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# Corporate Governance Reform in Japan: Why Does It Matter, What Has Been done, Is It Working?

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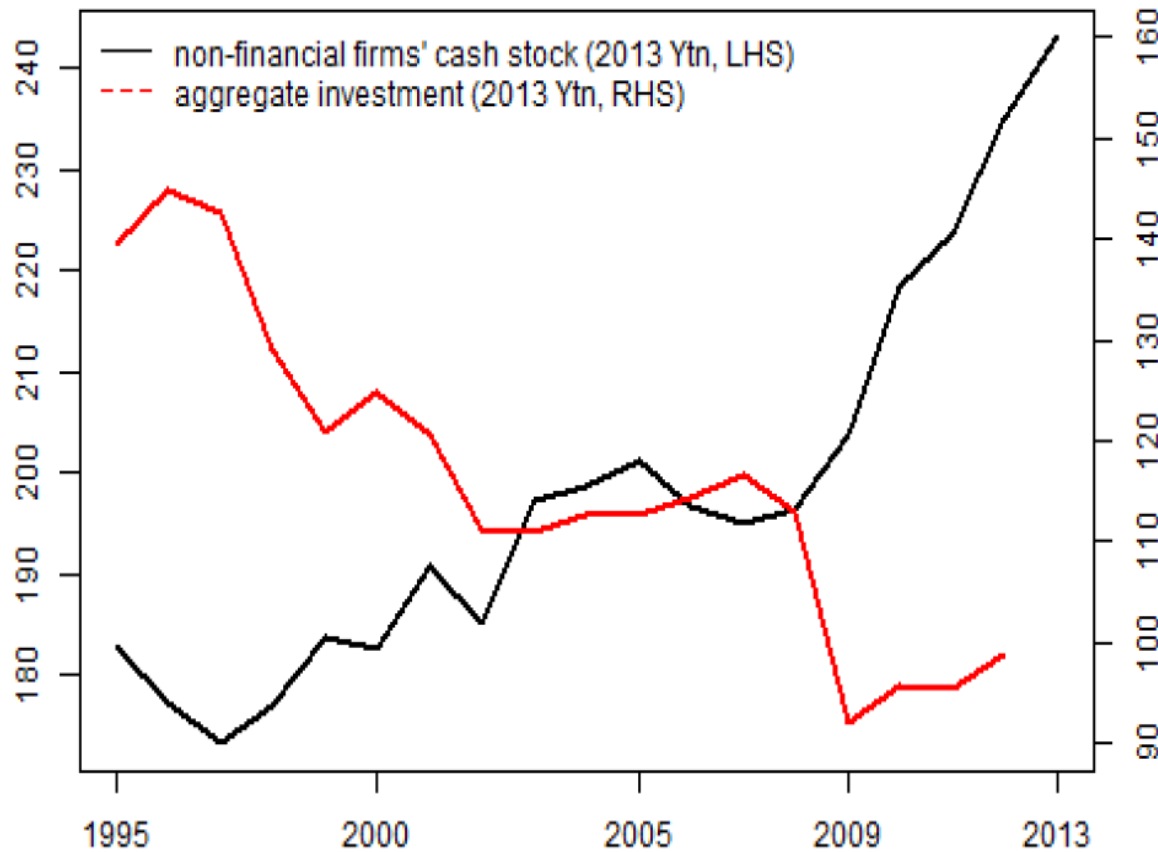
Asia and Pacific Department

International Monetary Fund

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# Why Does It Matter?



- Japan's nonfinancial corporate cash holdings amounted to 50 percent of GDP in 2013, or about 250 percent of aggregate investment.

