Corporate Governance of Japanese Firms: Empirical Studies on the Incentives and Characteristics of the Directors

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Abstract

In this dissertation, we intend to analyze the corporate governance of Japanese public firms by focusing to the origin, structure, and motivation of directors.

In the public joint companies, the managers, whose interests do not fully overlap those of the shareholders, may deviate from the best course of action for shareholders. Under the Japanese corporate law, general meeting of shareholders, board of directors and audit are expected to solve this agency problem between shareholders and managers. But, it is said that these mechanisms fail to monitor the managerial actions. If this is the case, it is important to motivate managers to pursue shareholders' interest.

In chapter 2, we investigate the role of bank-dispatched directors in Japan. We argue that previous studies on bank-dispatched directors failed to grasp an important characteristic of the board of Japanese firms -- intra-board heterogeneity. Senior directors, both indigenous (i.e., internally promoted) and non-indigenous (including bank-dispatched), have more responsibility, meet more frequently, and are involved in the management on a full-time and day-to-day basis. By contrast, many of the bank-dispatched junior directors are part-timers, with their main responsibility remaining with the banks. Noting this fact, we hypothesized that, at the time of the firm's financial distress, banks would insist on dispatching directors at a senior level. In other words, appointment of senior directors from banks would follow the firm's poor performance but the appointment of bank-dispatched junior directors need not.

We empirically confirm this hypothesis in two ways, using the panel of 116 Japanese firms over 1990-1998. First, the probability of banker appointment at the senior or junior level is regressed on the firm's performance variables and the dummy variable indicating the presence of predecessors. The results indicate that a lower industry-adjusted profit rate or the occurrence of negative profits is more likely to cause the appointment of bank-dispatched senior directors at the end of the year but not that of junior directors. Second, in order to separate new appointments and increases in appointments from the replacement of predecessors, we classify the sample into three subsamples, depending on whether no bank-dispatched director was present, such a directors was present at a senior level, or such a directors was present only at a junior level, and apply multinomial logit regression to each subsample. The results indicate that, provided a high borrowing ratio of the firm, a lower profit rate, firstly, increases the probability of new appointments, that is, appointments of bankers at a senior level in a firm that had no bank-dispatched director previously; secondly, increases the probability of additional appointments, that is, the bank's dispatching additional senior bank-dispatched directors to the firm that has already had such directors; and, thirdly, does not significantly affect the probability of banks' dispatching directors at a junior level, be it new dispatch, increased dispatch, or replacement. We then look at the firm's adjusted rate of return on assets during the three years following the appointment and found that a new appointment in fact improves the firm's performance but not additional appointments or replacements. These results are consistent with our principal hypothesis that the firm's poor performance triggers the dispatch of new directors from banks at a senior level who will involve themselves in a rescue operation, and that this tendency is stronger when the firm is financially more dependent on banks.

In chapter 3, we estimate the transition of presidents' financial incentive in Japan. We construct new dataset on presidents' wealth from 1977 to 2000, which include presidents' cash compensation, stock option grant, and presidents' stock and stock option holding, and estimate the sensitivity of Japanese presidents' wealth to shareholders' wealth for 24 years. We find that presidents receive small increases in their wealth when they perform well. In addition, contrary to the commonly held belief that Japanese corporate governance is becoming more like that in the US where each CEO has a direct financial incentive to maximize shareholders' wealth, we show that pay–performance sensitivity has actually decreased substantially after 1990. In 2000, presidents receive 2,652 thousand yen (approximately 22.1 thousand US dollars) when stock return increases from –2.1% (50 percentile of whole sample) to 14.8% (70 percentile). This is considerably lower than the 1.823 million dollars reported in the US. This figure is also smaller than the corresponding figure in 1977, when presidents receive 7,477 thousand yen.

When we use another measure of pay-performance sensitivity, the results are almost same. In 1977, when shareholders' wealth increases by 1000 yen, the median president receive .166 yen of direct pay, .017 yen of future salary by decreasing the possibility of dismissal and a .667 yen increase in the value of their ownership. In sum, each president receives .85 yen per 1000 yen increase in shareholders' value. This figure is quite small compared with the figure of 3.25 in the US, and this figure becomes smaller after 1977. In 2000, presidents receive .333 yen, which is less than half of the corresponding figure in 1977.

Career concern potentially mitigate agency problem between shareholders and managers. In chapter 4, we extend the source of Japanese presidents' incentive to

implicit career concern. In large Japanese firms, top managers are active after they resign as president. Many of presidents become chairperson of the firm. Some are elected to executive positions of industrial association and that of broader-based business organizations. After being 70 year old, some ex-top managers receive honors from government. If these activities after they resign as president were affected by their performance when they are presidents, presidents may work hard to improve firm performance even when monetary incentive is weak. To provide evidence on these issues, we collect the data about honors and executive of business organizations, and investigate the determinants of them. We find that presidents' probability of winning an honor from government is positively related with their accounting performance when they are presidents. We also argue that concern for future honor affect pay-performance sensitivity. In the presence of career concern, the optimal compensation contract in the standard principal-agent model between shareholders and managers optimizes *total* incentives for managers -- the combination of the implicit incentives from career concern and the explicit incentive from the compensation, stock ownership and stock option. Therefore, if the managers have strong implicit incentives from career concern, explicit incentives from the optimal compensation contract should be weak. Using the dataset on presidents' wealth from 1984 to 2000, we empirically confirm this hypothesis. We find that financial incentive of presidents is weaker for those who are more likely to receive higher honors.

In chapter 5, we examine the performance of the firms which is controlled by founding family in Japan. We construct new dataset on founding family, which includes founding family ownership, family management, and generation of family top managers. We find that founding families are a prevalent and important class of shareholders and

top managers. 738 firms (40% of all listed firms) have a shareholder related to founding family in twenty largest shareholders. In 550 firms (30%), founding family is the owner of at least five percent of the firm's equity. In 461 firms (25%), largest shareholder is founding family. In 759 firms (42%), there is at least one director on the board who is the founder or a member of founding family. In 659 firms (36%), top manager (president or chairman) is the founder or his descendant. In 423 firms (23%), largest shareholder is founding family and top manager is from founding family.

Furthermore, we empirically find that family firms outperform non-family firms in Japan. However, family firm premium is mainly arisen from active founders. After founders retired, the results are mixed. We find that the performance of family firms both owned *and* managed by founder's descendants is not superior to that of non-family firms. In contrast, family firms owned *or* managed by founder's descendants create firm value.