Corporate governance and the stakeholders' theory - a brief introduction of the German-Japanese model

NELSON SANTOS ANTÓNIO

THE PROBLEM

"The company belongs to people who invest in it – not to its employees, suppliers, nor the locality in which it is situated". Dunlap, Albert J., in "How I saved Bad Companies and Made Good Companies Great", New York, Time Books, 1996.

What Dunlap had in mind was that: the employees, the suppliers, the clients, the government and the spokesmen of the community have no say in the decisions that "the people who invest" may take. And that the true decision-makers, the investors, have the right to dismiss out of hand, and to declare irrelevant and invalid, any postulates which such people may make concerning the way they run the company.

Dunlap's message is not a declaration of intent, but a statement of fact. Dunlap takes for granted that the principle it conveys has passed all the tests which economic, political, social and any other realities of our time might have set to examine its viability. It has by now entered the family of self-evident truths, which serve to explain the world while themselves needing no explanation.

Should we accept this "truth" without discussion? Or are there other ways to govern the corporations?

INTRODUCTION

In the late 19th century, huge modern corporations emerged in the United States and the public corporation became the dominant business structure. Adolf Berle and Gardiner Means voiced concern over the power of management in these big corpora-

NELSON SANTOS ANTÓNIO
Full Professor of ISCTE, where he teaches Strategy. He was director of the Management School of the Macau University for 8 years. He is also visiting professor of the Management Institute of I Rennes (Rennes I University). He has been publishing work on Strategy, Quality Management, Comparative Management and Organisational Theory.
E-mail: njantonio@hotmail.com

tions with widely dispersed ownership; "to Adam Smith, private enterprise meant individual or few partners actively engaged in and relying in large part on their own labour or their immediate direction. Today we have tens and hundreds of thousands of owners, of workers and consumers combined in single enterprises" (Berle and Means, 1932). With the separation of ownership and control in a modern dispersed--ownership corporation, shareholders may incur agency costs as managers find it easy to pursue their own interests rather than those of the shareholders.

In contrast, Alfred Chandler, Jr. saw the growing concentration of power among the professional managers in a positive light; "In many modern business enterprises neither bankers nor families were in control. Ownership became scattered. The stockholders did not have the influence, knowledge, experience, or commitment to take part in the high command. Salaried managers determined long-term as well as short--term. They dominated top as well as lower and middle-management" (Chandler, 1977). Modern corporations seem to have performed well with internal governance.

The term "corporate governance", although now commonplace, was rarely encountered before 1990s. A few years ago the subject of corporate governance was little discussed certainly not under that name. Before Harold Wilson's book "The Governance of Britain"(1977) the word "governance" was not in popular usage.

Unfortunately, its subsequent rapid adoption has not been accompanied by consistent usage. Different writers vary widely in where they draw the boundaries of the subject. There is some doubt about what "corporate governance" means. Tricker (1984) defines it as "the process by which companies are run". The Committee on Financial Aspects of Corporate Governance (Cadbury) said that, "corporate governance is the system by which companies are directed and controlled".

In the narrowest sense, the term may describe the formal system of accountability of senior management to the shareholders. At its most expansive, the term is stretched to include the entire network of formal and informal relations involving the corporate sector and their consequences for the society in general. The economic debate concerning corporate governance is often posed in terms of a potential dilemma between strong direction and accountability, there being a tension in the paradox that assets are most efficiently valued when information to shareholders is maximized, whilst operational efficiency suggests that shareholders delegate surveillance and decision--making to managers. For example, the German-Japanese model of governance being based on a pattern of institutional relations, unlike the market-based Anglo-American model, it diminishes such tensions by relying much less on the market assessment, and by including a wide range of stakeholders in the governance process.

Corporations must be able to develop and implement their respective competitive advantages, to raise capital, to assemble and redeploy resources to that end and, at the same time, to meet the expectations of their shareholders, employees, suppliers, creditors, customers, communities and society at large. Corporate governance comprehends that structure of relationships and corresponding responsibilities among a core group consisting of shareholders, board members and managers designed to best foster the competitive performance required to achieve the corporation's primary objective.