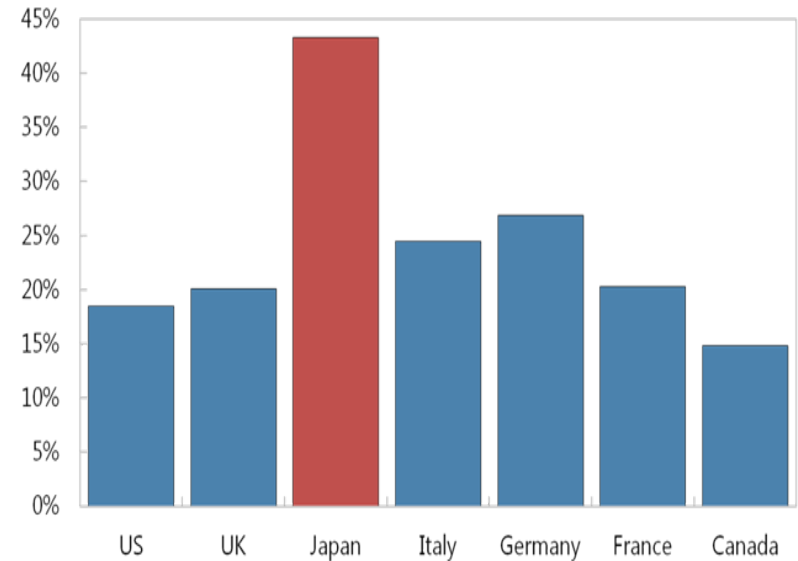
# Why Does It Matter?

Japanese corporations are accumulating cash holdings to a much greater extent than peers

These could be put to better use (increase wages, investments, redistribute dividends) to stimulate growth and help Japan exit deflation

Corporate governance reform could put pressure on firms to use their cash reserves (“unlock” corporate savings)

Listed companies' cash and cash equivalents holdings  
(% of market capitalization; Average between 2004 and 2012)



Sources: Bloomberg

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# Determinants of Firms' Cash Holdings

- Transaction cost motive
  - Precautionary demand motive
  - Agency cost Motive
  - Taxation Motive
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# Corporate governance and high cash holdings

Managers tend to have a preference for higher cash holdings than shareholders

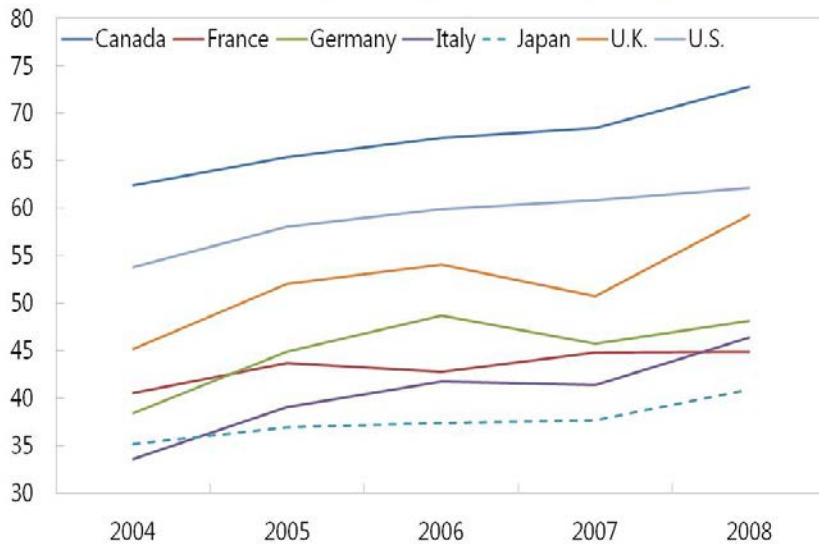
Weak corporate governance and lack of shareholder activism might be contributing to high cash holdings in Japan

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# International comparison

## Firm-Level Governance Index

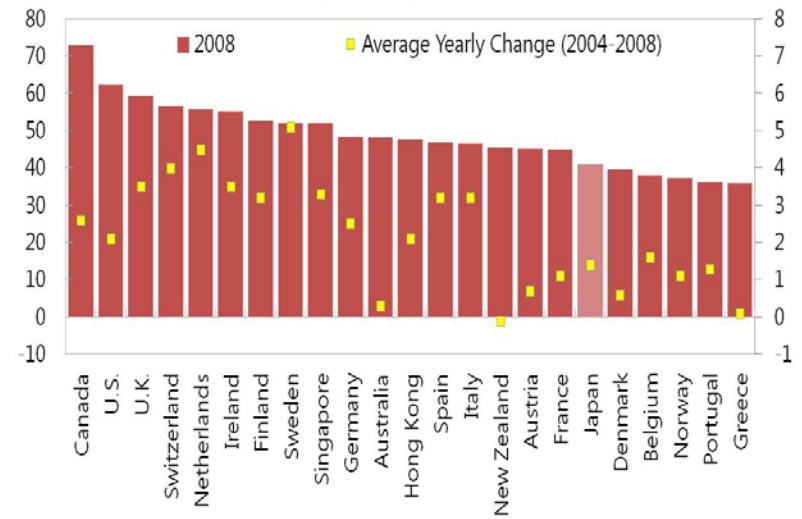
(An increase of this index signals an improvement in corporate governance)



