both
positions, the Combined Code requests that the board of directors hold the power to counter the CEO.

Looking at Figure 1.3.2, as the separation of the chairman of the board of directors and CEO is not legally required, there are still corporations with individuals that hold both positions. However, the ratio of persons concurrently holding both positions to the total number of listed companies is ten percent and the ratio is no more than five percent in the top 100 companies. From this it can be concluded that separation of the positions of the chairman of the board of directors and CEO is advancing in the UK.

Figure 1.3.2 Ratio of persons jointly holding positions of CEO and Chairman of the board in UK companies

<table>
<thead>
<tr>
<th></th>
<th>FTSE100</th>
<th>FTSE250</th>
<th>Other listed companies</th>
<th>Total listed companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rate of jointly held positions (%)</td>
<td>5</td>
<td>4</td>
<td>11</td>
<td>10</td>
</tr>
</tbody>
</table>

Source: The current population of non-executive directors
Non-executive directors Review team analysis of data supplied by Hemscott.

<Audit committee, nomination committee and remuneration committee>

Boards of directors in the UK are one-tier systems. Because boards of directors have a monitoring function, it is required that committees be established to fulfill each of the three important functions—audits, remuneration and nominations—in putting corporate governance into practice.

- Audit committees shall be composed of more than three non-executive directors, of whom the majority shall be independent.
- Remuneration committees shall be composed only of independent non-executive directors.
- The majority of a nomination committee shall be composed of non-executive directors and its chairman shall be the chairman of the board of directors or a non-executive director.

These are the conditions that need to be fulfilled in the composition of the three committees. All of them place importance on the role of non-executive directors to act as checks and balances. The aim of these conditions is to ensure the effectiveness of monitoring by boards of directors through the use of non-executive directors.

Figure 1.3.3 shows the actual degree to which each committee has been established in UK corporations. Nearly 100 percent of the top 350 companies have established audit committees and remuneration committees, while the corresponding figure for other listed companies is over 80 percent. As for nomination committees, as the Combined Code stipulates that nomination committees should be established “unless the board is small,” the degree to which they have been established is low (29 percent) in other listed companies whose boards are relatively small.

11 The Combined Code, A.3.2.
However, nomination committees have been established in 94 percent for the top 100 companies and 81 percent of the middle-ranking 250 companies.

Figure 1.3.3 Rate of existence of each committee in board of directors at UK companies

<table>
<thead>
<tr>
<th>Committee</th>
<th>FTSE100</th>
<th>FTSE250</th>
<th>Other listed companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Audit committee (%)</td>
<td>99</td>
<td>99</td>
<td>85</td>
</tr>
<tr>
<td>(2) Compensation committee (%)</td>
<td>99</td>
<td>99</td>
<td>86</td>
</tr>
<tr>
<td>(3) Nomination committee (%)</td>
<td>94</td>
<td>81</td>
<td>29</td>
</tr>
</tbody>
</table>

Source: The current population of non-executive directors (Non-executive directors Review team analysis of data supplied by Hemscott).

(3) Implementation mechanism for corporate governance reform in the UK

Corporate governance reform in the UK is characterized by its approach of establishing guidelines through the investigation, identification and creation of a code of favorable practices and operation methods, which have traditionally been carried out by UK corporations, and then conducting compliance advisories. This approach has been favored over one that has corporations complying with inflexible regulations through the revisions of laws, new legislation or enforced improvement orders. In the backdrop of such an approach is that the UK is a country with a common law system, and there is an established idea that actions of corporations are not controlled by provisions of corporate law but rather the accumulation of past practices.\(^{12}\)

Based on the idea that the discipline brought about by corporate governance is not sought through enforcement of laws and regulations but rather through outside pressure on corporations resulting from disclosure even while respecting the self-initiative of corporations, it is required that UK corporations disclose detailed information in their annual reports on the status of compliance with such advisories and policies. For this reason, corporations have become increasingly focused on negative effects and reputational risk\(^ {13}\) and taking proactive measures on disclosure. These negative effects and reputational risk, which are expected to crop up when problems develop in the corporate governance system, are caused by criticism from institutional investors and other stakeholders as well as the mass media.

(2) Looking at changes in the corporate system through the actual situation

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13 The risk that there will be an increased possibility that outside reputation will worsen and losses will be sustained because active disclosure was not conducted or inaccurate information spread about operations.
Generally speaking, the financial structure in the UK is the Anglo-Saxon model like the one in the US, which is characterized by a system centering on capital markets based mainly on direct finance. This section first discusses the recent changes in the fund procurement structure. Based on this discussion, it then provides an overview of the changes in the shareholding composition and the trends of institutional investors who, in recent years, have been expected to play an important role in corporate governance.

(a) Changes in the fund procurement structure

The UK has been regarded as a country whose financial markets are well developed. Fund procurement in corporations, as in the US, is structured based on direct finance whereby funds are obtained through markets.

Figure 1.3.4 shows the fund procurement structure of non-financial corporations in the UK. In recent years, the borrowing ratio has declined almost continuously, and the ratio which was 28.9 percent in 1991 fell to 18.6 percent in 1999 and marked 21.4 percent in 2000. On the other hand, the ratio of shares and other equities and securities other than shares (corporate bonds, etc.) has continued to increase. In 1991, this ratio was 60.8 percent, which rose to 76.4 percent in 1999 and 73.8 percent in 2000. These developments show that the trend of direct finance has further strengthened in the fund procurement structure in the UK and has become more based on the market.

As the Combined Code has no particular provisions that directly refer to the role of banks in corporate governance and the share of stocks held by banks is less than 1 percent\textsuperscript{14}, the role that banks play in corporate governance is minimal.

\textsuperscript{14} See Section (b) Changes in shareholding composition.
(b) Changes in shareholding composition

Figure 1.3.5 shows the shareholding composition in the UK. It has become clear that there is a shift from individuals to institutional investors and the percentage of stocks held by institutional investors\(^{15}\) in 2001 was as high as 50 percent. Furthermore, the proportion of foreign investors has risen rapidly in recent years. This is understood to have resulted from the financial services Big Bang beginning in 1986 under the Margaret Thatcher administration, which opened the UK securities market wide to foreign investors, as well as the fact that it has become the recipient of international diversified investment in recent years.

Moreover, because holdings have been diversified in the UK like in the US, the concentration of top stockholders and high rank stockholders is believed to be relatively low in comparison to Japan and Germany.

Banks are allowed to hold the stocks of other corporations after the Bank of England has conducted inspections, but the actual percentage of stocks held by banks is less than 1 percent, which certainly makes them a minority.

<Categories of institutional investors\(^{16}\)>

Insurance companies: There are three kinds of insurance companies in the UK—joint-stock corporations, mutual corporations and subsidiaries of other companies.

Pension funds: They consist of public and corporate pensions\(^{17}\). Large-scale pension funds are

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\(^{15}\) Institutional investors in this context include insurance companies, pension funds and investment trusts. This is because statistically, the proportion of foreign investors in institutional investors is unknown, which is due to the fact that the internal composition of foreign investors is unknown.

\(^{16}\) Japan Investor Relations and Investor Support (2002), p. 27.
independently managed. Trustees (generally directors and executives of pension management companies) bear responsibility for managing the pension system.

Investment trusts: Unit trusts refer to open-ended investment trusts, while investment trusts refer to closed-ended investment trusts.

<Role of institutional investors>
With the Maxwell incident in 1991 as a turning point, the government established the Pension Act in 1995 and institutionalized the public supervision of pension funds. Furthermore, disclosure was required through the Statement of Investment Principles (SIP). SIP was compiled for decision-making concerning investment, and corporations are obliged to conduct reviews afterward. The content includes the scope of investment, asset allocation, risk, expected returns and redemptions, as well as compliance with the obligation to diversify investments and minimum reserve levels.

The 1992 Cadbury Report, recognizing the influence of institutional investors on corporations in the corporate governance, recommended proactive voting and holding periodic meetings with the management of corporations in which investments are made and supervision of directors. Moreover, the Hampel Report criticized the mechanical voting by institutional investors. It called for institutional investors to be flexible and not only vote but also strive to have greater communication with corporations. In the end, one of the distinctive features of the Combined Code is that it stipulates standards for corporations as well as standards for stockholders consisting mainly of institutional investors.

Furthermore, it has been pointed out that the guidelines for institutional investors on voting are diversifying, thereby causing confusion. In response, in July 1999 the National Association of

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17 Influenced by the Thatcher reforms and other factors, the UK developed corporate pensions at an early date.
18 Investment trusts that can be freely converted to cash at any time. Conversion is carried out based on the amount of net assets.
19 Investment trusts for which redemption of issued stocks is not guaranteed. As such, issued stocks are purchased and sold at market prices in securities markets and over-the-counter markets, and selling prices sometimes go above or below net asset prices.
20 This was referred to in the Myners Review in 2001. Institutional investors in the UK focus primarily on pension funds and life insurance aiming at long-term, stable fund management.
21 The incident in which Robert Maxwell, owner of media giant Maxwell Communication Corporation Plc and the Mirror Group, used his position as chairman of the pension fund trustees of the corporations that he owned and diverted pension assets to corporate investment activities. Many employees were unable to receive pensions because the corporations in which Maxwell invested went bankrupt.
22 As a result of amendments to the Pension Act, corporations are now obliged to include statements on Socially Responsible Investing (SRI) in SIP.
23 This is called the box-checking approach.
Pension Funds (NAPF) and the Association of British Insurers (ABI) issued the joint statement entitled *Responsible Voting*, which explains the importance of voting and its usefulness in corporate governance.

2. US

(1) Changes in the corporate system from the systemic viewpoint

(a) Trends in corporate governance in the US

<Trends until the 1990s>

The concept of corporate governance in the US goes back to the discussion on the separation of ownership and management in *The Modern Corporation and Private Property*[^25], written by Adolf A. Berle and Gardiner C. Means in 1932. Since then, discussions have continued on the independence of boards of directors and corporate control.

In light of these developments, there were trends aiming to fully ensure the function of boards of directors. For example, in 1956, the listing rules of the New York Stock Exchange (NYSE) made it obligatory to have more than two outside directors. However, as the 1960s have been dubbed the “era of the CEO,” CEOs held tremendous power[^26].

However, the 1970s saw developments such as Campaign GM[^27], the failure of PennCentral[^28], the issue of illegal donations by corporations[^29], triggered by the Watergate incident, which shed light on issues such as the impairment of boards of directors and corrupt financial reporting and increased the momentum for corporate governance reform. Given these circumstances, the American Bar Association (ABA) issued the Corporate Director’s Guidebook in 1978. This outlined the standards of conduct for directors, and proposed the definition and importance of independent outside directors, in other words, the operation of boards of directors, the establishment of audit committees, remuneration committees and nomination committees.

Furthermore, in the same year NYSE created listing rules calling for listed companies to establish audit committees composed of independent outside directors.

[^27]: A movement which called for GM, one of the leading companies in the US, to recognize its social responsibility, change its articles of association to match its business purposes to public interest and allow representatives of public interest to participate in boards of directors.
[^28]: PennCentral, the biggest railway company in the US at the time, went bankrupt in 1970. Even though it had excessive debts, it paid enormous dividends of more than US$100 million over the two-year period before bankruptcy. It was discovered after the bankruptcy that the board of directors had not received an accurate report on the financial situation.
[^29]: According to investigations conducted by the Securities and Exchange Commission (SEC) in light of the Watergate incident that eventually led to the resignation of the then-president, it was discovered that illegal acts had been undertaken by several hundred corporations, including illegal corporate donations and improper expenditures.
Beginning in the 1980s, frequent mergers and acquisitions (M&A) and takeover bids (TOB) took place given the vast amount of funds. At the time, there was still little involvement of institutional investors in corporate governance. Corporations planned the acquisitions not from the perspective of improving corporate governance but instead targeted corporations for whom market assessment is low\textsuperscript{30}. After acquisitions took place, these corporations took shortsighted actions such as raising stock prices and selling it at the highest price by forceful means including corporate division and restructuring. Management took various counter-acquisition measures against such buyers and furthermore, local governments that feared the drain of local companies also resisted by establishing a legal system favoring those companies (acquired companies) preventing the acquisitions\textsuperscript{31}.

At present, the number of such hostile acquisitions is declining with public criticism of their forceful methods as well as the perception that the buyers’ awareness of improving corporate governance is low.

In the 1990s, due to the fact that institutional investors became obliged to vote in 1998, institutional investors such as the California Public Employees’ Retirement System (CalPERS)\textsuperscript{32} and the Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF) became actively involved in corporate governance, resulting in the creation of various guidelines on corporate governance\textsuperscript{33}. In any guideline, discussions have been held on ensuring the independence of boards of directors and the importance of independent outside directors as well as their relationship to accounting audit. Therefore, emphasis has been placed on clarifying the supervising function and business operations of the boards of directors within the one-tier system of the board of directors system, and a strong request was made for strengthened management supervision centering on audit committees.

<Recent trends>

In the 1990s, with the robust US economy, US-style corporate governance was fully functional and was even beginning to be recognized as best practice. However, there were scandals that shook corporate reliability, such as the Enron incident in 2001 and WorldCom’s accounting fraud,

\textsuperscript{30} For example, corporations that have abundant cash flow but their line of business or services are in a mature market and their stock market assessment is low.

\textsuperscript{31} On the other hand, there is criticism that such counter-acquisition measures will dampen efforts to increase stockholder value, but it is believed that it will be instrumental for stakeholders. As such, counter-acquisition measures are being continued today.

\textsuperscript{32} California Public Employees’ Retirement System (CalPERS).

\textsuperscript{33} Besides guidelines formulated by institutional investors themselves, there are guidelines such as the 1992 Principles of Corporate Governance: Analysis and Recommendations of the American Law Institute (ALI), 1996 Report of the NACD Blue Ribbon Commission on Director Professionalism of the National Association of Corporate Directors (NACD) and the 1997 Statement on Corporate Governance of the Business Roundtable.
that were followed by other corporate scandals thereby exposing the flaws in the US corporate governance system. However, in order to restore and maintain market confidence which had been lost, the US established the Sarbanes-Oxley Act for corporate accounting in July 2002 with unprecedented speed. Furthermore, in line with the objectives of this act, the NYSE and Nasdaq announced that they would conduct a drastic review of listing requirements. The content of this act includes: (i) ensuring the independence of the outside audit firms which failed to prevent accounting fraud and establishing oversight boards for outside audit firms; (ii) strengthening the monitoring function of boards of directors centering on audit committees and ensuring the independence of outside directors; (iii) further strengthening disclosure; and (iv) strengthening penalties on management corruption. In addition to this content, the US’s strong stance on corporate governance reform aimed at restoring confidence can be seen in developments such as the fact that a new act has been established a little more than nine months after the Enron incident and that a review of listing rules was carried out in each stock exchange in the same period.