The absence of any real consensus on the definition of "corporate governance" in the rapidly growing literature on the subject is symptomatic of the whole debate on governance reform. It is a debate in which the participants have entirely different analyses of the problem and therefore offer markedly different solutions. Fundamental disagreements cover key questions: for example, does the effectiveness of a firm's governance arrangements have implications which go beyond those for its shareholders and, if so, does this justify public policy intervention? Should any such intervention be concerned with distributional issues as well as those of efficiency? What is the nature of the shareholder's ownership claim? And what, if any, restrictions should be placed upon the shareholder's contractual freedom, as a resource owner, to maximize his financial reward from such resources?

The underlying problems of corporate governance as recognized by a long tradition of scholars stretching back from present day via Berle and Means (1932) and Marshall (1920) to Adam Smith (1776) lies with the separation of beneficial ownership and executive decision-making in the joint-stock company. All analysts agree that such a separation allows – if it does not actually encourage – the firm's behavior to diverge from the profit-maximizing, cost-minimizing ideal. However, the corporation's theorists disagree profoundly on the significance of this separation.

Corporate governance practices constantly evolve to meet changing conditions. As a work-in-progress, there is no single universal model of corporate governance. Nor is there a static, final structure in corporate governance that every country or corporation should emulate. Experimentation and variety should be expected and encourage firms around the world to be able to learn from each other. Innovation, knowledge, skills; these things are universals, and how we approach them can provide valuable lessons for others, just as we ourselves can learn from others. However, and this may be the most important single lesson going into the twenty-first century as communications and information flows improve and the distance between firms continues to shrink, firms can learn from each other without sacrificing their own uniqueness.

To illustrate this we will summarize two competing perspectives materialized on two different models: the Anglo-American model and the German-Japanese model.

THE ANGLO-AMERICAN MODEL

The theory behind the Anglo-American Model

The principal-agent, or finance, model is the dominant academic view of the cor-

poration and the basis for the Anglo-American model, and it is perhaps most clearly articulated by Hart (1995 a,b). It rests on the premises that markets – particularly the markets for capital, managerial labor, and corporate control – provide the most effective restraints on managerial discretion, and the residual voting rights of shareholders should ultimately commit corporate resources to value-maximizing ends.

According to the original definition of Jensen and Meckling (1976), an agency relationship is a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf, which involves delegating some decision-making authority to the agent. In a narrow sense, agency theory is a special contract theory. Agency theory holds that organizations can be analyzed in terms of a conflict of interest between principals and agents. Managers have interests, according to agency theory, which diverge from the principals, and so they may use their discretion to maximize their interests at the expense of the interests of the principals, called "residual loss".

Agency theory has developed along two distinct lines. On the one hand, there is the normative agency theory, which is largely concerned with the design of optimal incentives contracts. Recognizing that, monitoring and bonding expenditures paid out to align the behavior of the manager – agents with the interests of owner – principals represent costs to the economic system. However, rather than justifying public intervention, it suggests that such costs provide the incentive for innovations in corporate governance. Thus recent developments in the managerial labor market, such as executive stock options, and the market for corporate control, for example, leveraged and management buy-outs are seen as responses to institutional deficiencies.

On the other hand, there is an empirically oriented positive branch on agency theory that focuses on the explanation of different institutional arrangements, which can be observed in reality. Under realistic assumptions, all of the principal-agent relationships cause the so-called "agency problems". The first assumption is that the agent is an individual who attempts to maximize his or her own utility rather than of the principals. The second assumption concerns the asymmetrical distribution of information between the parties. Two kinds of information asymmetries can be distinguished: the hidden action case and the hidden information case. In the hidden action case, the action choice of the agent is unobservable by the principal, thus a moral hazard problem arises, that is, post-contractual opportunistic behavior of the agent is likely to happen. In order to maximize his or her own welfare, the agent may take actions, which are not in the best interest of the principal. The hidden information case refers to a situation where the agent has access to pre-contractual information, which is not observed by the principal. In such a situation, an adverse selection problem may arise, that is, the "bad" agents tend to drive out the "good agents". Agency theory tends to see managers as being ever ready to cheat the principals or owners, unless constantly

controlled in some way.

