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CORPORATE GOVERNANCE, COST OF CAPITAL AND FINANCIAL DISTRESS

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Abstract

The purpose of this paper is to investigate differences in the systems of governance in the United States and Japan. We will look at the unique characteristics of the Japanese financial system which lower capital costs to companies in Japan and prevent them from taking over companies in financial distress. Moreover, we will investigate major changes in the recent corporate financial system in Japan and the effects of the decline of financial institutions upon the governance system and its implication in the financial distress of manufacturing companies.

I. *Introduction*

The Japanese economy has been in an unprecedented depression since the end of the 1980's. The performance of industrial firms worsened because of the drastic apprecitaion of the Yen, the fall in the prices of land and securities, and stagnation of domestic demand. There are several opinions as to why the recovery of the Japanese economy has been delayed. It can be expected that drastic deregulation in several fields of economies will not occur, nor will clear guidlines for business behavior be established in such an unclear economic environment. The latter is very important for an improvement of the global competitiveness of Japanese enterprises in the future, so we want to develop our discussion of this topic in the article.

As P. Sheard has pointed out,[1] the particular characteristics of Japanese corporate governance have something to do with the performance of business. Also, in relation to this governance system, we would like to make clear whether (1) transactions within the Keiretsu system lower the cost of transactions, (2) it will have some implications for determining capital expenditures in connection with the cost of capital, (3) financing from the primary bank, and "expansion of scale" strategies will become effective weapons and (4) the relationship between Keiretsu groups will continue when the firms face financial distress, and if so, the merits and demerits of the system must be explained.

* The author would like to thank Mr. Ronald Siani for editing the English.

[1] Paul Sheard, *Interlocking Shareholdings and Corporate Governance*, in ed. Masahiko Aoki and Ronald Dore, "The Japanese Firm, Sources of Competitive Strength," 1994, Clarendon Press, Oxford.

II. *Characteristics of Japanese Corporate Governance*

It is to be noted that corporate governance must be discussed in the framework of the modern corporation. The corporation is a form of business which is financed with a good deal of monies. However, the institution of the corporation has drawbacks, in that the stockholders' meeting is now an empty shell, and boards of directors do not function well. The American and Japanese economies are examples of two different types of economies, which may account for difference in business behavior between the two nations.

According to Ide, the American economic system is a pure market economy, while the Japanese system is a mixed-type economy, half way between the American type and the old Soviet planned economy.[2] Therefore, the Japanese economy has a market mechanism but also a non-market mechanism, and the corporate goal is not profit alone, but rather plural goals which include the public welfare. In other words, the corporate governance of the United States is based upon the principle of the market mechanism, where managers must be oriented toward the best interests of stockholders. They are exposed to the dangers of M&A, when they cannot earn a fair return.

Japanese firms are managed under a corporate governance system which is different in behavior from that in the U.S. and in Japan. As is well known, businesses employ new college graduates, train them on the job, raise their wages according to their age or experience (Nenko in Japanese), and provide life time employment in most Japanese firms. These practices help deter unfriendly mergers and acquisitions. In addition, there are the practices of stable shareholdings (antei kabunushi) and interlocking shareholdings (kabushiki mochiai). Institutional investors tend to hold equity for long periods and are not active traders of most of the equities they hold. Interlocking shareholdings refer to the practice of one firm holding shares in a second firm which simultaneously holds shares in the first.[3] Stable shareholders agree to waive the exercise of control rights, and hold shares as a friendly insider to the incumbent management.

Therefore, these two practices place constraints on the "voice" of shareholders. Therefore, in corporate governance in Japan, managers maintain independent discretion and governability. Stable shareholders receive side payments, and request discounts on the price of shares. The same practices can be seen in the transactions between parent companies and subsidiaries. Since a long and friendly relationship exists among them, the subsidiaries are willing to cooperate to keep costs down, when the value of the Yen rises and exports of the products become difficult. Their cooperation extends from the design to the completion of products; design-in process cooperation. This form of friendly insider-type corporate governance contributes to a reduction of asymmetric information, and allows the firms to enjoy mutual cooperation and credibility through a long relationship.

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[2] Shosuke Ide, *Japanese Corporate Finance System and International Competitiveness* (Nihon no Kigyo-kinyu System to Kokusai Kyoso), Toyokeizai Shinposha, 1944, p. 14.