(b) Structure of corporate governance in the US

<Mechanism of boards of directors>

Directors are elected by a simple majority at the stockholders general meeting. Regarding their dismissal, directors can be dismissed in the middle of their term if there is approval from the majority of the stockholders general meeting. Whether a legitimate reason is necessary for dismissal depends on the provisions of the basic articles of association. The tenure of directors varies by state law but generally it is one to three years.

As with the UK that has an Anglo-Saxon model, boards of directors are one-tier systems in which they hold the dual functions of decision-making in business operations as well as management supervision.

As for the concrete content of the one-tier system, it is a structure whereby boards of directors, composed of directors elected at the stockholders general meeting, supervise the business operations of executive directors including the CEO, who is also the manager.

<Separation of boards of directors and business operations>

Boards of directors in the US are one-tier systems. There are various committees composed of independent outside directors, but it is a structure in which one institution has both a business

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34 Joint-stock companies in the US are regulated not by federal law but by state corporate law. As such, it is difficult to describe including everything, but as many large corporations are established in Delaware, one can get a rough idea of US corporate law by looking at Delaware state law (Fukao and Morita (1997), p. 169).

35 The changes to the listing rules proposed by the NYSE in August 2002 state that the majority of them must be independent directors.
operation institution and management supervision institution. The current situation in the US is that in most corporations, chairmen of the board of directors, who are heads of supervision, serve concurrently\textsuperscript{36} as CEO, who is head of business operations. This is in contrast to the UK, which also is a one-tier system, but has been advancing the separation of the chairman of the board of directors and CEO in corporate governance reform in recent years. Concurrently holding the posts of the chairman of the board of directors and CEO causes an irrational situation in which people supervise their own business operations. At the same time, this recognizes the existence of a leader that holds great power, which increases management risk such as managers doing whatever they like. Moreover, in many cases, outside directors, whose supervision is expected, are generally CEOs of other corporations. As such, they are busy with their own work and are unable to confront CEOs, who are well-informed about their own corporation’s business and are constantly thinking about their management. In addition, information about the corporation in question is provided by the CEO, so there is a danger that the information provided will be biased.

Many corporations have nomination committees composed of outside directors to elect the CEO and other directors. Yet many corporations have not gone any further than approving the submission of the list recommended by the CEO to the stockholders general meeting. As a result, there is criticism that nomination committees have only limited effects.

As can be concluded from the above, extensive management authority is concentrated on the CEO in the US corporate structure, and one of the main points at issue is ensuring the effectiveness of boards of directors.

\textbf{<Audit committee, nomination committee and remuneration committee>}

Committees are established within the board of directors as institutions by which to supervise management. The establishment of these committees is not enforced by corporate law. However, the NYSE and National Association of Securities Dealers (NASD) compel listed companies to establish an audit committee (composed of more than three outside directors). In addition, there are remuneration committees\textsuperscript{37} that decide on the remuneration of directors, as well as nomination committees\textsuperscript{38}, which select candidates for new directors, including CEOs, and reelect current directors.

All of the three aforementioned committees aim to clarify the duties of the board of directors.

\textsuperscript{36} The two posts are held concurrently in approximately 80 percent of corporations (Fukao and Morita (1997), p. 83).
\textsuperscript{37} The changes to the listing rules proposed by the NYSE in August 2002 required all members of the remuneration committee to be independent directors.
\textsuperscript{38} The changes to the listing rules proposed by the NYSE in August 2002 state that the committee should be called the nomination and corporate governance committee and required all members to be independent directors.
and ensure its autonomy. They are institutions that fulfill the essential role of maintaining the favored form of corporate governance.

<Accounting audit (outside audit)>

Accounting audits by external certified public accountants (CPAs) and audit firms objectively check financial statements from an outsider’s point of view. They compose an important aspect of checks and balances that are necessary to put the favored form of corporate governance into practice. However, there are risks because of the range of interpretation in accounting audit standards and the fact that audit firms may not be conducting appropriate audits since they provide services other than auditing, such as consulting. As a result, the Securities and Exchange Commission (SEC) has come to urge for disclosure on the clarification between remuneration for audit services and remuneration for non-audit services paid to auditors. Nonetheless, the inadequacy of the disclosure system became clear with the Enron incident in December 2001, the biggest bankruptcy ever at the time. Although the amount of remuneration for audit services and remuneration for non-audit services, as well as the independence of auditors, were clearly indicated in Enron’s proxy statement, Enron finally fell into bankruptcy as a result of fraudulent accounting procedures and dishonest off-balance-sheet transactions. Given these circumstances, the Sarbanes-Oxley Act for corporate accounting, established in July 2002, enhanced supervision by establishing new supervisory institutions for outside auditors and significantly restricted the overlapping of auditing services and non-auditing services for identical corporations.

(2) Looking at the changes in the corporate system from the actual situation

The fund procurement structure in the US is believed to be dominated by direct finance centering on procuring funds from the market. This section will examine this fund procurement structure. It will also reveal the trends of shareholding composition in recent years given the high degree of separation in the US between corporate ownership and management. In addition, this section will provide an overview of trends of institutional investors who play a significant role in this context.

(a) Changes in the fund procurement structure

In the US, fund procurement centers on direct finance from the market. This is evident from its financial structure, which has been generally referred to as a capital market-dominated system. Figure 1.3.6 shows the fund procurement structure in non-financial corporations in the US. The ratio of borrowings, which stood at 18.0 percent in 1991, gradually declined further in recent years and was 13.7 percent in 2000. Meanwhile, the ratio of shares and other equities and
securities other than shares (corporate bonds, etc.) has steadily risen, demonstrating that the fund procurement structure centers on the market.

In addition to the abovementioned factor, if the fact that, as in the UK, the ratio of shareholding by financial institutions is low is taken into consideration, the role of financial institutions, particularly banks, played in corporate governance is not very significant.

Figure 1.3.6 Breakdown of the balance of financial liabilities among non-financial corporations in US

(b) Changes in shareholding composition

Figure 1.3.7 shows the trends in US shareholding composition. In the US where stock investment is common, although the proportion held by individuals (household sector) remains high, there has been a shift to institutional investors (pension funds, investment trusts and life insurance) since the 1980s. In 1980, the share held by individuals was 58.6 percent and the total share of pension funds, investment trusts and life insurance was 24.8 percent. In 2001, the share held by individuals had declined to 39.5 percent. In contrast, the total share of pension funds, investment trusts and life insurance rose to 45.5 percent and surpassed the share held by individuals.

Furthermore, compared to Japan and Germany which have a contrastive system, many stockholders hold a few stocks each and the dispersion of ownership is advanced in the US, and it has a relatively low concentration of top stockholders and high rank stockholders. Although institutional investors are top stockholders, it is said that the share held by each of the institutional investors amounts to a few percentage points. However, in some cases the shares are concentrated in founders of companies and their families.

Underlying the advancement of dispersion of ownership is the fact that in cases where

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competition is limited, holding stocks of other companies (cross-held stock) is prohibited by the Antimonopoly Act as well as other factors. Furthermore, banks cannot hold stocks of other large corporations. Even though bank holding companies may hold stocks of other companies up to 5 percent of all issued stocks with the right to vote\textsuperscript{40}, in reality, hardly any of them hold such stocks.

\textbf{Role of institutional investors}

With the limitations on large-scale shareholding by financial institutions and corporations and increased pension funds brought upon by the aging of the population composition in the background, the US is facing a trend where the ratio of shareholding by institutional investors represented by pension funds is increasing. As such, institutional investors have an increasing influence on corporate management, which is an important point at issue in terms of corporate governance.

Up until the 1970s, the general view was that institutional investors also followed the so-called Wall Street Rule\textsuperscript{41}. It has been said that there is still a strong trend among institutional investors that they aim to maximize short-term profits of stocks, especially by investment trusts. Nevertheless, since the 1980s there has been a gradual trend whereby some pension funds are taking shareholders’ actions.

One of the underlying factors of these developments was the fact that fiduciary responsibility of pension funds and trustees\textsuperscript{42} was specified by the establishment of the 1974 Employee Retirement Income Security Act (commonly known as the ERISA Law\textsuperscript{43}) and state laws based on this law, in

\textsuperscript{40} Fukao and Morita (1997), p. 181.
\textsuperscript{41} Shibuya, Suto and Imura (2002), p. 67.
\textsuperscript{42} Private pensions are regulated by the ERISA Law; the public employees’ pension funds by state law.
\textsuperscript{43} Employment Retirement Income Security Act.
addition to the implementation of “prudent man rule”\(^{44}\) regulations. Furthermore, the notification of the US Department of Labor (commonly known as the Avon Letter) clearly stipulated in 1988 that exercising the right to vote was a part of fiduciary responsibility.

Another underlying factor is that there is a strengthening trend of adopting indexing\(^{45}\) as asset management of large-scale pension funds place importance on long-term stability and security.

For indexing, sales of stocks that are made according to the Wall Street Rule when performance is declining for corporations receiving investment that hold an important position in the index, also means the sales of stocks held by funds whose asset value is ballooning. In turn, this triggers a further decline in stock prices and operational results decline as well.

Because of these reasons, inserted stocks cannot easily be substituted in indexing and in order to improve operational performance, it is necessary to become involved in corporate management of the problematic corporations receiving investment. Even in these cases, however, undertaking a risk such as sending a director as a major stockholder is not permitted because of the limitations of fiduciary responsibility. What happens is that, as stockholders, institutional investors express their views to the board of directors (and top management) and exercise their right to vote at the stockholders general meeting.

In light of these two points, voting by pension funds has been exercised more often, but there is controversy over whether proactive governance actions by institutional investors using their right to vote has actually led to improving management efficiency.\(^{46}\)

Furthermore, institutional investors who actually exercise their right to vote are limited to a number of funds such as the public employees’ retirement pension funds represented in CalPERS and the TIAA-CREF. The background to this limitation is that active shareholders’ actions by pension funds to corporations are hampered by intercorporate relations such as transactions between corporations receiving investment and sponsoring corporations. This creates a situation where only pension funds, who share no transactional interests with corporations receiving investment such as the abovementioned, are able to actively exercise their right to vote. Furthermore, corporations receiving investment dislike direct intervention even for these pension funds, and cases have been pointed out where various pressures have been placed on them. In addition, results of experimental study have not been consistent in terms of whether the exercise of the right to vote by pension funds has improved monitoring.\(^{47}\)

\(^{44}\) Rule of conduct that should be observed, stipulating that those managing corporate pensions should take prudent actions regarding investment according to their various duties.

\(^{45}\) One of the reasons that indexing has spread is that operational costs are relatively low and stable, market average-level operational results can be obtained through dispersion (Shibuya, Suto and Imura (2002), p. 68).

\(^{46}\) Shibuya, Suto and Imura (2002), p. 68.

Despite these circumstances, there are no doubts that direct involvement in corporate management by a number of pension funds (CalPERS and the TIAA-CREF), which maintain relations with corporations receiving investment while calling for their managerial efforts, will increase the beneficiaries’ and individual stockholders’ awareness of corporate governance and create tension within corporate management. It is evident that changes in corporate control made by institutional investors, which aimed at shifting from one-sided sales to dialogue (exercise of the right to vote), are transforming, in no small measure, US-style corporate governance grounded in market adjustment.  

Furthermore, as for trends in CSR in the US, there has been progress in private sector-led efforts even though hardly any government-level measures have been taken. Specifically, it has been said that corporations have heightened their awareness of CSR through proactive measures undertaken by pension funds and SRI investment trusts aimed at SRI-style management.

3. Germany

(1) Changes in the corporate system from the systemic viewpoint

In recent years, Germany has been carrying out corporate governance reform with the intention of improving the profits and rights of stockholders, which is an area it had not paid much attention to in the past. This section will provide an overview of the background and factors which served as the driving force of reform, as well as the trends of specific arrangements.

(a) Background of corporate governance reform

The underlying factors of the reform include corporate bankruptcies, pressure from foreign institutional, privatization and pension system reform and self-initiative measures of corporations.

The corporate bankruptcy of non-ferrous metal giant Metallgesellschaft in 1993 and the management crisis of construction giant Philipp Holzmann in 1999 were major incidents that cast doubts on the effectiveness of boards of corporate auditors. Despite the fact that Metallgesellschaft had representatives of financial institutions such as Deutsche Bank, Dresdner Bank and Allianz on its board of corporate auditors, the problem was not identified beforehand, which caused the stockholders general meeting and the media to question the board’s responsibility. Holzmann had reported externally that its business performance was good, but immediately afterward, it was discovered that it had suffered huge losses from investments in former East Germany and was on the verge of bankruptcy.

In terms of the influence of foreign institutional investors, there was a case in 1992 where

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CalPERS, a US pension fund, pointed out the inequality of the stock system for German public enterprise RWE and supported a stockholder’s proposal to eliminate the inequality. As a result, RWE has abolished the system in which the right to vote was unequal.

The privatization of Deutsche Telekom in 1996 and the creation of new stock markets (Neuer Markt) for venture businesses had the effect of raising people’s desire to invest in IT stocks as well as the effect of luring private investors, who had hitherto been reluctant to invest in stocks, into the market. Furthermore, discussions took place on introducing a US/UK-style pension fund system as a result of the accelerated establishment of markets, which would enable more stable asset management, against the backdrop of the advancement of an aging population in Germany. In 2002, a private fund system based on the fund system was introduced.

International corporations, that are procuring funds and promoting business development overseas, have sought the understanding of foreign investors and have voluntarily advanced improvements in corporate governance in order to conform to the systems abroad. Specifically, by restructuring, such as selling and consolidating international business sectors or splitting them up into separate companies, efforts have been made to reach a suitable agreement by compromising on corporate governance systems in different countries. In addition to restructuring through mergers, there have been cases where corporations, on their own initiative, adopt SV-oriented (focus on stockholder value) management methods and international accounting standards.