Sources: Aggarwal et al. (2010)

## Figure 2. Firm-Level Governance Index

(An increase of this index signals an improvement in corporate governance)

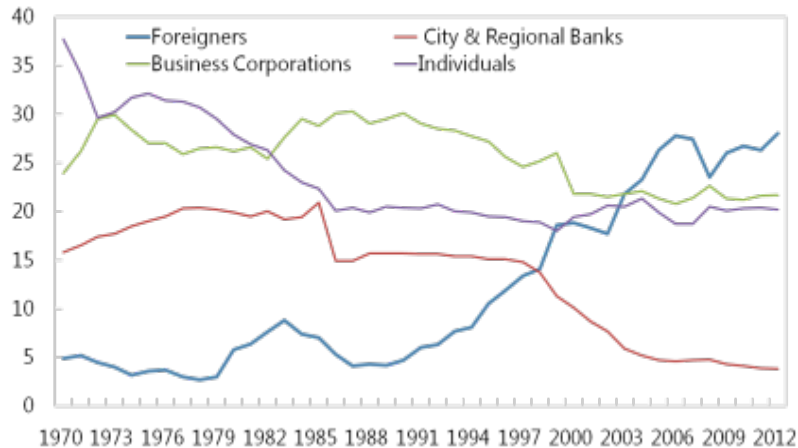


Sources: Aggarwal et al. (2010)

# Cross shareholding

Share Holding Ratio by Investor Category

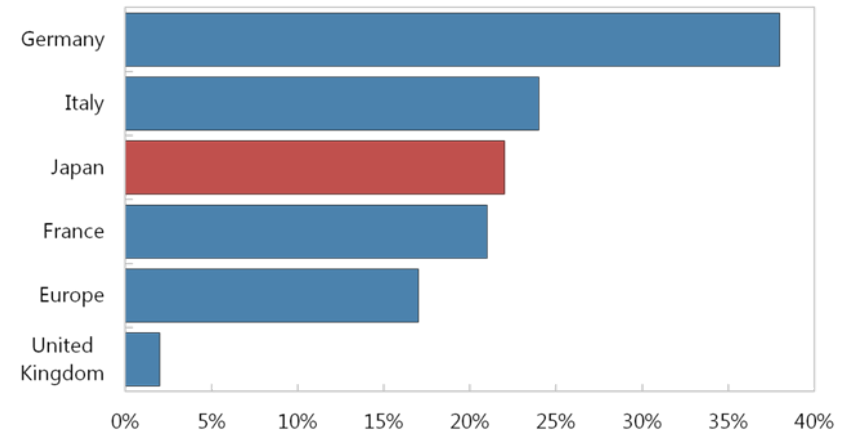
(%; on a value basis)



Sources: Tokyo Stock Exchange

Share Holding Ratio by Non-financial Companies

(2012)



Sources: The Financial Services User Group

- Cross-shareholding can also contribute to excessive cash holdings
- Driven by pursuit of “individual benefits” rather than by maximization of stock values

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# Empirical analysis

Aoyagi and Ganelli (2014 IMF WP, “Unstash the Cash!”) test the hypothesis that improving corporate governance can reduce firms’ cash holdings, using a panel of Japanese firms

Using various estimation techniques, their corporate governance variable has a negative and statistically significant impact on cash holdings

They conclude that improving corporate governance in Japan can help reducing excessive cash holdings

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### Table 3. Estimated Reduction in Cash Holdings Due to Improvement in Corporate Governance

(cash to market capitalization, percentage points)