[3] Sheard, *ibid.*, p. 319.

III. *The Trends of ROE and Changes in Corporate Governance in Japan*

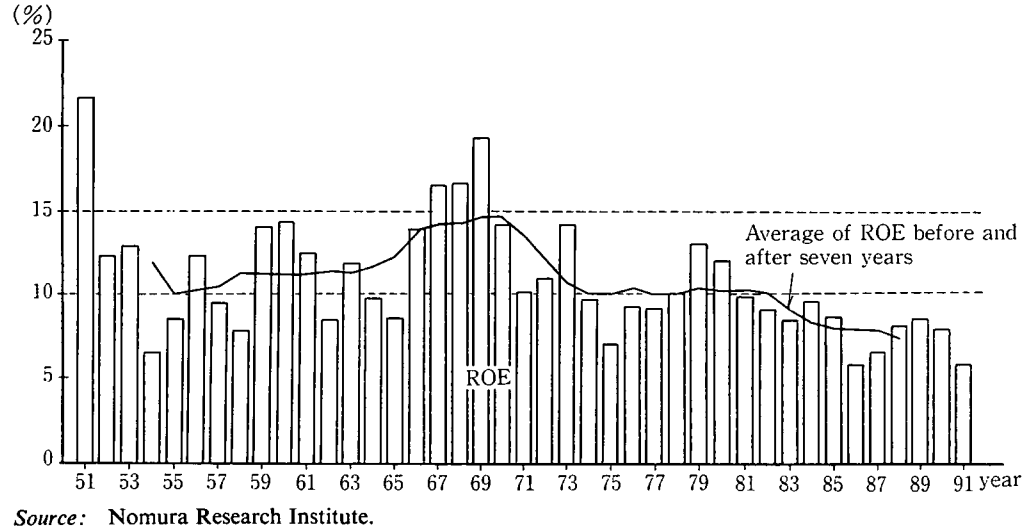
The Japanese manufacturing industries, especially the automobile, electric and machinary industries, achieved tremendous development until around 1985. For example, the semi-conductor, electronics and tele-communications industries have achieved parity with, and in many cases outstriped, U.S. industries. As is well known, the U.S. government has requested that the Japanese government establish numeric targets for imports on the Japanese-American Economic Restructuring Talks. The Japanese Government has continued to make efforts to increase domestic demand, deregulate and reduce taxes, but these efforts do not always satisfy to the U.S.

With the collapse of the "bubble" in 1991, Japan has been in a severe recession and no one is sure which industries will be the next leading industries in the future. The growth strategies which Japanese firms have pursued in the past, now present difficulties, and reflect the slow-down of profitability of business along with the overcapacity of industries.

Figures 1 and 2 make clear the trends of ROE of manufacturing industries according to NRI research.[4]

ROE rose about 17% in 1969, but fell 5.6% in 1991. In the same way, ROI rose about 15% in 1980 and fell 8.4% in 1991. Table 1 also shows ROI and ROE in the U.S. and Japan, according to Aoki and Matsuo.[5]

FIGURE 1. TRENDS OF RETURN ON EQUITY (MANUFACTURING INDUSTRIES)

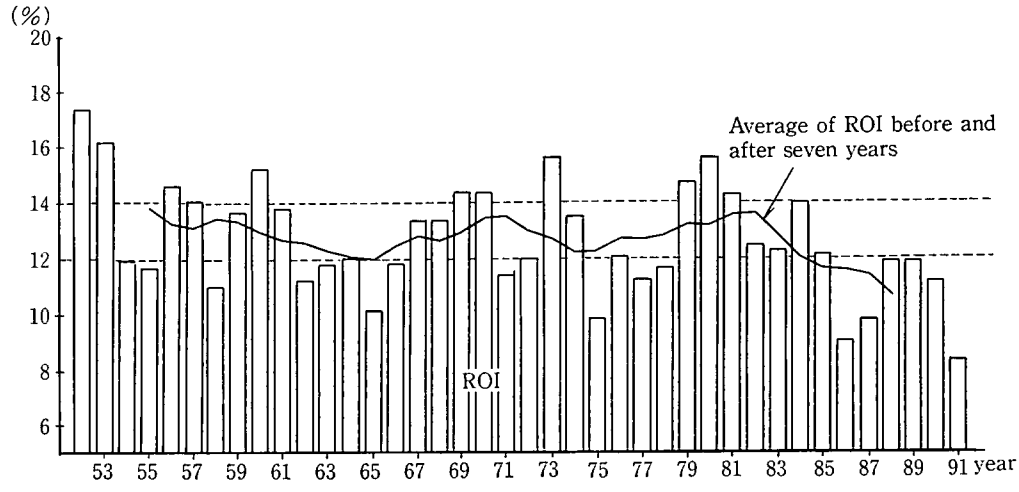


Source: Nomura Research Institute.

