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New Development in the Japanese Corporate Governance in the 1990s - The Role of Corporate Pension Funds

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New Development in the Japanese Corporate Governance in the 1990s - The Role of Corporate Pension Funds

Megumi Suto

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Contents

List of Figures

List of Tables

Abstract

In recent years, there has been a slow but steady change in ownership structures and corporate governance in Japan. As a result of economic stagnation, relations between companies characterised by cross-shareholdings and the main-bank system have become less rigid and institutional investors show increasing shareholder activism. This paper investigates the role of corporate pension funds in this process. Major trust banks and life insurance companies which act as trustees of pension funds are becoming more and more concerned with shareholder value. However, as will be demonstrated, this does not mean a transition from a relationship-oriented system to a pure market-based one. Instead, due to differences in the regulatory framework and schemes of corporate pension funds, but also due to differences in corporate relationships, there is rather a tendency towards convergence to a "communication-based" system with institutional investors taking the role of information intermediaries for their customers.

Zusammenfassung

In den letzten Jahren ist in Japan ein allmählicher stetiger Wandel in Besitzverhältnissen, Unternehmensführung und Managementkontrolle zu beobachten. Als Folge der Wirtschaftsrezession haben sich die Verbindungen zwischen großen Unternehmen, die durch Überkreuz-Aktienbesitz und eine starke Stellung der Banken bestimmt waren, gelockert und gerade institutionelle Investoren sind sich zunehmend ihrer Aktionärsrechte bewußt. Das Diskussionspapier untersucht die Rolle der Unternehmenspensionsfonds in diesem Prozeß. In Japan fungieren Treuhandbanken und Lebensversicherer als Treuhänder der Pensionsfonds. Sie schenken dem Shareholder Value zunehmend Aufmerksamkeit. Das bedeutet allerdings nicht, daß sich die japanische Wirtschaft von einem durch Beziehungen geregelten System zu einem reinen Marktsystem entwickeln wird. Stattdessen zeichnet sich ab, daß es hier zu einer Art "Kommunikationssystem" kommen wird, in dem den institutionellen Investoren vor allem eine Informationsvermittlungsrolle zukommt.

JEL classification: G0, G3, N2

Key words: Financial Economics, Corporate Finance and Governance, Financial Markets and Institutions

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1. INTRODUCTION

There has been a slow but steady change in corporate ownership, maybe as a result of so-called institutionalization in Japan, in step with the accumulation of personal assets, the aging population and the financial deregulation since the 1980s. It is widely recognized that permanent shareholding by business companies and large banks in a corporate group characterize the Japanese corporate governance mechanism, which efficiently functions to support the growth of the corporate sector with a stable supply of external funds. In this conventional view, general shareholders and financial institutions other than the large banks escape from monitoring costs to pay as shareholders and/or lenders.

Because of the prolonged stagnant economy, which resulted from the bursting of the bubble, relationships between companies, supported by cross-shareholding and stable holding by banks, have begun to change their structure and become less rigid and functioning less well. At the same time, a new movement towards shareholder-activism by institutional investors emerged in the late 1990s. The corporate pension funds and their trustee bodies, both of which had been "silent shareholders" for a long time, could not but play the leading roles in the new movement.

Major trust banks and life insurance companies, which are trustee bodies of pension funds, declared that they would implement active policies as shareholders, including the execution of voting rights. They are becoming more and more concerned with the increase in the market value of their customers' assets, especially of pension funds. It is an epoch-making and noteworthy change for them to choose "Voice" in order to take responsibilities for their customers and the end-users of their services.

Unless the corporate governance mechanism based on relationships works well, pension funds have to monitor companies more actively in response to increasing demand for improvement of their investment performance. Some interesting questions arise: Will institutional investors be able to monitor corporate behavior successfully? Can they function as complementary or substitute for lenders in the Japanese financial system? Is this a change from control by insiders, based on relationships, towards control by outsiders, based on direct communication with the board of management?

Shareholders' activism of pension funds is not a phenomenon unique to Japan. Rather, it has advanced remarkably in the US, which has a more liquid capital market, a more active corporate control market, more substantial legal protection of investors, and less concentration of ownership. Even in these different circumstances, some public pension funds choose to join corporate management as owners rather than arm's length investors who can sell the stocks easily when they are against the decisions of the management board.

The purpose of this paper is two-fold: firstly, to review some important changes in the Japanese corporate governance mechanism in the1990s, focusing on the behavior of pension funds and their trustee bodies as shareholders in the structural changes of corporate ownership. Secondly, to throw light on a new functional aspect of the Japanese corporate governance system, in adapting to surroundings, in comparison with that of the US.

There are some tentative concluding remarks. Firstly, the shareholders' activism of the pension funds, both in the US and in Japan, might suggest a sort of fusion between "market-based system" and "relationships-oriented system". In other words, it suggests a possibility of convergence towards "communication-based" governance by large investors as agents of individuals, caused by ownership concentration and investment strategies due to the aging population as well as the public policies for the collective investments towards more transparency. Secondly, in the current legal and institutional framework, the indirect execution of voting rights through trustee bodies of pension funds, such as trust banks and life insurance companies and investment advisory companies, is more effective in Japan. The activism of these institutions as agencies of pension funds managers will be an effective means of avoiding conflicts between sponsor companies of pension funds and the companies they invest in. Thirdly, however, this sort of shareholders' activism, observed in both Japan and the US, might show a general tendency towards diversification of the corporate governance mechanisms, responding to diversified investment behavior and highly developed financial technology. But, although this is an important point it is beyond the scope of this paper.

2. Erosion of the Japanese System and New Participants

(1) Japanese Corporate Governance System

Corporations can be defined as organizations consisting of various stakeholders including managers, stockholders, lenders, and employees. Thus, management performance is influenced by conflicts of interests and the incentive structure among the stakeholders. In this context, corporate governance can be defined as a system to control or monitor management by solving the conflicts of interests among stakeholders, aimed at giving incentives to improve management performance. Ownership structure is in general closely related to different types of corporate control. The differences in ownership structure cause different types of control system because there is a trade-off between incentives for owners to monitor management and dispersion of ownership.[1]

The German and Japanese corporate governance systems are generally characterized as "relationship-oriented" systems, in contrast to those of the US and the UK, which are characterized as "market-based "systems.[2] In the US and the UK, the capital market is highly liquid and ownership is relatively dispersed[3]. Corporate management is continuously monitored by investors and external corporate control markets work well to discipline managers' behavior. Besides, outside-managers influence the board of directors but banks keep arm's-length relations with the management.