(b) Corporate governance reform by the government

The aforementioned factors, such as corporate bankruptcies, pressure from foreign institutional investors and efforts by private sector groups to create corporate governance principles, have:

49 At the time, RWE had adopted an unequal system where state governments, which held only 30 percent of the number of stocks, had 60 percent of the right to vote. Systems with inequalities in the right to vote were widespread in Europe. The federal government and state governments maintained their management authority through this system.

50 The messages that CalPERS sent to the German company were later compiled as the principles of corporate governance and announced in 1998. They stated that boards of corporate auditors should represent the interests of all stockholders, that the right to vote should be equal, that management structure should place importance on accountability and independence, and encouraged Germany to adopt Anglo-Saxon-style ideas.

51 Compromise between German and French corporate governance systems was seen in Aventis, which was formed by the merger of Hoechst AG and Rhône-Poulenc SA. For example, it chose to be a two-tier system and in 2001, employee representatives were added to the board of corporate auditors, which had previously been composed of only by stockholders.

52 The stock option system was introduced in 1996 in Daimler-Benz and Deutsche Bank. The listing of stocks overseas (Tokyo Stock Exchange, New York Stock Exchange, etc.) by leading German companies such as Deutsche Bank and BASF promoted the adoption of international accounting standards by German corporations.

53 The German Panel on Corporate Governance (a committee led by Professor Theodor Baums of the
encouraged the government to seriously tackle corporate governance.

First, the Law Concerning the Supervision and Transparency in Corporations was established in 1998 with the aim of increasing transparency, strengthening the audit function, among other things. This was based on the Global Capital Market Policy for Increasing Employment, which was the comprehensive strategy of former German Chancellor Helmut Kohl. In 2000, a committee for corporate governance reform\(^{54}\) was established within the government, which conducted a broad review of the German corporate system. This committee submitted a report\(^{55}\) in 2001, which recommended amendments to the current law concerning corporate governance and urged that a committee for the compilation of corporate governance codes be established. Given such a request, a committee\(^{56}\), composed of private sector experts, was established with the aim of creating corporate governance codes and moved ahead with the task of formulating codes. In February 2002, this commission established codes (KODEX) including relevant laws. However, it was decided that these codes were not finalized and meetings would be held at least once a year to revise the codes according to the most current situation.

The content of KODEX is characterized by three points: protecting and enhancing rights of stockholders and investors—expanding the scope and methods of corporate management information disclosure (improving transparency in corporate management); enhancing and clarifying the function of the board of corporate auditors; and ensuring the independence of auditors and auditors in charge of account settlements. The content is not very novel because of the background that KODEX was created in to establish accountability, responding to criticism from foreign investors that “German corporate management is hard to understand.” However, KODEX has compiled regulations of stock laws and the commercial code concerning corporate

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\(^{54}\) This committee was chaired by Professor Theodor Baums of the Johann Wolfgang Goethe-University. Representatives of the government (Chancellor’s Office, Cabinet ministers, Federal Ministry of Justice, Ministry of Finance), academia, boards of corporate auditors, boards of officers, accounting offices, stock exchanges, labor unions and securities industries participated as members of this committee.

\(^{55}\) The Baums Commission Report is composed of six chapters: establishment of corporate governance codes, corporate management structure, stockholder and investor protection, fund procurement, information technology and disclosure, accounting standards and supervision.

\(^{56}\) This commission was chaired by Dr. Gerhard Cromme, Chairman of Thyssen Krupp. Thirteen members participated, including institutional investors, private investors, members of the board of officers and the board of corporate auditors, stock exchanges, representatives of labor unions, auditors and representatives from academia. The commission’s activities were independent of the government, but the Ministry of Justice attended as an observer and obtained information. The government provided powerful backing to unify principles aimed at preventing the arbitrary establishment of corporate governance principles and corporate confusion.
management and supervision in a comprehensible manner. It also includes Recommended Regulations and Recommended Items. In particular, the concept of “either compliance or an explanation” has been introduced for the status of compliance of each of the Recommended Regulations. In other words, KODEX urges corporations to report if they are complying with the Recommended Regulations and provide an explanation when they have not complied with them. As for the generally recognized practices incorporated in this code in addition to legal regulations, the code would fulfill a function as a type of legal code if investors acknowledge the code, and capital markets and institutional investors have expectations that knowing whether individual corporations are complying with the regulations would influence their decision on whether they should invest. Furthermore, in July 2002 the Law for the Further Reform of Stock Laws and Balance Sheets for Transparency and Principle of Disclosure (Law for Transparency and Disclosure in Corporate Management) was formulated. This law aims at broad reform of the commercial code and stock laws, in response to the proposals of the Baums Commission Report.

(c) Trends in CSR

In terms of developments in CSR, the Pension Reform Act was established in Germany as well in 2001 at the Federal Parliament (Bundestag) in order to prevent the collapse of pensions. Managers of pensions were obliged to release reports on the degree of ethical, social, environmental considerations they make in managing investment in funds.

(2) Looking at the changes in the corporate system from the actual situation

German-style corporate systems are characterized by the fund procurement structure that is mainly built on indirect finance centering on the Hausbank system and the cross-holding relationship between corporations. This section will explain how this system has changed in recent years.

(a) Changes in the fund procurement structure

According to Figure 1.3.8, in particular in the first half of the 1990s, the ratio of borrowing to corporate fund procurement fell somewhat at the same time that the ratio of marketable securities rose slightly. This reveals that direct finance became an important element of corporate fund procurement during this period.

However, regarding corporate fund procurement, the amount of borrowing increased significantly, and it is not conclusive whether there was a shift from indirect finance to direct finance. From the 1960s to especially in the 1980s, large corporations possessed strong self-financing ability given the enormous profits amassed through oligopoly. These large corporations have changed their fund procurement structure from one centering on internal funds (mainly
depreciation allowance and estimated liabilities) to one where an increased share is held by external funds (stocks, corporate bonds). Meanwhile, small and medium-sized enterprises which are still struggling to procure funds from capital markets have no choice but to consistently borrow from banks. However, fund procurement from direct finance markets has been difficult due to the stock market decline in recent years. At the same time, as banks have become increasingly reluctant to lend money, both large corporations and small and medium-sized enterprises seem to be facing difficulties.

(b) Changes in shareholding composition

<Shareholding composition of corporate stocks>

One of the characteristics in the shareholding composition of corporate stocks is the high ratio of shareholding by banks and non-financial corporations. In particular, banks have effectively held more stocks through stock deposits from private stockholders and maintained control over management. Furthermore, there is a cross-holding relationship between financial institutions,

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57 According to a hearing with Dr. Walter of Deutsche Bank Research and Mr. Panther of Commerzbank.
58 According to the central bank of Germany (Deutsche Bundesbank) and other sources, the growth rate of lending for domestic corporations stayed at nearly zero percent in 2002. The figure even shows negative growth for large banks.
59 As a result, banks have sent many representatives to boards of corporate auditors. While there have been many skeptical opinions on the function of boards of corporate auditors, there are a number of cases where auditors from banks have had some influence. For example, Deutsche Bank prevented the hostile takeover of Feldmühle Nobel by the Flick brothers by restricting the right to vote per stock (Franks and Mayer, 2001). Furthermore, there have been empirical analyses showing that control through the shareholding by banks has raised the ratio of current values/book values and return on equity (ROE) (Gorton and Schmid, 1999). But there have also been results of analyses that show such effects are not all in regard to the entrusted right to vote (Franks and Mayer, 2001).
creating a structure that is less susceptible to stockholder pressure\textsuperscript{60} (Fig. 1.3.9).

Shareholding by the government can be seen not only in the federal government but also in a number of state governments. For example, the State of Lower Saxony holds a certain percentage of Volkswagen AG stocks and the State of North Rhine-Westphalia (NRW) (including the city itself) holds Cologne Airport stocks. As privatization advances on a national scale, however, the ratio of shareholding by the government is on a downward trend\textsuperscript{61}. For example, the government-held stocks of Düsseldorf Airport were taken over to a construction company.

The ratio of stocks held by institutional investors is still low compared to the US and other countries, but it rapidly increased throughout the 1990s (Fig. 1.3.10).

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{Figure1.3.9.png}
\caption{Trends in German Shareholding Composition}
\end{figure}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{Figure1.3.10.png}
\caption{Scale of investment by institutional investors}
\end{figure}

\begin{table}[h]
\centering
\begin{tabular}{|c|c|}
\hline
Year & Amount \ (Unit: 1 million DM) \\
\hline
1970 & 2 \\
1980 & 20 \\
1990 & 230 \\
1998 & 1,300 \\
\hline
\end{tabular}
\caption{Scale of investment by institutional investors}
\end{table}

\textit{\< Role of institutional investors\textsuperscript{62}\>}

\textsuperscript{60} Most recent examples of cross-holding relationship between financial institutions include: Allianz and Munich Reinsurance Company and HypoVereinsbank. The ratios of cross-holding are as follows: Allianz $\rightarrow$ Munich Reinsurance Company (23 percent), Munich Reinsurance Company $\rightarrow$ Allianz (21 percent), Munich Reinsurance Company $\rightarrow$ HypoVereinsbank (25.7 percent), HypoVereinsbank $\rightarrow$ Munich Reinsurance Company (13.3 percent).

\textsuperscript{61} The example of the State of NRW was obtained in a hearing with Dr. Scholtz.

\textsuperscript{62} According to a hearing with Dr. Bergman of DWS.
In Germany, two institutional investors—DWS and UNION—are gaining attention because of their scale and established methods of involving themselves with corporations. Normally, the ratio of shares of individual corporations held by institutional investors is low at around 1 to 2 percent, and because of this situation, auditors are not dispatched to individual corporations. The way the institutional investors involve themselves in corporations is more UK-style than US-style, as they strive to resolve problems through constructive conversation and dialogue rather than immediately selling vast amounts of stock or exerting pressure which might lead to a change in directors. In terms of specific methods, corporations are asked to report and present at least once a year to asset operation managers of institutional investors on items including corporate strategies and status, and forecast of profits. If it is judged that management is not being carried out from the perspective of considering stockholder value and that corporations do not have the will to do so, corporations will have no choice but to make efforts to improve management because of pressure that their stocks could be sold. In addition, there are instances where institutional investors participate in a corporation’s stockholders general meeting and make comments. As is the case with the aforementioned presentation, it is expected that corporations will carry out management that takes stockholder value into consideration.

One of the specific cases in which DWS changed corporate strategy concerns the stock option system targeting top management, which was introduced by DaimlerChrysler in 1990. In the past, it took a few years (usually three years) until the rights could be exercised, but due to pressures that DWS exerted to make the system more flexible and effective, DaimlerChrysler ended up yielding to these pressures. Furthermore, DWS expressed to Siemens that Siemens was not concentrating on its core business in light of the fact that business fields had become extremely diverse and that this was not a desirable situation in terms of management strategy. In response, Siemens began to focus more on its core business, albeit partially, starting from the beginning of 2000.

<Structure of cross-held stock>

One of the characteristics of the structure of German shareholding composition is that it is a pyramidal structure. With a pyramidal structure\(^3\), top stockholders are able to obtain a value, by holding one stock, equivalent to more than one vote, thus obtaining corporate management control over the lower tier at low cost\(^4\).

Due to the globalization of the world economy and intensified competition during the 1990s, German corporations became more inclined to emphasize short-term performance and

---

*\(^3\) Besides this, it has been pointed out that it has the effect of strengthening management control through cooperation and mutual stockholding (Franks and Mayer, 2001).*

*\(^4\) Bebchuk, Kraakman and Triantis (1999). However, there is also empirical analysis that refutes this.*
There was progress in the partial sales and reduction of stocks held by large corporations as the risk that major stockholders would take in fulfilling their traditional role, such as debt forgiveness or underwriting debts for bankrupted corporations, was eliminated. Thus less value was placed on solidifying relations through shareholding. Moreover, the collapse of the reunification bubble has dissuaded especially financial institutions from holding corporate stocks. In addition, since 2002, in order to balance out the exemption of taxes levied on intercorporate dividends as a result of eliminating the imputation method for taxation on dividends, the intercorporate capital gains of corporations were also made tax exempt in principle. However, for revisions of the tax system, the expected effects of promoting stock sales and market revitalization were insignificant due to the current stock market decline.

In terms of numbers, these banks maintain their position as major stockholders of corporate giants. Moreover, the relations between financial corporations in particular regarding cross-holding were merely reshuffled and many significant issues still remain.

(3) Changes in relations between corporations and employees from the viewpoint of the joint decision-making system

As one of the key efforts to ensure that corporations fulfill their social responsibility and serve public interest, Germany has the Joint Decision-Making Law (1951 Montan Joint Decision-Making Law, 1952 Labor Management Relations Act, 1976 Joint Decision-Making Law). This law intended to adjust the profits of employees and employers, who were especially likely to have a conflict of interests, and its legal framework have not changed even today. The law puts...
employees and people contributing owners’ capital on equal footing and comprehensively establishes the relations of rights and obligations for both parties. The strength of the joint decision-making system include: (i) capital-labor consensus management is realized and labor disputes are avoided; and (ii) strategic decisions are made from a long-term perspective. Meanwhile, the system’s weaknesses include: (i) it has a strong tendency to act representing the interests of the electoral body, causing sectionalism within the board of corporate auditors. In particular, the chairman of the board of corporate auditors, who is elected from the representatives of stockholders, has special voting rights, thereby increasing the likelihood that decisions are made in favor of stockholders; and (ii) expeditious decision-making and necessary restructuring and innovation are impeded bringing about a decline in Germany’s international competitiveness. This section will provide an overview of the modality of employees’ participation in management as well as recent changes in this regard.

(a) Framework of the joint decision-making system

<Structure of the board of corporate auditors (Fig. 1.3.11)>

Figure 1.3.11 Structure of the board of corporate auditors

<table>
<thead>
<tr>
<th>Limited company</th>
<th>Limited company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than or equal to 500 persons</td>
<td>No obligation to establish a board of corporate auditors</td>
</tr>
<tr>
<td>Above 500 and up to 2,000 persons</td>
<td>One-third of the auditors must be representatives of employees</td>
</tr>
<tr>
<td>Above 2,000 persons</td>
<td>Half of the auditors must be representatives of employees</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Joint-stock company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than or equal to 2,000 persons</td>
</tr>
<tr>
<td>Above 2,000 persons</td>
</tr>
</tbody>
</table>

Source: Created by METI from various materials.