[4] Shigeru Watanabe and Isao Yamamoto, *Corporate Governance of Japanese Enterprise* (Nihon Kigyo no Corporate Governance), 1992, Security Analyst Journal, September 1, pp. 2–25.

[5] Jenny Corbett, An Overview of the Japanese Financial System, pp. 306–340, in ed. by N. Dimsdale, and M. Prevezer, *Capital Markets and Corporate Governance,* 1994, Clarendon Press, Oxford.

FIGURE 2. TRENDS OF RETURN ON ASSETS (MANUFACTURING INDUSTRIES)



Source: Nomura Research Institute.

TABLE 1. COMPARISON OF RATES OF RETURN IN U.S. AND JAPAN

	U.S.		Japan	
	All Industries	Manufacturing Industries	All Industries	Manufacturing Industries
ROI	4.1	3.8	1.9	2.8
ROE	13.0	12.3	7.2	7.7

Source: Aoki and Matsuo, ibid., p. 43.

Interestingly, the difference in ROI in the manufacturing industries of both countries was a narrow 1 point, but in terms of ROE-U.S. 12.3% and Japan 7.7; about a 4.5 point difference. Surely, in some industries in Japan, global competitive power surpassed the U.S. in ROI, and threatened its manufacturing industries since the end of 1988. However, during the past recent three years, manufacturing enterprises in the U.S. have undergone a dramatic and remarkable restructuring, which has resulted in a higher level of ROE compared with Japanese industries. For instance, Chrysler succeeded in a major restructuring effort and improved performance. It attempted to use outside suppliers, copying Japanese subcontractor relationship, and invested one billion dollars to establish a technology research center in order to transform the methods of new car development into a Japanese style system. This restructuring is characterized by a drastic labor reduction plan, along with investment in modernizing of equipment. As a result, Chrysler became healthy corporation.

On the one side, before the collapse of the economic bubble, Japanese enterprises were very aggressive in investing a great deal of monies into land and securities (Zaiteku). Generally, return on securities of financial investments are lower than those of physical investments, so that ROE fell in manufacturing industries. However, the real reason for the

fall of ROE was that the governance system did not function effectively. In the era of high economic growth, financial intermediaries, especially main banks, performed the leading role of governance as monitors of business behavior. Financial managers in the firms were of only secondary importance, in order to supply stable funds from main banks and to maintain friendly relationships. Therefore, the main bank functioned almost similarly to stockholders.

Since the end of the 1980's, big business in Japan has financed almost all of its capital expenditures with retained earnings and depreciation expenses. Moreover, they issued equity and convertible bonds in overseas capital markets with much lower costs of capital than in the domestic market. Therefore, while the monitoring function of banks weakened, investment standards were lowered, which resulted in the fall of ROE in manufacturing industries. In the U.S., institutional investors constantly minotor companies they have invested in, and often request a rise in the level of payout ratios, or in the level of the stock price. The CEO of GM, John Stempel, was dismissed, providing proof that the governance system exists in the U.S. On the other hand, boards of directors in Japan consist mainly of inside directors, and most executive directors have formerly been middle managers within their companies. The general structure of Japanese board looks very different from those in the U.S. There is usually a president, senior executive directors (senmu torishimariyaku) and other executive directors (joomu torishimariyaku), who make up the executive committee.[5] The executive committee is the top and final level in the main decision making hierarchy and the boards are used for approval only. The increase in the degree of cross-shareholding in Japan has met with criticism. It has given management undue power and is unfair to other investors, especially individual investors. The lack of a governance system is regarded as the reason for the fall of ROE in Japanese manufacturing industries in recent years.