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[1] Demsetz and Lehn (1985) discuss trade off between profit maximization by managers and dispersion in ownership.
[2] See Kaplan (1997).
[3] There has been a difference between ownership of equity in the UK and US. The US has a far higher

On the other hand, in relationship-oriented systems, the ownership of companies is rather concentrated and the capital market is relatively small in terms of both liquidity and external fund raising. Stakeholders of companies work cooperatively to discipline corporate management, aiming at long-term profit. But external markets for corporate control do not work effectively or are non-existent. Usually, banks play a key role in monitoring the management of borrowing companies, as long-term creditors who are concerned with long-term return, and they send members to the boards of directors if necessary.[4]

Focusing on this point, Franks and Mayer (1995, 1997) define the German system as an "insider system" rather than a relationship-oriented system, by contrast with the "outsider system" of the UK and the US. According to their definition, the Japanese system is a typical example of an insider system. In a conventional view, the peculiarity of the Japanese system is stylized as an insider control system with "internal disciplining", underpinned by cooperation between managers and employees, and "internalized monitoring" by outside stake-holders such as financial institutions and trading partners.

Internal disciplining in a typical Japanese company is based on "lifetime employment" and "career concerns of employees", both of which work to harmonize interests of managers and employees. With regards to internalized monitoring by outsiders, typical Japanese companies establish long-term inter-corporate relationships as a group based on "cross-shareholding" and corporate affiliations called "Keiretsu"[5]. This means that the outside stakeholders are internalized by sharing information, profits and risks with corporate managers in long-term implicit contracts.

In this view, relationships are an effective means of reducing agency costs caused by

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proportion of institutions, as Mayer (1993) notes.

[4] Examination by Prowse (1992), Kaplan and Minton (1994), Kaplan (1994), Kang and Shivdasani (1995) suggest that banks play an important monitoring role in the Japanese governance system.

[5] It is noteworthy that the shareholding in Japan is not concentrated in terms of occupancy by a large shareholder. The banking institutions are allowed only to hold up to 5% of shares by the Anti-trust law. Thus, the concentration of shareholding in financial institutions does not mean one bank has sufficient shares to control the company.

conflicts of interests among major stakeholders, such as managers, employees, customers, large shareholder and lenders. Consequently, managers can concentrate on management, sheltered from short-term disturbances caused by outsiders.

Another remarkable aspect of the Japanese system is the leading role of major lenders called "main banks" in a corporate group. There is some evidence that they not only supported active corporate investments as long-term suppliers of external funds[6] but also significantly mitigated asymmetric information problems between lenders and owners by monitoring their customers as lenders-owners.[7]

However, it is still controversial whether firms with main banks showed a higher performance in terms of profit and growth maximization. There is a possibility that they execute their strong negotiation power as lender-owners in order to acquire the beneficiaries produced in the system.[8] And internal disciplining in a typical Japanese company, underpinned by life-time employment and career concerns, needs some slack to maintain stability of employment and high educational investment into human resources in the internal organization. [9]

(2) Changes in Corporate Ownership

Looking at the ownership structure of the Japanese corporate sector, it is still true that corporate ownership is highly concentrated on banks and business companies. However, some noteworthy changes can be observed in the Japanese corporate ownership structure in the 1990s.

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[6] Hoshi et al. (1990a), show that Japanese group firms with strong ties with banks invest more and sell more after the onset of financial distress than the non-group of firms, using the sample period April 1978 – March 1985. Hoshi et al.(1991), focusing on the sensitivity of investment to internal funds, also report that corporate grouping mitigates the incentive and information problems in financial markets.

[7] Prowse (1992) finds evidence to support the notion that agency costs emerging from conflicts of interests and asymmetric information are lower in Japan than in the US, using a sample of 133 Japanese firms and 741 US firms in 1984.

[8] For examples, Nakatani(1984) and Weinstein and Yafeh (1998) examine the difference in performance between the firms with main banks and independent firms. The both find some facts that the group of firms with close-tie with banks shows lower performance in terms of profit rate and growth rate than the group of independent firms. Nakatani uses the data for 1971-82 and Weinstein and Yafeh(1998) use the data 1977-86. Weinstein and Yafeh conclude that in the Japanese system firms with main banks have to pay the cost of capital to secure the availability of funds.

[9] Several questionnaires show that stability of employment has been given a top priority by management in Japanese firms in general. See Fukao and Morita (1997) Chapter 5.

Firstly, in Japan, there has been a slight but steady decline in shareholdings by banks and business companies in 1990s. As Table 1 shows, the shareholding by commercial banks and long-term credit banks was 15.7% in 1990, but it decreased to 13.7% in 1998. That of business companies also decreased from 30.1% to 25.2% during the same period.

Table1: Distribution of Shareholdings of Listed Companies in Japan*

	Indivi-duals[1]	Foreign-ers[2]	Busi-ness com-panies	Banks[3]	Trust banks[4] (A)	Institutional investors[5] (B)	(A+B)	Others	Total
1990	20.4	4.7	30.1	15.7	5.2	16.6	21.8	7.3	100.0
1991	20.3	6.0	29.0	15.6	5.3	16.6	21.9	7.2	100.0
1992	20.7	6.3	28.5	15.6	5.5	16.8	22.3	6.6	100.0
1993	20.0	7.7	28.3	15.4	5.7	16.4	22.1	6.5	100.0
1994	19.9	8.1	27.7	15.4	6.4	16.2	22.6	6.3	100.0
1995	19.5	10.5	27.2	15.1	6.3	15.1	21.4	6.3	100.0
1996	19.4	11.9	25.6	15.1	6.8	15.5	22.3	5.7	100.0
1997	19.0	13.4	24.6	14.8	8.0	16.0	24.0	4.2	100.0
1998	18.9	14.1	25.2	13.7	7.4	16.0	23.4	4.7	100.0

* Fiscal year base, in per cent.
1 Including non-corporations.
2 Including incorporated associations.
3 Including commercial banks and long-term credit banks.
4 Excluding Investment trusts and annuity trusts.
5 Including life insurance companies, pension trust funds and investment funds.
Source: Tokyo Stock Exchange, *Fact Book* 2000.