<Workplace councils and collective bargaining>

Workplace councils are also called management councils and corporations with more than 500 employees are obliged to establish them. Each business establishment is to establish one workplace council and the corporation as a whole has a central council. At the central council, management and labor negotiate on employment services, unemployment insurance, unemployment benefits and wages. These reflect the results of collective bargaining between employers’ associations and labor unions. For example, in terms of wages, the minimum wage is

71 In general, however, the chairman of the board of corporate auditors will strive to achieve consensus, and it is rather rare that employees block the board of corporate auditors (according to a hearing with Dr. Streeck of the Max-Planck-Institut).
set by the level determined by outside collective bargaining which takes place independently of individual corporations. With this in mind, negotiations are held within the corporation on the amount which will be added to the minimum wage. Corporations themselves decide on the guidelines for recruiting, education and training, as well as health and safety, which are in line with the labor agreements that have been decided upon by the industry as a whole between labor unions and employers’ associations.\(^72\)

One of the concrete effects is that the actual variation is kept limited for wages and working environment in each corporation within the industry. Furthermore, wage levels are set by type of job group in collective bargaining. Because the wage level difference between different types of job groups is small, a flat, high-level wage structure has been realized among employees of each corporation. The income gap between management and the workers who are actually out in the field is relatively low compared to Anglo-Saxon countries. These high wages serve as an incentive for employees to actively invest in training and re-training that befit their wage level, which also contributes to the effectiveness of labor organizations.\(^73\)

(b) Actual situation of the transformation of the joint decision-making system

<Strengthened function of the board of corporate auditors>

There are quite a few voices that say that boards of corporate auditors are not fulfilling their expected role aimed at the long-term profits of corporations.\(^74\) The main reasons for this include the fact that as the board is composed of a large number of people, little information is provided by the board of directors and the number of times meetings are held (in principle, four times a year) is too low. Furthermore, in the case of auditors representing employees, discussion tends to focus on issues such as employment and working conditions, or even if they do not, auditors have little expertise of audits. This is because in many cases, executives of workers’ organizations are appointed auditor or hold the position concurrently. First of all, these executives are not knowledgeable about the business in question since they are not directly involved with the business. Yet it seems that employee representatives are obliged to receive training from labor unions in the knowledge and skills needed for balance sheets and other audits.\(^75\) Other points have

\(^72\) Basically, mutual monitoring takes place among corporations that belong to the Bundesverband der Deutschen Industrie.

\(^73\) Jackson, Höpner and Kurdelbusch (2002).

\(^74\) For example, construction giant Philipp Holzmann faced financial crisis in 1999 in the wake of the slump in the construction industry and other factors. In the final gains and losses, it marked a loss of approximately 1.3 billion euros. Philipp Holzmann averted a crisis thanks to large-scale financial support measures by the government, but this was an incident where Deutsche Bank, which had sent one of its currently serving directors as chairman of the board of corporate auditors, was criticized for delaying the discovery of risk.

\(^75\) According to a hearing with Dr. Köstler of the German Trade Union Federation (DGB). Furthermore, the DGB has established the Hans Böckler Foundation in Düsseldorf, which trains employee
also been raised in the recent corporate governance reform, and efforts have been made to strengthen the function of the boards of corporate auditors. To be specific, various committees are encouraged to be established under the board of corporate auditors in order to eradicate inefficiencies that are caused by their size\textsuperscript{76}. Moreover, boards of directors were placed under greater obligation to report to boards of corporate auditors so that more information can be provided for audits. At the same time, it was clarified that such information gathering would be a cooperative task for boards of corporate auditors and boards of directors\textsuperscript{77}.

\textbf{<Changes in labor unions>}

In recent years, labor unions have changed from being established on a regional or industry basis to being established on a corporate basis. More and more employers are withdrawing from employers’ associations and each corporation is creating workers’ policies that are individualized and appropriate for each corporation. As a result, there is frequent conflict between micro-level corporate decisions, and macro-level central council and labor union goals. For instance, when Krupp made moves for acquisition in 1997, although the union IG Metall continued to resist, in the end Krupp employees expressed their support. Thus employees thought not of their class but of their own interests as a part of the corporation\textsuperscript{78}. Previously there had been deviations where corporations that were not raising profits because of a slump decided on lower wages or poorer working conditions in the actual working field than what had been decided during collective bargaining. However, this approach of reflecting the results of industry-level collective bargaining in wages and working conditions of various corporations within the industry is now seriously being challenged.

Underlying this change is that it is becoming difficult to maintain high wages, holidays and welfare benefits that have been established through the joint decision-making framework. This is because of the fact that in recent years, there have been concerns about unemployment, heavy welfare burdens and intensified foreign competition\textsuperscript{79}, in contrast to the period when the unemployment rate was low, the economy grew steadily and high-quality goods sold at high prices in the market. Furthermore, corporations in former East Germany after reunification were representatives in boards of corporate auditors (Japan Investor Relations and Investor Support, 2002).

\textsuperscript{76} KODEX 5.3, which states that audit committees “shall” be established but others “can” be established. In effect, for example, Schering has established committees for audits, research and development, human resources and operations. E.ON has established committees for audits, investment and operations. It appears that these committees contribute to improving efficiency in various business operations.

\textsuperscript{77} KODEX 3.4, etc.

\textsuperscript{78} Jackson, Höpner and Kurdelbusch (2002).

\textsuperscript{79} One of the reasons was that low-priced parts from Eastern Europe became available beginning in the 1990s, thereby causing severe pressures to cut costs in the economic slowdown that ensued after the reunification of East and West Germany.
not very willing to introduce the joint decision-making framework that would lead to a high-cost structure\(^80\).

<Introduction of management methods that place importance on stockholder value (SV)\(^81\)>

Another factor causing difficulty in maintaining the joint decision-making system is that corporations are proactively adopting management methods that place importance on stockholder value (SV) in light of emerging pressures from the stock market. Under management that places importance on SV, strategies that prioritize profit rather than growth and employment are preferentially selected. In fact, the proportion of core employment is declining because of the increasing frequency of suboptimal methods such as the contractual employee system, attrition of labor, early retirement and part-timers. Furthermore, since the mid-1990s, as there has been an increasing trend of salary and remuneration of employees being coupled with individual and corporate business performance, the system of even and stable salaries that had been in place until then is gradually falling apart.

4. Republic of Korea

(1) Progress in the reform of chaebols

One of the characteristics of the economic system in the Republic of Korea that distinguishes it from other Asian countries and regions is the existence of large corporate conglomerates called chaebols\(^82\), which wield overwhelming economic power in the national economy. This section will provide an overview of chaebol reform\(^83\) that was advanced by the Kim Dae Jung administration.

(a) Outbreak of the currency crisis and beginning of chaebol reform

\(^80\) In many state-owned enterprises in former East Germany, there was a strong tendency for party officials who were sent in as managers to play “ornamental” roles. Meisters and the managerial class were the ones that were responsible for actual management. As such, there was a great deal of camaraderie among employees. This created the sentiment of “We managed to survive the transition period together” after reunification. This then resulted in a stronger trend in former East Germany compared to former West Germany for employees to allow themselves more overtime work and limited wages.

\(^81\) Jackson, Höpner and Kurdelbusch (2002).

\(^82\) Ko’s (2000) definition of chaebols has been used here: “Large corporate conglomerates that are largely owned and controlled by the founding family and which have advanced multidimensionally into unrelated sectors as well (Ko (2000), p. 64).”

\(^83\) The People’s Solidarity for Participatory Democracy (PSPD), established in 1994, most actively carried out corporate governance-related activities from the viewpoint of stakeholders besides chaebols owners in parallel with the government’s efforts in chaebol reform. The PTSD’s goal is to supervise government power, but it has done more since the 1997 currency crisis. It has proactively proposed stockholders’ derivative actions for chaebols as well as stockholders’ proposals at stockholders general meetings, keeping in mind the viewpoint of minority stakeholders.
Since the 1990s, business conglomerates in the Republic of Korea have increased plant and equipment investment through diverse fund procurement means such as borrowing from banks and from non-financial institutions, direct finance and foreign capital. This eventually led to excessive investment, which triggered bankruptcies in one business conglomerate after another. The currency crisis broke out in 1997, which resulted in the Republic of Korea receiving emergency loans from the International Monetary Fund (IMF) in December\textsuperscript{84}. Kim Dae Jung, who was elected president in these circumstances, powerfully led chaebol reform even before his administration was inaugurated.

(b) Key points in chaebol reform

The next section will give an overview of chaebol reform advanced by the Kim Dae Jung administration. The four key points of chaebol reform can be summarized as follows.

The first point was to reduce the debt ratio\textsuperscript{85} by disposing of corporations with poor operation to improve the weakened financial structure of business conglomerates. The second point was to eliminate the so-called excessive diversification by carrying out the Big Deal (large-scale swapping of businesses). The third point was to improve the dysfunctional condition of internal governance resulting from the strong control exercised by the founding family in terms of ownership and management\textsuperscript{86}. The fourth point was to improve the dysfunctional condition of external governance whereby governance by capital markets does not function. The following will outline each of the four key points of chaebol reform by the Kim Dae Jung administration.

<Improving the financial structure of business conglomerates>

Business conglomerates expanded their business activities while highly dependent on borrowing from banks. As a result, their debt ratio rose and they faced a vulnerable financial system where they would have a high risk of defaulting if economic circumstances worsened. In response, in February 1998 the government announced its policy of reducing the debt ratios of the top 30 chaebols to below 200 percent by the end of 1999 and requested that this policy be put into effect.

Furthermore, high debt ratios of business conglomerates can be attributed to the fact that the custom of mutual debt guarantees had continued for a long time\textsuperscript{87}. In this custom, the core

\textsuperscript{84} Chaebol bankruptcies in 1997 are as follows: Hanbo (ranked 14\textsuperscript{th} in terms of asset value), Mitsumi (26\textsuperscript{th}), Jinro (19\textsuperscript{th}), Tenon (34\textsuperscript{th}), Kia (8\textsuperscript{th}), Haitai (24\textsuperscript{th}), New Core (25\textsuperscript{th}) and Hanra (12\textsuperscript{th}). In addition, the Daewoo Group went bankrupt in 1999 and Hyundai Group also fell into financial difficulty (Akama, et al. (2002), pp. 4-5).

\textsuperscript{85} The debt ratio is defined as debt divided by capital.

\textsuperscript{86} Ko (2000), p. 141.

\textsuperscript{87} It has been pointed out that through mutual debt guarantees, chaebol were able to borrow more and expand their businesses, but at the same time, this created a structure where a crisis of the credit-
company guaranteed the debts of the affiliated corporations. The government first required that the cross-industrial debt guarantees be eliminated by the end of 1998, and then, that all existing cross-subsidiary debt guarantees be eliminated by the end of March 2000.

<Eliminating the so-called excessive diversification through the Big Deal>

Under immense pressure from the government, the Big Deal was put into effect in order to eliminate the so-called excessive diversification of business conglomerates. The Big Deal targeted the five major corporate conglomerates (Hyundai, Daewoo, Samsung, LG and SK) representing the key industries and called for them to swap their businesses. Specifically, in line with its agreement with the government in July 1998, the Federation of Korean Industries (KFI) compiled the final draft of the Big Deal in October 1998. It announced a plan for large corporations to swap their businesses covering the seven industries of semiconductors, petrochemistry, automobiles, aircraft, railways, power generation infrastructure, and vessel engines and oil refining. Furthermore, after the business swapping plan was announced, the government set forth an aggressive industry specialization policy with the goal of clarifying the prospect of chaebol reform by the end of 1998 (announced as the Corporate-Government-Creditor Banks Agreement on Accelerating Restructuring of Big-Five Conglomerates).

<Remedying issues concerning internal governance>

Because business conglomerate owners held exclusive decision-making power, checks and balances were nonexistent in business conglomerates. For this reason, in order to remedy this situation where internal governance was dysfunctional, the government (i) abolished group chairmen and chairmen’s secretarial offices, and (ii) developed a system of outside directors. As for the former, before the currency crisis, business conglomerate owners reigned over the whole group as the group chairman, and the chairman’s secretarial office that assisted this role, and were involved in important decision-making for the entire group. Since the Commercial Code provides no grounds for these positions to exist, the government required that group chairmen and their secretarial offices be abolished so that management responsibility could be pursued. In conjunction with this, the government also developed a mechanism through which legal responsibility could be pursued by having business conglomerate owners serve as representative directors (equivalent to representative directors in Japan) in subsidiary companies guaranteeing core corporation would immediately lead to a crisis of the entire group (Fukagawa (2000), p. 198).

88 Mizuno (1999), p. 46.
90 For example, Chong Ju Yong, owner of the Hyundai conglomerate, assumed the post of representative director for Hyundai Construction (Yanagimachi (2001b), p. 199).
(implementation of a director system in effect).

As for the latter remedy, the government introduced and expanded a system of outside directors in order to strengthen the supervisory function of the board of directors and to curb the exclusive decision-making power of business conglomerate owners. Beginning in FY1998, listed companies were obliged to elect at least one outside director. In addition, large-scale listed companies with assets of over two trillion won were obliged to have more than half its board of directors composed of outside directors by the end of 2001\(^{91}\).

**<Remedying issues concerning external governance>**

In response to the issue that the governance of business conglomerates by outside economic entities was dysfunctional, the government undertook the following measures after the currency crisis: (i) increased the rights of minority stockholders; and (ii) obliged business conglomerates to create combined financial statements besides consolidated financial statements with a view to ensuring transparency in management.

First, in regard to (i), the rights of minority stockholders were strengthened so that the monitoring management by stockholders would be functional. To be specific, the government eased the conditions for stockholders’ derivative actions by minority stockholders as well as the conditions for requesting the dismissal of board members. At the same time, the government introduced a concentrated voting system for electing directors at the stockholders general meeting, which is equivalent to the cumulative voting system in Japan\(^ {92}\).

As for (ii), the government ordered the creation and release of combined financial statements, which aimed at disclosing the overall financial situation of business conglomerates. These combined financial statements are financial statements created by integrating corporate groupings after offsetting internal transactions such as investments, sales and debt-credit transactions between subsidiary companies of corporate groupings that are, in effect, controlled by business conglomerate owners (Economic Policy Direction for the Second Half of 2000, Ministry of Finance and Economy). With the consolidated financial statements that were obligatory before, it was difficult to gain an overall picture of the chaebol and financial information on the entire business conglomerate was unclear because of the complexity in investment and internal transaction relations among conglomerate subsidiaries. Thus, the combined financial statements aimed at remedying this situation\(^ {93}\) (Fig. 1.3.12).