IV. *The Cost of Capital Enigma*

The cost of capital has recently been regarded as a serious competitiveness issue. Many industries in the United States which are losing ground to foreign competitors are capital-intensive businesses such as consumer electronics, steel, and automobile companies. Putting aside the complexities of real versus nominal rates and the myriad assumptions needed to compute a company's cost of capital, it is commonly believed that a gap exists between the U.S. cost of capital and the capital cost of companies in Japan.[6] Texas Instruments CEO Jerry Jenkins stated the case as follows: To put the consequences of Japan's cost of capital advantage in numerical terms, in the past five years, Japanese semiconductor companies have invested $10 billion more in R&D, plant, and equipment than U.S. suppliers, were able to invest. And they gained more than 10 points of world market share—mostly at the expense of U.S. companies.

The cost of capital is defined as the required minimum return investments should earn. An international comparison in capital cost is difficult, because there are several differences

[6] Michael T. Jacob, *Short-term America*, 1991, Harvard Business School Press, p. 176.

in accounting systems, capital markets and the valuation of land. Table 2 summarizes some of the studies that have attempted to measure capital costs in the United States and Japan. This table illustrates that the capital costs of companies in Japan are much lower than those in the United States. A. Ando and A.J. Auerback, however, claim that interlocking shareholdings and the appreciation of the price of land owned by Japanese manufacturing companies decrease the discrepancies in capital costs, if we estimate them during 1980–1988, correcting the data in line with the above consideration.

In the same way, the Economic Reports in 1992, published by the Economic Planning Agency states that capital costs of companies in Japan in the 1980's were lower than in the United States by about 3 percent.

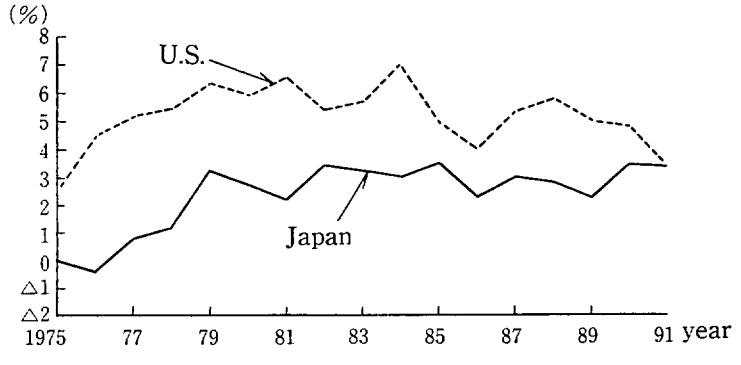
Nakatani concludes in his book that the important thing these studies illustrate is not the ex-post estimated cost of capital, but how Japanese management considered the financing costs ex-ante. Interlocking shareholdings and the primary bank system contributed to stable management and a reduction of business risk.[7] In other words, even if the return

TABLE 2. ESTIMATED COSTS OF CAPITAL, U.S. AND JAPAN

		Cost of Capital	
	year	United States	Japan
Hatspoulos-Books	1980	14.1%	4.0%
	1985	9.7	3.8
McCauley-Zimmer	1980	11.5	8.8
	1985	11.2	7.2
Bertheim-Shoven	1980	18.7	11.0
	1985	11.1	4.1

Source: James M. Poterba, "Comparing the Cost of Capital in the United States and Japan: A Survey of Methods," Federal Reserve Bank of New York Quarterly Review, Winter 1991, p. 30.

FIGURE 3. COMPARISON OF THE CAPITAL COSTS IN THE U.S. AND JAPAN



Sources: "Economic Survey of Japan, 1991–1992," Economic Planning Agency.

[7] Iwao Nakatani, *Conditions for Revival of Japanese Firms* (Nihon Kigyo Fukkatsu no Jyoken), Toyo Keizai Shinposha, 1993, pp. 47–48.

on investments were not high, financial intermediaries or capital markets could invest in investment opportunities which would be expected to earn high returns in the future, and this is the reason why Japanese companies were able to perform advantageously in terms of competitiveness.

In addition, the behavior of city banks is noteworthy in Japan. From the beginning to the middle 1980's, not only large companies but also medium-sized companies could borrow money easily, because the prices of land which was used as collateral for loans appreciated greatly, even if the estimated rate of return was lower. In those times, the author can not forget the impression, gained during a visit to the Kyushu industrial district where there are a number of semi-conductor and electronics factories. Suppose a semi-conductor factory was established in Kyushu where labor costs are lower, and there was access to clean water. Other rival companies will establish themselves in the district, because otherwise they will lose market share, and find themselves at a competitive disadvantage. Therefore, they will compete with each other by expanding the scale of their factories, even if their investment is not able to earn an adequate return.