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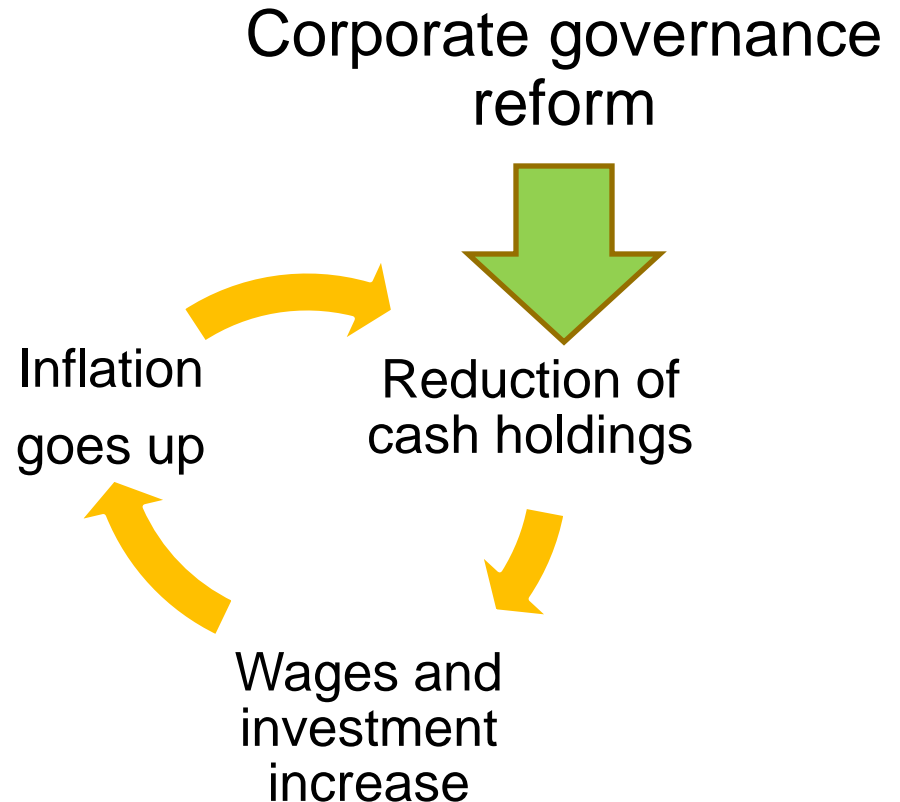
	Fixed Effects	Random Effects	Arellano-Bond	Average of Estimation Methods
Average to Maximum in Panel (index from 41.5 to 62.5)	1.9	8.0	6.9	5.6
Average to Theoretical Maximum (index from 41.5 to 100)	5.2	22.2	19.1	15.5

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Source: IMF staff calculations

# Economic impact

- First round effect (substantial cash holding reduction)
- Virtuous circle
- Potentially high impact on growth



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# What Has Been Done?

Recent initiatives and current plans go in the right direction:

- Stewardship Code for institutional investors (introduced in February 2014)
  - Amendment of Companies Act (outside directors on a comply or explain basis, June 2014)
  - Draft Corporate Governance Code (to take effect in June 2015; requiring at least two outside directors on a comply or explain basis, and explaining rationale for cross-shareholdings and anti-take over measures)
  - JPX-Nikkei 400 (launched in January 2014, private sector initiative)
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# Is It Working?