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\(^{91}\) Ko (2001), p. 137.

\(^{92}\) Ko (2001), pp. 136-137.

(2) Current situation and issues of the corporate system

(a) Changes in the fund procurement structure

As capital markets did not develop in the Republic of Korea until the 1970s, it had a fund procurement structure that centered on borrowing from banks, which were tightly controlled by the government. In the 1980s, the government continued to exercise strong control over banks. For example, bank heads (bank presidents) were practically appointed by the government even after privatization. On the other hand, as a result of advancements in financial liberalization and fostering of capital markets, direct finance surpassed indirect finance in terms of fund procurement in the latter half of the 1980s. In the 1990s, as a result of eased conditions for issuing corporate bonds and commercial papers (CP), it became possible for the top business conglomerates to procure abundant funds through direct finance.

In addition, the government promoted business expansion and free entry of the second financial zone including securities companies, insurance companies, investment trust companies and
In response, business conglomerates entered this second financial zone which was under loose government control, and advanced the creation of financial institutions that they would be able to control. As a result, business conglomerates increased their fund procurement from the second financial zone beginning in the 1990s (Fig. 1.3.13).

With the liberalization of finance as such, business conglomerates, especially the top conglomerates, began to secure their own fund procurement sources that were independent from banks. These sources included direct finance, borrowings from the second financial zone and procuring funds from abroad. Thus, business conglomerates obtained a method with which they could increase their plant and equipment investment and foreign investment without being dependent on bank funds (Fig. 1.3.14). After the currency crisis as well, the use of direct finance methods such as stocks and corporate bonds is rising while borrowings from indirect financial institutions as a fund procurement method declined (Fig. 1.3.15).

Figure 1.3.13 Balance of borrowings of the top 30 chaebols

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<tbody>
<tr>
<td>Balance of borrowing of the top 30 chaebols from banks (A)</td>
<td>18,572</td>
<td>23,818</td>
<td>26,788</td>
<td>30,372</td>
<td>29,938</td>
<td>32,483</td>
<td>35,293</td>
</tr>
<tr>
<td>Ratio to total borrowing from banks</td>
<td>23.7</td>
<td>19.8</td>
<td>19.5</td>
<td>19.0</td>
<td>16.6</td>
<td>14.9</td>
<td>13.9</td>
</tr>
<tr>
<td>Balance of borrowing of the top 30 chaebols from the second financial zone (B)</td>
<td>7,047</td>
<td>14,902</td>
<td>20,316</td>
<td>26,547</td>
<td>31,926</td>
<td>38,128</td>
<td>52,689</td>
</tr>
<tr>
<td>Ratio to total borrowing from the second financial zone</td>
<td>32.4</td>
<td>37.8</td>
<td>36.6</td>
<td>35.9</td>
<td>37.1</td>
<td>37.2</td>
<td>38.4</td>
</tr>
<tr>
<td>Total borrowing of the top 30 chaebols (A) + (B)</td>
<td>25,619</td>
<td>38,720</td>
<td>47,104</td>
<td>56,919</td>
<td>61,864</td>
<td>70,611</td>
<td>87,982</td>
</tr>
</tbody>
</table>


General financial companies in the Republic of Korea refer to financial institutions authorized by the Law Concerning General Financial Companies established at the end of 1975 to undertake general financial operations such as banking and securities operations. General financial companies are an anomaly given the pro-specialization nature of financial institutions in the Republic of Korea because they undertake a wide range of operations. These operations include: borrowing and lending of foreign currencies; investment and loans to equipment funds and operating funds, discount, purchase and sales of corporate bills; call operations; underwriting, subscription and selling securities services; issuing corporate bonds and bills of bond; leasing operations; and securities funds.

(b) Changes in shareholding composition

Looking at shareholding composition, the biggest stockholders in the listed companies in the Republic of Korea are traditionally individuals, who accounted for 37.7 percent in 2000. Even though this figure shows a downward tendency in comparison to its 1980 level, individuals still hold the largest percentage of shares. Shareholding by corporations accounts for the next biggest share after individual shareholding. In this shareholding composition, the fact is that the family of...
business conglomerate owners holds a broad range of the business conglomerates’ stocks, either
directly or through its subsidiary companies. For example, the internal shareholding ratio of the
top 30 chaebols was 43.0 percent in April 1997 and 45.0 percent in April 2001. These figures
reveal that family control of corporations, with the business conglomerate owner at the top, still
maintains the position as the biggest and stable stockholder by combining the subsidiary
companies’ stocks and the corporations’ own stock (Fig. 1.3.16).

Conversely, foreign investors and institutional investors also comprise the stockholders other
than the family of business conglomerates described above.

First, although the presence of foreign investors cannot be ignored as their shareholding ratio is
rising, they are currently not a major shareholding entity compared to the family of business
conglomerates and subsidiary companies. For example, in terms of the net foreign investment
(amount of investment minus the amount of sales) in the year 2000, investment to Samsung
Electronics was 3.8 trillion won (33.4 percent), 3.39 trillion won (29.8 percent) to Hyundai
Electronics and 960 billion won (8.4 percent) to SK Telecom. These three companies account for
approximately 72 percent of the overall net foreign investment. As such, stock investment by
foreigners is concentrated on a number of blue-chip companies, so the position that foreign
investors hold among corporations in the Republic of Korea as a whole is quite limited. However,
there are also positive views concerning the enhanced role played by foreign investors.

Second, as for institutional investors, independent institutional investors have yet to be fostered
even after the currency crisis as chaebol-type financial institutions (securities companies, life
insurance, investment trusts, etc.) gained power as the key players in capital markets since the
1990s. Therefore, institutional investors cannot be expected to monitor business conglomerates in
the current situation. One of the issues that should be tackled in the future is to foster institutional
investors who are independent from business conglomerates, including foreign-affiliated
financial institutions. Nonetheless, some developments have been seen, such as the fact that
there has been (i) an influx of foreign capital in a number of non-bank financial institutions
(Hyundai Investment Trust Management, etc.); and (ii) the government has advanced reforms in
control structure including increasing the number of outside directors in non-bank financial
institutions.

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104 Ko (2001), pp. 142-143.
(3) Current situation and issues of chaebols in the Republic of Korea

(a) Vulnerable financial system

In response to the government’s policy of reducing the debt ratio of the top 30 chaebols by the end of 1999 that had been announced as a financial structural reform plan for chaebols, the debt ratios of the four top chaebols\(^{105}\) have achieved the target, reaching 174 percent at the end of 1999. Moreover, the debt ratio of the entire manufacturing industry, which includes the top four chaebols, was 396 percent in 1997, but it dropped to 182 percent in 2001. However, considering the fact that the amount of actual debt has not substantially decreased compared to the fall in the ratio, it may be that the fall in the debt ratio is the result of the increase in capital, which is the denominator of the debt ratio (Fig. 1.3.17). What is worth mentioning in relation to this is that subsidiary ownership by the top five chaebols rose rapidly because the regulation on investments to other companies\(^{106}\) was abolished with the amendment to the Monopoly Regulation and Fair Trade Act (Fair Trade Act) in 1998. Against this background, there is a high likelihood that the rise in capital held by business conglomerates was accomplished by increased investments to subsidiary companies\(^{107}\).

As the government has increased pressures to reduce the debt ratio, business conglomerates have merely reduced their debt ratios by changing their traditional fund procurement method from one based on debts such as mutual debt guarantees to one based on investments by subsidiary companies. Thus the problem with business conglomerates, namely their vulnerable financial

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105 They are called the four top chaebols because Daewoo, which was one of the top five chaebols, went bankrupt in 1999.

106 According to the Monopoly Regulation and Fair Trade Act (Fair Trade Act), “any company (excluding any company engaging in the financial or insurance business, and any holding company), belonging to a major business group shall be prohibited from acquiring or owning stocks of another domestic company in excess of an amount derived from the multiplication of its net asset amount by 25/100.”

system, has not been fundamentally resolved\textsuperscript{108}.

\textbf{Figure 1.3.17 Debt indices for the manufacturing industry}

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<tbody>
<tr>
<td>Debt ratio (debt/capital)</td>
<td>396%</td>
<td>303%</td>
<td>215%</td>
<td>211%</td>
<td>182%</td>
</tr>
<tr>
<td>Debt amount (entire industry, trillion yuan)</td>
<td>788</td>
<td>776</td>
<td>776</td>
<td>800</td>
<td>821 (June)</td>
</tr>
<tr>
<td>GDP ratio</td>
<td>174%</td>
<td>175%</td>
<td>161%</td>
<td>155%</td>
<td>152%</td>
</tr>
<tr>
<td>Interest coverage ratio</td>
<td>129%</td>
<td>68%</td>
<td>96%</td>
<td>157%</td>
<td>133%</td>
</tr>
<tr>
<td>Percentage of companies under 100%</td>
<td>...</td>
<td>...</td>
<td>33%</td>
<td>26%</td>
<td>29%</td>
</tr>
</tbody>
</table>

Note: Debt ratio: USA 159% (2001), Japan 160% (2000).
Original source: Bank of Korea.

\textbf{(b) Issue concerning the so-called excessive diversification}

In order to eliminate the so-called excessive diversification in business conglomerates, the top five \textit{chaebols} undertook reforms such as the Big Deal and industry specialization policy beginning in 1998. These efforts have brought about certain results, such as the fact that the number of subsidiaries of the top five \textit{chaebols} was halved and their key industries became specialized\textsuperscript{109}. However, there are problems, as described below, which remain unresolved.

First, at this stage it is difficult to evaluate the Big Deal as a success\textsuperscript{110}. Although a number of reforms succeeded, such as the one in the vessel engines sector and the buyout of Kia Motors Corporation by Hyundai Motor Company, other cases failed. For example, the merger of Samsung Motor Inc. and Daewoo Motor Co., Ltd., which had attracted the most attention in the Big Deal, ended in failure because Samsung Electronics Co., Ltd. applied for statutory management.

Second, there is a possibility that advancing the Big Deal created even more of an oligopolistic, competition-restricting domestic market than before\textsuperscript{111}. To be specific, monopolies emerged in the railway and power generation infrastructure industries where one firm controlled 100 percent of the domestic market. The semiconductor and other industries had oligopolies where two firms controlled the market. Thus, monopolization and oligopolization advanced in a number of industries (Fig. 1.3.18).

\textbf{(c) Ensuring the efficacy of internal governance}

With the aim to ensure the efficacy of internal governance in business conglomerates, the Kim Dae Jung administration (i) abolished group chairmen and chairmen’s secretarial offices and (ii) developed a system of outside directors. However, there are problems that remain, which are described below.

\textsuperscript{111} Ko (2001), p. 131.
First, as a solution to the problem of business conglomerate owners making decisions for the entire group by assuming the position of group chairman, a position for which the Commercial Code provides no grounds for its existence, the government abolished the position of group chairman in business conglomerates and made business conglomerate owners serve as the representative directors in the core company. However, the reality is that even though business conglomerate owners serve as presidents in the core company, they wield control over not only the core company but also the entire group. Given this, it can be presumed that the problem where internal governance is not functioning effectively has not been resolved after all\textsuperscript{112}. Still further, chairmen’s secretarial offices, which had assisted business conglomerate owners and had been involved in the group’s decision-making, continue to exist under a different name, as structural adjustment headquarters\textsuperscript{113}.

Moreover, although the number of outside directors has risen, it has been pointed out that in actuality, monitoring management is not functioning very effectively. For instance, a study by the Korea Listed Companies Association reveals that as of August 2000, outside directors were selected based on recommendations from major stockholders or operating officers in 79.8 percent of all cases and outside directors’ attendance rate at board of directors’ meetings was low at 53.5 percent. Given such findings, there is some validity in the assertion that the system of outside directors is not fulfilling its monitoring management function while maintaining its independence and expertise\textsuperscript{114}.

Figure 1.3.18 State of progress of Big Deal (as of December 2002)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Vision</th>
<th>Status</th>
<th>Progress</th>
</tr>
</thead>
<tbody>
<tr>
<td>Semiconductors</td>
<td>Samsung Electronics. Merger of Hyundai Electronics and LG Semiconductor: two-company structure</td>
<td>LG Semiconductor is taken over Hyundai Electronics; however, Hyundai Electronics (Hynx Semiconductors) face financial crisis.</td>
<td></td>
</tr>
<tr>
<td>Petrochemistry</td>
<td>Merger of Samsung General Chemicals Co. and Hyundai Petrochemical</td>
<td>D</td>
<td>The deal broke off due to the conflict over management authority and the failure of foreign capital inducement.</td>
</tr>
<tr>
<td>Home appliances</td>
<td>LG Electronics. Merger of Samsung Electronics and Daewoo Electronics through business conversion: two-company structure</td>
<td>D</td>
<td>Samsung-Daewoo business conversion fails. Daewoo Electronics was sold to foreign capital.</td>
</tr>
<tr>
<td>Oil refining</td>
<td>Hyundai Oil Refinery Co., Ltd. buys out Hanwha Oil Refining Co., Ltd. SK buys out oil refinery unit of Ssang Yong Co.</td>
<td>D</td>
<td>Hyundai-Hanwha deal was completed; however, the joint company proceeds with difficulty. SK-SsangYong failed. SsangYong independently proceeds with the sellout.</td>
</tr>
<tr>
<td>Aircraft</td>
<td>Merger of Hyundai Space &amp; Aircraft, Samsung Aerospace, and Daewoo Heavy Industries</td>
<td>D</td>
<td>Joint company established; however, the inducement of foreign capital failed.</td>
</tr>
<tr>
<td>Power generation infrastructure</td>
<td>Merger of Korea Heavy Industries &amp; Construction Co. and Hyundai/Samsung Heavy Industries</td>
<td>D</td>
<td>Merger was completed but the conflict continues between Hyundai and Samsung over management authority. The sellout to Korea Heavy Industry &amp; Construction, Doosan Group is advancing.</td>
</tr>
<tr>
<td>Railways</td>
<td>Merger of Hyundai Precision &amp; Industry Co., Daewoo Heavy Industries &amp; Machinery Co., Hanjin Heavy Industries &amp; Construction Co.</td>
<td>D</td>
<td>Proceeding with difficulty. Established the company; however, tangled with issues over management authority. It is possible to split off again.</td>
</tr>
<tr>
<td>Vessel engines</td>
<td>Korea Heavy Industries &amp; Construction Co. acquires the heavy industries sector of Samsung</td>
<td>D</td>
<td>Completed. (Joint company established.)</td>
</tr>
<tr>
<td>Automobiles</td>
<td>Hyundai Motor Company buys out Kia Motors Corporation Daewoo Motor Co., Ltd. merges with Samsung Motor Inc.</td>
<td>D</td>
<td>Hyundai-Kia successful, returns to profitability. Business conversion failed as Samsung Motor applied for statutory management. Samsung Motor was sold to Renault. Daewoo Motor was sold to GM.</td>
</tr>
</tbody>
</table>


\textsuperscript{112} Yanagimachi (2001a), p. 50.
\textsuperscript{113} Yanagimachi (2001a), p. 50.
5. Changes in the corporate economic system of Japanese companies

As the above sections have demonstrated, although there is diversity in corporate economic systems in different countries, a common direction has been confirmed that the countries are trying to improve these mechanisms. The above discussion has also touched upon the fact that in recent years, there have been new dynamic efforts aimed at a wide range of stakeholders being able to realize profits. These endeavors go above and beyond the previously developed form of governance which had focused on stockholders in capital markets. These developments can be seen in Japan as well and reforms are advancing in the economic system that centers on the corporate system. In particular, since the economic and social circumstances—which served as the precondition for conventional corporate governance to function—are changing radically, what is desired is the creation of a new corporate governance system that takes into consideration a wide range of stakeholders. The next section will offer a detailed analysis of the changes that are arising in the conventional system with a focus on the financial market and labor market in which changes are especially pronounced.