Supporters of the principal-agent, financial, model do not dismiss the possibilities of shareholders gains via improved corporate governance arrangements and many would endorse the introduction of a voluntary code such as Cadbury. They tend to be suspicious of legislative changes, which impose costs or obligations upon either the firms themselves or their major shareholders. In general, it is argued that if it is possible to introduce some governance improvement which will raise the profits and hence the value of the firm, it will be adopted without compulsion. Attempts to encourage relationship investor behavior by imposing obligations or restrictions upon institutional investors are also viewed with concern from the principal-agent position. First, anything which locks the investors into long-term positions may damage the market's liquidity. Second, encouraging a greater involvement by institutional shareholders is sometimes seen as an encouragement to insider dealing, which is illegal and widely – but not universally – seen as a threat to outsider participation.

But one view of the source of competitive strength emphasizes the role of corporate finance (Dore, 2000). Competitive strength depends increasingly on the power to innovate. Innovation is risky and takes a long time; it requires the sort of organizational learning, which only stable organizations can provide. Organizations, which are capable of such innovation, need patient capital, not flighty capital, they need also commitment not liquidity.

THE GERMAN-JAPANESE MODEL

The theory behind the German-Japanese Model

The most fundamental challenge to the principal-agent approach comes from supporters of the stakeholder model of the firm. The notion of stakeholding in business is not collectivist, nor is it soft in the non-competitive sense. Rather it is based on a sophisticated view of a company as a social vehicle whose speed and steering are dependent upon careful reading of the road signs and the behavior of other users. Meanwhile, the route is best determined by involving all passengers with knowledge to contribute to the map reading.

This view is presented in numerous ways: sometimes as an instrumental or predictive one, and often as a normative theory (Jones, 1995). However, the central proposition at the heart of the stakeholder approach is that the purpose – the objective function – of the firm should be defined more widely than the maximization of shareholder welfare alone. In particular it holds that there should be some explicit recognition of the well-being of other groups having a long-term association with the firm – and therefore an interest, or "stake", in its long-term success.

The decisive point is that the firm must commit itself at all the four levels of the

cycle of the product. This means that we must reflect on the communication related to distribution, production, circulation and consumption. The concept of "distribution" relates to the historical structures of ownership in the society. Ever since the Middle Ages private ownership was the principal axis of the capitalist economy. Today it seems possibly to be under threat within the democratic societies of the West. The very concept of "stakeholder" might slowly undermine the almost sacred concept of "shareholder", removing the crux of distribution from private ownership of the firm in order to serve it in the best way. Participation comes to be a way to reintroduce earlier. The criteria of distribution, then, is going to change from passive capital-providing to intellectual and social performances to the advantage of the firm. This development is obviously enforced by the enormous importance of radical new technologies and market conditions, setting the focus on human resources, and hence, on inventive cooperativeness on the part of the employees. Modern information technology, and the programs of knowledge management, cannot be implemented without the commitment of highly skilled employees. Private ownership appears to be almost irrational in that context.

But today a firm must, so it appears, first and foremost be able to communicate in relation to consumptive production. It must handle environmental problems related to the functioning of the production process: to convince the general public and the specific stakeholders about its seriousness in relation to spills, escapes of radioactive materials, gasses, dangerous chemicals, and threatened species. As Wallerstein (2000) refers: "The second secular trend disturbing to capitalists is rather different. It has to do… with the cost of material inputs. What is involved in the cost of inputs? It is not only the price at which they are bought from a different firm but also the cost of treating them. Now while the cost of purchase is normally borne entirely by the firm that will eventually get the profits, the costs of treating the materials is often partially borne by others". A firm is today actually obliged to prove its active attitudes on these fields by engaging in problems peculiar to the third world. It thereby convinces the public of its seriousness, even if it does no business in these regions at all.

The efficiency case for the stakeholder model has been developed in two principal ways. First, it has been demonstrated that many firms which develop a reputation for the ethical treatment of suppliers, clients, and employees are able to build up trust relations which support profitable investments and mutually beneficial exchanges; and second, proponents of the stakeholder view have pointed to Japan and Germany – both economies with extensive stakeholder involvement with the firm and where corporate goals are typically defined fairly widely – as examples of successful industrial societies which reject the principal-agent model.