The preceding arguments have shown that as the cost of capital is higher for U.S. companies, they must select projects with higher rates of return. If these projects are so innovative that rival firms cannot duplicate them, the companies will be able to gain innovator's profit. Such a unique characteristic in decision making for plant and equipment exist as a value premise in the United States. On the one hand, Japanese manufacturers do not neglect capital cost, which is an important criterion in evaluating plant and equipment projects, but regard sales or market share as more important. If similar plants and equipment are introduced continuously in the same industry, price competition will increase in severity, and a production overcapacity will result. Nevertheless, the allowance of lower return projects in Japan is due to the lack of maturity of capital markets. If the market is so efficient that the price of stocks immediately reflect the performance of business, the market will become more efficient, for the SEC (Securities Exchange Commission) in the U.S. ensures the disclosure of business information. However, in Japan banks are the main lenders for long-term borrowers' needs. So, the degree of assymetric information will be less, and agency cost is also less. This suggests that disclosure of information and regulations for insider transactions were not adequate until 1988.

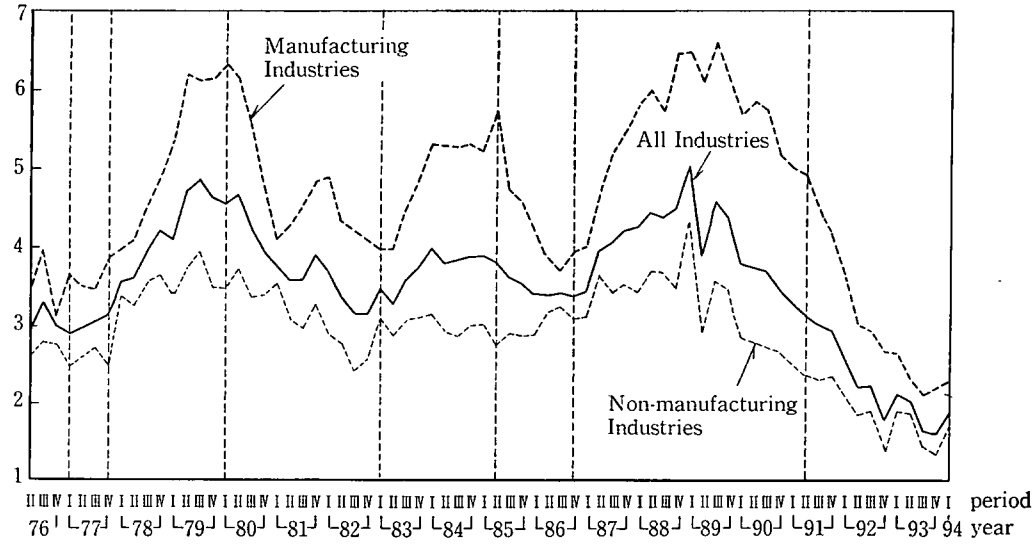
It is to be noted that recently, the lending activities of banks have been more cautious owing to the regulation of the BIS. The drastic decline of interlocking shares and land owned during the bubble period resulted in a large losses in the value of these assets, and in bad debts. Therefore, because of changes in the environment, Japanese businesses have come to regard profitability as more important, and the level of the cost of capital is now almost the same in Japan as in the U.S., or perhaps a little higher in Japan. In other words, we cannot regard the cost of capital as a serious competitiveness issue.