(1) Changes in the corporate system from the systemic viewpoint

Since the beginning of the 1990s, there has been a continuing trend that revisions are being made to the systems centered on the Commercial Code which regulate corporate activities. These revisions can be divided into two tracks: (i) revisions concerning the internal and external governance of corporations; and (ii) deregulation which enhances the degree of freedom in corporate activity and tightened regulations which increase supervision in corporate activity. This section will outline the major systemic changes concerning corporate systems that have taken place since the 1990s (Fig. 1.3.19). It will also give an overview of the system of companies with committees that uses outside directors, which is characteristic of US-style corporate governance. The revision of the Commercial Code in 2002 made it possible for corporations to adopt this system.

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(a) Major systemic changes concerning corporate systems

The main underlying factors of the systemic changes that took place in the beginning of the 1990s included the series of finance- and securities-related scandals which frequently erupted starting around 1990 including compensations for losses, *tobashi* (an illegal practice where a brokerage shifts securities investment losses suffered by a corporate client to another which operates under a different fiscal calendar) and payoffs to *sokaiya* (corporate racketeers) as well as demands by the US for Japan to increase its stockholders’ rights in the Japan-US Structural Impediments Initiative Negotiations in 1991.

In light of these circumstances, the board of corporate auditors was institutionalized in 1993 as an institution to check and supervise boards of directors, which was one of the causes of the scandals because the monitoring system was dysfunctional. In addition, the function of corporate auditors was reinforced by extending their tenure and introducing outside auditors. Furthermore, to make it easier for stockholders to exercise their rights, the commission for stockholders’ derivative actions was fixed at a standardized rate of 8,200 yen, which made it easier to put forth

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**Figure 1.3.19 Major systemic changes in corporate systems**

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
<th>Content</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>Revision of Commercial Code</td>
<td>Introduction of outside auditors and board of corporate auditors</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Extension of period of assignment of auditor (From 2 to 3 years)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Establishment of fixed price for stockholders' derivative action (8,200 yen per action)</td>
</tr>
<tr>
<td>1997</td>
<td>Revision of Commercial Code</td>
<td>Relaxation of acquisition of treasury stock (Introduction of stock option system)</td>
</tr>
<tr>
<td></td>
<td>Revision of Antimonopoly ACT</td>
<td>Lifting of ban on holding companies</td>
</tr>
<tr>
<td>1999</td>
<td>Revision of Commercial Code</td>
<td>Establishment of stock exchange and transfer system</td>
</tr>
<tr>
<td>2000</td>
<td>Revision of Commercial Code</td>
<td>Establishment of stock split system</td>
</tr>
<tr>
<td></td>
<td>Application of new accounting standards</td>
<td>Full-fledged transition to consolidated accounting system</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Disclosure of consolidated cash flow statements</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Introduction of tax effect accounting</td>
</tr>
<tr>
<td>2001</td>
<td>Revision of Commercial Code</td>
<td>Lifting of ban on treasury stock</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Establishment of system for new stock acquisition rights (improvement of stock option system)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Diversifying the kinds of stocks (Introduction of voting limited stock and recognition of tracking stock)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Increased strictness of conditions for outside auditor and expansion of composition ratio</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Enhancement of position of auditor and auditing functions</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Extension of period of assignment of auditor (From 3 to 4 years)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Reduction in the liabilities of directors and auditors in a stockholders' derivative action</td>
</tr>
<tr>
<td></td>
<td>Application of new accounting standards</td>
<td>Introduction of accounting that takes into account retirement benefit costs</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Introduction of current value accounting for financial products</td>
</tr>
<tr>
<td>2002</td>
<td>Revision of Commercial Code</td>
<td>Selective introduction of company with committee system</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Establishment of assets and loan management committee</td>
</tr>
<tr>
<td></td>
<td>Application of new accounting standards</td>
<td>Diversifying the kinds of stocks (rights to select and dismiss directors and auditors)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Introduction of current value accounting for crossheld stock</td>
</tr>
</tbody>
</table>

Source: Created by METI from various materials.
stockholders’ derivative actions that pursue the responsibility of the directors of companies.\textsuperscript{116}

Since then, corporations have faced demands to increase transparency in disclosure and place importance on stockholders as a result of strengthened market effects and monitoring functions for corporations brought on by a series of market reforms epitomized by the financial Big Bang. Moreover, there was a greater need for Japanese corporations to heighten their international competitiveness in response to the advancement of economic globalization and intensified international competition.

In the context of these developments, there was pursuit of a direction to further strengthen monitoring management by introducing new accounting standards that respond to international standards and strengthen the function of auditors. At the same time, there was also pursuit of a direction to create a more flexible decision-making system symbolized by lifting the ban on holding companies, among other things.

In addition, in terms of the direction to allow a greater degree of freedom in management, one of the systemic changes that took place throughout the 1990s was the elimination of restrictions on acquisitions of treasury stock for which there had been stringent limitations in the past considering the perspective of protecting creditors.

Restrictions on the acquisition of treasury stock were eliminated one by one in order to fulfill goals such as introducing a stock option system, returning profits to stockholders and improving balance sheets, and for the most part the goals have been fulfilled by the revision of the Commercial Code (lifting the ban on treasury stock and establishing the new stock acquisition rights) in 2001.

Furthermore, in the course of eliminating the series of restrictions on the acquisition of treasury stock, a stock exchange and transfer system was created in 1999, which allows the acquisition of corporations through treasury stock as well as establishments of holding companies. A corporate split system was established in 2000 that enabled division and acquisition of businesses by treasury stock allocation. The introduction of these systems allowed corporations to restructure their businesses more flexibly and promptly.

As such, although a variety of systemic changes concerning the corporate system, characterized by the revision of the Commercial Code, took place during the 1990s, there were no significant changes to the basic governance system focused on the board of directors and board of corporate auditors. Nevertheless, as a result of the revision of the Commercial Code in 2002 (which went


\textsuperscript{116} After 1993, the number of stockholders’ derivative actions increased rapidly. Against this backdrop, there was criticism that the possibility of high liabilities served as an extreme deterrent for management. With the revision to the Commercial Code in 2001, a system was introduced whereby it was possible to reduce the amount of liabilities to six times the remuneration for president, four times for internal directors other than representative directors and twice for outside directors and auditors.
into effect on April 1, 2002), Japanese corporations\(^{117}\) were able to select a corporate governance system that incorporates the so-called US-style system of companies with committees. Moreover, the revision of the Commercial Code also allowed the establishment of assets and loan management committees\(^{118}\). Items of arbitrary decision by board of directors could be partially delegated to the assets and loan management committee in order to realize flexible decision-making in management even if the corporations have conventional systems.

As of March 2003, around 40 corporations have announced their decision to convert to companies with committees\(^{119}\). In comparison to the number of corporations that have announced their decision to convert to the system of companies with committees, there are fewer corporations that have announced their decision to establish assets and loans committees, but in April 2003 Honda Motor Co., Ltd. announced that it would establish an assets and loan committee. The system is elective, and even though many corporations continue to use their current and conventional governance system for the time being, it is true that they now have more choices in terms of the type of management, which enables them to adopt a governance system that suits the needs of each corporation.

**(b) Overview of companies with committees**

**<Conditions of companies with committees>**

With the revision of the Commercial Code in 2002 (which went into effect on April 1, 2002), it became possible for joint-stock companies that are “large companies” or “deemed large companies” to convert to “companies with committees” (Fig. 1.3.20) if they meet the following conditions.

\(^{117}\) Corporations that can adopt the system of companies with committees (the same goes for assets and loan management committees) must be either “large companies” with more than 500 million yen in capital or more than 20 billion yen in debts on the balance sheet, or “deemed large companies” that are audited by accounting auditors among the corporations with more than 100 million yen in capital and under 20 billion yen in debts on the balance sheet.

\(^{118}\) Assets and loan management committees can be established by “large companies” or “deemed large companies” that fulfill the following conditions: (i) the board of directors has ten or more members, of whom one is an outside director; (ii) assets and loan management committees are composed of three or more directors; (iii) delegated by the board of directors; (iv) continuation of the board of corporate auditors. Generally in Japanese corporations, in cases when there are many members of the board of directors, many corporations have a structure where they delegate actual decision-making to management committees or executive directors’ meetings in order to realize flexible decision-making. In corporations with a conventional system of boards of corporate auditors, assets and loan management committees provide legal grounds for management committees and executive directors’ meetings, allowing them to make decisions in management both in name and substance. Assets and loan management committees can make decisions on their own on matters that boards of directors have delegated to them (disposing or granting crucial assets or large debts), thus enabling more flexible and prompt decision-making.

\(^{119}\) Nihon Keizai Shimbun (March 30, 2003).
The current auditing system should be eliminated and the three committees—the audit committee, nomination committee and remuneration committee—should be established with the following functions.

**Audit committee:** Auditing and monitoring of the enforcement of duties of directors and officers. Decisions on agenda items submitted to Stockholders General Meeting pertaining to the selection and dismissal of accounting auditors as well as the decision not to reappoint the accounting auditors.

**Nomination committee:** Decision on bills concerning the selection and dismissal of directors that will be submitted to the Stockholders General Meeting.

**Remuneration committee:** Decision on remunerations for directors and officers.

- Each of the committees shall be composed of three or more members, among whom half must be outside directors\(^\text{120}\).
- The board of directors shall select and dismiss CEOs and officers and delegate the daily enforcement of duties.
- The tenure of directors shall be one year.

Figure 1.3.20 Overview of the governance system of companies with committees

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\(^{120}\) Here, outside directors are defined as people who have not served or are not currently serving as executive directors, officers, managers or other employees of the corporation in question or any of its subsidiary companies.
Generally speaking, Japanese corporations have many members on their boards of directors, which led to criticism that decision-making takes a long time and hampers prompt management decisions.

Furthermore, there was progress in a series of financial deregulation measures as a part of the financial Big Bang that advocated the three principles of “free,” “fair” and “global.” In addition, there were also cases where stockholders, namely foreign investors and institutional investors, demanded a stricter supervision of a corporation’s profits and performance, as well as its transparency in management. Given these developments, combined with the occurrence of corporate scandals, there have been demands from the market to strengthen monitoring management.

In order to respond to these demands, the boards of directors in companies with committees have delegated a great deal of their authority in the enforcement of duties to representative officers and officers. Therefore it is expected that effective and prompt decision-making can be accomplished by shifting its axis to management supervisory functions centering on each committee, of which the majority of its members are outside directors, and by clearly dividing the roles of management supervision and enforcement of duties.

It is also expected that having the majority of the members of the committees within the board of directors be composed of outside directors will prevent representative officers and top management from running amok and lead to more transparent management. In addition, setting one year as the maximum tenure for a director makes it easier to bring in new faces to the board of directors, thereby strengthening the management monitoring function.

The above has provided an overview of the companies with committees, but there are certainly problems with this system as well. The problem that has also been pointed out by corporations that have not announced their intention to convert to companies with committees is the lack of human resources that could serve as outside directors in Japan, who are expected to play a significant role in this system. As one of the reasons for this, it has been pointed out that Japan has had, in principle, a lifetime employment system under which few opportunities have been provided for people to be involved in the management of other companies. In addition, the human resources market for managers has not fully developed, which causes difficulties in securing distinguished, independent outside directors.

Furthermore, there is another problem with the committee system that has also been identified in the US, which has already adopted the committee system. Even though nomination committees exist in the US, in many cases outside directors are appointed upon recommendation by the CEO and nomination committees do not do much more than approve the CEO’s recommendations. Thus, it has been pointed out that the actual monitoring management function deteriorates as a result of collusive relations that have developed through practices such as CEOs
eventually assigning their acquaintances or CEOs serving as outside directors at each other’s corporations. In addition, one of the problems with the provision of information to outside directors is that although outside directors are management professionals, they are not particularly knowledgeable about the internal situation of corporations, which is why it is essential to have an information provision system for appropriate management decisions. However, in many cases information is provided to outside directors by CEOs, who may only give them information that is to their advantage. For this reason, it has been pointed out that there is a possibility that outside directors are unable to make appropriate decisions. Another problem with the system of companies with committees is that in the majority of US corporations, one person concurrently holds the posts of Chairman of the Board of Directors, who is the head of the board of directors, and CEO, who is the head officer. It has been pointed out that because power is too concentrated on one individual, the monitoring management function is not fully effective\(^\text{121}\), which has stirred concern that the same problem will occur in Japan as well.

(c) Future trends in corporations

Although at present there are few corporations that have announced their intention to convert to companies with committees, it is expected that stockholders, namely foreign investors and institutional investors, will increase pressures on corporations to convert to companies with committees because this system, which uses independent outside directors, apparently strengthens the monitoring management function.