In the last two decades the stakeholder approach to understanding the firm in its environment has been a powerful tool, intended to broaden management's vision of

its role and responsibilities beyond the profit maximization function to include interests and claims of non-stockholding groups. Stakeholder theory, in contrast, attempts to articulate a fundamental question in a systematic way: which groups are stakeholders deserving or requiring management attention, and which are not?

In the stakeholder literature there are a few broad definitions that attempt to specify the empirical reality that virtually anyone can affect or be affected by an organization's actions. What is needed is a theory of stakeholder identification that can reliably separate stakeholders from non-stakeholders. Also in the stakeholder literature are a number of narrow definitions that attempt to specify the pragmatic reality that managers simply cannot attend to all actual or potential claims, and that propose a variety of priorities for managerial attention.

There is not much disagreement on what kind of entity can be a stakeholder. Persons, groups, neighborhoods, institutions, societies, and even the natural environment are generally thought to qualify as actual or potential stakeholders. In an early statement Jones (1980) defined corporate social responsibility as "the notion that corporations have an obligation to constituent groups in society other than stockholders and beyond that prescribed by law or union contract, indicating that a stake may go beyond the mere ownership". He then asked the pragmatic questions stakeholder theory still seeks to answer: "What are these groups? How many of these groups must be served? Which of their interests are most important? How can their interests be balanced? How much corporate money should be allotted to serve these interests?"

These questions are still being explored in stakeholder literature and management thinking. Alkhafaji (1989) for example, defines stakeholders as "groups to whom the corporation is responsible". Thompson, Wartick, and Smith (1991) define stakeholders as groups " in relationship with an organization". Windsor (1992) points out that stakeholder theorists differ considerably on whether they take a broad or a narrow view of a firm's stakeholder universe. Freeman and Reed (1983) recognized early on that there would be serious differences of opinion about broad versus narrow definitions of "Who or What Really Counts". Their broad definition of a stakeholder as an individual or group who "can affect the achievement of an organization's objectives or who is affected by the achievement of an organization's objectives" is virtually identical to Freeman's (1984) definition "any group or individual who can affect or is affected by the achievement of the organization's objectives".

This is one of the broadest definitions in the literature, for it leaves the notion of stake and the field of possible stakeholders unambiguously open to include virtually everyone. In this definition the basis of the stake can be unidirectional and bi-directional – "can affect or is affected by"- and there is no implication or necessity of reciprocal impact, as definitions involving relationships, transactions, or contracts require. Excluded from having a stake are only those who cannot affect the firm (have

no power) and are not affected by it (have no claim or relationship).

In contrast, Clarkson (1994) offers one of the narrower definitions of stakeholders as voluntary or involuntary risk-bears: "Voluntary stakeholders bear some form of risk as a result of having invested some form of capital, human or financial, something of value, in a firm. Involuntary stakeholders are placed at risk of the firm's activities. But without the element of risk there is no stake". A stake, in this sense, is only something that can be lost. The use of risk to denote stake appears to be a way to narrow the stakeholder field to those with legitimate claims regardless of their power to influence the firm or the legitimacy of their relationship to the firm. Between the broad and the narrow are many others efforts to define what constitutes a stakeholder.

Narrow views of the stakeholders are based on the practical reality of limited resources, limited time and attention, and limited patience of managers for dealing with external constraints. In general, narrow views of stakeholders attempt to define relevant groups in terms of their direct relevance to the firm's core economic interests. For example, several scholars define stakeholders in terms of their necessity for the firm's survival (Bowie, 1988; Freeman & Reed 1983), and Cornell and Shapiro (1987) speak of stakeholders as contractors or participants in exchange relationships. A few scholars narrow the field of relevant groups in terms of their moral claims, arguing that the essence of stakeholder management should be the firm's participation in creating moral relationships (Freeman, 1994; Wicks, Gilbert & Freeman, 1994), or the firm's fulfilling its affirmative duty to stakeholders in terms of fairly distributing the harms and benefits of the firm's actions (Donaldson & Preston, 1995; Evan & Freeman, 1988). In any case, we see those favoring a narrow definition of stakeholders as searching for a "normative core" of legitimacy so that managers can be advised to focus on the claims of a few legitimate stakeholders.