## **The Corporate Governance drive had some impact of firms' governance:**

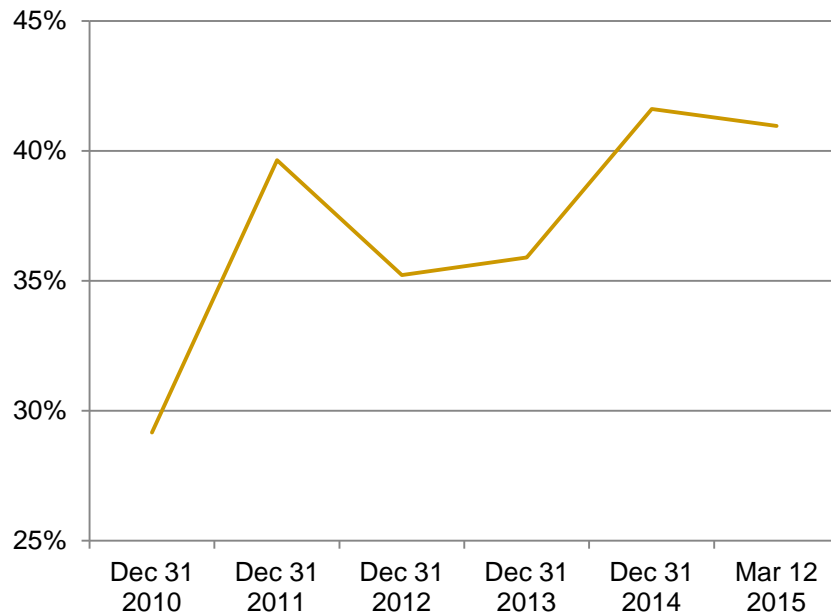
- As of February 2015, a total of 184 institutional investors, including the GPIF, have adopted the Stewardship code.
- The percentage of listed companies which have appointed outside directors increased from 47 percent in 2013 to 61 percent in 2014
- However, the percentage of outside directors out of total directors remain low at 8 percent (compared to 70% in the US, 50% in the UK, 30% in South Korea) reflecting the fact that in Japan most companies only have one or two outside directors.

# Is It Working?

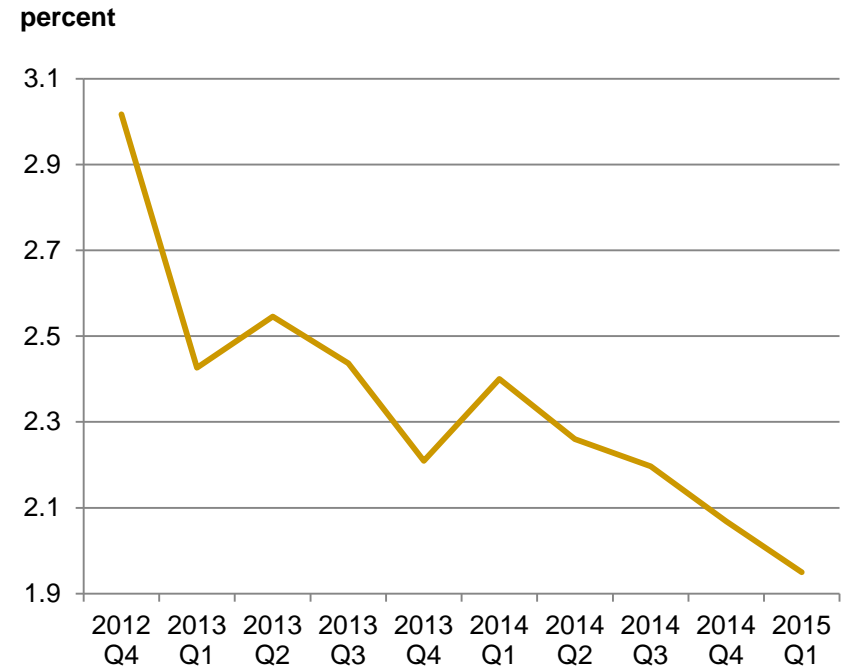
**However, the economic impact remains limited so far:**

Cash holdings are still high and dividend payments low...

