The Evolution of Corporate Finance and Corporate Governance in Prewar Japan: Comments on "Were Banks Really at the Center of the Prewar Japanese Financial System?"[1]

Tetsuji Okazaki
Professor, University of Tokyo

The paper (Teranishi [2007]) nicely organizes the major issues surrounding the subject and does a good job presenting the views of the author, a scholar who has long played a leading role in historical and empirical research on banking and finance. The main argument is made using 12 propositions, a structure resulting in an extraordinarily clear paper that I read with great interest.

The first comment I would like to make on Teranishi (2007) concerns the overall tenor of the argument. The primary division in his paper is between Section II on the quantitative flow of funds and Section III on the "qualitative capacities" of banks and equity markets. The author notes that both sides of the debate base their claims on comparisons of the quantitative flow of funds and clearly articulates his intention to introduce the perspective of qualitative capacity with this paper. Unfortunately, this summation is not accurate. Okazaki (1993) and its expanded form in Okazaki (1994) provide a quantitative picture of the distinctive differences between the prewar and postwar Japanese financial system and corporate finance, and clearly state as their rationale that corporate governance, including the powers of shareholders and banks, is one of the defining differences. Hoshi and Kashyap (2001) make similar points. Indeed, the titles of Okazaki (1993, 1994) are "Corporate Systems" and "The Development of Corporate Governance in Japan," respectively. Hoshi and Kashyap (2001) is titled "Corporate Financing and Governance in Japan." In other words, Okazaki (1993, 1994) and Hoshi and Kashyap (2001) and others began by using quantitative data on corporate finance and financial systems to identify the problems in prior research that emphasized the role of banks, supplementing and expanding arguments by bringing in the perspective that was lacking in the prior research: the relationship between

1. This paper is a commentary on Juro Teranishi's paper, "Were Banks Really at the Center of the Prewar Japanese Financial System?" (subsequently revised and included in this issue), which was first presented on September 9, 2005 to a workshop sponsored by the Institute for Monetary and Economic Studies (IMES) of the Bank of Japan (BOJ) entitled "Direct and Indirect Finance in Prewar Japan: Were Banks Really the Center of the Prewar Japanese Financial System?" The views expressed in this paper are those of the author and do not necessarily reflect the official views of the BOJ. Any mistakes are entirely the responsibility of the author.

corporate finance and financial systems on the one hand and corporate governance on the other. On this point, Teranishi (2007) shares a common framework with the previous studies. Likewise, Teranishi's (2007) propositions (5) and (6) on "qualitative capacity" are basically the same as the points emphasized in Okazaki (1993, 1994) and Hoshi and Kashyap (2001).[2] In other words, Teranishi (2007)'s assertions that equity markets were at the center of the prewar Japanese financial system and that major shareholders led the corporate governance structure actually support the views of Okazaki (1993, 1994), Hoshi and Kashyap (2001), and other previous studies.

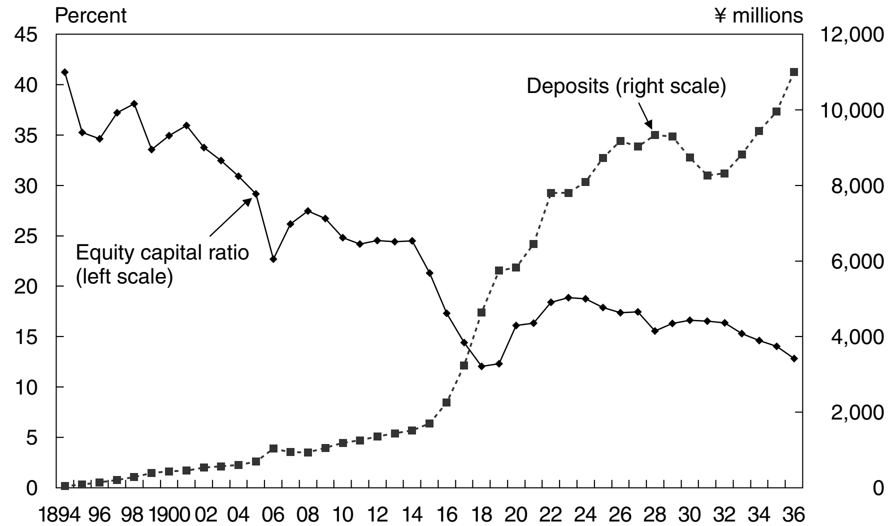
However, Teranishi (2007) also emphasizes the fact that there was no change in basic capital-raising patterns after the end of the 19th century when viewed in terms of enterprise size and industrial sector. This point is a valid criticism of Okazaki, Hamao, and Hoshi (2004), but it does not hold up against the published version of the paper, Okazaki, Hamao, and Hoshi (2005). Okazaki, Hamao, and Hoshi (2005, p. 17) distinguish between major and non-major enterprises and describe the leading role played by equity markets for major enterprises consistently since the period of the industrial revolution.