V. *Financial Distress and Financial Strategy*

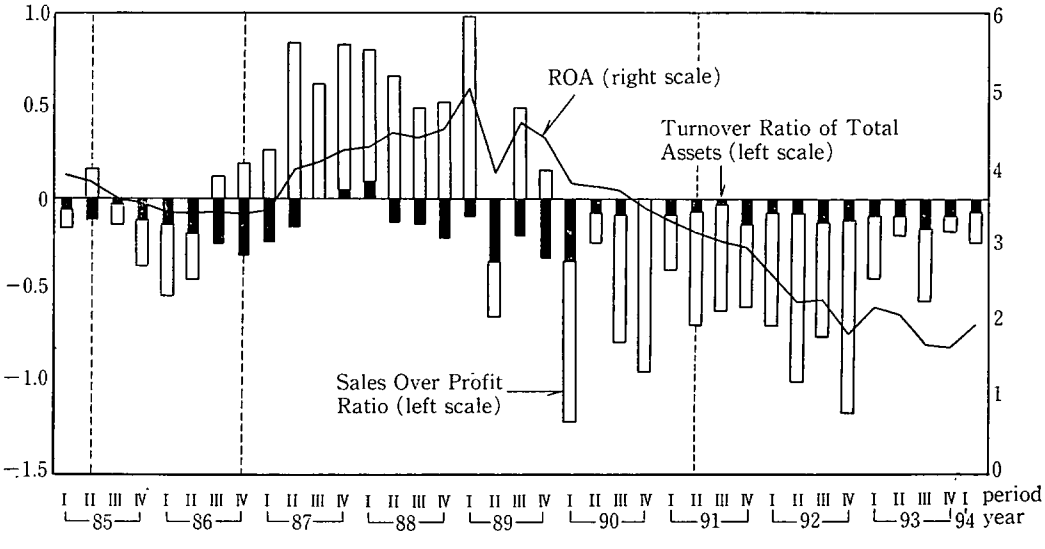
From 1989 to 1990 plant and equipment investments in the private sectors achieved a peak, but after the collapse of the bubble they decreased. Figure 4 illustrates that the return on assets (ROA) decline remarkably as a result of the depression.

FIGURE 4. TRENDS OF ROA AND ITS FACTOR ANALYSIS

① Trends of ROA



② Factor Analysis of Rise and Fall of ROA



Source: "Economic Survey of Japan," 1993–1994, Economic Planning Agency.

ROA fell down to about 3%, which shows the severity of the depression at this time. According to a factor analysis of ROA, the fall of ROI was due to the decline in the Sales over Profit Ratio (sales/profits). It stands to reason that restructuing is the most important strategy of Japanese manufacturing companies. In the same way, although there are differences between the U.S. and Japan, financial restructuring is now attracting notice. In the U.S., financial restructuring is carried out in association with a reorganization of bankrupt firms, or in the process of mergers and acquisitions. In Japan restructuring occurred as a result of a decline in business performance.

Here, we must make clear the scope of financial restructuring. We restrict our studies to the adaptive behavior of business in responce to financial distress. There are several strategies involved, depending upon the degree of financial distress. Here, we suppose there are three options which businesses can take in the face of financial distress:

1) capital structure arrangements for improvement of debt equity ratio
2) divestiture or sale of assets
3) corporate bankruptcy or dissolution

We would like to take into consideration (3) item above.

In Japan there are five Acts under the Bankruptcy Code; Corporate Reorganization Law, Corporate Dissolution Act under the Commercial Law, Compositions Law, Special Dissolution Act under the Commercial Law and Bankruptcy Act. These laws are divided into reorganization and dissolution laws. On the other hand, in the United States Chapter 11 and 5 under the Bankruptcy Reform Act correspond to the reorganization and dissolution laws, respectively. Therefore, from the viewpoint of the Bankruptcy Code, the Japanese system is more complicated than the one in the U.S.

From Table 3 the number of compositions with creditorsc (323) exceed that of corporate reorganizations (44) in 1993. Also, the numbers of corporate dissolution are 110, greater than the compositions with creditors . Corporate dissolution is applied to cases where the amount of debts exceeded the stock of equity, and where the probability of repayment is very low. On the other hand, under the Reorganization Act, the bankruptcy court can appoint a receiver, who exercises control over the corporation. Under the Corporate Resolution Act, the incumbent management is able to reorganize the company, and thus if they are trusted, to reorganize the corporation they are more likely to succeed in the reconstruction effort.

We define financial distress as the interest coverage ratio (earnings before interest and after taxes/interests) less than 1. The capital structure arrangement or restructuring which belongs to the first of financial distress includes the following strategies. All of them include some form of negotiations with banks. For example, mitigation of financial convenants, reduction or redemption of interest payments, postponement in the maturity of claims, and suspension of relief financing for the bankrupt companies.

According to J. Franks and W. Torous, the financial restructuring of firms were undertaken more, on average, by a distressed exchange of publicly traded debt or cash (exchange offer) than those reorganizing under Chapter 11.[8]

[8] J.R. Franks and Walter N. Torous, A Comparison of Financial Recontracting in Distressed Exchanges and Chapter 11 Reorganization, *Journal of Financial Economics* 35, 1994, pp. 349–370.