The broad view of stakeholders, in contrast, is based on the empirical reality that companies can indeed be vitally affected by, or they can vitally affect, almost everyone. This idea of comprehensively identifying stakeholder types, then, is to equip managers with the ability to recognize and respond effectively to a disparate, yet systematically comprehensible, set of entities that may or may not have legitimate claims, but that may be able to affect or are affected by the firm nonetheless, and thus affect the interests of those who have legitimate claims.

The ultimate claim of stakeholder management practices, according to this view, could be firm centered or system centered; that is, managers might want to know about all of their stakeholders for firm-centered purposes of survival, economic well-being, damage control, taking advantages of opportunities, "doing in" the competition, winning friends and influencing public policy, coalition building, and so forth. Or, in contrast, managers might want an exhaustive list of all stakeholders in order to participate in a fair balancing of various claims and interests within the firm's social

system. Both the former public affairs approach and the latter social responsibility approach require broad knowledge of actual and potential actors and claimants in the firm's environment.

SOME CHARACTERISTICS OF THE GERMAN ENTERPRISES GOVERNANCE

The *Hausbank*

There are generally conceived significant differences between the corporate governance structures of Anglo-American companies, and European companies, with the German model of governance often portrayed as the most distinctive of the European types. Anyone looking for European examples always starts with Germany, home of the continent's most highly developed capital goods sector. Germany has acquired the symbolic status of the counterpart of the Anglo-American style of management. Whereas "the Englishman likes to imagine himself at sea, the German is in the forest". While in Britain firms compete aggressively for market share and profit, in Germany many firms prefer to co-operate. The difference is that between a market philosophy, emphasizing the need for free competition, including hostile takeovers, versus a co-operative philosophy, centered on the concept of co-determination.

Among the notable features of the German business sector is the relatively strong concentration of ownership of individual enterprise; the importance of small and medium-sized companies, with a close correspondence between owners and managers; and the limited role played by the stock market (OCDE, 1995). While it can be observed that, in general terms, German companies have tended to be more product-led than market-led and bank-funded than stock-financed, the real essence of innovative co-operative management in the 1990s rests with the so-called *Mittlestand*. The *Mittlestand* or medium-sized companies, have succeeded in entering foreign markets worldwide because they are willing to make strong commitments to the development of people.

More broadly the dominant characteristic of German enterprises is the inside characteristics of their governance systems through which all interested stakeholders – managers, employees, creditors, suppliers, and customers – are able to monitor company performance. A stylized version of the German model is that it relies on continuous monitoring of managers by other stakeholders, who have a long-term relationship with the firm and engage permanently in the important aspects of decision-making, and in the case of dissatisfaction, take action to correct management decisions through internal channels.

The German environment tends to give strong support to cartels and other inter-firm agreements, and fosters commitment to the company rather than providing incentives to sell shares. Merchants banks, insurance companies and employees,

through their membership of the supervisory board, are directly involved in the future of the companies. The importance of the banks, in their double role as both lenders and important shareowners, has often, perhaps too often, been stressed. In contrast the Anglo-American model is typically taken to imply that individual stakeholders have little direct influence on management and that dissatisfied stakeholders "vote with the feet", e.g. firms shifting sub-contractors or shareholders selling their equity holdings in a firm. Resulting downward pressure on share prices, however, serves as an indirect disciplining device on management. As a result of these differences, the stock market is seen to be much more central to the Anglo--American model than the German model which, in contrast, relies importantly on continuous participation by banks, business partners and employees in the running of companies, creating greater potential for conflict of interest (OCDE, 1995).

The distinctive aspects of the role of banks in German firms can be summarized as follows:

1. The small and medium-sized unincorporated companies are relatively more important in Germany.
2. The main bank (*Hausbank*) system implies a long-term relationship involving exchange of information and continual surveillance.
3. In the absence of a strong market for venture capital, bank finance is extremely important for smaller firms.
4. Banks are important shareholders.
5. The widespread practice of proxy voting implies that banks influence significantly their direct shareholding. (OCDE, 1995).

The *Hausbank* system of finance and monitoring by banks through long-term implicit contracts between a firm and its main bank connection to some extent performs a role similar to that of venture capital firms in the Anglo-American system of enterprise governance.