Is it true that the prewar Japanese financial system experienced no institutional changes? Teranishi's (2007) take on this point is that the basic features did not change except for the emergence of professional managers at enterprises. The author, however, argues that significant changes took place in both banking and equity markets when viewed from the perspective of corporate governance or the "qualitative capacity" discussed in Teranishi (2007). The basic factor common to changes in both spheres is the increasingly serious agency problem between the providers of funds and banks or enterprises (Okazaki [2005a]).

Looking first at banking, it is important to note the major changes in bank liability structures during the period of World War I. Bank capital ratios were around 40 percent at the beginning of the 20th century and still around 30 percent prior to World War I, but had declined to below 20 percent by the 1920s (Figure 1). In the early 20th century, Japanese ordinary banks were still basically lending their own capital, but as the figure indicates, World War I brought a rapid reorientation of banks into deposit-taking institutions (Okazaki [2004]). The sharp declines in capital ratios exacerbated the agency problem between depositors and bank shareholders. "Organ bank relationships," in which banks had close ties with specific enterprises and concentrated their lending activities on these enterprises, were prevalent in the early 20th century, but the negative impact on the financial system was relatively light, at least in comparison to the 1920s. The reason was banks' high capital ratios, which meant that bank shareholders bore the majority of lending risks. Generally, declining capital ratios reduce the ability of banks to withstand risk, while at the same time raising moral hazards for bank shareholders. Furthermore, during World War I, banks saw a simultaneous fragmentation of their shareholders. One can compare the shareholder data for the 13 ordinary banks that are listed in both the 1915 and 1921 editions of the *Stock Yearbook* (Osakaya Shoten) and see that over this period of time the average number of shareholders grew from 1,307 to 2,479 (Table 1). This fragmentation

2. Okazaki (1993) was subsequently translated into English as Okazaki (1999).

Figure 1 Transition of Ordinary Banks to Deposit Banks



Source: Goto (1970).

Table 1 Increase in Number of Shareholders in Ordinary Banks

Number of shareholders

	1914	1920
Sanjushi	2,036	5,695
Dai-Ichi	2,762	4,811
Meiji	1,698	3,597
Omi	1,088	3,247
Dai-San	1,420	3,202
Sanjuhachi	87	2,466
Toyokuni	2,198	2,054
Aichi	779	2,005
Teikoku Shogyo	2,677	2,003
Hyakusanju	1,470	1,873
Yonjusan	1,021	1,743
Meiji Shogyo	602	1,369
Nihon Shogyo	453	640
Average	1,307	2,479

Source: Osakaya Shoten, *Stock Yearbook*, 1915 and 1921 editions.

of shareholders added an increasingly serious agency problem between controlling shareholders and minority shareholders to the existing agency problem between shareholders and depositors.

These changes are the reason why "organ banks" are discussed as a factor in the destabilization of the Japanese financial system in the 1920s. Okazaki, Sawada, and Yokoyama (2005) use data on bank and enterprise directors to demonstrate that directors concurrently serving on the boards of banks and enterprises had a negative impact on bank profitability during the 1920s. The implication from this finding is that there were moral hazards for banks' controlling shareholders vis-à-vis their minority shareholders and depositors when the controlling shareholders had ties to industrial firms. Generally, close relations between banks and industrial companies serve to alleviate the asymmetry of information between lenders and borrowers (Lamoreaux [1986]), but are also a cause of moral hazards for the controlling shareholders of banks investing in industrial firms (La Porta, Lopez-de-Silanes, and Zamarripa [2003]). Which of these two functions becomes dominant is determined by the liability structure of banks and the equity ownership structure of industrial companies. The decline in bank capital ratios and the fragmentation of their shareholders seen during World War I exacerbated the negative aspects of lending based on close ties between banks and enterprises.