Cash Holdings per Market Cap



Dividend Yield

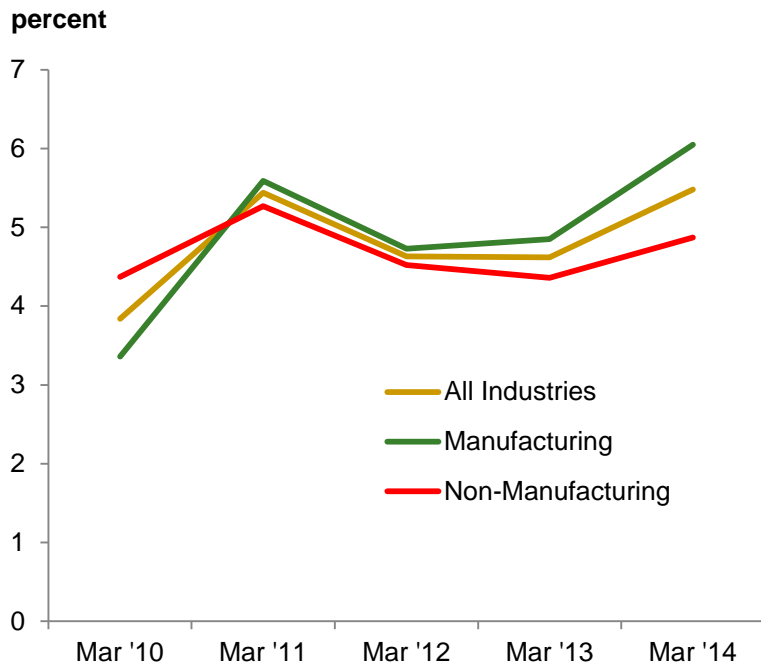


Source: Bloomberg

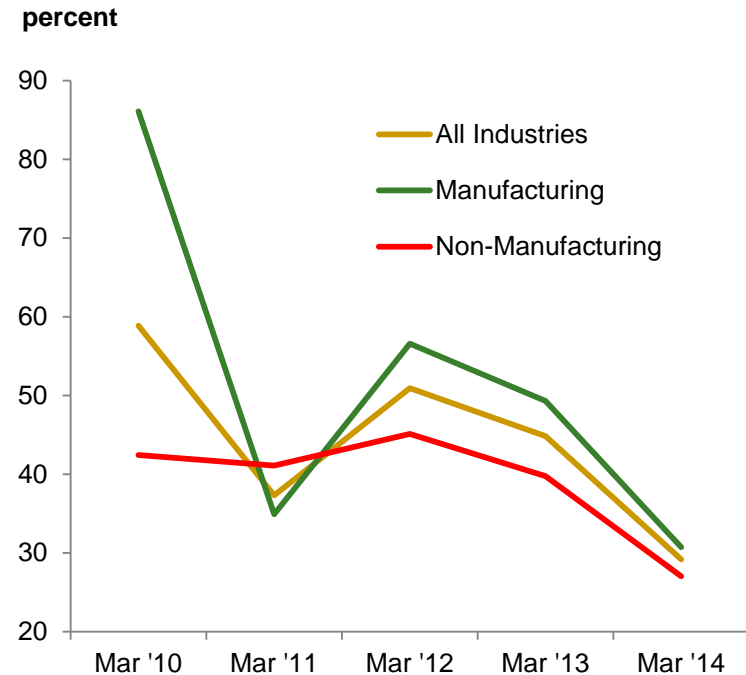
# Is It Working?

...despite a pick-up in profits

### Operating Profit Ratio



### Divident Payout Ratio

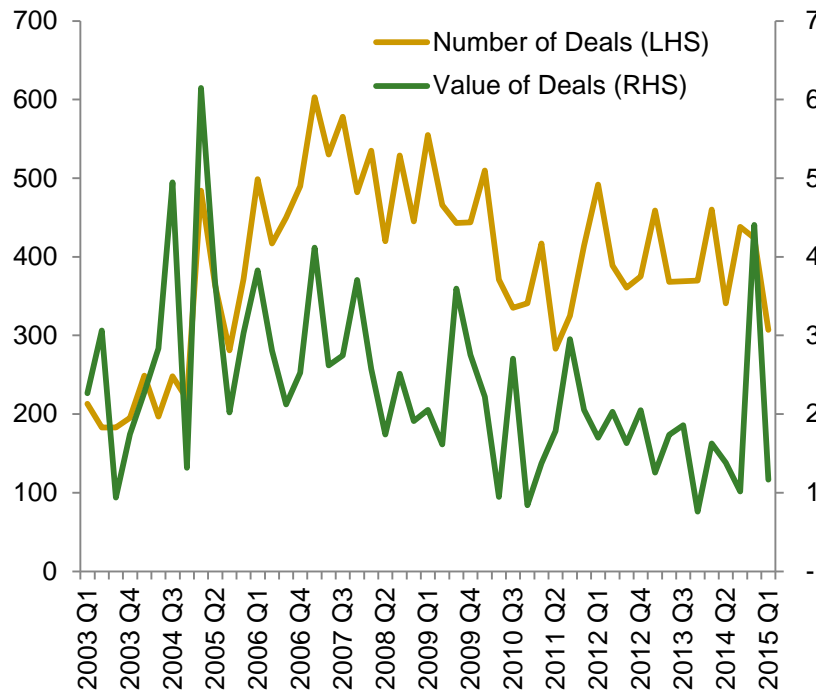


# Is It Working?

Some pick-up in M&A in value terms, but difficult to attribute to corporate governance reforms