Secondly, institutional investment increased slightly. In 1998, institutional investors, including life insurance companies, trust banks, pension funds and investment funds, held 23.4% of shares of all listed companies. In addition, most of investments by foreigners were also made by financial institutions. Their share increased from 4.7% in 1990 to 14.1% in 1998, which is almost twice higher than that of the US at the moment. There was an emergence of institutional investors in the Japanese market in terms of both domestic investments and foreign investments.

In a long perspective, the decline in direct shareholding by individuals and the extension of institutional investment are more obvious in the 1980s, as shown in Table 2, although they are less obvious than those of the US in the 1970.

Table 2: Shareholding by Individuals and Institutional Investors

	Individuals	Institutional investors[1]	Institutional investors[2]	Foreigners
Japan				
1970	37.7	12.1	-	4.9
1980	27.9	13.8	-	5.8
1990	20.4	16.6	21.2	4.7
1998	18.9	16.0	23.4	14.1
U.S.A				
1970	82.1	14.0		-
1980	60.8	23.1		4.2
1990	49.9	34.6		6.9
1998	41.9	44.4		7.3

1 Including life insurance companies, pension funds and investment funds.
2 Including life insurance companies, pension funds and investment funds as well as trust banks. Data for banks were not available before 1986.

Sources: Tokyo Stock Exchange *Fact Book 2000*, US Flow Funds.

Thirdly, there is a tendency towards the loosening of close and stable corporate relationships through shareholdings in 1990s. As shown in Table 3, cross-shareholding as percentage of total shareholdings declined from 21.2% at its peak in 1990 to 18.2% in 1997. One-side shareholdings by large companies or financial institutions decreased as well. In consequence, the share of stable shareholdings fell from 41.1% to 35.7% during the same period.

These facts suggest that the Japanese corporate governance system entered a new stage. Financial institutions as well as business companies could not bear the increasing costs of shareholding during the prolonged stagnancy of the stock market in the 1990s. The main purpose of shareholding by financial institutions seems to have gradually changed from stability of corporate relationships to efficiency in fund management.

Table 3: Stable Ownership by Financial Institutions and Business Companies*

	Stable shareholding			Total
	Subtotal	Cross-holding	One-side holding	
1990	41.1	21.2	19.9	100.0
1991	41.1	21.2	19.9	100.0
1992	41.3	21.1	20.2	100.0
1993	40.6	20.8	19.8	100.0
1994	40.5	20.8	19.7	100.0
1995	39.0	20.6	18.4	100.0
1996	37.7	19.6	18.0	100.0
1997	35.7	18.2	17.5	100.0

* In per cent. Cross-holding is mutual shareholding between a business company and a financial institution. Stable shareholding is the sum of cross-holding and onside-holding between a business company and a financial institution.
Source: NLI Research Institute, Nissei Kisoken Shoho, Vol.10 Summer 1999, p. 47, Table 4.

Table 4: Average Rates of Return on Stocks and Profit Rates*

	Rate of return on stocks (A)	Current profit rate (B)	Spread (A-B)
1986	24.5	3.9	20.6
1987	23.9	4.8	19.1
1988	32.6	6.0	26.6
1989	28.2	6.3	21.9
1990	3.9	5.6	-1.7
1991	-8.4	4.6	-13.0
1992	-23.6	3.1	-26.7
1993	-9.2	2.3	-11.5
1994	-4.2	2.7	-6.9
1995	6.3	3.1	3.2
1996	4.4	3.4	1.0
1997	-7.4	4.0	-11.4
1998	-10.4	2.7	-13.1

* Manufacturing industry, in per cent.
Source: NLI Research Institute(1999), p. 49, Table 7.

Table 4 confirms this point. Since the average rate of return on stocks became negative in the 1990s, the spread from returns of real investment remains almost always negative as well. Even if a long-term profitability in relationship-businesses were expected, the current dead weight loss would heavily depress the corporate management in the stagnant economy. Furthermore, the banks suffered a decrease in capital, an increase in non-performing loans, and business setbacks.

In sum, the ownership structure that used to function as a means of disciplining corporate management has been gradually loosened since the 1990s.[10] Meanwhile, the external capital market was so depressed and skewed that it could not replace the role of inter-corporation relationships, at least in the 1990s. Does the tendency towards decreasing ownership by banks and cross-shareholding of business companies show a sign of melting the Japanese corporate governance system? If so, what will emerge in its place or supplement it?

3 NEED FOR CORPORATE GOVERNANCE BY INSTITUTIONAL INVESTORS

(1) Growth of Corporate Pension Funds

To answer these questions, I would like to note the growth in institutional investors, especially corporate pension funds as shareholders. During the period of 1970-97, the total amount of personal assets grew rapidly in Japan, more than 15 times; to be precise,

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[10] This understanding is supported by a research based on a questionnaire executed by Institute of Fiscal and Monetary Policy, Ministry of Finance, in November 1999. The following table shows the results of the questionnaire which asked the listed companies about their attitudes towards cross-shareholding in the near future.

Table: The Future of cross-shareholding will ...*

Scale of capital in billions of yen	Less than 1	1- less than 3	3 - less than 10	10 - less than 30	More than 30	Total
Strengthen	1	1	1	0	1	1
Rather strengthen	9	3	1	1	1	2
No change	63	53	52	43	28	48
Rather slacken	22	28	30	40	46	34
Slacken	4	15	16	16	23	16
Number of Companies	68	264	350	243	142	1067

* Answers in per cent.

On the average, almost 50% of the companies are going to slacken cross-shareholding in the near future. Besides, the larger the scale of the companies concerned, the more remarkable this tendency is. With regard to the largest companies with capital more than ¥30 billion, about 70% answered that they would reduce cross-shareholding.

from ¥78 trillion to around ¥1300 trillion. In addition to this quantitative expansion, we find three remarkable qualitative changes in personal assets in the 1990s (see Table 5).