The same trends also spurred evolution within the banking system. The closure of banks during the financial crises of the 1920s, combined with the policy-driven bank mergers in response to the crises, produced changes in the governance structures of banks and in the relations between banks and enterprises. Smaller banks, where the damage from agency banking was most apparent, disappeared either through attrition or merger, and directors concurrently serving on the boards of industrial firms were purged from the merged banks, leading to the elimination of "agency banking" by the mid-1930s, at least in the sense of causing moral hazards between dominant shareholders with strong ties to industry and the minority shareholders and depositors of the bank (Okazaki, Sawada, and Wang [2007]).[3]

The change that occurred in equity markets was the same fragmentation of shareholders experienced by banks. The equity boom of World War I lured large numbers of new participants to the market. Comparing the 100 companies listed in both the 1915 and 1921 editions of the *Stock Yearbook* (Osakaya Shoten), the average number of shareholders went from 1,488 to 3,949 between 1914 and 1920. The geographical breakdown likewise shows strong rises for outlying areas such as Hokkaido, Tohoku, Hokuriku, Chugoku, and Shikoku (Takeda [1979, pp. 146–147]).

The fragmentation of minority shareholders and the geographical dispersion aggravated the agency problems between controlling shareholders and managers on the one side and minority shareholders on the other. These problems became apparent during the 1920s, when corporate profitability entered a long-term slump and problems such as bogus dividends began to be seen (Takahashi [1930]). While this was taking place, there was also an important change in share ownership structures between the 1920s and the 1930s. Increasingly, major shareholders became corporations (Shimura [1969]). The percentage of individual shareholders among the (10 to 15) largest shareholders of major companies declined from 74.4 percent in 1919 to 15.7 percent in 1936; over the same period, the percentage of corporate shareholders grew from 15.1 percent to 60.8 percent. In 1936, 53.8 percent of the major corporate shareholders were holding companies (Shimura [1969, pp. 408–413]). Okazaki (2001) demonstrates that during the 1920s and 1930s the *zaibatsu* holding

3. See Okazaki (2005b) for international and chronological comparisons of bank-industry relations from the perspective of agency problems.

companies provided organized governance functions for their existing subsidiary companies and discipline for outside companies through the mechanism of acquisitions.

The emergence of major corporate shareholders and the functions of the *zaibatsu* can be seen as an autonomous institutional evolution triggered by the moral hazards that came from the fragmentation of equity ownership after 1910. What is interesting is that this phenomenon was not unique to Japan. In the early 20th century, the United States also experienced a decline in the ability of shareholders to monitor companies because of the fragmentation of equity ownership. Stepping in to provide corporate governance functions were large investment banks such as J.P. Morgan & Co. The large investment banks had their partners join corporate boards, providing corporate governance while signaling to investors, which resulted in an increase in corporate value (De Long [1991]). The emergence of corporate equity ownership and *zaibatsu* equity ownership in 1920s–30s Japan corresponds to the investments made by large investment banks in companies in the United States, and in that sense may represent one form of universal change experienced in the historical evolution of corporate governance structures.

In other words, during World War I changes in the liability structures of banks combined with the fragmentation of shareholders at both banks and industrial companies to create serious agency problems between the people ultimately supplying funds and the banks/agencies to which they were supplied. These issues expressed themselves in the form of the financial crises and the many corporate problems seen during the 1920s. However, the financial crises and prolonged slump also triggered institutional evolution in both the banking and equity markets, resulting in sounder banks and effective corporate governance from large holding-company and corporate shareholders. This is what provided the institutional underpinnings for the expansion of the equity markets and the consequent economic growth achieved during the 1930s.

References

De Long, J. Bradford, "Did J.P. Morgan's Men Add Value?: An Economist's Perspective on Financial Capitalism," in Peter Temin, ed. *Inside the Business Enterprise: Historical Perspectives on the Use of Information*, The University of Chicago Press, 1991.

Goto, Shinichi, *Nihon no Kin'yu Tokei* (Japanese Financial Statistics), Toyo Keizai Shimposha, 1970 (in Japanese).

Hoshi, Takeo, and Anil Kashyap, *Corporate Financing and Governance in Japan: The Road to the Future*, Cambridge, Massachusetts: The MIT Press, 2001.

Lamoreaux, Naomi, "Banks, Kinship, and Economic Development: The New England Case," *The Journal of Economic History*, 46 (3), 1986, pp. 647–667.