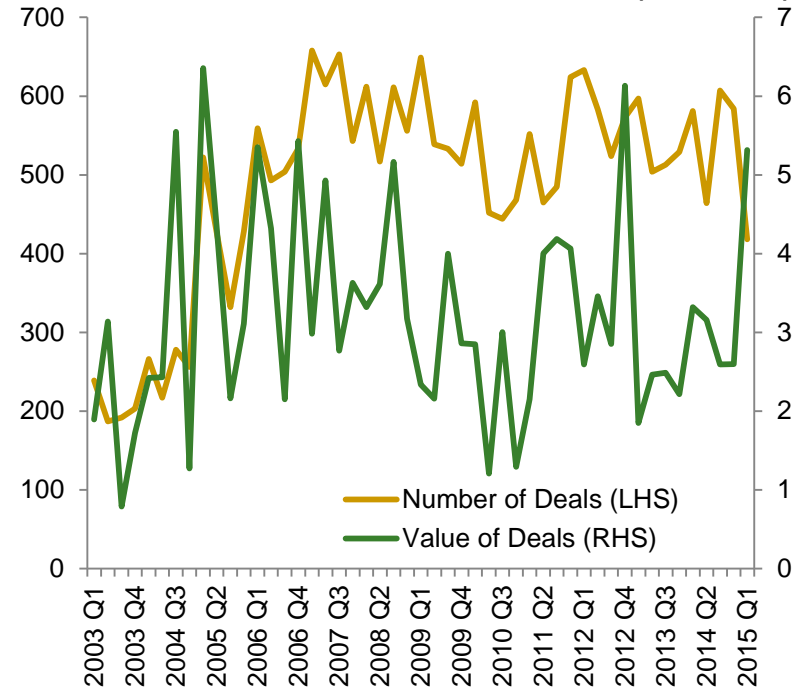
M&A- Japanese Companies as Target

(JPY trillion)



M&A- Japanese Companies as Acquirer

(JPY trillion)



Source: Bloomberg

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# Is It Working?