Table 5: Structure of the Financial Assets of the Personal Sector[1]

	1970	1980	1990	1995	1997
Total cash and deposits	57.3	62.8	52.3	55.1	57.2
▪ Cash and deposits	15.4	11.4	8.8	10.0	10.9
▪ Time deposits	41.9	51.4	43.5	45.1	46.3
- Bank deposits	32.0	33.9	29.2	27.1	26.5
- Postal savings	9.9	17.5	14.3	18.0	19.8
Managed funds	19.3	20.8	31.6	34.7	34.3
▪ Trust funds	5.2	6.0	6.8	6.6	6.2
▪ Investment funds	1.6	1.5	3.9	2.7	2,6
▪ Insurance	12.5	13.3	20.9	25.4	25.6
Securities	21.0	15.7	14.7	10.1	8.4
▪ Bonds	5.4	8.3	4.8	3.1	2.0
▪ Stocks[2]	15.6	7.4	9.9	7.0	5.7
Others	2.7	0.8	1.4	0.0	0.0
Total	100.0	100.0	100.0	100.0	100.0
Total amounts (in trillions of yen)	78.276	353.104	954.509	1182.950	1213.478

1 Fiscal year, in per cent.
2 Market value.
Source: Bank of Japan, *Annual Report of Economic Statistics* and others.

Firstly, there is a sharp decline in bank deposits. However, this does not mean a decrease in safe assets because the share of the total amount of cash and deposits remains at 55 to 57% of personal assets. It is notable that a substantial decrease in time deposits by banks was replaced by an increase in postal savings. Households shifted safe assets from banks to the government institution in the 1990s. Concerning non-performance loans, the banks maintained a negative attitude towards disclosing full information of the scale to the general public. This attitude increased public distrust in the banks.[11] The shift from bank deposits towards postal savings was induced by decreasing public confidence in the banking sector following the failure of effective governance in bank management. This is quite different from the expansion of postal savings observed in 1960s and 1970s, which was induced by tax-exemption for those savings.

Secondly, managed funds have continued to increase. At the end of 1995, they were about one third of personal assets. The increase of insurance and trust funds is related, to a large extent, to the growth in the corporate pension funds. In contrast to the managed funds, direct investment into securities declined. This means that households have switched from direct holding of securities to indirect holding through financial institutions, reflecting the concerns of a maturing and aging society.

Thirdly, among managed funds, investment funds were relatively stagnant and significantly decreased in the 1990s. Investment funds are especially useful measures for individuals in terms of efficiency of risk diversification and liquidity or tradability in the market. However, until the early 1990s, the investment funds industry in Japan had been underdeveloped and distorted by protective regulation. Disclosure of fund-performance and portfolio management policies was insufficient and competition was restricted in terms of both new entrance and new types of products. In addition, investment management companies were historically dependent on their parent securities companies in terms of both portfolio management strategies and sales policies.[12]

Another reason for the underdevelopment of investment funds in Japan is regulatory constraints on pension funds. A strict portfolio regulation was put on the corporate pension funds. The fund-managers were allowed to invest only a limited part of their funds into risky assets, including stock-investment funds. One reason is that a defined

[11] Hanazaki and Horiuchi (1999) emphasize that the severeness of the Japanese banking crisis resulted from the delay in disclosing non-performing loans and responses to manage them rather than the scale of non-performing loans. They call this situation a vacuum of governance in banking.

[12] Suto (1999a) discusses the structural problems of Japanese investment companies from the viewpoint of industrial organization.

contribution pension funds scheme was not introduced in 1990s. [13].

(2) Enhancing Needs for Corporate Governance by Pension Funds

There has been a dramatic growth of corporate pension funds, with the growing needs of an aging population. Nevertheless, the performance had been stagnant even in the late 1980s, when the Japanese economy came to its peak, and further deteriorated in the 1990s.[14] In Japan, there have been, inevitably, calls for the reform of the corporate pension funds scheme as well as the public pension funds scheme. Managers of corporate pension funds are increasingly expected to take their responsibility to subscribers and beneficiaries in terms of diversifying portfolios and enhancing the value of their assets. They have to allocate assets as efficiently as possible according to their plans of benefit and contribution.

Some changes were observed, after the "Financial System Reform Law", intended to promote competition among different types of financial businesses, was promulgated in June 1992 and came into force in April 1993. Trust banks and insurance companies became exposed to fierce competition with newcomers on the performance of managed funds. As agents of individuals and pension funds, they are not allowed to be silent any more. They have to clarify their policies as trustees and work on behalf of their customers if they have business with corporate pension funds. Thus, pension funds and other leading investors are expected to play a new role in monitoring companies as outsiders in the Japanese corporate governance.

Meanwhile, the emergence of large investors as active shareholders is not a phenomenon peculiar to Japan. In a market-based system, investors have typically kept arm's-length relationships with corporations. They can easily sell their shares and choose "Exit" from the corporation if they are unsatisfied with the management but they will keep holding them if they are satisfied with it. Thus, the so-called "Wall Street Rule" operates.

[13] US 401K type corporate pension funds scheme is going to be introduced in 2001.

[14] Average annual rate of return of the Japanese corporate pension funds was far inferior to that of the US in every year between 1985 and 1993. The accumulated real rate of return of Japanese funds is 40.3% and that of US funds is 189.0% during the same period. The data are from Kosei-nenkin-kikin and Frank

In this system, it is shown that companies are often affected by the myopic behavior of investors and are exposed to high volatility of stock prices in the market. Therefore, they cannot but suffer from unstable external fund raising. In this conventional view, such an attitude on the part of investors forces management to focus on short-term profits rather than long-term investment returns.[15]

Recently, the US pension funds affected corporate governance in a different way, namely by the execution of "shareholders' rights" or "Voice". For general investors, exit from ownership might be the cheapest means of executing shareholders' rights. Meanwhile, for pension funds, exit is a less efficient means of increasing their assets' value, for the following reasons.

Firstly, large investors have to consider the "market impacts" on their asset value when they buy or sell in the market. Large scale selling could possibly make the market price fall. They have to bear higher costs of exit than general investors do. Secondly, pension funds are inclined to implement "Index Funds" strategies for their portfolios. Investing in index funds, portfolio managers cannot sell some components of a portfolio easily, even if some low-performing assets are included. It is better for them to choose "Voice" rather than "Exit", as active shareholders to improve the performance of their portfolio. It is common where the company is so large and well known that its price has strong linkage with the market index.

Why are US pension funds inclined to implement an index funds strategy? There are two factors. One is concerned with the "discipline of policy" as pension funds pursue long-term and stable returns. They prefer passive investment strategies to active ones. Active fund management requires significant costs for searching and selling but it does not secure a stable performance in the long run. The other is a "legal restraint" on pension fund management, so-called "Prudent Man Rule" for fiduciaries in the Employment Retirement Income Security Act 1974 (ERISA). Public funds are under state-level regulation, similar to the prudent man rule of the ERISA. Under this sort of

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Russel. (Tsuno (1995), Table 3-8, p.113.)

[15] However, some recent analyses question this conventional view. See Roe (1994), Kaplan (1997) and Mayer (1993).

regulation, pension funds are required to diversify their portfolio sufficiently.