La Porta, Rafael, Florencio Lopez-de-Silanes, and Guillermo Zamarripa, "Related Lending," *The Quarterly Journal of Economics*, 118 (1), 2003, pp. 231–268.

Okazaki, Tetsuji, "Kigyo Shisutemu (Corporate Systems)," in Tetsuji Okazaki and Masahiro Okuno, eds. *Gendai Nihon Keizai Shisutemu no Genryu* (The Japanese Economic System and Its Historical Origins), Nihon Keizai Shimbunsha, 1993, pp. 97–144 (in Japanese).

———, "Nihon ni Okeru Koporeto Gabanansu no Hatten: Rekishiteki Pasupekuchibu (The Development of Corporate Governance in Japan: From Historical Perspectives)," *Kin'yu Kenkyu* (Monetary and Economic Studies), 13 (3), Institute for Monetary and Economic Studies, Bank of Japan, 1994, pp. 59–95 (in Japanese).

———, "Corporate Governance," in Tetsuji Okazaki and Masahiro Okuno-Fujiwara, eds. *The Japanese Economic System and Its Historical Origins*, New York: Oxford University Press, 1999, pp. 97–144.

———, "Role of Holding Companies in Prewar Japanese Economic Development: Rethinking *Zaibatsu* in Perspectives of Corporate Governance," *Social Science Japan Journal*, 4 (2), 2001, pp. 243–268.

———, "Senzen Nihon no Kin'yu Shisutemu to Ginko Tota (The Financial System and the Selection of Banks in Prewar Japan)," *Keizaishi Kenkyu* (The Economic Review), 8, 2004, pp. 1–18 (in Japanese).

———, "Keizai Kyoshitsu: Kigyo Tochi to Nihon, Ge (Lectures on Economics: Corporate Governance and Japan, Second Issue)," *Nihon Keizai Shimbun*, April 20, 2005a (in Japanese).

———, *Koa Tekisuto Keizaishi* (Core Text for Economic History), Shinseisha, 2005b (in Japanese).

———, Yasushi Hamao, and Takeo Hoshi, "Senzen Nihon ni Okeru Shihon Shijo no Seisei to Hatten: Tokyo Kabushiki Torihikisho heno Kabushiki Jojo wo Chushin toshite (The Emergence and Evolution of Capital Markets in Prewar Japan: Focusing on Listings on the Tokyo Stock Exchange)," CIRJE Discussion Paper No. J-119, 2004 (in Japanese).

———, ———, and ———, "Senzen Nihon ni Okeru Shihon Shijo no Seisei to Hatten: Tokyo Kabushiki Torihikisho heno Kabushiki Jojo wo Chushin toshite (The Emergence and Evolution of Capital Markets in Prewar Japan: Focusing on Listings on the Tokyo Stock Exchange)," *Keizai Kenkyu* (The Economic Review), 56 (1), 2005, pp. 15–29 (in Japanese).

———, Michiru Sawada, and Ke Wang, "The Fall of 'Organ Bank' Relationships during the Wave of Bank Failures and Consolidations: Experience in Pre-War Japan," *Corporate Ownership and Control*, 5 (1), 2007 (forthcoming).

———, ———, and Kazuki Yokoyama, "Measuring the Extent and Implications of Director Interlocking in the Prewar Japanese Banking Industry," *The Journal of Economic History*, 65 (4), 2005, pp. 1082–1115.

Shimura, Kaichi, *Nihon Shihon Shijo Bunseki* (An Analysis of Japanese Capital Markets), University of Tokyo Press, 1969 (in Japanese).

Takahashi, Kamekichi, *Kabushiki Gaisha Bokoku Ron* (The Devastating Effects of Joint-Stock Companies on the Nation), Banrikaku Shobo, 1930 (in Japanese).

Takeda, Haruhito, "Nihon Teikoku Shugi no Keizai Kozo: Dai Ichiji Taisen Bumu to 1920-Nen Kyoko no Kiketsu (The Economic Structure of the Imperialism of Japan: The Outcome of the First World War Boom and the Depression in 1920)," *Rekishigaku Kenkyu* (Journal of Historical Studies), Bessatsu, 1979, pp. 142–155 (in Japanese).

Teranishi, Juro, "Were Banks Really at the Center of the Prewar Japanese Financial System?" *Monetary and Economic Studies*, Institute for Monetary and Economic Studies, Bank of Japan, 25 (1), 2007, pp. 49–76 (this issue).