TABLE 3. TRENDS OF BANKRUPTCY

	Corporate Bankruptcy		Number of Suspensions of Business by Banks*			Filling under Reorganization of Courts				
	Number of Bankruptcies	Totals Debts (million)	Total Number of Suspensions	Corporations over 100 millions yen	Corporations under 100 millions yen	Total Numbers	Bankruptcies	Compositions with Creditors	Reorganizations	Special Dissolutions
1975	12,606	1,914,645	16,797	104	16,693	1,886	1,408	191	121	166
1976	15,641	2,265,778	19,235	166	19,069	2,144	1,515	320	125	184
1977	18,471	2,978,061	21,197	177	21,020	2,844	1,984	493	126	241
1978	15,875	2,475,635	17,285	160	17,125	2,702	2,070	382	80	170
1979	16,030	2,191,279	16,519	169	16,350	2,905	2,321	401	61	122
1980	17,884	2,722,486	18,441	216	18,225	3,590	2,877	514	63	136
1981	17,610	2,692,463	17,177	198	16,979	3,902	3,221	517	39	125
1982	17,122	2,393,193	16,174	208	15,966	5,693	5,029	521	39	104
1983	19,155	2,584,108	17,219	238	16,981	18,564	17,878	557	28	101
1984	20,841	3,644,105	18.405	284	18,121	27,111	26,384	574	49	104
1985	18,812	4,235,518	16,490	279	16,211	17,660	16,922	575	41	122
1986	17,475	3,831,428	13,519	247	13,272	14,222	13,556	521	41	104
1987	12,655	2,122,362	9,067	167	8,900	11,594	11,202	265	20	89
1988	10,122	2,000,964	7,834	159	7,675	11,225	10,980	156	10	79
1989	7,234	1,232,296	5,417	134	5,283	10,324	10,173	85	10	56
1990	6.468	1,995,855	6,268	172	6,096	14,265	14,063	107	14	81
1991	10,723	8,148,750	9,982	363	9,619	31,001	30,666	217	14	104
1992	14,069	7,601,499	11,254	492	10,762	47,885	47,438	302	30	115
1993	14,564	6,847,689	10,717	471	10,246	46,694	46,217	323	44	110

* Exclude the numbers of individual firms under suspension.

Sources: Tokyo Shoko Research, National Bank Association, Annual Report of Justicial Statistics.

From panel A of Table 3, the majority of payments in the distressed exchange of senior debt are in the form of cash (29%) and new senior debt (38%), whereas in the distressed exchange of junior debt, common stock (67%) constitutes the majority of the payments. Similarly, in the Chapter 11 reorganization (panel B), senior debt is paid primarily in either cash (32%) or new senior debt (39%) and the majority of payments to junior debt are in common stock (50%). The authors also found that firm recovery rates were significantly smaller under Chapter 11 reorganization than in distressed exchanges.

As is well known, under Chapter 11 of the U.S. Bankruptcy Reform Act a financially distressed firm or debtor is typically allowed to act as the trustee, in which case he is referred to as the *debtor in possession* and retains complete control over the operations of the firm. Furthermore, the debtor alone is entitled to file a reorganization plan during the first 120 days following the filing of a bankruptcy petition and has an additional 60 days to obtain acceptance by the creditors.

Generally, there is one obstacle to successfuly completing an exchange offer. Those

TABLE 4. DISTRESSED EXCHANGES AND CHAPTER 11 REORGANIZATIONS

Payments received	Panel A: Distressed Exchanges Creditors					Total
	Bank & insurance debt	Senior debt	Junior debt	Preferred stock	Trade debt	
Cash	10.46%	29.23%	2.25%	1.73%	87.86%	13.08%
Bank debt	55.55					35.39
Senior debt	10.57	38.32	11.30		9.69	15.19
Junior debt	0.53	1.70	13.15			2.43
Preferred stock	20.28	15.88	3.21	71.48		18.97
Equity	1.81	13.25	66.92	26.79	2.45	13.70
Warrants	0.32	1.62	0.11			0.51
Property	0.48		3.05			0.72