Therefore, there are some reasons why pension funds choose passive investment strategies rather than active ones and commit corporate governance as active shareholders by execution of "Voice". However, in the US, pension funds which choose to be active shareholders, in practice, are limited to a small number of large public pension funds, for instance, CalPERS and TIAA-CREF.

There are few corporate pension funds that engage corporate governance actively. This is partly due to trading relations between the sponsoring companies of the pension funds and the companies they invest in. Even in the US, there is a possibility of emerging conflicts of interests between sponsoring companies and the pension funds (Aramaki 1994). It is also partly due to the balance of cost and benefits of activism for pension funds as stockholders with voting rights and other legal measures. The costs are high but the results are uncertain.[16]

In sum, even in the market-based system, the growing scale of investment and the introduction of regulation of institutional investment affect the corporate governance mechanism. Taking legal responsibilities as agents of subscribers and beneficiaries, some pension funds started corporate governance with measures of direct communication with corporate managers. Active pension funds are still limited to several public pension funds in the US, but corporate managers as well as market players cannot ignore their behavior anymore.

4 JAPANESE CORPORATE PENSION SCHEME AND SHAREHOLDERS' RIGHT

(1) A Historical Background of the Corporate Pension Fund

For every country, pension funds systems have their own institutional peculiarities and different historical background. The basic schemes of the Japanese corporate pension funds were established in 1960s, aiming to increase benefits for employees and to supplement public pension funds. They are classified into two types, "Kosei Nenkin

[16] Results of empirical tests on performance of shareholders' activism are various. Nesbit (1994) and Smith (1996) have positive results on efficacy of governance by CalPERS. However, Karpoff and others (1996) and Wahal (1996) question the efficacy.

Kikin" and "Tekikaku Nenkin Kikin".

Kosei Nenkin Kikin Funds are for employees of large companies. They are allowed to manage a part of government pension funds to increase benefits for their employees (it is known as "Daiko-seido"). Tekikaku Nenkin Funds are for employees of small firms that fulfill certain criteria. In terms of the scale of funds and the extent of coverage of employees, Kosei Nenkin Kikin dominates the Japanese corporate pension funds. As of March 1998, the total assets of corporate pension funds amounted to ¥67.7 trillion, of which Kosei Nenkin Kikin Funds occupied 71% (see Table 6). As of March 1999, there are 1850 Kosei Nenkin funds, which cover 37% of employees in the corporate sector (Takayama 1999).

Table 6: Total Assets of Corporate Pension Funds and Shares of Trustees

Fiscal year	Total assets[1]	Share of Kosei-Nenkin-Kikin funds	Shares by trustee (in %)			
			Life insurance companies	Trust banks	Investment advisors[2]	Others[3]
1987	263405	64.2	38.2	61.6	-	0.2
1988	301100	65.3	38.6	61.1	-	0.2
1989	343468	65.5	39.3	60.4	-	0.2
1990	386070	66.3	40.5	58.9	0.4	0.2
1991	429256	67.1	41.6	57.3	0.8	0.3
1992	472193	68.2	42.8	55.6	1.3	0.3
1993	514879	68.8	43.8	54.0	1.9	0.3
1994	553867	69.4	44.5	52.5	2.8	0.3
1995	595761	70.1	44.8	51.1	3.8	0.3
1996	634253	70.9	41.7	50.8	7.2	0.3
1997	677323	71.7	38.7	50.3	10.7	0.3

1 In ¥100 million. Total of Kosei-Nenkin-Kikin funds and Tekikaku-Nenkin funds.
2 Entrance of investment advisors was permitted in 1990.
3 Association of cooperation is qualified to be a trustee of Tekikaku-Nenkin funds.
Sources: Trust Banks Association, Life Insurance Association and Agricultural Cooperation.

Under high economic growth, the corporate pension funds had developed steadily until the 1990s. They kept growing in the 1990s in terms of the scale of funds even after the end of the economic bubble. However, after 1994, some funds broke up one after another in the prolonged economic stagnancy. During the five years between 1994 and 1998, 41 funds failed (see Table 7).

Table 7: Number of Dissolute Funds (Kosei Nenkin Kikin)

End of fiscal year	Dissolute funds	Total number of funds
1991	0	1593
1992	0	1735
1993	0	1804
1994	1	1842
1995	1	1878
1996	7	1883
1997	14	1874
1998	18	1850

Source: Association of Kosei Nenkin Kikin.

On the other hand, institutional reform of the comprehensive pension funds system has been discussed as one of the urgent problems for Japanese society as well as for the economy. Regarding corporate pension funds, some notable deregulation was implemented in the 1990s. For both the sponsor companies and their shareholders, the costs of corporate pension funds became a heavy burden in the existing scheme.

(2) Regulation on Pension Fund Management

In what follows, the major characteristics of the regulatory framework of corporate pension funds before the 1990s will be examined. They are summed up as follows:

(1) Defined-benefit pension plans on savings by subscribers, as a supplement to government pension funds,

(2) legally demanded to earn 5.5% annual return at least,

(3) strict regulation on assets allocation (5・3・3・4 regulation),

(4) rigid entrance regulation of trustee bodies, which protected trust banks and insurance companies from contest.

(5) In addition, the pension funds management itself is administrated by the Ministry of Welfare and financial institutions legally qualified as trustees are under the Ministry of Finance.

In the above regulatory framework, the Japanese corporate pension funds system has shown some distinctive defects, which are as follows: (1) Ambiguity of responsibilities and obligations of both pension fund managers and their trustee bodies, (2) organizational weakness in pension funds management in terms of self-discipline and (3) lack of transparency in terms of disclosure of both portfolio management policies and performance.

Decision-making by the fund managers on assets allocation was so strictly regulated that they did not need to be careful about the outcomes of portfolio management. For them, paternalism for employees was the first priority but not fiduciary responsibility as trustees. In the organization of pension funds, posts of managers were usually provided for so-called "old boys" of sponsoring companies or additional posts for the current managers. Pension funds were not required to disclose management policies, investment strategies and performance of portfolios to their subscribers and beneficiaries.

Further, sustained growth of the Japanese economy allowed managers to remain unconcerned about how to manage their funds before 1990s. This is partly because the contributions both by sponsor companies and their employees kept increasing in the growing economy. Another reason is that the average age of employees was much less before the 1990s than thereafter. In addition, it had been easy for corporate pension funds to earn 5.5% return under the high growth economy. Earnings more than 5.5% return were usually spent on welfare facilities on behalf of current employees and beneficiaries. This contributed to strengthening the unification between corporate managers and employees. In other words, it is a means for a sponsor company to maintain good relationships with their employees.