In-company Training

The Anglo-American concept of management as a unified profession has not been widely accepted in Germany. In Britain the role of apprenticeship is not widely related to management education, while in Germany the link between in-company training and specialized and general education in *Berufschulen* (vocational schools) is often seen as the corner stone of Germany's business success.

German nineteenth century guilds grew organically into modern associations, and often received legal protection in doing so. Such is the origin of many of the trades and professions now described in the Artisanal Chamber – including architects, for instance, and a good number of the Mittelstand firms which the courts deem to

belong to the artisanal rather that the industrial category because they are operated "in an artisanal fashion". The licensing of these activities (enforced by the prosecution of the unlicensed), and the involvement of the licensed in the licensing process through their control over training, in effect gives monopoly rights. It is a version of "old corporatism": the granting to a civil corporation to share in governance, conferring material privileges on it in return for its promise to act in the public interest – to ensure standards of competence, suppress cheating, and charge a fair price. In this case, there was an additional "public purpose" which prompted Bismarck to reinforce and legalize – and often create – these protective privileges at the end of the nineteenth century. He hoped to call a halt to the potentially dangerous proletarianization of the skilled-craftsmen artisans. The threat to social stability as factory production, using unskilled workers, came to invade many markets formerly dominated by the family--based, self-employed skilled artisan was clearly perceived.

What Japan and Germany have in common is the deep involvement of the state in establishing and maintaining levels of skill competence – in contrast to countries like Britain where state involvement really began, with the competitiveness scare, only a decade ago. The differences are, first, that in Japan the use of legal backing for licensed skill monopolies is sparing, and largely confined to issues of public safety (airline pilots, structural engineers) or agreed national economic objectives (energy conservation managers in factories), though the social importance attached to state examination certificates of skill of competence (the bicycle repairer exhibiting his bicycle repair certificate) is great. Secondly, Japan has protective subsidy policies for small and medium enterprises of a similar Bismarckian inspiration to those of Germany, but they are entirely unconnected to the practice or the ideology of the skill-training system.

In Germany, by contrast, for licensing as a *Handewerk* enterprise, the owner – or his production manager – has to have a certificate of competence equivalent to the *Meister* level. He has to show – a word with Lutheran overtones – that he has a *Beruf*, a calling.

SOME CHARACTERISTICS OF THE JAPANESE ENTERPRISES' GOVERNANCE

Unlike the United States, Japan has distinct and historical antecedents. Japanese society is characterized by its relative homogeneity and by its emphasis on the group rather than the individual, perhaps rooted in the imperatives of rice cultivation, a group exercise where members are highly dependent on each other. In contradistinction to the European tendency toward intellectualism and American pragmatism, the Japanese approach may be described as incremental experimentation, or learning by doing. In Japanese innovation, we see the successful alliance of an ancient culture with modern technology.

Japan, together with Germany, has a "late industrializer" profile, with a rapid transition from feudalism to an industrial society. In both countries, industry has tended to be built on collective concepts of feudal obligations and reciprocity. The education systems of both are more focused on successful technologies and science applied to key sectors; the industrial banking system has a central role and often acts through employers' associations. The governments of both also have a central role through their various ministries in facilitating industrialization and knowledge creation. In this sense the industrial relations systems of Japan and Germany, based on employee participation, lead towards the concept of the "mutual gains enterprise" in which all share the rewards for success.

The crucial economic problem in Japanese society is typically not the individual but rather the network in which the individual is embedded. Japanese believe that social relations between economic actors do not impede market functioning but rather promote it. Just as Western economies have institutionalized ways of maintaining autonomy between actors, Japanese economy is rooted in institutions that encourage and maintain ties. In Japan, the relationship between employer and employee is not to be explained in contractual terms. The attitude of the employer is expressed by the spirit of the common saying, "the enterprise is the people". This affirms that employer and employee are bound as one fate in conditions, which produce a tie between individuals, often as firm and close as that of husband and wife.