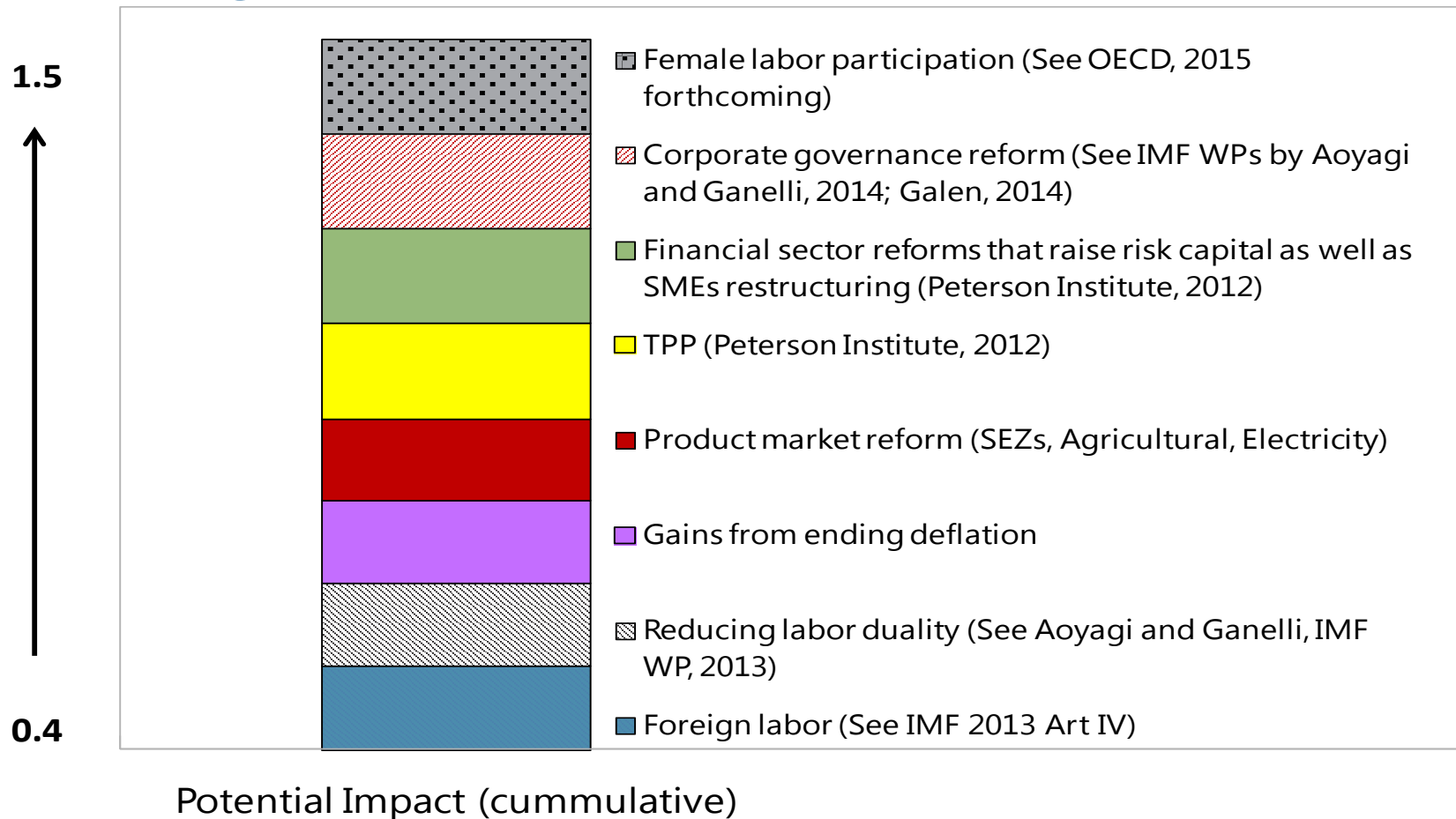
## **Corporate governance reforms could be more ambitious:**

- The Corporate Governance Code could be more ambitious in its requirements for independent directors
  - Implementation of tax and regulatory reforms to discourage excessive cross-shareholdings
  - Removing bottlenecks which prevent takeovers
  - Measures aimed at reducing the threat faced by firm managers in case of filing for bankruptcy
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# Corporate governance reforms should be complemented by other structural reforms

## Potential Impact of Path-Breaking Structural Reforms (Potential growth; Illustrative)



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- Thank you very much.
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## References

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**Table 2. Determinants of Cash Holdings in a Panel of Japanese Firms: Regression Results 1/**

	Fixed Effects	Fixed Effects (Robust SE)	Random Effects	Arellano Bond (2 lags)
<b>Dependent Variable: Cash Holdings in Percent of Market Capitalization</b>				
Governance Index	-0.089 [-1.82]*	-0.089 [-1.44] 2/	-0.380 [-8.59]***	-0.327 [-4.87]***
Log of Common Stock	-0.380 [-0.69]	-0.380 [-0.78]	0.280 [1.35]	0.232 [0.28]
Log of Number of Employees	8.179 [4.45]***	8.179 [2.81]***	2.002 [5.17]***	10.367 [4.08]***
Cash Conversion Cycle	-0.009 [-0.72]	-0.009 [-0.37]	-0.003 [-0.82]	-0.014 [-0.92]
Log of Capital Expenditure	-1.838 [-3.42]***	-1.838 [-2.30]**	-2.187 [-7.78]***	-0.790 [-1.23]
Debt-to-Equity Ratio	0.010 [3.70]***	0.010 [1.61]	0.005 [2.61]***	0.011 [3.77]***
Free Cash Flow per Share	0.007 [2.77]***	0.007 [2.20]**	0.002 [1.18]	0.014 [5.38]***
Lagged Dependent	0.095 [7.26]***	0.095 [1.93]**	0.786 [98.32]***	0.129 [6.47]***
Lagged Dependent				-0.158 [-11.53]***
R-squared (overall)	0.060	0.060	0.647	...

Source: IMF Staff Calculations