Nonetheless, it does not mean that simply converting to companies with committees will invoke a positive evaluation from stockholders. The governance system needs to be fully functional and be able to secure independent outside directors and provide information appropriately to outside directors. Furthermore, whether a corporation chooses a conventional governance system or a new one, what is important is that top management is accountable for why they chose to adopt it to stakeholders, who are represented by stockholders, in order to gain their understanding. It is also important for corporations to adopt a governance system that is better suited for them so the system can function effectively.

Leading electronic manufacturers such as Sony Corporation, Toshiba Corporation and Hitachi Ltd., as well as ORIX Corporation and Seiyu Ltd. which became a subsidiary of a foreign affiliate, have announced that they will convert to companies with committees. Meanwhile, corporations such as Toyota Motor Corporation and Matsushita Electric Industrial Co., Ltd. have decided to reform their boards of directors while maintaining their current system. In light of these

\(^{121}\) In the UK-style corporate governance system, which has the same system of companies with committees, the Combined Code stipulates the division of the chairman of the board of directors and CEO. In Japan, Sony Corporation has announced that it has separated the roles of the chairman of the
developments, it is expected that there will be progress in corporate governance reform in each corporation as they maintain their diversity.

This section has examined systemic changes with a focus on the revision of the Commercial Code in the 1990s that were enacted keeping public companies in mind. However, over 99 percent of joint-stock companies in Japan are non-public, and there are many commercial companies besides public companies including limited companies. Moreover, in recent years, specified nonprofit organizations (NPOs) have become remarkably active in a wide range of fields in the economy and society. As a result, governance regarding such NPOs will be an issue that will need to be tackled in the future.

(2) Looking at changes in the corporate system through the actual situation

The Japanese-style management system was supported by two things: a fund procurement structure backed by main bank relations and the silent stable stockholders and cross-held stocks propped by these main bank relations and transactions between affiliated companies. This section will elucidate how these systems have changed in recent years.

(a) Looking at transformations in main bank relations through changes in the fund procurement structure

Since the latter half of the 1980s, fund procurement from capital markets increased primarily among large corporations as financial deregulation progressed. Banks, who lost their exceptional borrowers, put excessive focus on the collateral value of real estate and increased their loans to small and medium-sized enterprises and some parts of service industries such as the construction and real estate industries. Although it is believed that the function of main banks were weakened in light of these circumstances, the economic growth and soaring real estate prices during this period contained the actual occurrence of corporate bankruptcies, which helped avoid the manifestation of the weaknesses. However, bailouts by main banks, which had been depleted much of their strength, did not necessarily succeed after the 1990s, a decade during which economic stagnation and asset deflation continued. In addition, given the successive large-scale bankruptcies that occurred, fewer people held the belief that the main banks would not allow their main customer corporations to go bankrupt. It is understood that these developments have influenced the transformation of main banks being manifested in a more conspicuous way.

Furthermore, throughout the 1990s, corporations were less eager to make plant and equipment investments due to the economic downturn as well as other factors. Since the second half of the
1990s, there were some cases, especially among large corporations, where they adjusted their balance sheets by repaying loans that they had obtained during the bubble period using surplus such as free cash flows, or buying back their own stocks.

Figure 1.3.21 indicates the dependency on borrowing from financial institutions. Large companies’ dependency on borrowing from financial institutions was mostly flat in the first half of the 1990s, but began to decline in the second half of the 1990s. For small and medium-sized enterprises, their dependency on borrowing from financial institutions rose throughout the 1990s, which peaked out in FY1998 and began to decline. These declines in dependency are seen as effects of the banks’ reluctance to lend money, but at the same time, these are assumed to be the results of adjustments made to balance sheets by the corporations themselves. Furthermore, Figure 1.3.22 depicts the breakdown of the balance of financial liabilities in stock-based private-sector non-financial corporations. Equity finance, which surged around 1990, fell around FY1994. Due to the effects of the banks’ reluctance to lend money as well as the information technology (IT) boom, it is difficult to observe a clear unidirectional trend. However, the borrowing ratio, which stood at 43.0 percent in FY1994, after repeated fluctuations, fell to 38.0 percent in FY2001. As main bank relations are currently undergoing transformation, it is possible to assume that corporations are adjusting their balance sheets in order to shrink their borrowing ratio.

![Figure 1.3.21 Dependency on borrowing from financial institutions](chart.png)

In the period when corporations were dependent on borrowing from banks for most of their fund procurement and banks played both the roles of creditor and major stockholder in the cross-held stock structure, banks supervised corporate management. For example, at a time of financial crisis, banks provided corporations with financial support and sent in their own executives, which served to ensure that corporate governance was exercised in these corporations. However, as main bank relations are currently undergoing transformation, and taking into consideration the fact that banks play less of a role in fund procurement because of balance sheet adjustments made on the
corporate side, it can be noted that the role that banks play in corporate governance is diminishing at least in large corporations.

(b) Changes in shareholding composition

Figure 1.3.23 depicts the trends in Japan’s shareholding composition. One of the characteristics is that the holding ratio of financial institutions and non-financial companies was on a downward trend in the 1990s. The total shares held by these two parties fell 16.6 percent, from 68.5 percent in FY1990 to 51.9 percent in FY2001.

This trend in the shareholding composition is believed to be result of the fact that the cross-holding of stocks between corporations, including banks, is rapidly being eliminated. In the 1990s, the disposal of non-performing loans and falling rates of return in financial institutions was identified as a problem. Against this backdrop, financial institutions did not have the luxury of holding their customers’ stocks. At the same time, because of the transformation of main bank relations, there was not much of a point on the corporate side to hold the stocks of financial institutions. Furthermore, progress in the withdrawal of the relations among affiliated companies has also been a factor in the decline in cross-held stock and stable holding. In addition, another factor that has contributed to this trend is the introduction of current value accounting for shareholding. Likewise, the fact that it became necessary to conduct current value assessments every term even for cross-held stock, which caused fluctuations in profits in terms of accounting, also served as a factor in driving the sale of stocks.

Looking at Figure 1.3.24, the cross-stockholding ratio fell, on a cash basis, from 18.0 percent in FY1990 to 8.9 percent in FY2001. The stable holding ratio also fell from 45.6 percent in 1990 to 30.2 percent in FY2001 on a cash basis. These figures demonstrate that there has been progress in the withdrawal of cross-held stock and stable holding.
Meanwhile, institutional investors and foreign investors which are made up of investment trusts and pension trusts may take over these cross-held stocks. The total shares held by investment trusts and pension trusts rose from 4.6 percent in FY1990 to 9.3 percent in FY2001. The shares held by foreign investors, which drastically increased, surged from 4.7 percent in FY1990 to 18.3 percent in FY2001.

One of the underlying factors of the increase in shares held by foreign investors is the fact that diversified international investment is rising throughout the world. In addition, another possible factor is that a series of financial deregulatory measures were taken, such as the liberalization of stock brokerage fees resulting from the financial Big Bang and revisions of the Foreign Exchange and Foreign Trade Control Law. It is believed that these foreign investors include foreign institutional investors represented by CalPERS. On the domestic front, the share of investment trusts and pension trusts are also increasing. If these foreign and domestic developments are taken into consideration, it can be concluded that institutionalization is also occurring in Japan, as it has in the US and UK.

If circumstances such as the aging of Japan’s society and the introduction of the defined contribution pension plan are considered, it is expected that institutional investors will play a significant role in corporate governance. This will be accomplished through the further increase in the invested asset balance of investment trusts and pension trusts in the future and the increase in the proportion of institutional investors in shareholding entities.

Generally, cross-holders and stable stockholders will not attempt to sell stocks even if there are slight fluctuations in corporate profits and stock prices as long as collaborative relations in business are stable. However, because the basic purpose of institutional investors including foreigners who hold stocks is to secure investment returns, they attempt to improve corporate management through means such as selling the stocks that they hold, despite criticism that this seems to be the Wall Street Rule, and exercising their voting rights at the stockholders general meeting if corporate profitability is worsening and stock prices are falling. In other words, the constant monitoring of corporations by the market reinforces the system of checks and balances in management and intensifies the pressure to improve management.

Nevertheless, seeing that there are free rider and cost-benefit problems with institutional investors as well, not all of them are proactively taking action in corporate governance. Some of the major issues that need to be tackled in the future include how to functionally activate institutional investors instead of putting automatic expectations on them and how to recall private investors to the stock market and foster them since their holding ratio has dropped in recent years.
An example of a measure taken by institutional investors>

Here the pioneering measure taken by the Pension Fund Association (PFA) will be examined as an example of a pension fund whose purpose of investing is to guarantee long-term returns, and which has generally been noted for its high degree of awareness regarding corporate governance, even among institutional investors that exercise voting rights at the stockholders general meeting for pension funds (Fig. 1.3.25). Overall, the PFA voted against 234 corporate bills, which accounts for 24.1 percent of the 970 corporate bills for which a vote was cast at the stockholders

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The PFA began to exercise direct voting rights as it commenced indexing for internal management in April 2002.
general meeting.

The highest percentage of dissenting votes cast by the PFA was on corporate bills regarding amendments to a part of the articles of association, which accounted for 48.9 percent. A majority of these bills were on lowering the quorum for special resolutions at the stockholders general meeting and the reason why they were voted down was that specific reasons for change, such as the need for the changes, were not clearly indicated. The next highest percentage of dissenting votes is attributed to corporate bills on retirement bonus gifts for retired directors, which accounted for 42.9 percent. The PFA voted against them because it believed that providing retirement bonuses to outside directors and outside auditors, for whom there are high expectations that they will keep top management in check, was problematic from the perspective of independence. Furthermore, the PFA voted against providing retirement bonuses in cases where business responsibility should be questioned in response to the prolonged business slump that had continued. In addition, 20.3 percent of the PFA voted against the selection of directors and 33.3 percent voted against remunerations for directors.

Such proactive use of voting rights sheds light on the fact that institutional investors are beginning to have a greater awareness of corporate governance as well as the checks and balances in management.

**Figure 1.3.25 Status in exercising of voting rights at companies invested by the Pension Fund Association**

<table>
<thead>
<tr>
<th>Bills discussed at the General Meeting</th>
<th>Number of bills</th>
<th>Against</th>
<th>For</th>
<th>Percentage of dissenting votes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selection of the director</td>
<td>138</td>
<td>28</td>
<td>110</td>
<td>20.3%</td>
</tr>
<tr>
<td>Remuneration for the director, etc.</td>
<td>8</td>
<td>2</td>
<td>4</td>
<td>33.3%</td>
</tr>
<tr>
<td>Selection of the auditor</td>
<td>124</td>
<td>14</td>
<td>100</td>
<td>12.9%</td>
</tr>
<tr>
<td>Remuneration etc for the auditor, etc.</td>
<td>8</td>
<td>0</td>
<td>8</td>
<td>0.0%</td>
</tr>
<tr>
<td>Processing of profit, etc.</td>
<td>161</td>
<td>26</td>
<td>135</td>
<td>16.1%</td>
</tr>
<tr>
<td>Stock option</td>
<td>34</td>
<td>5</td>
<td>29</td>
<td>14.7%</td>
</tr>
<tr>
<td>Establishment of the limitation on treasury stock acquisition</td>
<td>95</td>
<td>5</td>
<td>90</td>
<td>5.3%</td>
</tr>
<tr>
<td>Retirement bonus gift for retired directors</td>
<td>133</td>
<td>57</td>
<td>76</td>
<td>42.9%</td>
</tr>
<tr>
<td>Amendment to a part of the articles of association</td>
<td>184</td>
<td>90</td>
<td>93</td>
<td>48.9%</td>
</tr>
<tr>
<td>Merger, partition, transition into holding company</td>
<td>39</td>
<td>3</td>
<td>35</td>
<td>5.1%</td>
</tr>
<tr>
<td>Transfer of business</td>
<td>6</td>
<td>1</td>
<td>4</td>
<td>16.7%</td>
</tr>
<tr>
<td>Decrease in capital reserve</td>
<td>22</td>
<td>1</td>
<td>20</td>
<td>4.5%</td>
</tr>
<tr>
<td>Total</td>
<td>970</td>
<td>234</td>
<td>732</td>
<td>24.1%</td>
</tr>
</tbody>
</table>

Note: 1. Data covers 212 companies which held a Stockholders General Meeting between July 2002 and March 2003.
2. The total number of votes against and for do not match the number of bills due to abstention votes.
Source: Pension Fund Association.

Moreover, in February 2003 the PFA announced the *Kabunushi Giketsuken Koushi Kijun* and decided that it would begin exercising voting rights according to these standards in April 2003. The standards clearly stipulate that Corporate Governance Principles should be followed by corporations and Specific Voting Standards for the voting rights. Based on the stipulation, the standards position voting rights as an essential means of raising stockholder value and requires stockholders to exercise voting rights in an appropriate way so that fiduciary can be fulfilled.

**c) Dynamic changes in the governance environment in the stock market**
<Trends in M&A>

As the fund procurement structure that had been supported by main bank relations are changing, it is likely that M&A such as TOBs has been aggressively utilized in business revival or business restructuring.

Here the trends of M&A in the last ten years will be examined (Figs. 1.3.26, 1.3.27, 1.3.28). In Japan, cash-based M&A peaked out in 1999. Due to the contraction in large projects that took place during the IT boom, cash-based M&A fell steeply, reaching a level equivalent to approximately a quarter of what it was at its peak. In terms of the number of transactions, M&A peaked out in 2000 and its magnitude of decline, or approximately 10 percent, was smaller than for cash-based M&A. In the UK during the same period, cash-based M&A in 2002 was approximately a quarter of its peak in 1999, a magnitude of decline that was similar to Japan’s. The number of transactions in the UK has fallen below 60 percent in comparison to its 2000 peak figure. Furthermore, as for the level of M&A in the US in 2002, cash-based M&A had decreased to about a quarter of its 1999 peak figure. This trend is similar to Japan and the UK, but the number of transactions has fallen greatly to about half of the peak figure in 1998.

One of the reasons why the magnitude of the decline in the number of cases in Japan was small is that various corporations, including foreign affiliates, are beginning to make full use of M&A in business revival and business restructuring. Although the transaction value per transaction has been reduced, this has resulted in minimizing the margin of decline in the number of transactions. It is expected that in the future, business revival and industrial restructuring will be further bolstered by measures such as fundamental revisions of the Industrial Revitalization Law, establishment of the Industrial Revitalization Corporation of Japan and formulation of the Guidelines for Early Revitalization of Business. Given these circumstances, there are expectations that M&A will be more than just a temporary boom and that it will be developed further as it maintains its effectiveness.