Payments received	Panel B: Chapter 11 reorganizations Creditors						Total
	Bank & insurance debt	Secured debt	Senior debt	Junior debt	Preferred stock	Trade debt	
Cash	27.00%	31.38%	32.03%	10.54%	27.61%	98.57%	29.33%
Bank debt	6.74						1.80
Secured debt	2.02	5.00	4.30	10.88			4.19
Senior debt	49.70	41.34	34.26	15.40		0.86	38.71
Junior debt	3.92		1.20				1.57
Preferred stock	0.31	1.84	5.30	2.57			2.97
Equity	7,64	20.43	22.28	56.45	42.45	0.57	20.00
Warrants	0.11		0.63	4.16	29.94		0.74
Property	2.55						0.68

Percentage of creditors' total payments received in the form of a particular security, cash, or property. Figures are based on a sample of 45 firm that restructured their debt informally and 37 firms that formally recorganized under Chapter 11 in the period 1983–1990.

Source: J.R. Franks and W.N. Torous, Financial Recontracting of Firms in Distress

debtholders who do not tender can see the value of their bonds rise if the exchange offer is successful since tendering creditors forgive some of the debt and reduce the default risk of the original debt.[9] Although public debtholders as a group would be better off if the exchange offer goes through, those with small stocks have an incentive to hold out. However, the free-rider problem can be mitigated by offering a more senior security in exchange for the public debt, one with shorter maturity, or, when it is available, cash.

In Japan we do not have such exchange offers in financially distressed firms, because the Japanese bond market does not function as actively as the U.S. markets, except for the period when a large amount of convertible bonds or warrants were issued in 1980's. After the collapse of the Bubble in 1988, the prices of common stocks fell sharply lower, and made the conversion of convertible bonds into common stock difficult. Further, because of payments on outstanding CB's, straight bonds must now be issued.

Notwithstanding, banks still have a major influence upon distressed firms, even if it is argued that the power of control has broken down. Bank relationships which exist in Japan, as we already stated, do not always require exchange offers as in the U.S. When banks in Japan purchase the distressed securities, they acquire control over the incumbent management, and new directors are sent to reorganize the company. Here we can recognize a specific type of governance system in financially distressed firms in Japan.

Hoshi and Sharfstein have focussed on the performance of financially distressed firms, and have shown how corporate groupings and the primary bank system are useful in mitigating incentive and informational problems in financial markets and reducing the costs of financial distress.[10]

VI. *Concluding Remarks*

We found that there are large differences in meeting financial distresses in Japan and the U.S. Of course, we cannot judge definitely which system is more favorable or economically significant. In such a pure market economy as in the U.S., the risks of financial distress can be reduced by several methods, especially by an exchange offers. In Japan, there exist several constraints or rules to influence business, either distressed or healthy; for instance by the Ministry of Finance or Bank of Japan. However, following deregulations of the bond markets, and globalization of markets, many firms have weakened their bank ties which have played a central role in corporate groupings and interlocking shareholdings in the past. To be sure, weakening of bank ties will continue in the near future, but that does not mean that the interlocking shareholding system will break down. It will continue with a further loosening of bank ties and a reduction in the dependence of business on bank loans.

Studying the economic implications is an important issue to be further investigated in the future, but we can say here that stockholder groups as core or institutional investors,

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[9] R. Gertner and D. Scharfstein, A Theory of Workouts and the Effects of Reorganization Law, *The Journal of Finance*, September 1991, pp. 1189–1221.

[10] Hoshi, T. and D. Sharfstein, The Role of Banks in Reducing the Costs of Financial Distress in Japan, *Journal of Financial Economics*, 27, 1990, pp. 67–88

will assume the central role in corporate governance, and these shareholders will demand a higher payout ratio. Furthermore, it is estimated that deregulation of financial rules by the MOF (Ministry of Finance) will increase out-in-type M&A's (mergers and acquisitions of Japanese firms by foreign companies) and collaboration with outside suppliers in foreign countries. More importantly, the primary bank system is now undergoing change, because most principal banks need help in meeting the debt equity ratio set by the Bank for International Settlement (BIS). Therefore they cannot aggressively lend because of the amounts large of distressed loans they carry. Lending activities must be changed to support venture business which has not grown to date in Japan. The financing system for supporting venture businesses in Japan is an extremely important issue. The weakening tie to banks and changes in the capital markets will greatly influence the structure of corporate governance and the cost of capital in Japan.

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