Such a relationship is manifestly not a purely contractual one between employer and employee; the employee is already a member of his or her family, and all members of his or her own family are naturally included in the larger company "family". Employers do not employ a man's or woman's labor itself but really employ the total man or woman. The company trains the employees not only technically but also morally. In Japan, it has always been believed that individual moral and mental attitudes have an important bearing on productive power.

According to Chie Nakane (1970), for a variety of reasons it is difficult for a Japanese to establish operational, contractual personal relations. First, it is hard for a Japanese to differentiate his or her roles, and once a relationship is established, both parties tend to expect more from it than work itself, and so involve themselves emotionally: only through this involvement can they feel certain that the operation in question will be performed smoothly and effectively. His or her emotional security seems the foremost requirement for a Japanese engaged in cooperative work. Second, in Japan it is very difficult to form a corporate group by inviting those best suited to the work in question; everyone is already more or less involved in a particular group, and the links and loyalties thus established will not easily be cut. For example, if a man is invited to join a new group, he may try his best to take along his whole entourage

to the new group, or he may still hold loyalty to his former group. In major Japanese firms, cohorts are often hired, compensated, and promoted, with individual performance differences having little import until late in career (Clark, 1979).

The overall picture of a society resulting from such interpersonal (and inter-group) relations is not that of horizontal stratification by class or cast but of vertical stratification by institutions or group of institutions, which originate special organizational forms, for example, "the main bank system".

The Main Bank System

A Japanese firm usually has a bank that is its largest lender, one of its largest shareholders, and sometimes supplies one or two board members. The bank in this case is called the "main bank" of the firm, and such a relation is often referred to as "the main bank system". The term main bank as used in Japanese business society means the bank with which a company maintains the closest relationship. All else being equal, a company does financial transactions with its main bank. Business information will be transferred between them on a priority basis; information costs are reduced through the long-term relationship between a company and a bank. A main bank relationship is one type of "relationship banking" which can be found when prices and the quality of financial products are the same among banks.

The lead bank concept rests upon an important foundation – Japanese banks, whether long-term credit banks or city banks, view themselves as being in long-term relationships. To use the modern jargon, they are relationship not transaction oriented. Although some Japanese banks have the privileged position of borrowing and lending long-term money, other types of banks have moved into such operations even before the formal breakdown of the barriers now being organized by the authorities. The long-term approach of Japanese banks affects staffing and training levels at the banks. As they expect to visit companies daily, and aim to get to understand their business "exactly well" as one banker said, and to know their people, the contact demands both time and knowledge; even so the switch away from collateral-based lending in the early 1990s is posing problems. Their basic concept, however, is to be able to provide some value added as well as funds: to assist in this, banks organize themselves to collect and dispense a flow of intelligence (gleaned from its client network) which its customers find invaluable about the economy in general but more especially about their own industry.

The bank firm relations in Japan are subtle, and the arrangements are implicit. Similarly, the boundary of a corporate group is ambiguous: it is often hard to decide whether a firm belongs to a group. The primary relationship of the Japanese firm is with its main bank. The relationship is not limited to credit dealings, in fact, even

firms that do not borrow from banks normally have their main bank.

When a firm goes from the normal to the critical wealth state, a mechanism is triggered for control to shift from the incumbent management to the main bank. Because the main bank is a major stockholder, carries major payment settlement accounts, and is the major creditor and *de facto* lead manager for an "informal" loan syndication in the case of borrowing, it may be able to acquire information indicating possible financial trouble of the firm at a relatively early stage (Aoki and Dore, 1994).

The role the banks play in corporate governance depends very much on the strength of a particular customer. In the case of an established and prosperous major company it will be minimal; the company does not need and would not brook interference. A company making its way will find itself in the warm embrace of its bank, with frequent visits from its officers. A company in trouble – of any size – may find itself losing its freedom of maneuver and ultimately its top people if a bank decides to parachute in its rescue troops; in the very last resort it may face a total loss of identity as the bank negotiates a merger – which will at least save its staff's jobs.

Hoshi (1994) identifies six types among banks and industrial firms within the horizontal *keiretsu* (group of large firms in diverse industries): (1) presidents' council meetings; (2) bank borrowings; (3) cross-share holdings; (4) board members' exchanges; (5) transactions in intermediate product markets; and (6) joint projects". Hoshi defines "the main bank system" as the close relationship between a firm and a specific bank that is characterized by (2), (3) and (4) of the above ties, that is, bank borrowings, cross-share holdings, and board members' exchange.