Figure 1.3.26  Trends in M&A in Japan

Note: Rank value=The transaction value subtracted from debt transferred+short-term debt+straight debt+preferred stocks-cash+marketable securities=transaction value including net debt
Source: The Thomson Corporation.
<Initial public offering (IPO) and trends in bankruptcies of listed companies>

Japan has also expanded its opportunities for IPO with the purpose of facilitating fund procurement for newly established companies who are expected to show great potential for growth such as venture businesses. For example, a new stock market called Mothers was established at the Tokyo Stock Exchange in November 1999 and Nasdaq Japan at the Osaka Securities Exchange in May 2000.

Note: Rank value=The transaction value subtracted from debt transferred+short-term debt+straight debt+preferred stocks- (cash+marketable securities)=transaction value including net debt
Source: The Thomson Corporation.
Figures 1.3.29, 1.3.30 and 1.3.31 illustrate trends in IPO in Japan, the US and UK. In Japan, the number of transactions marked the highest level of the past decade in 2000 due to the effects of the IT boom and launching of new stock markets. Since then, the number of IPO transactions has been on a downward trend because of the effects of slumping stock market prices, among other factors. In 2002 the number of IPO transactions had declined to a little over 60 percent of its peak level. In the UK, in 2002 this figure had fallen to below 30 percent of its peak in 2000. In the US, the number of IPO transactions in 2002 fell below 20 percent of its peak level in 1996. Thus, relatively speaking, the drop in the corresponding figure is small in Japan. Furthermore, it has been noted that there is a significant reserve of companies that plan to list their stocks but have postponed their release date because of slumping stock market prices, which sheds light on the high level of interest that Japanese corporations have in IPOs.

Meanwhile, along with mounting pressure on banks to dispose of their non-performing loans, the business environment surrounding corporations faced with stagnant business performance and excessive debt has become even more severe due to the protracted recession. As a result, it is no longer unusual for listed companies to go bankrupt. According to Figure 1.3.32, which shows the trends in bankruptcies in listed companies in Japan, there were only 16 bankruptcies of listed companies throughout the 1980s. However, this figure has been on an upward trend since the mid-1990s. It peaked in 1997 with 14 cases. Although the number of cases fell slightly in 1998 and 1999, it resumed its upward trend, marking its post-World War II high in 2002 with 29 cases.
Figure 1.3.30 Trends in IPO in UK

Source: The Thomson Corporation.

Figure 1.3.31 Trends in IPO in US

Source: The Thomson Corporation.

Figure 1.3.32 Trends in bankruptcies of listed companies in Japan

Source: Survey of Trends in Bankruptcies of Listed Companies 2002 (Teikoku Databank, Ltd.).
(d) Summary

As the above has explicated, the analysis of corporate governance in a limited scope in financial markets centering on stockholders reveals the changes in main bank relations as well as shareholding composition and revitalized M&A and IPO. In terms of systemic changes, since April 2003, companies have been able to adopt a system of companies with committees. In this context, there are many points in common with US-style corporate governance.

An underlying factor in these developments was that the US economy was booming in the 1990s and the US-style corporate system was at its best. This, in turn, has brought about the global trend to adopt US-style corporate governance, characterized by its use of market mechanisms.

On the other hand, it became clear that US-style corporate governance had its own share of problems, as was seen in the frequent occurrence of corporate scandals since late 2001 that were exemplified by the Enron and WorldCom incidents. In addition to these events, as there were Japanese corporations showing strong management performance using the conventional system, some held a view only emphasizing positive features of Japanese corporate governance and disregarding the necessity for corporate governance reform.

However, the fact that there were flaws in the US-style corporate governance which was supposedly at its best should more than stress the shortcomings of the US-style corporate governance system. The flaws in US-style corporate governance has merely elucidated that constant efforts toward reform are necessary in order to establish a better corporate governance system that responds well to the times and circumstances as there is no “final version” or “complete version” of the corporate governance system, and no single corporate governance system suits every corporation as corporations have their individual circumstances.

In fact, in response to the string of corporate scandals, the US has made unremitting efforts toward reform. For example, it immediately established the Sarbanes-Oxley Act in July 2002. Similarly, Japan needs to do more than merely devote itself to discussions on choosing one or the other—the conventional Japanese system or the US-style system. Instead, it should continue reforms with the intention of establishing a better corporate governance system that can respond to Japan’s unique economy and culture.

(3) Changes in labor-management relations

This section will primarily focus on the relations between corporations and employees, who are the major players. Together with main bank relations, this is an important issue of Japanese-style corporate governance. In recent years, there has been a trend of increased employment market mobility. With the introduction of a new salary system characterized by performance-based salaries and the annual salary system, presumably, labor-management relations are also changing. This section will examine changes in labor-management relations, focusing on changes in the
Shunto, or spring labor offensive, which serves as an indispensable opportunity in which employees (labor) and corporations (management) to negotiate wages and working conditions.

(a) Trends in the Shunto

<Trends in the 2002 Shunto>

The 2002 Shunto was launched amidst increasingly severe employment conditions as indicated by the unemployment rate rising to 5.5 percent in December 2001 in response to the worsening economic climate.

The management side exhibited powerful resistance to raising wages arguing that it was “necessary to take the plunge to implement unprecedented measures that go beyond deferring pay raises and freeze or review steady wage increases as well as temporary work-sharing as an emergency escape. Meanwhile, the Japanese Trade Union Confederation (RENGO), representing labor, decided that it would in effect defer its unified wage demand, the first time doing so since its establishment in 1989. RENGO also decided that its wage increase standard would be the level maintained by the wage curve plus something extra, which meant that RENGO’s demand ended up focusing more on securing employment rather than wage increases.

Both management and labor were in accord on the viewpoint of securing and maintaining employment, and many unions decided to defer wage increases. Even for unions that demanded wage increases for industries such as automobiles and shipbuilding, management responded that none of these industries would get wage increases. Moreover, after the date when responses were to be released simultaneously, management revealed one measure after another as part of the “wage lowering counterproposals” (emergency labor measure) for leading electronic manufacturers. These measures included wage cuts, postponing wage increases and lowering overtime wage rates. Hence these developments illustrate that Shunto itself had reached a significant turning point in its history.

As a result, the spring wage increment rate was 1.66 percent (for leading companies according to the Ministry of Health, Labour and Welfare). This was even lower than the 2.01 percent wage increment in 2001 when the wage increment remained close to the standard level of 2 percent. It is likely that this low wage increase reflects the fact that wage increases were kept at zero and that some corporations reviewed their standard wage increments (Fig. 1.3.33).

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126 The Institute of Labor Administration (2003), p. 38.
As Figure 1.3.34 illustrates, the 2003 Shunto was launched amidst management taking an even tougher stance on annual wage increments.

First, the Japan Business Federation (Nippon Keidanren), representing management, released the 2003 Nenban Keiei Roudou Seisaku Iinkai Houkoku on December 17, 2002. In this paper, the 2003 Shunto was described as follows: “The social phenomenon of the Shunto that intends to create across-the-board wage increases is over. Today, rather than wage levels and the amount of wage increases, the two sides are more concerned with discussing how to create personnel and wage systems to stimulate high value-added labor while making utmost efforts to maintain employment for corporations to be able to survive.” Regarding wage increases, this position paper contends that “management and labor are attempting to determine wages in a practical manner in the face of a deflationary spiral. Maintaining and strengthening competitiveness precludes any further rise in nominal wage levels, and increasing base wage levels is out of the question. Freezing or reviewing the annual wage increment in line with reforming wage systems is another issue that could come up for discussion.” Therefore, this paper reveals that management intends to reform annual wages in addition to keeping wage increments at zero.

Meanwhile, RENGO announced the 2003 Shunki Seikatsu Tousou: Immediate Policies (2) on January 10, 2003. This paper placed top priority on efforts to maintain and stabilize employment. In terms of wages, this paper set out a policy aiming at securing the wage curve. The paper’s

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128 Until the 2002 edition, the former Japan Federation of Employers’ Associations announced this as the Roudou Mondai Kenkyuu Iinkai Houkoku. The title was changed after the Japan Federation of Employers’ Associations and the Japan Federation of Economic Organizations merged.
position meant that RENGO would, as it did the previous year, forego its unified wage demand and secure annual wage increments. Furthermore, the paper mentioned promoting the improvement of benefits for part-time workers and others, and equal treatment. In addition, the paper touched upon promoting efforts to eliminate unpaid overtime (voluntary overtime work) and reduction of total working hours. From this, it can be concluded that RENGO is shifting to the policy of Shunto centering on wage negotiations.

Figure 1.3.34 Future directions for wage determination

<table>
<thead>
<tr>
<th>Annual wage increase only. When possible, reflect in bonus.</th>
<th>Annual wage increase. Annual base up is not necessary.</th>
<th>Review the annual wage increase system. Should also consider wage decrease.</th>
<th>Both annual wage increase and base up but mainly the annual wage increase.</th>
<th>Annual wage increase and base up.</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>33.2</td>
<td>10.2</td>
<td>37.6</td>
<td>4.4</td>
<td>1.1</td>
<td>13.5</td>
</tr>
</tbody>
</table>

Note: The survey was directed toward top management of permanent and financial directors company of the former Japan Federation of Employer's Association and members of the Tokyo Employers' Associations (1,966 companies) whose positions are equal to or higher than directors in charge of labor. Responses were obtained from 275 companies. (Response rate: 14%)

Source: Summary of the Results of the Questionnaire Survey for Top Management Regarding the Spring Labor Negotiations (Japan Federation of Economic Organizations, August 2002).

(b) Summary

As demonstrated by the developments in Shunto in recent years, relations between corporations and employees have begun to change in the face of increasing employment mobility. These relations had been typified by the lifetime employment system and characterized by salaries that would continue to rise the longer an employee stayed at the company.

In the period when corporate performance was continuously rising, corporations made wage increments every term and increased base wage levels in order to secure employment. At the same time, corporations also increased incentives for employees by establishing an employment system premised on lifetime employment.

However, under current conditions, in which economic globalization is advancing and international competition is intensifying even more, in addition to the influence of the Japanese economy’s descent into a long-term slump in the 1990s, corporations are shifting a salary system that puts greater emphasis on results and performance by reviewing their policies on across-the-board wage increases that are characterized by annual wage increments and base wage level increases with the aim to improve rigid employment relations.

Figure 1.3.35 examines the trends in introduction rate of an annual salary system in listed companies. This rate has continued to rise, illuminating the changes that are taking place to the past practice of establishing across-the-board wage increases at Shunto.

In terms of the recruitment of new university graduates, the idea of introducing year-round recruitment of new university graduates is taking root and a significant number of corporations,
centered on large corporations, are beginning to contemplate or investigate the implementation of such as system (Fig. 1.3.36). Thus it is coming across that the once-universal system of new recruits is changing into one that is more flexible.

In Japan, it used to be that corporations and employees were united in their interests. One aspect was that corporations valued employees as important stakeholders. However, in recent years, there have been signs that they are beginning to view one another as loosely defined, equal partners. The fact that an environment is being developed where employees can choose corporations indicates that they are expected to play a greater role as governing entities. It appears that the adoption of the market mechanism by corporations also leads to its incorporation in relations between corporations and employees as well.

(4) The perspective for the future

In spite of the diversity in their economic systems, developed countries such as the UK, US and Germany are all involved in the task of improving their systems in a similar direction of sharing information and securing a mutual supervisory system. These countries consider various
stakeholders’ perspectives in making such improvements, which are intended to maximize long-
term corporate value. Furthermore, as was seen in the section on the ROK, East Asian countries
and regions also explored ways in which corporations would be able to function more effectively.
In order to get back on a stable economic growth track after the Asian currency crisis in 1997,
these countries hastened the disposal of non-performing loans and developed legislation
concerning corporations such as corporate law, bankruptcy law and competition law. Moreover,
developing immature direct finance provided corporations with an assortment of finance methods
which were independent of bank loans as one of the causes of the currency crisis was
underdeveloped direct finance. This process accomplished more, however, as it urged
corporations to have appropriate disclosure in response to strengthened monitoring management
and the need to standardize and tighten accounting standards. From these events, one can gather
that East Asian countries and regions also had a common direction of sharing information while
maintaining diversity.

Meanwhile, there are now many voices that say that the Japanese economy is in a state of
stagnation with no changes taking place, exemplified by the phrase “the lost decade.” On the
other hand, as we have observed in this chapter, the fact is that steady progress has been realized
since the mid-1990s including the development of legal systems, and further changes are
expected in corporate economic systems in Japan.

Even in a stringent economic environment, there are companies that are making ceaseless
efforts\textsuperscript{131} in management reforms, and performing to a high standard\textsuperscript{132}. Of such companies there
are a considerable number that are not only concerned about raising profitability, but are also
paying a good deal of attention to this relationship with society through conducting corporate
activities. Discussions on corporate systems are expected to become even more vigorous in the
future in Japan, and in this context, it is expected that discussion will be further expanded from a
broader perspective, including the modality of CSR\textsuperscript{133}.

Reforms are also underway in East Asia that share similarities in their direction, despite the
diversity among the various countries. Constant efforts in reform are required in each country,
including in Japan, from the perspective of maintaining and enhancing corporate competitiveness

\textsuperscript{131} For example, the group of corporations introduced in Section 3, Chapter II is showing high
performance through establishing new brands to create new demand, using strong management
resources and maintaining optimal production and division of labor systems.
\textsuperscript{132} The year 2002 saw significant recovery in the current profit rate for sales in the electrical machinery
sector, which had been slumping in response to the IT boom, because of the turnaround in inventory
adjustment in 2002 and reduction of fixed costs by restructuring. The transport machinery sector,
particularly automobiles, is also showing strong performance exceeding levels for 2001.
\textsuperscript{133} For example, the Japan Association of Corporate Executives announced its 15\textsuperscript{th}
Corporate White Paper in March 2002 entitled \textit{Market Evolution and Corporate Social Responsibility Management:
Toward Corporate Confidence-Building and Sustainable Creation of Value}. 
in an area of ever-expanding economic globalization, in order for companies to achieve sound
development as members of civil society.