(3) Pension Funds Reforms in 1990s

The reform plan of the corporate pension funds system started in the early 1990s. It focused on the liberalization of fund management and strengthening of disclosure towards more efficiency and more transparency. Table 8 sums up the major reforms related to corporate pension funds. As a result of these reforms, freedom of decision making for fund managers was significantly increased. In 1998, regulations on asset allocation were finally abolished. Since then, the Japanese corporate pension funds have rapidly expanded investment into risky assets. At the end of March 1998, investment into domestic stocks accounted for 26.4% of total assets and stock investment amounted to 44.8% including overseas stocks (see Table 9).

Table 8: Major Regulatory Reform of Corporate Pension Funds in the 1990s[1]

Year	
1990	*Entrance of investment advisers as trustee bodies *Permission of implementation of new types of asset management (but under ongoing regulation of assets allocation) *Permission of in-house management (for funds with more than ¥50 billion etc.)
1993	*Decrease in cost to take action against managers (revision of Commercial Law)
1996	* Partly relaxation of asset allocation regulation (５・３・３・２ Regulation on each trust bank base)[2] *Funds managers are obliged to publish their management policy (Three-steps policy: Plan, Do, and See)
1997	*Relaxation of design of portfolios (target returns, level of defined benefits etc.) *Change of assets allocation base from book value to market value
1998	*Abolition of regulation on asset allocation
2000	*Introduction of new accounting standards for sponsor companies (scheduled, net debts related to payments for and after retirement have to be written on the balance sheets of sponsor companies.)
2001	*Introduction of the Japanese type 401K Plan (defined contribution plan)

1 The above reform refers to Kosei Nenkin Kikin, which occupies about two thirds of total assets of corporate pension funds.
2 The ５・３・３・２ regulation means that more than 50% of assets have to be allocated in bonds and loans, less than 30% in stocks, less than 30% in foreign currencies and less than 20% in property. Originally this regulation was on each trustee body not on the whole portfolio of a pension fund.

Meanwhile, the responsibility for fund management was still ambiguous. A new discipline of regulation, the "fiduciary responsibility" of funds managers, was discussed in the late 1990s. In April 1997, the Ministry of Welfare published a set of guidelines for the managers of pension funds from the viewpoint of fiduciary responsibility and transparency of management, following the ERISA of the United States. Here, it is significant that, for the first time, the duties and responsibility of pension fund managers were clarified officially. Pension funds managers have to make best efforts to undertake their duties including monitoring the companies they invest in.

Table 9: Asset Allocation of Trust Funds in Corporate Pension Funds*

	Domestic assets			Overseas assets		Others
Fiscal year	Bonds	Loans	Stocks	Total	Stocks	
1991	43.2	13.9	16.9	16.9	-	9.1
1992	46.6	14.2	16.6	16.1	-	6.5
1993	46.9	13.5	20.5	15.9	-	3.2
1994	47.6	13.7	19.8	16.8	-	2.1
1995	47.5	8.9	22.9	19.4	-	1.3
1996	44.1	8.0	21.8	22.1	14.55	4.1
1997	40.7	4.7	26.4	26.4	18.44	1.8

* In per cent. Market values. Only Kosei Nenkin Kikin.
Source: Association of Kosei Nenkin Kikin, *Annual Research on Assets Management*.

However, these guidelines do not cover the duties and responsibilities of trustee bodies. Though trust banks, life insurance companies and investment advisory companies are agencies of corporate pension funds, they are beyond the monitoring of the Ministry of Welfare. As far as trust banks and life insurance companies are concerned, they are legally entitled to shareholders. This inconsistent treatment is due to the "sectional administration system" based on the legal separation of entities; pension funds are under the Ministry of Welfare while financial institutions are under the Ministry of Finance. This problem can be solved by the establishment of "the Financial Services Law" which comprehensively regulates financial institutions based on the services they provide. The shift from regulation based on different types of entities to regulation based on different types of functions is one of the purposes of the Japanese Big Bang, which started in 1998 (Suto 1998).

However, it takes time to reform the administration system fundamentally. Under the existing administrative framework, a pragmatic step for pension funds to improve the efficiency and transparency of management is to clarify their policies for responsibility and demand that trustee bodies explain their strategies and the performance of portfolios as agencies of pension funds. The execution of shareholders' rights could be a way for the trustee bodies to fulfill their obligation. Financial liberalization accelerates competition on trust business among different types of financial institutions and provides the conditions to make pension funds become more active in this respect.

5 New Movements to Active Shareholders and Institutional Constraints

(1) Execution of Shareholders' Rights and the Pension Funds Scheme

How can pension funds commit to corporate management as real shareholders? A large proportion of shareholding currently belongs to corporate pension funds.[17] However, the Japanese scheme of pension funds is so complex that it is difficult to obtain the exact figures of shareholding by pension funds. The corporate pension funds entrust fund management to the legal trustee bodies by making three types of contracts with them: With trust banks, pension funds make "money trust contracts" to entrust fund management. With life insurance companies, they make "insurance contracts" in the form that they purchase insurance commodities from life insurance companies. With investment advisers, they make "investment advice contracts" but the execution of fund management is by trust banks.

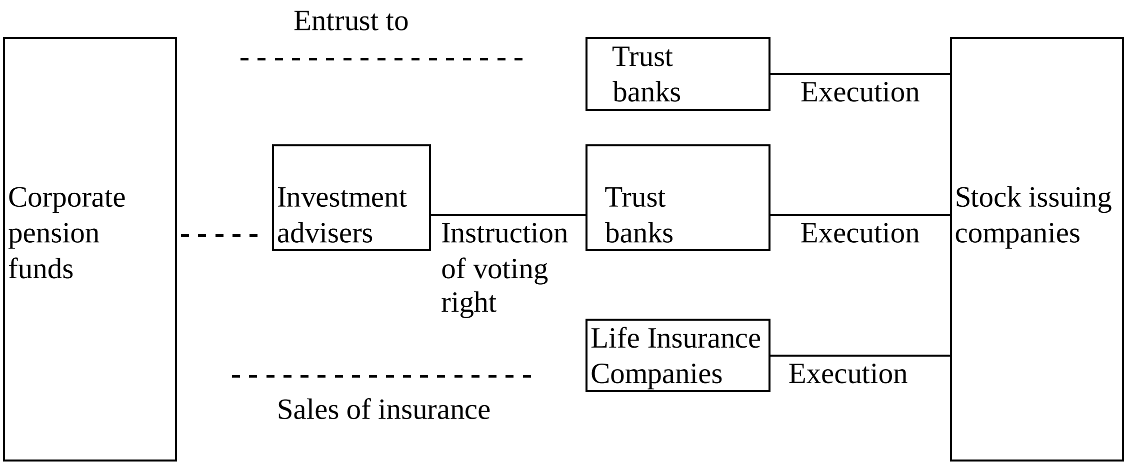
In money trust contracts, pension funds are not legally allowed even to give specific instructions about the buying and selling of individual stocks. On the other hand, investment advisers, according to an administrative guidance of the Ministry of Finance, can give instructions to trust banks on how to exercise voting rights. Life insurance contracts are not asset management contracts so that an instruction to execute shareholders' rights is completely out of question.