Bank borrowing: Group financial institutions (typically, a city bank, a trust bank, a life insurance company, and a casualty company) are important debt holders of industrial companies in a horizontal *Keiretsu.* Although firms also borrow from financial institutions from outside of the group, a substantial proportion of bank borrowing comes from group financial institutions. Japanese firms rely a great deal on debt finance. Until the 1980s their debt-equity ratios were higher than elsewhere. Most of the big firms deal with a number of banks, but one of them is usually recognized as the main bank, which keeps track of a firm's performance, plans, and needs, and gives a lead to the other banks in providing investments funds. It is also the bank which has to pick up the pieces when a firm gets into trouble and needs a restructuring rescue from the brink of bankruptcy. This rescue is frequently a highly loss-making activity, which is undertaken less for profit than from obligation. Obligation not so much to the firm itself as to the banking community, to all the fellow-bank creditors, who are equally concerned to minimize losses.

Cross-Share Holdings: Group financial institutions are also shareholders of other firms in the group, thus debt holders are often shareholders at the same time. This network of mutual shareholding is often called "cross-share holding", which constitutes another defining characteristic of the horizontal *Keiretsu.* Due to stable patterns of cross-share holding among the members of the horizontal *Keiretsu,* the top management of the Japanese firm is freed from the short-term pressures of the stock market. This relationship between top management and the capital market is quite different from the Anglo-American model in which the capital market functions as an effective monitoring device.

After the war the shares of the big *Zaibatsu* were impounded and dispersed, and in the 1960s, when the prospects of capital liberalization raised fears of wholesale takeovers by powerful American firms – a pattern of cross-shareholdings was developed which gives most large firms "stable shareholders" who can provide a safe guarantee against the possibility of a hostile takeover. Typically, Japanese firms have up to 60 or 70 per cent of their shares in the hands either of the banks with whom they do their loan business, or of the insurance companies with whom they do their insurance business, or of other industrial and commercial companies with whom they do a lot of their trading. The crucial point about this stable shareholding is that the shareholders are more interested in the other business they do with the issuing firm than they are in the profits to be made from the shareholding itself. The holding is an expression of a multistranded relationship, rather than a property right to be exploited to the full.

Board Members' Exchange:

The group bank often sends an employee to become a board member of a group firm. When a bank employee is sent to a group firm in this way, he or she usually leaves the bank, becomes a permanent employee of the industrial firm, and serves as a board member for more than ten years. He or she becomes an important source of information for the bank in critical times. When a firm is in serious financial trouble, the group bank sometimes sends current employees to act as directors and thereby intervenes in the management of the firm in order to rescue it. According to Aoki and Dore (1994), the selection and policy orientation of top management is controlled by both the body of employees and the main bank, to whom other investors and financiers delegate monitoring functions. The controlling power of the main bank is not explicit in the normal or favorable financial state. However, once a firm faces financial distress, governance shifts from insider to outsider (the main bank). In this sense, the controlling power of both parties is contingent upon the financial state of the firm. This disciplinary mechanism under the main bank system differs from the Anglo-American system, which is based on takeovers and bankruptcy procedure.

CONCLUSIONS

If it is true that, in the last decade, the Anglo-American model of short-term management has rapidly spread and expressions like "core business", "stock options" and

"economic value-added" have become the new buzzwords, it is also true that Europe remains glued to its history (the state still plays an important role in the economy, even in the financial system). As The Financial Times (February, 2001 in Europe Reinvented) refers: "Many European bosses have misgivings when it comes to the creation of shareholder value. Without worrying their Anglo-American shareholders, they secretly admit that they do not want a shareholder dictatorship to rise in their court under the pretext of shareholder democracy. Joined by a large portion of European public opinion, these business leaders would rather see a stakeholder society than a shareholder society. Business think-tanks across Europe as well as political leaders are debating the merits of the "citizens' company" these days. A company, they say, must not work exclusively for its shareholders – and its short-term interests. Rather, it must take into account all of its partners: including its clients, but also the management, its employees, its suppliers and its local associates".

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