In sum, in the Japanese pension funds scheme ownership and legal rights to control the companies are separated. In any contracts, legal shareholders are trustee bodies such as trust banks and life insurance companies, though actual shareholders are pension funds. In the existing regulatory framework, there are no distinct rules for pension funds to

[17] The public pension funds consist of Kokumi Nenkin and Kosei Nenkin, both of which are managed by

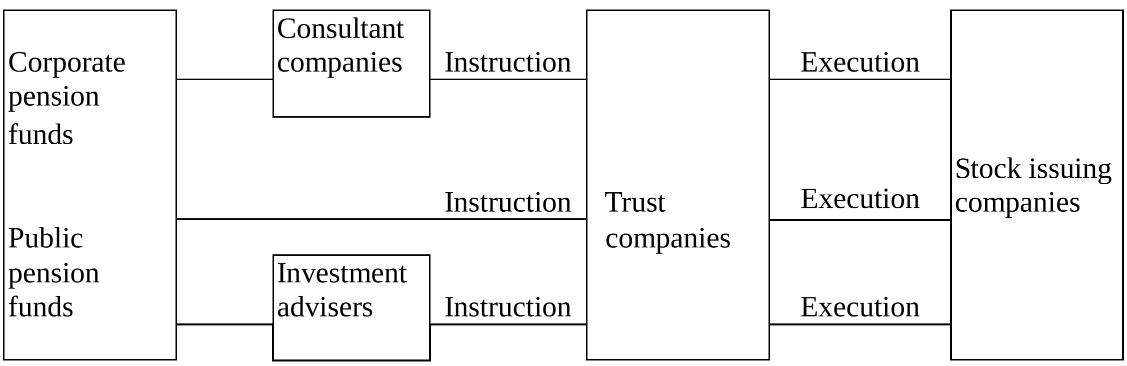
exercise their rights as shareholders. All shareholders' rights are passed through to their trustee bodies, although the pension funds finally have to take the investment risks.

Figure 1: Routes of Execution of Voting Rights for Corporate Pension Funds in Japan



Let us compare the routes of execution of voting rights by pension funds in Japan with that in the US (see Figure 1 and 2).[18] In the US, the execution of voting rights by pension funds is explicitly included in extent of their fiduciary responsibility by the Guideline of the Department of Labor. Pension funds can naturally give instructions to their trustees to execute voting rights, as fiduciary responsibility covers both pension funds managers and their trustees.

Figure 2: Routes of Execution of Voting Rights for Pension Funds in the US



the Ministry of Finance. Liberalization of the management of public pension funds is under discussion.

[18] Suto (1999b) pp. 162-169 and Suto and Suzuki (1998).

On the other hand, there is no explicit route for pension funds to execute voting rights in Japan. If the pension funds wish to execute their rights as shareholders to take their fiduciary responsibility, the only route is to put pressure on their trustee bodies to fulfill their obligation to increase the long-term value of pension assets, as far as is possible with the available measures.

In 1997, the Ministry of Welfare published guidelines for pension funds management in an attempt to introduce more transparency in management policies. After that, major institutional investors voluntarily announced one after another that they would execute voting rights as a means of taking fiduciary responsibility if necessary, or to draw up guidelines for execution of voting rights on behalf of the pension funds. (See Table 10) In other words, they expressed their desire to become active shareholders. Real changes always precede institutional changes

Table 10: Introduction of Guidelines for Execution of Voting Rights by Institutional Investors

Date	
1998.6	Mitsui Trust Bank voted against management of companies they invested in.
1999.4	Nomura Assets Management Company published a policy to execute voting rights at a general meeting of shareholders on behalf of their customers.
1999.6	Three insurance companies (Nissei, Dai-ichi, Sumitomo) and three trust banks (Yasuda, Sumitomo,Toyo) started to make guidelines for the execution of voting right.*

* The investment assets of the above trust bank and three life insurance companies amounts to ¥23.2 trillion and their shares make up for 7% of capitalization of listed Companies on the First Board of the Tokyo Stock Exchange. (Source: Nikkei, June 1 1999)

(2) Competition among Trustees and their Activism in the 1990s

In 1990, the ban on the entrance of financial advisers into trustee business was lifted. Since then, newcomers have rushed into this fields and liberalization of asset allocation has contributed to promoting competition among trustee bodies for their customers' benefits. Among trust banks, life insurance companies and investment advisory companies, competition for trustee business became fierce due to an increase in suppliers as well as stronger demand for more efficient and more transparent portfolio management from pension funds. (See Table 11)

Table 11: Number of Financial Institutions

	1990.3	1995.9	1996.3	1997.9
Commercial Banks	159	165	167	167
Domestic[1]	76	75	75	74
Foreign	83	90	92	93
Trust Banks	16	21	30	33
Domestic	7	7	7	7
New Entry[2]	0	5	14	17
Foreign[3]	9	9	9	9
Insurance Companies	48	57	57	77
Life Insurance	25	29	29	44
Others	23	26	26	33

1 Including only city banks and local banks.
2 Subsidiaries of securities companies entered in 1993. Subsidiaries of city banks entered in 1995.
3 Foreign institution began to enter in 1985.
Data Source: Bank of Japan.

As Table 6 shows, investment advisory companies have extended their share rapidly since they were permitted to enter the business in 1990. Supplying information of their policies for portfolio management and the instruction of voting rights, they have been challenging the trust banks and insurance companies, which occupied trustee business for a long time. The actions by newcomers have accelerated competition among trustee bodies of pension funds.

This point is important. There are high expectations that enhancing competition among trust banks, insurance companies and investment advisors and increasing the concern of pension funds on the portfolio performance will improve the Japanese corporate governance mechanism, which functioned less and less efficiently in the 1990s. Competition in investment performance will serve to increase the transparency of corporate governance through rational assessment of corporate value in the market. As legal shareholders, the institutional investors could strengthen monitoring through "communication" with corporate managers.[19]

For the pension funds, the establishment of a legal route to execute voting rights directly might be desirable as one of the measures taken to monitor the companies they invest in. However, the constraints derived from relations with sponsoring companies on the behavior of corporate pension funds might be stronger in Japan than in the US. If the Japanese corporate pension funds had an explicit route to execute voting rights it could be more difficult for them to use it in practice than in the US, because of stronger relationships between business companies and financial institutions. In the Japanese system, it is not only more realistic but also less expensive to monitor the companies indirectly through trustee bodies than through direct corporate governance by pension fund managers.

The new movement of activism among trustee bodies of pension funds could increase the possibility of fusion or harmony between the market-based system and the relationships-oriented system. Communication with corporate managers is critical in the corporate governance by the pension funds as long-term investors.

(3) Challenge by Minority Shareholders in Courts

According to some recent studies, concentration of ownership in shares is highly related to the legal framework to protect corporate shareholders.[20] In Japan, the legal protection of shareholders itself was established early. Under the terms of the 1950 Revision of Commercial Law, shareholders acquired the right to take managers to court, as under

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[19] Pension Fund Corporate Governance Research Committee (1998) introduced the action guideline for exercising voting rights by trustee bodies.

[20] La Porta et al. (1998) examined relations between legal rules for protection of corporate shareholders and creditors for 49 countries and found a negative relation between concentration of ownership of investor protections on large public companies. La Porta et al. (1997) assess the dependency of firms on external finance in the different legal environments.

the US law. They can execute voting rights and take corporate managers to court. However, it was rare for shareholders to execute their rights in court before the 1990s. In addition to free rider problems on the side of small investors, it has been considered that there were two legal constraints on the execution of shareholders' rights in Japan. There are the "high legal cost to plead" in comparison with the expected compensation and the "concentration of the general meeting of shareholders".

Under the term of the 1993 revision of the Commercial Law, the fee to plead was reduced significantly enough for individuals to execute the right.[21] After that, cases against management decisions in court increased from 84 to 240 cases between 1993 and 1998.[22]

The second constraint is "the general meetings of shareholders" which are concentrated in a few days so that it is inconvenient for shareholders to participate. One of the reasons is the tendency for Japanese corporations to dislike external interference in management. But another reason is accounting procedures under the Commercial Law, which requires companies to have a meeting within a certain period after the end of fiscal year. As a result of these procedures, the dates of shareholders meetings have not been dispersed enough even in 1990s.[23]

The general shareholders meetings are held only once a year. It is a precious opportunity for the shareholders to execute their legal rights. However, the potential of the general shareholders meeting should not be overestimated. Appropriate and timely communication with managers could be more practical and effective as a means to increase corporate value.

The trend towards activism on the part of small investors should be noted. Institutional investors, as agencies of individuals, cannot neglect this sort of action by individual shareholders. Rather they push the institutional investors to take responsibilities for their customers. A higher proportion of equity owned by institutional investors does not

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[21] For one case it is ¥8200.

[22] These figures include cases pleaded at district courts and high courts. NLI Research Institute (1999), table14.

[23] As of 1997, for 1968 out of 2391 public companies the fiscal year ends in March. The concentration of

mean one institution owns a larger part of one company, as institutional investments are usually well diversified, although institutionalization increases the indirect holding of equity by individuals through financial institutions.

As Shleifer and Vishny point out, "legal protection of investors and some form of concentrated ownership are essential elements of a good corporate governance system …Legal protection and large investors are complementary in an effective corporate governance system".[24]

6. CONCLUDING REMARKS

Concentration of ownership on financial institutions is still one of the remarkable characteristics of the Japanese corporate system. However, in recent years, we find a significant decline in the ownership by business companies and banks. There is an obvious trend towards indirect ownership by the personal sector through institutional investors. Enhancing consciousness of small shareholders and the general public about corporate governance helps to change the behavior of institutional investors. Undoubtedly, the exercising of voting rights by large shareholders promotes transparency in corporate control. It means that the corporate governance mechanism is partly changing from the conventional "insider system" towards an "outsider system".

In the Japanese financial system, pension funds and their trustee bodies have begun to choose "Voice" in the form of direct communication with corporate managers since the late 1990s in order to adapt to the changing financial circumstances. The execution of voting rights by trustee bodies is the first step in this movement. This is not only because the costs of exit of selling shares are high in the undeveloped corporate control market, but also because "communication" with corporate managers is a more efficient measure of governance for long-term large investors, namely pension funds.

In the US, this sort of shareholders' activism taken by some public pension funds could be due to the legal protection of subscribers and beneficiaries and to financial

general shareholders meetings on 26 July amounts to 75.5% of total public companies.

[24] Shleifer and Vishny(1997), p.769.

technology for large-scale well-diversified portfolios. In sum, with the growth of pension funds, monitoring by the market is being partly replaced by direct monitoring, which is based on "communication" between the large investors and management boards.

The uniqueness of the Japanese case is that shareholders' activism is caused not only by corporate pension funds, which are confronted with increasing fiduciary responsibility, but also is implemented by their trustee bodies indirectly. It will be an effective means of avoiding conflicts between sponsor companies of the pension funds and the pension funds of their employees. Even if the Japanese corporate pension funds secured a legal route to exercise their voting rights directly, it would be more difficult for them to do it than in the US. The difference between the US and Japan could be partly explained by the differences in the regulatory framework and schemes of corporate pension funds. But, partly it could also be explained by the difference in corporate relationships.

These new phenomena observed both in the US and Japan might suggest a sign of fusion between a market-based system and a relationships-oriented system, in other words, a movement of convergence toward "communication-based" governance. The communication-based system is not a closed communication system, which was typically observed between corporate managers and financial institutions in the old Japanese system, but a more open and transparent one, where institutional investors function as information intermediaries for their customers, namely pension funds or individuals.

It might show a common tendency for diversification of the corporate governance mechanism, caused by the concentration of ownership and preference for long-term investment strategies in an aging society. We need much more research to examine the changes in the corporate governance systems in general.

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